

Tax Savvy for Small Business

Chapter 1 – Business Income & Tax Deductible Expenses

A. How the Tax Code Focuses on Profit

There are many systems of business taxation in use over the world. In much of Europe, the “value added tax,” or VAT, is the rule. The VAT taxes the incremental value added to a product at each stage of manufacturing and distribution. Another approach is to tax a business on its gross receipts, whether or not it makes a profit.

The U.S. tax code zeros in on a business’s profits: the more you make, the more you pay. So the American entrepreneur has a strong incentive to keep taxable profits low, while at the same time taking home as much money and benefits as the law allows. Doing this legally has a price—you need to learn your ABCs (and even your DEFs) about how your enterprise is taxed. We’ll start with some basic tax rules governing how expenses are deducted, to give you the greatest tax benefit. Congress says just about any expense to produce income can be deducted from a business’s receipts. But to get the deduction, you must follow the Internal Revenue Code (IRC).

Here’s a very simple illustration of how taxable profits are determined.

EXAMPLE: Sam and Jeannie own Smiths’ Computer Sales and Service as a sole proprietorship. Because their business produces a good profit, they are in the highest federal tax bracket (39.6% in 2000). Here is how the business determines its taxable profit.

Gross Sales (receipts from sale of computers)	\$2,500,000
Less: Cost of Goods Sold (what was paid for the computers by the Smiths)	<u>- 1,900,000</u>
Gross Profit (before operating expenses)	= 600,000
Less: Deductible Business Expenses	<u>- 300,000</u>
Net Profit (Taxable to Smiths)	= <u>\$ 300,000</u>

The \$300,000 net profit is subject to income tax. How much tax the Smiths will actually owe on their business income depends on other factors, including: their other income, losses on any investments, personal deductions such as for home mortgage interest and, most important, how much they can take out of the business in fringe benefits.

Federal Excise Taxes:

Some businesses face federal “excise taxes.” For instance, an interstate trucking company may have to pay a federal excise tax on fuels or on each truck. Excise taxes affect few small businesses, so we won’t go into detail. Businesses most likely to be subject to excise taxes are in transportation or manufacturing. If you are curious, see IRC §§ 4041 to 5763 to find out whether or not you are affected. Otherwise, you may not discover this special tax until it is too late—when you receive a huge bill for delinquent excise taxes.

B. What Is Earned Income?

Before getting into business deductions, let's make sure we all understand what the tax code means by the term "income." With a few exclusions discussed below, the tax law doesn't care whether you get it from your business, from wages paid by someone else's business or from an investment: it is taxable to you as an individual.

Actually, the better question for small business tax understanding is, "What is gross income?" The tax code (IRC § 61) talks in terms of gross income, so we will, too. It reads: "Except as otherwise provided ... gross income means all income from whatever source derived." You can't get much broader than that, can you?

Goods and services. Income, for tax purposes, doesn't mean just cash; it can take many forms. Goods, property or services received have all been held to be within the definition of income.

If you barter (exchange goods or services for the same), the fair market value of the item or service you received should be included in your tax reported income. I know—a lot of bartering goes on, and the IRS isn't any the wiser, but getting away with it doesn't make it right. Anything of value your business (or you individually) receives is income, unless it specifically falls within the exclusions discussed below.

Constructive income. Income includes anything you have the right to put your hands on but don't for some reason. The legal doctrine of "constructive receipt" says that as soon as money or property is available to you, or is credited to your account, it becomes income—whether you grab it or not. For instance, you can't get a check for your services in November 2001 and hold it for deposit until 2002 without being taxed on it in 2001, the year received.

Illegal income. Note that IRC § 61 is morally neutral; it doesn't distinguish between illegal and legal income. If you earn a living as a hit man for the mob, you still are earning income, and had better declare it on your tax return. Al Capone wasn't sent to prison for murder, bootlegging or racketeering; he was - convicted of tax evasion for not reporting the fruits of his labors to the IRS. You don't have to disclose the sources of your income in some cases, however.

Worldwide income. Americans are taxed on their worldwide income; no matter where earned it is still income taxable in the U.S. There is one exception: if you earn it and reside outside the United States for most of the year, some or all of your foreign income may be excludable. This exception is beyond the scope of this book. See IRS Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad. You may also be entitled to a credit toward your U.S. income tax bill if you paid foreign income taxes.

What isn't income: exclusions. Some kinds of income fall into the "except as otherwise provided" exception of IRC § 61. For instance, the tax code specifically excludes gifts and inheritances from taxable income. There is no dollar limitation on how much you can get by these means without tax to you. (Sorry, the \$10 million that is being dropped off by the Prize Patrol from Publisher's Clearinghouse is not legally a gift and is taxable.) Thankfully, many so-called fringe benefits provided by businesses to owners and employees are specifically excluded from income. Specific exclusions from income granted by Congress are found in IRC §§ 101 to 150.

Return of capital. Of great importance to owners and investors in businesses is that the return of a capital investment is not taxable income. In other words, to the extent that you sell a business or an asset and get back your money exchanged for the asset, you haven't earned any taxable income. Only the profit, if any, is taxed.

EXAMPLE: Toni invests \$1,000 in the stock of Ronaldo's Rubber Fashions, a small business corporation, and later sells her stock for \$1,500. Only \$500 is considered income for tax purposes; the other \$1,000 is a return of capital to Toni.

Tax-free withdrawals. If you borrow against an asset, whether it belongs to your business or to you personally, the loan proceeds are not income. This is a valuable tool for taking money tax-free out of an unincorporated business that holds an appreciated asset, such as real estate.

C. What Is Tax-Deductible in Business?

The tax code allows you to deduct costs of doing business from your gross income. What you are left with is your net business profit. This is the amount that gets taxed.

So knowing how to maximize your deductible business expenses lowers your taxable profit. To boot, you may enjoy a personal benefit from a business expenditure—a nice car to drive, a combination business trip/vacation and a retirement savings plan—if you follow the myriad of tax rules. The balance of this chapter deals with the best ways to get the biggest business expense deduction bang for your buck.

1. Business Operating Expenses

Internal Revenue Code Section 162 is the cornerstone for determining the tax-deductibility of every business expenditure. It is fairly lengthy, but the first hundred or so words are the key:

"Internal Revenue Code § 162. 'Trade or business expenses.'

"(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including

"(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

"(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

"(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Section 162 goes on—and on—but the rest of it deals with specific items that can't be deducted. Those with relevance to small businesses are covered later. Other code sections contain specific rules for deducting purchases of assets used in your business—machinery, cars and a thousand other things. We'll get to asset write-offs in the next chapter. Right now we are focusing on the day-to-day operating expenses of a business.

In most cases, a legitimate business expense under IRC § 162 is obvious. In some cases, such as outlays for travel, the IRS provides specific instructions for determining whether or not an expense is "ordinary and necessary." This is often done through various IRS publications ("pubs") and "regulations" mentioned above and noted throughout this book.

Like the rest of the tax code, IRC § 162 is far from crystal clear. Starting with the meaning of "ordinary and necessary," we suspect that things could go wrong for us. The tax code doesn't define either "ordinary" or "necessary." Instead, myriads of federal courts have tried to figure out what Congress intended and apply it to a particular set of facts. "Ordinary" has been held by courts to mean "normal, common and accepted under the circumstances by the business community." "Necessary" means - "appropriate and helpful." Taken together, the legal consensus is that "ordinary and necessary" refers to the purpose for which an expense is made. For instance, renting office space is ordinary and necessary for many business folks, but it is neither unless it is actually used in running an enterprise for profit.

Given these broad legal guidelines, it is not surprising that some folks have tried to push the envelope on "ordinary and necessary" business expenses, and the IRS has pushed back. Sometimes a compromise is reached, and sometimes the issue is thrown into a court's lap.

EXAMPLE: *Mr. Henry, an accountant, deducted his yacht expenses, contending that because the boat flew a pennant with the numbers "1040," it brought him professional recognition and clients. The matter ended up before the Tax Court. The court ruled that the yacht wasn't a normal business expense for a tax pro, and so it wasn't "ordinary" or "necessary." In short, the yacht expense was personal and thus nondeductible. (Henry v. CIR, 36 TC 879 (1961).)*

The laugh test. Tax pros frequently rely on the "laugh test": Can you list an expense without laughing about putting one over on the IRS? In the example above, the Tax Court laughed the accountant and his yacht out of court.

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D. Current or Capitalized Expense?

Tax rules cover not only what expenses can be deducted but also when—what year—they can be

deducted. Some types of expenditures are deductible in the year they are incurred, but others must be taken over a number of future years. The first category is called "current" expenses, and the second "capitalized" expenditures. You need to know the difference between the two, and the tax rules for each type of expenditure. I'll try to make it easy on you, but there are some gray areas.

"Current expenses" are everyday costs of keeping your business going, such as the rent and electricity bills. Rules for deducting current expenses are fairly straightforward; you subtract the amounts spent from your business's gross income in the year the expenses were incurred.

Expenditures are those expected to generate "capitalized" revenue in future years. They become assets of the business. As capital assets are used, their cost is "matched" to the business revenue they help earn. This, theoretically, allows the business to more clearly account for its profitability from year to year.

However, it is not always clear what is a current expense and what is a capital one. Normal repair costs, such as fixing a broken copy machine or a door, are obviously current expenses and so can be deducted in the year incurred. On the other hand, the tax code says that the cost of making improvements to a business asset must be capitalized if the enhancement:

- adds to its value, or
- appreciably lengthens the time you can use it, or
- adapts it to a different use.

"Improvements" usually refers to real estate—for example, putting in new electrical wiring, plumbing and lighting—but the capitalization rule also applies to rebuilding business equipment.

EXAMPLE: *Gunther uses a specialized die-stamping machine in his metal fabrication shop. After 15 years of constant use, the machine is on its last legs. His average yearly maintenance expenses on the machine have been \$10,000, which Gunther has properly deducted as repair expenses. In 2001, Gunther is faced with either thoroughly rehabilitating the machine at a cost of \$80,000, or buying a new one for \$175,000. He goes for the rebuilding. The \$80,000 expense must be capitalized—that is, it can't be taken all in 2001 when the die stamper is rebuilt. The tax code says that metal-fabricating machinery must be deducted over five years.*

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E. Special Deduction Rules

Some common and not-so-common business expenses have special rules that govern how they must be tax-deducted.

1. Vehicle Expenses

Motor vehicle expenses are frequently one of the greatest small business tax-deductible items. Fine-print tax rules for claiming car and truck expenses for your business are tricky, but well worth mastering; they can provide a jumbo payoff at tax time.

Records. The first thing to know is to make sure you keep the right records to calculate your vehicle expense deduction—and to back you up if you are ever audited. It is a good idea to keep a trip and mileage log.

