

2024 Guide