Business/personal use allocation. Keep in mind that if your automobile is used for both business and pleasure, only the business portion produces a tax deduction. So you must track the use of a dual-purpose vehicle and allocate business/personal use. The proper allocation will come from a year-end analysis of your records to come up with the percentage of each use, such as "62% business, 38% personal."

If you own or lease just one car or truck, no IRS auditor will allow you to claim that 100% of its use is - business-related. (I have seen folks get away with as much as 90%, though.) Of course, if you have both business and personal vehicles, and the business one is obviously dedicated to a business use (a minivan with your logo painted on the side), it isn't necessary to do any allocation to claim 100% business use.

Two methods to claim vehicle expense deductions. The tax code gives you a choice of two ways to - calculate and deduct business vehicle expenses: the standard mileage and actual expense methods. With some qualifications explained below, you may switch between the two methods each year and choose the one that gives you the largest tax benefit. As a rule, if you use a newer car primarily for business, the

actual expense method provides a larger deduction. But the mileage method works better for some folks and requires much less recordkeeping.

a. Standard Mileage Method for Deducting Vehicle Expenses

The simplest way for writing off business vehicle expenses is called the mileage or standard mileage rate method. You just total up the number of business miles driven over the year and multiply by 34.5¢ (2001 tax code allowed rate). Commuting miles (getting to and from your business location) are nondeductible personal miles, but if you're home-based, generally all trips from home for a job are considered "business." You can elect to use the mileage method whether you own or lease your vehicle. Not everyone can choose the mileage method. If any of the following conditions apply, you must use the "actual expense" method (discussed next):

- You used more than one vehicle simultaneously for business.
- You previously used the actual expense method on this same vehicle and claimed an accelerated depreciation method.
- You ever claimed IRC § 179 to write off part of the vehicle's purchase price.

If you choose the mileage method, you cannot also deduct your operating expenses—gas, repairs, license tags and insurance—but you can deduct parking fees, tolls and any state and local property taxes on the car or truck.

EXAMPLE: In 2001, Morris drove 10,000 business miles in his practice of veterinary medicine. He also spent \$700 in bridge and highway tolls and for parking garages. Morris's 2001 vehicle expense deduction is \$3,450 (34.5¢ x 10,000) + \$700 = \$4,150. If Morris's practice is incorporated, the business could deduct this sum and reimburse Morris the same amount. However, if the corporation paid Morris a car allowance of \$4,800 per year for the use of his personal car for business, the excess over the proper business deduction (\$650) would be reportable as income to Morris on his tax return.

Primary disadvantage of mileage method. If the mileage method for claiming auto expenses is chosen, you can't take a depreciation deduction on the vehicle—which could be substantial with newer cars. But again, the more miles you drive the more the mileage method may be to your advantage. It pays to figure it both ways, as we shall see.

b. Actual Expense Method for Deducting Vehicle Expenses

The mileage method described above works well for some, but it doesn't cover the full cost of owning and operating most newer cars. If your auto costs more than \$15,800, it is usually better to use the actual expense method to get the depreciation deduction. Simply total up your car operating expenses—gas, repairs, insurance and so on—and then add the depreciation deduction allowed in the tax code.

EXAMPLE: Sam buys a Plymouth minivan in 2001 for \$25,000 and uses it 100% for his business. He drives the van 10,000 miles the first year. The tax code allows a maximum of \$3,060 for depreciation in the first year of ownership (2001). Sam's actual operating expenses for 2001 for gas, maintenance and insurance total \$2,600, plus \$700 for parking and tolls. Sam can deduct a total of \$6,360 for car expenses in 2001, including depreciation.

How to Claim Expenses for Autos

A business claiming expenses for car use must file IRS Form 4562, Depreciation and Amortization, with its tax return. This form requires a breakdown listing the business, personal and commuting miles driven during the year. Even if you don't use the mileage method, you still must use this form and report the number of miles driven for business.

2. Costs of Going Into Business

All costs of getting a business started before you actually commence operations are not current expenses but are capital items—including advertising, travel, office supplies, utilities, repairs and employee wages. (IRC § 195.) This can be a bit of a shock, since these are the costs that can be immediately deducted as expenses once you are open for business. Under the tax code, these start-up expenses must be deducted ratably over the first 60 months you are in business. Technically, the tax code calls these deductions "amortization" of expenses. (For sole proprietors, partners and limited liability company members, these deductions are claimed on IRS Form 4562, Depreciation and Amortization.)

EXAMPLE: Bill and Betty set up Management Consulting Partners (MCP). During the first three months of 2001, they locate and fix up office space (with the help of a handyman) and have brochures printed and mailed to prospective clients. MCP spends a total of \$6,000, and on April 1st, it opens for business. Tax result: all of the pre-April costs are capital expenditures and as such are deductible at the rate of \$100 per month over the first 60 months MCP is in business. Therefore, in

2001, \$900 can be deducted for the nine months the business was open, \$1,200 in 2002, and so on until 60 months elapse. Expenses incurred after the business is in operation—April's rent and most other recurring monthly costs—are 100% deductible in 2001.

You can work around this limitation. If it would tax benefit you to deduct start-up costs in the first year rather than pro rata over five years, you might legally be able to:

- delay paying pre-opening costs until you start serving customers. (Whether or not your suppliers and workers will allow you this much time to pay is another matter.) The IRS, if you are audited, may challenge this tactic, however.
- do a trivial amount of business before you are officially open. That will probably be enough to get you by an IRS audit. Make a \$75 sale to a friend or give a few people a bargain they can't resist, just to get some activity on the books.

Before rushing to get the start-up cost deduction all in the first year, make sure this really helps your tax situation. If, like many businesses, you will suffer low gross receipts or even losses the first few years of operation, you might be better off taking this deduction over 60 months.

Costs of not going into business. What happens if, after incurring start-up expenses, you back out and never go into operation? Your costs may or may not be deductible, depending on the tax rules you fall under. The tax code (IRC § 195) divides expenses of trying, but failing, to establish a business into two categories:

- Costs of investigating whether to start a business. Any expenses for a general search or preliminary investigation are not deductible.
- Costs of attempting to acquire or start a specific business. These are classified as "investment" expenses. All investment expenses are itemized deductions on Schedule A of your individual income tax return. As such, they don't provide as much tax benefit as do "start-up" type expenses. They are not considered start-up expenses because you never went into any business.

3. Legal and Other Professional Fees

Professional fees for attorneys, tax pros or consultants generally can be deducted in the year incurred, as long as you actually go into business. For instance, fees for forming the business—drawing up a partnership agreement or reviewing license requirements—are immediately deductible. However, when professional fees clearly relate to future years, they must be deducted over the life of the benefit. Some fees, however, fall into a gray area, and you can choose between deducting them all in the first year or spreading them over future years.

EXAMPLE: *Carlos and Teresa's attorney helps them negotiate and prepare a five-year lease for their restaurant. In this case, the lawyer's fees may be deducted either in the current year or in equal amounts over the lease's 60-month period. Carlos and Teresa should figure out which method gives them the best tax benefit. Taking the expense all in the first year of operation may not be a good idea if they won't have sufficient income to offset it.*

Tax assistance and tax return preparation fees are deductible. But again, it can get sticky. Folks usually want tax advice covering both their business and individual taxes, which in most cases are intertwined. For instance, you might ask a tax pro how to minimize taxes on income from all sources—your sole proprietorship, stock and real estate investments and your spouse's income. Her fee qualifies as a business tax deduction in proportion to the business advice given or time spent to prepare the business tax schedule or return. The remaining portion, for tax advice on investments and spouse's income, can be deducted (but not as a business expense—as a personal itemized deduction on Schedule A of your return along with fees for tax preparation).

Separate bills for business and personal expenses. If you see a lawyer or a tax pro, ask that the bill clearly show the extent the work was related to your business. The IRS rarely questions the apportionment used, so ask the advisor to be liberal in putting as much of the expense as possible to the business side.

4. Research and Experimentation Expenditures

Certain enterprises are entitled to a research tax credit equal to 20% of these expenses. A "credit" is more valuable than a deduction, as it comes straight off your tax bill. Very few businesses qualify, however. Check with a tax pro to see whether or not you can use this credit (chances are you won't qualify), and whether or not it has been extended by Congress to the current year. (Form 6765 and Form 3800 are used to claim this credit.)

5. Business Bad Debts

If you are in business long enough, you will eventually be stiffed by a deadbeat. The resulting bad debt may or may not be a deductible expense. Read on. (IRC § 166, Reg. 1.166.)

If your operation offers services—consulting, medical, legal and so on—you cannot deduct an unpaid bill as a bad debt. No tax deduction is allowed for time you devoted to the client or customer who doesn't pay. The tax code rationale is that if you could deduct the value of unpaid services, it would be too easy to inflate your bills and claim large bad debt deductions—and too hard for the IRS to catch you.

If your business provides goods, however, you can deduct the costs of any goods sold, but not paid for, as an ordinary business expense. You cannot deduct any lost profits you would have collected from the sale.

The same is true if you actually lose dollars. For instance, say you made a loan to a customer or client and didn't get paid back. To get the deduction, there must have been a business—not personal—reason for the loan. Also, you must have taken reasonable steps to collect the debt—such as making a written demand for payment, going to court or turning the debt over to a collection agency.

EXAMPLE: *In 2000, Ralph and Rhonda's incorporated print shop made a \$2,000 loan to Susan, a friend and good customer, to keep her florist business afloat. Despite this help, Susan went into bankruptcy in 2001 before making any repayment. Result: As long as Ralph and Rhonda's corporation made the loan to protect their business relationship—and not just to help a friend—the bad debt is deductible for the corporation in 2001.*

Nonbusiness bad debts. There are different tax rules for "nonbusiness" bad debts—ones that don't qualify as business expenses. A bad debt in your personal life can still produce a tax benefit, but under the much more restrictive short-term capital loss rules for individuals. Generally this means that a bad debt can be claimed only to offset any capital gains—plus up to another \$3,000 in ordinary income. To claim a nonbusiness bad debt deduction, file Schedule D, Capital Gains and Losses, with your tax return. A loan to Uncle Festus falls into this category, but not if it was really a gift to get him into alcohol rehab and you never expected to get the money back. To bulletproof the deduction, get a signed promissory note from Festus and show you made some written efforts to try to collect on it. Expect an auditor to be suspicious if a relative is the deadbeat you are trying to wangle into a tax deduction.

A business or nonbusiness bad debt claimed on a tax return will likely increase your audit chances. Attach a statement to the return referring to the bad debt with the date it became due, the name and address of the debtor and your reason for determining it was worthless—the guy skipped town, died, declared bankruptcy or whatever. Of course, there is no free lunch; if in 2001 you collect the debt previously deducted as worthless, you must then report it as income in 2001.

Note: If your business uses the accrual accounting method, you have an alternative way to deduct bad debts, which may be more advantageous than described above. This is too technical to get into here, so see your tax pro or IRS Publication 535, Business Expenses, for details.

6. Promotion Expenses and Business Entertaining

If you pick up the tab for entertaining present or prospective customers, clients or employees, the cost is partially—not wholly—deductible.

You may deduct 50% of a business entertainment expense if it satisfies one of two tax code tests. The expense must either be:

- "directly related" to the business. Business must actually be discussed during the entertainment. For example, a catered meeting at your office would qualify, or
- "associated with" the business. The entertainment must take place prior to or immediately after a business discussion. This is more common—no business has to be discussed while having fun—for example, if your meeting is followed by an evening out at a restaurant, play or sporting event.

The costs of transportation to the entertainment event are fully deductible, and so aren't subject to the 50% limit.

Corporate entertainment expenses. If your enterprise is a C corporation, and you entertain customers or clients, you can either personally pay the expenses and claim reimbursement, or have the corporation pay the expenses directly. Direct corporate payment is better—for instance, using a credit card and letting the corporation pay the bill.

If you are not reimbursed by the corporation, you must claim the expenses as deductions for "unreimbursed employee expenses" on your individual tax return, which is less advantageous tax-wise. Also, claiming this type of expense increases the chances of an audit of your personal return.

Employee parties. Holiday parties and picnics for employees and their families are Congressionally recognized morale builders. These affairs are not subject to the regular entertainment rule and so are 100% deductible. Don't overdo it, though. To be fully deductible, employee get-togethers must be infrequent, and everyone at work must be invited. No business need be discussed.

Home entertaining. You can get a deduction for home entertaining if you follow the rules. To qualify, guests must either be employees or have a business connection—that is, they must be a present or - potential customer or client. If family or social friends are also present, their pro-rata share of party costs is not deductible. You are on the honor system here. If audited, it will help your cause to show you gave other (purely social) parties you did not claim as business expenses. For guests other than employees, keep notes showing who was present and the nature of the business discussed before, during or after the get-together.

Business gifts. You may make deductible gifts to clients and customers as long as the value does not exceed \$25 per person per year. You can also deduct the cost of wrapping, mailing or even engraving the gift, so the real limit is slightly higher than \$25. And items costing less than \$4 on which your business name is imprinted aren't counted against the \$25 limit.

Keep good records of business entertainment. If you have a business party, keep a written guest list, along with your explanation of the business connection or general nature of business discussed. This should satisfy most IRS auditors, unless the amount spent was outrageous. I have never heard of an auditor contacting guests to see whether or not business was really discussed or there was a business tie-in.

The following table may help you understand the various tax code rules on entertainment expense deductions.

When Are Entertainment Expenses Deductible?

General Rule:

You can deduct expenses to entertain a client, customer or employee if the expenses meet the "directly related" test or the "associated" test.

Definitions:

- *Entertainment includes any activity generally considered to provide amusement or recreation, and includes meals provided to a customer or client.*
- *The type of expense must be common and accepted in your field of business, trade or profession.*
- *The expense must be helpful and appropriate, although not necessarily indispensable, for your business.*

Two tests:

"Directly related" test

- *Entertainment took place in a clear business setting such as your business premises, or if it didn't, the*
- *Main purpose of entertainment was the active conduct of business, and*
 - a. *You did engage in business with the person during the entertainment period (such as, you talked business during lunch), and*
 - b. *You had more than a general expectation of getting income or some other specific business benefit (such as, it was a long-time customer). However, you don't have to prove that income actually resulted from the entertainment.*

"Associated" test

- *Entertainment is associated with your trade or business, and*
- *Entertainment directly precedes or follows a substantial business discussion.*

Other rules:

- *You can deduct expenses only to the extent that they are not lavish or extravagant under the circumstances.*
- *You generally can deduct only 50% of your business entertainment expenses.*
- *If your client brings along a spouse, you can bring yours, too, and deduct the cost as an entertainment expense.*

7. Advertising and Promotion

The cost of ordinary advertising for your goods or services—business cards, Yellow Page ads and so on—is

deductible as a current expense.

Promotional costs that create business goodwill—for example, sponsoring a Peewee football team—are also deductible as long as there is a clear connection between the sponsorship and your business. For example, naming the team the “Southwest Auto Parts Blues” or listing the business name in the program is evidence of the promotion effort. A contest prize given to a customer qualifies as a promotional expense, but not if an employee wins it.

Any cost that is primarily personal is not deductible. For example, you can’t deduct the cost of inviting customers or clients to your son’s wedding. Also not deductible are costs of lobbying a politico (with a few limited exceptions).

The cost of advertising signs, if they have a useful life of over one year, must be capitalized, and depreciation deductions taken over seven years.

8. Taxes

Various kinds of taxes incurred in operating your business are generally deductible. How and when to deduct taxes in your business depends on the type of tax.

Sales tax on items purchased for your day-to-day operation is deductible as part of the cost of the items. It is not deducted separately as taxes. On the other hand, sales tax (or federal luxury tax) on a business asset—such as a truck bought for your business—must be added to the vehicle’s cost basis. This means the sales tax is not totally deductible all in the year the truck was purchased.

Sales taxes that you collect as a merchant and pay over to the state are not deductible unless you included them in your business’s gross receipts.

Excise and fuel taxes paid by qualifying businesses are deductible as separately stated tax expenses.

Employment taxes (FICA) paid by your business are partially deductible. The employer’s one-half share is deductible as a business expense.

Self-employment (SE) tax isn’t a business expense. However, the owner can deduct one-half of the SE tax on the front page of his or her Form 1040 tax return.

Federal income tax paid on your business’s income is never deductible.

State income tax can be deducted on your personal federal tax return as an itemized deduction on Schedule A, not as a business expense.

Real estate tax on business-used property is deductible, along with any special local property assessments. However, if the assessment is for improvements (for example, a sewer or sidewalk), it is not immediately deductible; instead, the cost is added to the basis of the property and deducted (amortized) over a period of years. (See Chapter 2.) Real estate tax for nonbusiness property, such as your home, is deductible as an itemized deduction on Schedule A of your personal tax return.

Penalties and fines paid to the IRS and any other governmental agencies are never tax-deductible, - because this is deemed to be against public policy.

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F. How and Where Deductions Are Claimed

Although the tax deductibility rules for business expenses are consistent, how you claim the expenses on your tax return often depends on your particular entity form. The basics of expense tax reporting for business entities are as follows.

Sole proprietors (including independent contractors) and statutory employees report business expenses on Schedule C of their individual income tax returns (Form 1040). Always keep in mind that in the eyes of the tax code, a sole proprietor and his business are one and the same.

S corporations (Form 1120S), partnerships and limited liability companies (Form 1065) file their own returns showing expense deductions. In turn, these entities issue Form K-1s to their owners showing how much profit or loss is reportable by each individual. This amount is reported on Schedule E of their Form 1040s. So, with a few exceptions, an S corporation shareholder, partner or limited liability owner’s tax returns won’t list any of their business’s expenses.

Non-owner employees of businesses who incur out-of-pocket business expenses which are not reimbursed to them can also deduct them, but only under the restrictive "unreimbursed employee expense" rules on Schedule A of their Form 1040s. For this reason, a business should always either fully reimburse its employees for their expenses or should pay those expenses directly.

Some things, such as business charitable contributions and moving expenses, are not technically business expenses, but must be claimed on Schedule A of the business owner's personal tax returns.

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G. General Business Credit

The general business credit is a dollar-for-dollar credit against income tax, which can be taken by a relatively few small business owners. Since so few qualify, I won't go into much detail, but will just alert you to the possibilities. If anything below sounds like it might affect you, check it out with the IRS or your tax pro.

A taxpayer's general business credit is the sum of the following individual credits:

- investment credit, which is composed of the rehabilitation property, energy and reforestation credits
- welfare-to-work credit for wages paid to long-term family assistance recipients
- low income housing credit (Form 8586)
- alcohol fuels credit
- research
- disabled access
- renewable resources electricity production
- American Indian employment
- contributions to certain community development corporations, and
- work opportunity credit (Form 5884).

There are also a few other really esoteric items, not mentioned above.

To claim any credits, file Form 3800, General Business Credit, along with your annual income tax return. None of these credits are "refundable," meaning that they can't be used to claim a tax refund, only to reduce a tax liability.

Commonly Overlooked Business Expenses:

Despite the fact that most people keep a sharp eye out for deductible expenses, it's not uncommon to miss a few. And some folks don't list a deduction because they can't find what category it fits into. Some overlooked routine deductions include:

- *advertising giveaways and promotion*
- *audio- and videotapes related to business skills*
- *bank service charges*
- *business association dues*
- *business gifts*
- *business-related magazines and books*
- *casual labor and tips*
- *casualty and theft losses*
- *coffee and beverage service*
- *commissions*
- *consultant fees*
- *credit bureau fees*
- *education to improve business skills*
- *office supplies*
- *online computer services related to business*
- *parking and meters*
- *petty cash funds*
- *postage*
- *promotion and publicity*
- *seminars and trade shows*
- *taxi and bus fare*
- *telephone calls away from the business.*

Just because you didn't get a receipt doesn't mean you can't deduct the expense, so keep track of those small items and get big tax savings. Generally, business expenses of less than \$75 do not need receipts to be claimed on a tax return.

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Excerpted from "Tax Savvy for Small Business", by Frederick W. Daily

Chapter 2 – Writing off Business Assets

"Of all debts, men are least willing to pay the taxes."

—Ralph Waldo Emerson

As a business person, one of the few joys of spending money on a new computer, photocopier or even that great rosewood desk you have been coveting is knowing that the government is paying part of the expense—maybe as much as 50%. Just how much tax benefit you get from buying equipment depends on your business's earnings and your tax bracket; the more you make, the more your business purchases will be subsidized by Uncle Sam.

You can't deduct costs for equipment, buildings or other "fixed assets" as ordinary business expenses. Instead, you must "capitalize" these costs. (IRC § 263.) With one important exception, this means you must spread these expenditures by taking tax deductions (in tax lingo, "depreciate") over a number of years. Put another way, you recover your costs for these assets as tax benefits in future years. (IRC §§ 167 and 168.) Just how many future years depends upon which category of the tax code the particular asset falls into—it may be as few as three or as many as 39 years.

Important exception to the rule that capital expenditures must be depreciated or recovered over a number of years. Section 179 of the tax code lets you write off or deposit, immediately, up to \$24,000 of most capital expenditures (2001).

This chapter explains how to use both IRC § 179 and regular tax code depreciation rules to benefit your small business.

Writing Off Business Assets in a Nutshell

1. *The tax code divides expenditures for business into "current expenses" and "capital items," and treats each type differently.*
2. *Capital expenditures for business assets must be deducted over a number of years under regular tax code depreciation rules.*
3. *A special tax code provision, IRC § 179, allows most business owners to tax-deduct up to \$24,000 or more of capital expenditures as if they were current expenses.*
4. *Typically, assets are tax-deducted using one of two methods, called "accelerated" and "straight-line" depreciation. No matter which method is used, the entire cost of the asset may be written off over a number of years.*
5. *There are several ways to tax-deduct the business-use portion of an automobile.*

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A. Some Expenditures Must Be Capitalized

The most fundamental rule of deducting business expenditures is that they must first be divided up into two categories, called "current expenses" and "capitalized" costs. Generally, costs of things used up within a year are current expenses. These include ordinary operating costs of a business such as rent, equipment repair, telephone and utility bills for the current year. Garden-variety supplies, such as stationery and postage stamps, are also considered expenses even though they may be around from one year to the next. All items that fall into the current expense category can be fully deducted in the tax year they are purchased.

Capitalized costs, on the other hand, are usually for things the tax code says have a useful life of more than one year—equipment, vehicles and buildings are the most common examples. A capital cost may be either to acquire an asset, or to improve one so as to substantially prolong its life or adapt it to a different use.

No matter the size and scale of the business, all capital items come under the heading of "business assets." And while almost all provide tax write-offs for a business owner, not all capital expenditures are treated equally by the tax code.

Business Assets That Must Be Capitalized

Buildings

*Cellular phones and beepers**

*Computer components and software**

Copyrights and patents

*Equipment**

Improvements to business property

Inventory

*Office furnishings and decorations**

*Small tools and equipment**

Vehicles

*Window coverings**

(See IRC § 263 and Reg. 1.263 for details about items that must be capitalized.)

*[*May be subject to immediate deduction under IRC § 179 at your option.]*

1. Types of Property

Almost any kind of property, such as a building or a car, can qualify for a tax write-off if it is used in a business.

The tax code categorizes assets as “tangible” or “intangible,” and “real” or “personal.” These distinctions are important because they dictate how you must calculate and deduct asset costs and how fast you can take the tax deductions.

Tangible items of property are things that can be touched—for example, warehouses, machines, desks, trucks, vans and tools. The vast majority of property owned by a small business is tangible. Intangible property refers to things like trademarks, franchise rights or business goodwill.

Long ago the English legal system, which we adopted, divided the world of property into two broad kinds: real and personal property. Real property is land and anything permanently attached to it, termed “improvements,” such as fences, parking lots, buildings and even trees. Everything else in the universe is called personal property, such as furniture, equipment, cars and paper clips.

These two divisions are deeply imbedded in all our laws, including our tax law. In general, the tax code dictates much longer periods to write off real property than personal property. This makes sense. Real property improvements—structures—wear out more slowly than personal property, such as cars. Land itself is considered to never wear out, and so logically it should be nondeductible, and it is.

2. Inventories

Businesses selling goods (rather than services) usually maintain stock, called “inventory.” Money spent for goods to sell is not a current business expense. Instead, inventory is considered a business asset and its cost is expensed as it is sold—or discarded.

You must value your “cost of goods sold” using an IRS-approved inventory accounting method. In effect, what you spend for inventory is deducted, as it is sold, from the revenue it generates, to come up with your gross profit. From this figure, your general business expenses are deducted to determine your net profit. It is the net profit that is taxed.

Tax rule. Inventory generally must be listed at the lower of cost or market value.

EXAMPLE: *At the end of its first year of operation, Rick’s Music Store has an inventory of compact discs that cost him \$50,000, and vinyl LP records that cost \$30,000. Using the “cost method,” Rick has an ending inventory worth \$80,000. Here is Rick’s cost of goods sold deduction:*

\$0	beginning inventory
+ \$300,000	purchases
- \$80,000	ending inventory at cost
= \$220,000	cost of goods sold

You may reduce (“write-down”) the value of any inventory that has become unsalable. For tax purposes, this needs to be documented. For instance, if you write-down and destroy dead stock, keep evidence of the destruction—photos, videos, receipts or the statement of a reputable third party who can certify the goods were destroyed.

EXAMPLE: *At inventory time, Rick knows his inventory of CDs have held their value, but his LP records hardly sell any more. Rick asks a prominent music distributor to appraise the LP inventory and gets a written statement saying the market value is only \$8,000. Accordingly, Rick reduces their retail prices and lowers the inventory on his books by \$22,000. Now Rick’s cost of goods sold deduction for tax reporting looks like this:*

\$0	beginning inventory
+ \$300,000	purchases
- \$58,000	ending inventory
= \$242,000	cost of goods sold

The difference between the two examples is the method of valuing the inventory. Using fair market value instead of cost reduces Rick’s income for tax purposes by \$22,000. It is improper to reduce the book value of the inventory without some evidence of the loss in value and without reducing the retail price of the goods. With the taxes saved from the inventory write-down, Rick can build up his CD inventory or do anything he wants to with the extra money in his pocket.

B. Expensing Business Assets: IRC Section 179

Small business owners don't need to learn the Internal Revenue Code by section number, but it pays to remember at least one: IRC § 179, perhaps the best small business tax break of all. IRC § 179 allows—but doesn't require—a business owner or C corporation to deduct up to \$24,000 (in 2001) of asset purchases each year as current expenses. This produces an immediate write-off of capital assets.

Using § 179 is referred to as "expensing an asset," as opposed to capitalizing it under normal tax code rules. Within the \$24,000 limit, a business may buy assets at any time during the year and deduct the costs in full—as long as they are "placed in service" in that same year. I once bought, set up and started using a new computer on December 31 for \$3,000, and wrote it off completely that year.

EXAMPLE: *Hal, a self-employed consultant, buys a computer for \$5,000 in early 2001. Hal plans on using IRC § 179 to write off the computer. Hal's business is very profitable and later in the year, while estimating how much he is going to owe in taxes for 2001, Hal finds he will owe \$4,000 more than the estimated quarterly tax payments he has made. Hal was planning to buy a \$12,000 color printer in 2002. If, instead of waiting, Hal purchases and starts using the printer before December 31, 2001, he qualifies under § 179 to write off a total of \$17,000 in 2001 and wipe out most or all of his 2001 tax balance.*

It works out like this: Hal is in approximately a 30% combined federal and state income tax bracket and pays self-employment taxes of 15.3%. This means that for Hal's tax bracket every business deduction dollar saves him roughly 45¢ in taxes. So the total tax savings resulting from the \$12,000 printer purchase in 2001 wipes out Hal's projected \$4,000 tax balance. Of course, Hal had to spend \$12,000 to get the tax savings. But Hal would still get the deduction even if he purchased the machine on credit and paid in later years. As long as he needs the printer, this is still the next best thing to a free lunch.

Think twice about taking a 179 deduction. When would you not want the fast deduction of IRC § 179? Answer: When you don't get much, if any immediate tax benefit from it. For instance, say your business is new and you don't have enough business income to offset the Section 179 deduction, but you expect big things in a year or two. In that case, choosing regular depreciation and spreading the deduction over future years makes more tax sense.

EXAMPLE: *Hal's advertising agency loses money in 2001 when a major account doesn't pay him and then declares bankruptcy after Hal buys a \$5,000 computer. The tax code prescribes a five-year depreciation period for computers. Hal doesn't have any outside income, so spreading the deduction over five years makes more sense than writing off the whole cost under IRC § 179 in 2001.*

A few other tax code sections let you choose whether to expense all assets similar to IRC § 179 or capitalize certain assets. These special provisions don't affect small businesses except for research (IRC § 174), agriculture (IRC §§ 175, 180 and 193), publishing (IRC § 173) or mining (IRC §§ 615 and 616). (See IRC § 263 and Reg. 1.263 or a tax pro for details.)

Increasing § 179 Deductions

The annual limit on expensing of business assets under IRC § 179 is scheduled to increase as follows:

<i>2001 and 2002:</i>	<i>\$24,000</i>
<i>2003 and thereafter:</i>	<i>\$25,000</i>

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C. Depreciating Business Assets

Because of its obvious advantages, most successful small business owners look first to IRC § 179 to write off asset purchases. But you must go with regular depreciation methods instead of IRC § 179 if:

- you don't have other earned income to offset the IRC § 179 deduction, or
- the asset doesn't meet IRC § 179 qualifications, or
- you've already used up your IRC § 179 dollar limit that year.

1. What Is Depreciation?

The tax code recognizes that almost everything wears out over time. So property used in a trade or business or held for the production of income is entitled to a tax deduction called "depreciation." A depreciation deduction is commonly called a "write-off"; the formal term favored by the tax code is "cost recovery." In a few special cases, this deduction is called "amortization" or "depletion."

A tax deduction for depreciation works something like this. You buy and use a copy machine in your business. Under the tax code a copy machine is assigned a (rather arbitrary) five-year life expectancy. (IRC § 168, Reg. 1.168.) This means you can write off part of the cost of the copier in the year you bought it and in each of the following five years, by taking annual deductions. (Yes, I know this is a total of six years, not five, as the tax code seems to indicate.) Eventually, the whole cost of the copier has been deducted from your business income if you stick around that long. Just how much you can take each year, and how to claim the deduction, are explained next.

An important exception to the normal depreciation rule: land costs can never be deducted.

Special rules also apply to deducting business inventories and natural resources.

Keeping Up With Changing Depreciation Rules

Congress changes the depreciation rules frequently—five times in the last two decades. The good news is that if the rules change after you acquire something, the old rules still apply. The bad news is that you will have to learn and use the new rules for any new property. So, you may end up tracking depreciation of different business assets—computers, buildings or whatever—under several sets of rules. A tax pro can keep the process straight and even compare different methods available to see which one produces the best results for you. Software (such as TurboTax for Business) also can track depreciation under multiple schedules.

2. Depreciation Categories

The tax code establishes depreciation categories for all assets. Each category is assigned an arbitrary "useful life," which is the minimum time period over which the cost of an asset can be deducted—for example, five years for a computer. In tax lingo, this is called the "recovery period." IRS Publication 534 lists the categories and the depreciation periods for different assets.

Most small business assets fit into one of four classes. Here is a summary of the rules, which are quite technical:

- 3-Year Property: Manufacturing equipment (plastics, metal fabrication, glass).
- 5-Year Property: Cars, trucks, small airplanes, trailers, computers and peripherals, copiers, typewriters, calculators, manufacturing equipment (apparel), assets used in construction activity and equipment used in research and experimentation.
- 7-Year Property: Office furniture, manufacturing equipment (except types included in 3- and 5-year categories above), fixtures, oil, gas and mining assets, agricultural structures and personal property that doesn't fit into any other specific category.
- Real Estate (varying periods): Business-use real estate is depreciated over 39 years using the straight-line method only (discussed below) if placed in service after May 31, 1993. Residential rental real estate is allowed a 27.5-year recovery period. Some types of land improvement costs (sidewalks, roads, drainage facilities, fences and landscaping) are depreciable over 20 years.

There are also classes of 10, 15 and 20 years, which might apply if your business is agricultural or unusual, like breeding horses or operating tug boats. See IRC § 168 and IRS Publication 534 for more information on all asset classes.

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3. Methods of Depreciation

Once you find the correct tax category for an asset, you must determine the most advantageous depreciation method to use. You may or may not have a choice, depending on the type of asset. Depreciation methods fall into two general types, which accountants call:

- straight-line depreciation, and
- accelerated depreciation.

The tax code makes it a little more complicated by offering four principal methods of depreciating most business assets—one straight-line and three accelerated—all of which result in the same total amount of deductions in the end. An additional method, for farm equipment only, isn't covered here. (See IRS Publication 946.)

a. Straight-Line: The Slowest and Simplest Tax Depreciation Method

The straight-line method allows the cost of an asset to be deducted as a depreciation expense in equal amounts every year, except for the first and last years. In those two bookend years, you get only half of a year's tax deduction.

For instance, with a \$10,000 business machine, straight-line tax code depreciation allows these - deductions:

Year 1	\$1,000 (one half year)
Years 2, 3, 4 & 5	2,000 each year
Year 6	1,000 (one half year)
Total deductions	\$10,000

Assuming you own and use the machine for six years, you can deduct 100% of its cost.

b. MACRS: The Fastest Accelerated Tax Depreciation Method

The present tax code accelerated depreciation system is known by the acronym MACRS (pronounced "makers" by tax folks). This stands for "modified accelerated cost recovery system."

Technically, MACRS covers all of the accelerated depreciation methods, but also is a shorthand reference to just the most widely chosen accelerated method: MACRS 200% Declining Balance. This is the very fastest—that is, most "accelerated"—way to write off assets (except for IRC § 179, described above). It allows greater deductions in early years of ownership of an asset than in later ones. For instance, using this method to depreciate a \$10,000 business machine produces \$7,120 in depreciation deductions in the first three years, versus \$5,000 with the straight-line method.

To find the yearly deduction amounts, refer to the IRS tables that show the deduction as a percentage of the cost for each year of ownership. MACRS tables are found in your annual Form 1040 instruction booklet, IRS Publication 946 and annual tax preparation guides. Tax software such as TurboTax for Business will automatically compute these amounts, too.

c. Special Depreciation Rules for Motor Vehicles

Special tax code depreciation rules and limits apply to motor vehicles used in business. The technical name for these rules is "alternative ACRS depreciation." These rules favor trucks over passenger cars, and will be different if the vehicle is partly used for pleasure and partly for business, which is often the case with small time operators.

As long as your business vehicle use is more than 50%, then accelerated depreciation deductions are allowed. However, there are caps (annual dollar limits) on motor vehicle deductions, as shown in the table below. The total depreciation for the first three years is \$11,110 if the car is 100% used for business. Note that the annual depreciation deduction after the third year of ownership drops to only \$1,775 per year. The net effect is to extend the period for deducting the cost of most vehicles to five years or more.

Should business use be 50% or less, slower straight line depreciation rules apply. The annual cap is the same, no matter whether the accelerated or straight-line depreciation method is used. Don't forget that the percentage of personal use reduces the amount of depreciation deduction each year. This can get a little tricky. IRS tables guide you through the process, but better is tax software like TurboTax for Business.

The fastest depreciation method may not be the best. Don't automatically conclude that the quicker you can take a deduction, the better. If your business has been around a while and is quite profitable, you are probably right. But most start-up businesses are not money-makers, so they don't benefit by using accelerated depreciation. For them, the straight-line method, with smaller deductions in their formative years, gives the best long-term tax benefit.

Depreciation Limits for Vehicles

The tax code imposes absolute dollar maximums on depreciation deductions for each year that you own a passenger car used for business—no matter how much it costs; but see the exception for heavy vehicles in Section B2 above. For 2001, you are limited to depreciation deductions of:

<i>1st year</i>	<i>\$3,060</i>
<i>2nd year</i>	<i>\$5,000</i>
<i>3rd year</i>	<i>\$2,950</i>
<i>4th and subsequent years</i>	<i>\$1,775</i>

These amounts are adjusted annually for cost of living changes. (IRC § 280F.) New electrically powered vehicles enjoy significantly higher limits, though!

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Excerpted from "Tax Savvy for Small Business", by Frederick W. Daily

Chapter 3 – Recordkeeping and Accounting

"The income tax has made more liars out of the American people than golf has."

—Will Rogers

Most ventures are started by enthusiastic people with ambition and drive. Whether they are hoping to build the next Fortune 500 company or simply to supplement their day job, it's usually what the business will buy, sell, make or fix that interests them most. They aren't intrigued by the paperwork. You are not alone if you hate paperwork, but the law mandates some basic recordkeeping.

The good news is that the IRS does not require business records to be kept in one uniform fashion. Any format is OK, as long as it is reliable and paints a true picture of income and expenses. Since no two enterprises are alike, no two recordkeeping systems are exactly alike. Never forget that the IRS (and state taxing agencies too) has the right to audit you and inspect your records.

This chapter outlines the minimum recordkeeping required and has tips on how to set up and maintain a good system. It also touches on basic accounting principles.

Recordkeeping in a Nutshell

- 1. The IRS doesn't prescribe any particular format for keeping your business's records, as long as they clearly reflect your income and expenses.*
- 2. You can choose a manual or computerized recordkeeping system, but a computer saves time and is more accurate.*
- 3. Small businesses are usually required to keep records and tax report on a calendar-year basis.*

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A. Why You Need a Bookkeeping System

Some fledging entrepreneurs think that if there is money in their business checking account at the end of the month, they must be making a profit. But only if you keep accurate records will you really know if your business is making or losing money. A recordkeeping system is also crucial for preparing your annual federal and state income tax returns.

The first commandment of the tax code is thou shalt keep "records appropriate to your trade or business." (IRC § 6001.) Most records don't have to be kept in any particular form, but they must be accurate. (Reg. 31.6001-1(a).)

Records can also serve as an early warning system to let you know whether changes need to be made in your enterprise. Indeed, operating without good records is like flying in dense fog with no instruments. I can almost hear you saying, "I think I'll skip this chapter; I hate bookkeeping. After all, if my business takes in enough money, all these paperwork matters will resolve themselves. If they don't, I'll hire someone to clean them up." Think twice, please.

Take recordkeeping seriously. If you only get one thing out of this book, go away knowing that ignoring recordkeeping is inviting disaster. If the IRS ever audits and finds insufficient records or significant mistakes, it can force you out of business and wipe out your life savings as well.

Recordkeeping must become part of your everyday business routine, just like opening your doors each morning. Believe me, I am not an accountant, and I hate paperwork as much as any of you. I also hate shaving every morning, keeping fat out of my diet and carrying out the garbage in the rain, but these tasks never seem to go away. As we shall see, though, recordkeeping doesn't need to be drudgery, and you don't need to spend godawful amounts of time tracking every last penny.

Random Business Record Inspections

You may be audited after written notice, but there are no "IRS inspectors" roaming around spot-checking to see that records are being kept. In many states, however, employment or sales tax auditors do show up unannounced and demand to see records. So, just like the Boy Scouts, "be prepared."

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B. How Long Records Should Be Kept

The IRS normally has three years to audit you and your business, starting from the date you file a tax return. So, three years is the absolute minimum period for record retention. However, for serious tax reporting misstatements, the IRS can go back six years—and for outright fraud, it can go back an unlimited period of time. Don't overlook the fact that your state tax agencies can inspect your records, too. Some state agencies have statutes of limitations for auditing longer than the IRS's.

Considering all the laws here, I advise my clients, as a rule, to keep their regular tax-related documents—receipts, invoices, bank statements—for six years.

There is an exception for asset records. Many entrepreneurs buy equipment, vehicles and sometimes real estate for their business. For assets like these, records should be kept longer than the normal six years. The reason is that depreciation deductions on assets are often taken over an extended period. If a tax agency audits, the issue of a depreciation deduction on the tax basis of a long-term asset is frequently questioned. Only by having the original acquisition documents can the starting tax basis be proven.

EXAMPLE: *In 1986, Calista bought a building for her insurance agency. She tax deducted all expenses of maintaining the building and took depreciation deductions. Calista sold her agency, including the real estate, in 1998. She filed her tax return reporting the sale of the business on 4/15/99. Calista should keep her 1986 documents on the purchase of the building until at least April 15, 2002 (three years from the date of the tax return), or better, for six years, to April 15, 2005.*

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C. Timing Methods of Accounting: Cash and Accrual

Besides recordkeeping systems, there are also two accounting methods for recording the income and expenses called the "cash" and "accrual" methods. These are two sets of accounting rules for the timing of income and expenses.

The general proposition is that a venture's income and expenses must ordinarily be tax-reported in the period in which they occur. Normally the period is a calendar year, but for a few businesses it may be a fiscal year.

EXAMPLE: *Monique bought \$7,000 in supplies for her hairdressing salon in January 2001. But Monique hasn't filed her 2000 income taxes yet—can she deduct the \$7,000 expense on her 2000 tax*

return? No, because the expense was incurred in 2001. Monique cannot shift it to another year. This is true no matter which accounting method is applied.

Less clear-cut is the question: What if Monique had bought the supplies in 2000, but didn't pay for them until 2001? In which year does Monique take the deduction? To answer, you need to know the difference between cash and accrual methods of accounting and which one Monique's business is using.

1. Cash Method Accounting

The term "cash method" refers to recognizing for tax purposes an expense when it is paid or income when it is received—not how it is paid. So, don't take the word "cash" here literally; it covers any kind of payment—checks, barter, credit cards, etc.—as well as the green stuff.

Most businesses selling services use the cash method of accounting for income and expenses. The cash method makes sense even to us non-accountants. You simply report income in the year you receive it and an expense in the year you pay it.

The cash method seems simple, but there are a few special tax rules to watch out for. One is a legal doctrine called "constructive receipt," which requires counting some items as income before you actually receive them. This means you have income, for tax purposes, as soon as it is available or credited to your account—even if you don't take it.

EXAMPLE: *Ray got a \$3,000 check for consulting in early December 2001, but didn't deposit it until January 2002. Because Ray could have cashed it in 2001—the banks were open and the check was good—2001 is the tax year in which Ray "constructively received" the \$3,000.*

The corollary of the constructive receipt rule is that you are not allowed a deduction in the current year for items paid for but not yet received.

EXAMPLE: *Ray got a special deal on Consulting Times, a monthly business publication. He paid \$360 for a three-year subscription in July of 2001. He can tax-deduct only \$60 in 2001 ($\frac{1}{6}$ of the total); the balance must be prorated over the term of the subscription and deducted \$120 ($\frac{1}{3}$) in 2002, \$120 ($\frac{1}{3}$) in 2003 and \$60 ($\frac{1}{6}$) in 2004.*

Watch the calendar. There is some flexibility allowed by the IRS for prepaying some expenses at the end of the year. The last week of every December, I review the income and expense figures of my law practice to see if I can shave some money off my tax bill. For instance, if I pay January's office rent on December 27, I'll get the deduction a year earlier. As long as I don't prepay an expense more than 30 days in advance, I'm okay. Or, if I had an especially good year (meaning a big tax bill), I can stock up on office supplies or buy new equipment to write off under IRC § 179. And in some years I've found the converse is true—my late December accounting shows a disappointing year. Then I put off new purchases or paying creditors until January and hope for the best in the coming year.

2. Accrual Method Accounting

Most larger C corporations, manufacturers and businesses with inventories of goods must use the accrual method of accounting. The accrual method requires some getting used to for most folks.

With accrual accounting, income is treated as received when it is earned—regardless of when it is actually received. On the other side, an expense is recorded at the time the obligation arose—which is not necessarily when it is paid.

In accountant's lingo, business expenses and income are considered accrued at the moment they become "fixed" under this method. Don't fret, the example below shows that this is not rocket science.

Both income and expenses must meet what the tax code calls the "all events" test to become fixed. This means that everything required—all events—to secure a right to receive the income, or to cause a liability for the expense, must have happened. At that point in time it becomes fixed for accrual accounting purposes—whether or not any cash has changed hands.

EXAMPLE: *George's Foundry, which uses the accrual method, receives a \$4,500 deposit in 2001 for custom ironwork to be manufactured in 2002. The foundry won't report \$4,500 as income in 2001 because it hasn't been earned yet. On the expense side, if the foundry incurs a \$250 charge in 2001 for lawyer's fees relating to the contract, it is accrued and tax deducted in 2001—even if not paid for until 2002.*

Get help setting up accrual accounting. If your operation keeps inventories, manufactures goods or is

a C corporation, consult a tax pro in setting up your accounting system. Find someone familiar with your industry, whether it is a gas station, a loan company or a medical practice. Most software programs accommodate accrual accounting.

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Excerpted from "Tax Savvy for Small Business", by Frederick W. Daily

Chapter 4 – Tax Concerns of Employers

"If there isn't a law, there will be."

—Harold Farber

Chances are if your venture is successful, you won't be able to do all the work yourself. If you can do it all on your lonesome, don't worry about this chapter. But being an employer carries a whole new set of tax responsibilities. Once you have employees, the IRS will be looking over your shoulder to see if you are filing payroll tax returns and making required tax deposits.

If your business uses independent contractors instead of employees, you can avoid payroll taxes and hassles of paperwork. However, the IRS may audit to see if anyone you call an "independent contractor" rather than an "employee" is classified correctly. If you lose, the consequences can be very expensive, as we shall see.

Every employer has an obligation to:

- withhold payroll taxes from employees' wages
- remit these taxes, together with the business share of employment taxes, to the IRS, and
- make periodic employment tax reports to the IRS. (IRC § 3509.)

According to the IRS, the majority of small businesses fall behind in filing reports or making federal tax deposits at one time or another. (I have to confess that my office missed getting an employment tax form filed on time on at least one occasion.) While many of these delinquencies are oversights—like missing a deadline—others reflect poor office management or poor understanding of employer tax obligations.

It is tempting, in a "cash crunch," to pay rent, utilities and key suppliers instead of making a payroll tax deposit. Folks rationalize that since it takes the IRS months (if not years) to find out, employment taxes can wait. Too often, however, the business keeps struggling or goes under altogether, but the tax obligation survives.

Under all circumstances, pay your payroll taxes, in full and on time. If you don't, the IRS will knock at the door, and when it does, it won't be gentle. The IRS tacks on interest and penalties to delinquent payroll taxes. The bill can skyrocket so fast that often, businesses fail as a result. And unlike ordinary debts, payroll taxes survive the death of the owner or bankruptcy of the enterprise. Payroll taxes, by law, are personal liabilities of business owner(s) or their heirs. (IRC § 6502.)

Employer Tax Concerns in a Nutshell

1. *If your business has employees, you must withhold taxes and file payroll tax reports.*
2. *IRS auditors are on the alert for businesses that misclassify employees as independent contractors, and they can levy heavy penalties on violators.*
3. *Business owners, and sometimes employees, too, can be held personally liable for unpaid payroll taxes of the business. (You may, however, appeal IRS findings of responsibility.)*

A. Payroll Taxes

The term “payroll taxes” covers three different types of taxes that every employer is responsible for:

- Income tax withheld from each employee’s paycheck throughout the year. You must send an IRS W-2 form to each employee showing all payments and all withholdings from their wages. W-2 forms must be furnished by January 31 of each following year. By February 28, you must also file IRS Form W-3 (summary and transmittal form) and copies of all the W-2s to the Social Security Administration, which transmits the data to the IRS.
- Social Security and Medicare tax (FICA). The employee’s share is withheld from each paycheck; the employer must match this amount. The total FICA tax rate is 15.3% of wages paid up to \$80,400 (2000). All income over this amount is taxed at 2.9%.
- Federal Unemployment Tax (FUTA). This tax goes to the unemployment insurance system and must be paid by the employer. The employee pays no part of FUTA.

How to figure tax withholding for employees is shown in IRS Publications 15 and 15-A, Circular E, Employers’ Tax Guide. Form W-4 (Employees’ Withholding Allowance Certificate) helps an employer determine how much to withhold from employees’ paychecks for federal income tax purposes. One look at Circular E, however, might convince you to hire a payroll tax service or get your accountant to do the forms for you—at least the first time around.

Generally, each employee’s withheld income and FICA taxes are paid to the IRS monthly, by making federal tax deposits at specified banks. (If the total owed is \$2,500 or less, the deposits are due quarterly.) An IRS Federal Tax Deposit coupon (Form 8109-B) must be submitted with each payroll tax payment. If your total annual payroll tax obligation exceeds \$200,000, you must make electronic deposits. Call the IRS at 800-555-4477 or 800-945-8400 for details, and see IRS Publication 966.

In turn, these payments are reported to the IRS on Form 941, Employer’s Quarterly Federal Tax Return. This form is due one month after the end of each calendar quarter that you have employees. Form 941 shows how many employees you had, how much you paid them and the amount of Social Security, Medicare and federal income tax withheld during the three-month period. (A sample Form 941 follows.) Alternatively, you can file Form 941 TeleFile by using a touchtone phone. Call the IRS at 800-829-1040 or go to the IRS’s website at <http://www.irs.gov> for details.

There is also an annual unemployment tax report detailing FUTA taxes due (Forms 940 or 940EZ). This form shows how much federal unemployment tax is owed. A credit is allowed for any state unemployment taxes paid. (You don’t get any credit unless you paid the state unemployment tax on time.) FUTA is 100% paid by the employer; there is no contribution or deduction from the employee’s wages.

Payroll tax obligations are based on a “trust fund” theory. The employer initially acts as a tax collector by holding employees’ taxes in trust until paid to the IRS. Violation of this trust can bring on both civil and criminal punishments to the employer. Although the IRS seldom throws anyone in jail, it can—and often does—seize a business’s assets and force it to close down if it owes back payroll taxes.

Most states that tax income also require employers to withhold employees’ taxes similar to the federal law. Some cities, such as New York City, have payroll taxes, too.

B. Employee or Independent Contractor?

Individuals who perform services for your small business are usually classified as either regular employees (legally termed “common law employees”) or independent contractors (usually meaning they are “self-employed” for tax purposes).

A small percentage of people may fall into two other categories recognized by the IRS: “statutory employees” and “statutory non-employees.” We’ll talk about all of these categories of workers in more detail below.

It may not make much difference to you how someone is classified, as long as the work gets done. The distinctions, however, are very important to the IRS, and can be very costly if you don't pay attention to them. Let me warn you: the law is muddled here, and legal experts regularly disagree as to whether someone is an employee or an independent contractor.

Congressional Dithering

In recent sessions, Congress has repeatedly failed to pass bills which would have greatly simplified the question of just who is an employee and who isn't. Sooner or later, Congress will again try for clarification—we hope.

If you have been with me since the beginning of this chapter, you realize that you have payroll tax withholding and reporting obligations for all of your employees. You report your employees to the IRS on quarterly 941 forms and W-2 forms issued annually.

On the other hand, with a true independent contractor, you don't have any withholding or contributions for payroll taxes, and your only duty to the IRS is to issue a 1099 form once a year to each worker. (There are 11 versions of the 1099 form; the "1099-Misc." is the one issued to an independent contractor.) And you don't have to make any report to the IRS at all if you pay the independent contractor less than \$600 a year, or the services were performed for you personally and not for your business or if the service provider was incorporated.

The employee/independent contractor determination is crucial. The most important advice in this book might turn out to be this: Always make a determination (hopefully, a correct one) of whether or not the person you hire is an employee or independent contractor before the work begins.

Calling someone an independent contractor is very advantageous to a business—it saves a lot of time that would otherwise be spent on complying with IRS reporting requirements. Even more significant, you won't have to make the employer's share of the FICA contributions for each worker; this saves you 7.65% (2001) of each paycheck. You won't have to pay unemployment compensation tax, either. But you should realize that the IRS is very aware of the benefits of misclassifying an employee as an independent contractor, and has wide powers to make life miserable for all those it catches doing it.

Business Owners. Sole proprietors, limited liability company members and partners are neither employees nor independent contractors. These folks are owners, so are not subject to payroll tax withholding and paying. They should pay and file quarterly Estimated Taxes instead. This amounts to about the same amount of tax being paid, but with a lot less accounting and IRS paperwork required. However, small business shareholders/owners of corporations—C or S type—who work for the corporation are employees and subject to payroll tax rules.

No other classifications of workers are recognized by the IRS. Many employers mistakenly believe that a short-term worker is not an employee. Sorry, whether part-time or temporary, called a consultant or subcontractor, a worker must fit into one of the four categories discussed below for tax reporting purposes.

1. Common Law Employees

Anyone who performs services that can be controlled by an employer (what work will be done and how it will be done) is termed a "common law employee" or just plain "employee." Even if an employer doesn't actually exercise control, but gives the worker freedom of action, she is the employee. As long as an employer has the legal right to control the method and result of the work done, there's an employer-employee relationship. Under this definition, most working people who do not own their businesses are common law employees.

Here are more factors the IRS says that show a worker is a common law employee:

1. The worker can be required to comply with instructions about when, where and how to work.
2. The worker is trained by the employer to perform services in a particular manner.
3. The worker's services are integrated into the business operation, or a continuing relationship exists.
4. The worker is required to render services personally.
5. Assistants to the worker are hired by the business, not the worker.
6. The worker has set hours of work.
7. The worker is required to devote substantially full time to the employer.
8. Work is done on business premises.
9. The worker is required to submit reports regularly.
10. The worker is paid by the hour, the week or month, unless these are installments of a lump sum

amount agreed for the job.

11. The business pays the worker's business or travel expenses.
12. The business furnishes tools, equipment and materials.
13. The business has the right to fire, and the worker has the right to quit at will.

2. Independent Contractors

The IRS says that people in business for themselves—not subject to control by those who pay them—are independent contractors, not employees. When you hire an independent contractor to accomplish a task for your business, you don't have an employer-employee relationship and don't, therefore, have to pay employment taxes. Independent contractors (ICs) are responsible for their own tax reporting and are treated as business owners themselves.

The IRS says these factors tend to show a person is an independent contractor:

1. The worker hires, supervises and pays her assistants.
2. The worker is free to work when and for whom she wants.
3. The work is done on the worker's premises.
4. The worker is paid by the job or on straight commission.
5. The worker has the risk of profit or loss.
6. The worker does work for several businesses at one time.
7. The worker's services are available to the general public.
8. The worker can't be fired except for breach of contract.

Protect yourself from potential IRS claims that you misclassified employees as independent contractors. As a business owner, any independent contractor you hire should be:

- paid by the job, not by the hour.
- working on his or her premises only, if possible.
- showing you a business license and workers' compensation insurance coverage (if applicable).
- signing a contract spelling out the terms of the work relationship. (See "Contracts With Independent Contractors," below.)

Contracts With Independent Contractors

If an IRS auditor attempts to reclassify a worker from independent contractor (IC) to employee, a written contract with the IC may sway the auditor. A signed contract won't help if the worker in question is obviously an employee, but it can be persuasive in borderline situations. A written agreement with an independent contractor should acknowledge that he or she is an IC, spelling out his or her responsibilities. (Pay attention to the IRS list of factors.) Include a clause stating that all payments to the IC will be reported to the IRS on Form 1099. If you will be using any independent contractors, develop blank contract forms and have each IC sign one before they start performing any services.

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C. Recordkeeping Requirements on Service Providers

You must keep records on most folks—whether employees or independent contractors—who provided services to your business. The IRS and state tax agencies can demand to see these records as part of a regular audit or a special employment tax audit. Normally, the minimum amount of time to keep these records is three years, but six years is advisable for having these records handy. Basic employer records should show:

- Employer Identification Number document issued by IRS
- amounts and dates of wage and pension payments to workers
- names, addresses, Social Security numbers, occupations, dates of employment for everyone paid for their services
- fringe benefits and goods or services provided in addition to cash to workers
- employee tips reported (if applicable)
- Forms W-2 and 1099 showing payments to workers, including any that were returned by the post office as undeliverable
- income tax withholding certificates completed by each worker (Forms W-4)
- federal and state payroll tax deposit forms with dates and proof of payment (deposit slip, canceled check or financial institution receipt)

- federal Forms 940 (annual) and 941 (quarterly) and corresponding state payroll tax forms
- income tax returns of yours or the business entity on which payments to workers were claimed, and
- FICA (Social Security & Medicare) and FUTA (unemployment) taxes paid for each worker.

For details on these and other employer recordkeeping requirements, see IRS Publication 15, Circular E. As with most IRS forms, it is available at IRS offices by calling 800-829-3676 and on the Internet at <http://www.irs.ustreas.gov>.

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Excerpted from "Tax Savvy for Small Business", by Frederick W. Daily

Chapter 5 – Sole Proprietorships

"The most enlightened judicial policy is to let people manage their own business in their own way."
— Oliver Wendell Holmes, Jr.,
U.S. Supreme Court Justice

For tax purposes, the term "sole proprietor" is an individual (or husband and wife) who owns a business. A business is any enterprise operated with a profit motive. Sole proprietors are also folks who, acting as independent contractors, provide services to other businesses.

There are 15 to 20 million sole proprietorships in the U.S., comprising over 80% of all businesses. Most folks choose this way because it is the easiest, fastest and cheapest way to go into business.

For most legal purposes, a sole proprietor and her business are indistinguishable. Business profits and losses are reported on the owner's personal tax return every year. The sole proprietor is personally responsible for business debts, including all taxes. And when the owner dies, a sole proprietorship - terminates by law—unlike a corporation or limited liability company.

Sole proprietorships may offer any type of goods or services, have multiple employees, lose or make millions. In most parts of the country you can start a sole proprietorship by simply putting up a sign offering your goods or services. You may also need a local business license and possibly a sales tax permit as well, but that's about it—you are a sole proprietorship.

Taxes and Sole Proprietorships in a Nutshell

1. *The tax code does not consider a sole proprietorship a separate entity from its owner, so the business does not file its own tax return. Its income or loss is reported on a schedule filed with the owner's tax return.*
2. *Sole proprietors, as self-employed individuals, must pay quarterly estimated income taxes, as well as self-employment tax for Social Security and Medicare contributions.*
3. *The great majority of small businesses begin as sole proprietorships, but many eventually convert to a partnership, limited liability company or corporation.*

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A. Business Expenses

All legitimate business expenses can be tax-deducted no matter what form your business takes—sole - proprietorship to major corporation.

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B. Profits Left in the Business

The following bit of tax news comes as a shock to most sole proprietors: You are taxed on all profits in the year they are earned—whether you take the money out of the business or not. Any profits remaining in a business bank account at the end of the year are taxed as if you had put them in your pocket. Remember, under the tax code a sole proprietor and the business are one.

For retailers and manufacturers, this rule means if you put profits into building your inventory—which is usually the case—you first will be taxed on them. In other words, you will have to use “after-tax” dollars to expand your business.

EXAMPLE: *Jose made a net profit of \$85,000 in his magic and novelty shop last year. He took \$50,000 out of the business bank account for living expenses and spent the remaining \$35,000 on inventory. Jose pays income and self-employment tax on the full \$85,000.*

If your small business is incorporated, you may pay less tax on profits put into inventory. This is because owners of C corporations do not report profits left in the business on their personal tax returns. Although profits left in a corporation are taxable to the corporation, initial rates of taxation are lower than for most individuals, producing a tax saving for most small businesses.

Start-Up Permits

*Although it is easy to start a sole proprietorship, certain businesses and professions (restaurants and attorneys, for example) need state or local licenses before beginning operation. For more information, see *The Small Business Start-Up Kit*, by Peri Paknoo (Nolo), and *Small-Time Operator*, by Bernard Kamoroff (Bell Springs).*

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C. How Sole Proprietors Tax-Report

As far as the IRS is concerned, a sole proprietorship starts the day an individual begins taking in income for goods or services. No IRS licensing or even form-filing is required to start off. A sole proprietorship and its owner (or married couple filing a joint tax return) are one and the same for tax purposes. Here are the tax reporting forms you will have to deal with.

1. Schedule C (or Schedule F, for Farming)

Business income is reported on a separate “schedule” (form) attached to the proprietor’s annual Form 1040 individual tax return. You’ll use either Schedule C or C-EZ, Profit or Loss From Business (Sole - Proprietorship), or Schedule F if your business is farming.

You must file Schedule C if your net income (after deducting expenses) from all sole proprietorship ventures exceeds \$400. But you should file one even if you make less than \$400 or even lose money. One reason for filing is that if you have a loss, it may produce a tax benefit. Also, filing starts the statute of limitations (the period during which the IRS legally can audit you) running. If you don’t report, the IRS has forever to audit you for the business operation.

EXAMPLE: *In December 2000, Sam and Jeannie Smith open Smith’s Computer Sales and Service as a sole proprietorship. The Smiths just about break even that year. Even though they didn’t make or lose money, prudence dictates that by April 15, 2002, they should file their 2001 income tax return, including a Schedule C or C-EZ for the business.*

2. Schedule C-EZ

If you run a tiny side business, you may use a simplified form, Schedule C-EZ. You are eligible if you:

- have gross receipts under \$25,000
- claim less than \$2,500 in business expenses
- have no inventory
- have no employees
- use the cash method of accounting
- don’t claim IRC § 179 or depreciation expenses to write off any assets, and
- don’t have an overall loss in operation.

Most businesses worthy of the name can either claim much more than \$2,500 in business expenses or will not otherwise qualify for Schedule C-EZ. Since it is only a little more effort to fill out a regular Schedule C form, I recommend it in most cases.

More Than One Sole Proprietorship

If you and your spouse operate more than one sole proprietorship, you must file a different Schedule C, or C-EZ, for each business. You might have any number of Cs filed with one tax return if you have your finger in many pies.

EXAMPLE: Jeannie and Sam Smith own Smith's Computer Sales and Service. Besides helping run their business, Jeannie has an Amway distributorship, and Sam buys and sells sports trading cards. The Smiths file one 1040 form, with three Schedule Cs. Since the sports card venture incurs more than \$2,500 in expenses, they must use a regular C form, even though the other, smaller, ventures qualify for the EZ form.

3. How Sole Proprietor Income Is Taxed

Schedule C, line 31, shows the bottom line—profit or loss—from your sole proprietorship. This figure is entered on the front page of your Form 1040 tax return and is added to your income (or losses) from all sources—regular jobs, dividends, capital gains and so on.

After deducting your personal exemptions and itemized or standard personal deductions, the combined income is taxed at your tax bracket range, from 15% to 39.6%. You are also subject to self-employment taxes of 15.3% of the first \$72,600 of your total self-employment income and 2.9% of everything over \$72,600 (1999 rate).

If your business loses money, you can use the sole proprietorship loss to offset your other earnings in that year—say from a regular job. Or, if you don't have enough other earnings, you may carry the loss over to the following year's tax return. If the business makes a profit in a future year, you can use the previous unclaimed business losses to offset it and reduce your taxes.

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D. Estimated Tax Payments

Wage-earners have their income taxes siphoned off by their employer every paycheck. It's not so simple for a sole proprietor who is required by law to make income tax payments, called estimated taxes, four times a year. If you wait until April 15 to pay your taxes, you will incur a penalty for failing to make estimated tax payments. You must make estimated tax payments if you expect to owe at least \$1,000, and any tax withheld will be less than:

- 90% of the tax you'll owe, or
- 100% of last year's tax bill.

To make the quarterly estimated tax payments, use IRS Form 1040-ES. The four equal payments are due on April 15, June 15, September 15 and January 15 (of the following year). Estimated tax payments cover self-employment taxes (better known as SE or Social Security and Medicare taxes) as well as plain old income taxes.

The chief difficulty for most people with estimated taxes is knowing how much to pay. In effect, you must predict how much you will earn for the whole year ahead of time or pay a penalty. To avoid the estimated tax penalty, you should make payments equal to your tax liability for the previous year. For example, if you paid \$5,000 in income taxes in 2000, you should make four estimated tax payments of \$1,250 each during 2001. Tax-preparation software will also tell you how much you should pay each quarter.

Spouse's Self-Employment Taxes

Spouses who co-own a sole proprietorship are taxed as one on income of the business. However, they are treated as two individuals for purposes of self-employment tax (SE). (IRC § 1402 (a)(5)(A), Reg. 1.1402(a)(8).) So a separate SE tax form must be filed—and taxes paid—based on an allocation of each spouse's share of the net income. The allocation should be based on how much each spouse contributed to the operation. Beware: This rule has more significance than just filing another form. Listing your spouse as a co-worker in a sole proprietorship can cost you extra taxes if the business profit exceeds \$80,400 (2001). To save this expense, you might list only one spouse as an owner. The other spouse can be treated as an unpaid "volunteer."

If estimated tax payments are too small or aren't made on time, the IRS will assess an underpayment of estimated taxes penalty. This penalty is currently based on an annual interest rate of 8% of the underpaid amount for each quarter. Skipping quarterly ES payments, waiting to pay in one lump sum with your annual Form 1040 income tax return, may be a costly mistake. You may not have the funds by tax time. And if you don't catch up by paying all the estimated taxes by April 15, the IRS will tack on another tax penalty and interest for paying late.

Most states also require quarterly estimated income tax payments. Get forms and information from your state's tax agency.

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Excerpted from "Tax Savvy for Small Business", by Frederick W. Daily

Chapter 6 – Microbusinesses & Home-Based Businesses

"Of course there's a different law for the rich and the poor; otherwise who would go into business?"
— E. Ralph Stewart

According to Time magazine, big business of the future will consist of a relatively small core of central employees and a mass of smaller firms working for it under contract.

Millions of Americans already operate very small businesses, many of them home-based. Quite a few of these ventures supplement a regular job or another business. Most tax rules are the same whether your business has 500 employees and is based in its own building or it's just you, working alone from home. Nevertheless, a few tax code restrictions are aimed at home-based and other small enterprises that look more like hobbies than businesses to the IRS.

This chapter focuses on sole proprietorships, but most of these principles apply to any type of unincorporated business.

Microbusinesses and Home-Based Businesses In a Nutshell

- 1. Business expenses are deductible no matter where they are incurred. But to deduct part of your home rent or depreciation for a home office, you must meet strict tax law requirements.*
- 2. Losses from home-based and sideline businesses can be claimed against your other income to reduce your overall individual tax bill.*
- 3. If you claim losses from your small business, an IRS auditor may challenge you, saying your business was really a hobby. Defend your business loss by showing a "profit motive."*
- 4. Unless you run the very smallest of businesses, you are responsible for making estimated tax payments and paying self-employment taxes.*

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A. Business Expenses Incurred at Home

Most expenses related to your business are tax-deductible, no matter where they are incurred—at home, on the road or in a traditional office or shop. Tax-deductible home office expenses include: office supplies, materials, professional and trade memberships and dues, travel, business use of your auto, meal and entertainment expenses, insurance premiums for business assets, local and long-distance telephone calls on the home phone (but not the cost of the basic monthly service), maintenance and repair of office computers and other equipment, depreciation (or IRC § 179 write-off) of furniture and other business assets, interest on business debts, employee wages and benefits, publications and software, advertising.

You can claim home-based business expenses without a home-based office. You may deduct all of the above kinds of home-based business expenses whether or not you qualify for the "home office" deduction discussed below.

B. Deducting Part of the Cost of Your Home

If you operate out of your home, you may (or may not) qualify to tax-deduct part of your rent or take a depreciation deduction. This tax break is commonly called the "home office" deduction. Regardless of what you might have heard, the home office deduction is alive and well. About 1.6 million folks claim a home office deduction each year, according to the IRS. Undoubtedly, more people could legally claim the deduction, but don't know how or are scared they will be audited if they do.

A house, apartment, condominium, mobile home, motor home, boat or just about anywhere else with sleeping and cooking facilities can qualify for the home office deduction.

First, you need to know whether or not you qualify to take the deduction at all. If you don't, your housing costs are nondeductible personal living expenses (except for home mortgage interest and real estate tax deductions available to every home owner).

To claim a home office deduction, your home office must be:

- The principal place of your business, and
- A separately identifiable space in your home, and
- Regularly and exclusively used for business.

All three of the rules must be satisfied, and are discussed in detail next. (IRC § 280A.)

1. Principal Place of Business

Determining whether or not your home is the "principal place" of your business is not as simple as it sounds. And if it is not, there's no tax deduction for depreciation or rent.

If your only jobsite is at home, and you spend most of your working hours there, it is your principal place of business. But if you conduct the business at a site outside your home and just bring home work sometimes, the home is not the principal place of business.

EXAMPLE: *Jake, a plumber, works out of his home office. He keeps a full-time employee there to answer phones and do bookkeeping. Jake is working at his home office ten hours a week and in the field 40 hours a week. As of January 1, 1999 he is entitled to a deduction for rent or depreciation, and can deduct all other ordinary business expenses, such as the salary of his employee working at his house.*

Taxpayers Win: Soliman Overturned by Congress!

Beginning Jan. 1, 1999, the Taxpayer Relief Act of 1997 expanded the meaning of principal place of business. Congress undoubtedly recognized the advances in technology favoring the home office and current business trends of downsizing and outsourcing. Now a home office deduction is available if:

- 1. You use the home office to conduct "administrative or management activities" of a trade or business.*
- 2. There is no other "fixed location of the trade or business" where you conduct "substantial administrative or management activities" of the trade or business.*
- 1. You meet the rest of the home office rules discussed below requiring a separately identifiable space and regular and exclusive use.*

So now service providers and professionals, as well as outside sales persons and tradespersons who spend most of their time at job sites, are entitled to the home office deduction.

2. Separately Identifiable Space

Assuming your home is the principal place of your business, let's move on to the second rule. The space in which you work must be separate from the rest of your home to qualify for the home office deduction.

A completely separate structure works best as proof of a legitimate home office to the IRS—for example, a detached garage converted to an office. But many self-employed people just convert a spare bedroom to a legitimate home office by removing the bed and personal items. To pass IRS muster, if your home office is not physically divided by walls, some kind of demarcation should be evident between the business and personal space.

3. Regular and Exclusive Use

If you still qualify, then let's go to the last hurdle. It isn't usually enough to use the home office space occasionally—one or two days a month—for business. The tax code requires "regular" business use, which is, admittedly, vague. If you meet business customers or clients at your home office, it should satisfy the regular use test. Keeping a record of appointments, in case you're ever questioned by an IRS auditor, is wise.

"Exclusive use" is more straightforward. It means you can't use the space for any other reason than business. This eliminates the kitchen table, or the room in which you watch TV with the kids, as your home office. This rule is akin to the "separately identifiable space" rule above.

Don't be afraid of a legitimate home office deduction. Claiming a home office depreciation or rent expense on your tax return increases your audit risk. As described below, a home office deduction is reported on IRS Form 8829, attached to your tax return, so it is easy to spot.

However, even if taking the deduction doubled your chances of audit, statistically, there's only a one in 20 chance of an IRS confrontation. And then, you would lose only if you failed to meet the home office qualifications discussed above. If audited, you will have plenty of time to make sure your home office appears "office-like." Take some photographs of the home office to show the auditor, unless the auditor makes a rare personal visit.

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C. Calculating Your Home Office Deduction

If your home office qualifies, calculate the amounts you are entitled to deduct on IRS Form 8829, - Expenses for Business Use of Your Home. This form is filed with your individual income tax return.

This form is intimidating, taking considerable time and patience to complete. If you don't use Form 8829, and claim the deduction anyway, you risk the wrath of the IRS.

Limitation on your overall home office deduction. The deduction cannot be greater than the profit generated by your home-based business. For instance, if your business made a profit of \$2,700 before taking into account a home office deduction, the deduction can't be larger than \$2,700.

In calculating your home office deduction, first divide the number of square feet used for your home business by your home's total square footage. The resulting percentage of business use determines how much of your rent or depreciation is deductible each year.

Also, if the business use of the home is for less than 12 months, you must prorate to the nearest month. For instance, three months business use means $\frac{3}{12}$ of the home office is deductible.

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D. Self-Employment (SE) Tax

All of your business's net profits are subject to "self-employment" tax, Social Security and Medicare. This is equivalent to the payroll tax for employees of a business. The SE tax is 15.3% on all net self-employment income (after deducting business expenses).

Under current law, your obligation for the Social Security tax stops when your total earned income (from all sources) reaches \$80,400 (2001). (IRC § 1401.) This amount is subject to annual cost of living adjustment. You are subject to tax only on the Medicare portion of the SE tax (2.9%) on all further earned income.

EXAMPLE: *Wing, who is self-employed, earns \$97,700 total this year. The first \$80,400 is taxed at the rate of 15.3% (\$12,301) and the next \$17,300 at 2.9% (\$502), for a total SE tax of \$12,803.*

You are still liable for the SE tax on business income even if you are currently drawing Social Security or Medicare benefits.

Paying self-employment taxes qualifies you for a tax break as well as Social Security benefits. One-half of the SE taxes are deductible. (IRC § 164.) This is not an expense claimed on the business schedule of your tax return. Instead, it is deducted on the first page of your Form 1040 tax return from your total adjusted gross income.

EXAMPLE: *Carol quits her job and operates Carol's Catering as a full-time business. During her first year she makes a profit and pays self-employment taxes of \$1,102. She is in the 28% bracket. Carol can deduct one-half of her SE taxes, \$551. This shaves \$154 ($28\% \times \$1,102 \times 50\%$) off her income tax bill.*

A one-time job may not be subject to SE tax. For example: John, a retired mechanic, took a short-term job—less than a month—installing windows in an office building. The Tax Court held that this did not establish John in a “trade or business,” so he wasn’t liable for the self-employment tax. Of course, the income was subject to income tax, though. (John A. Batok, TC Memo 1992-727.)

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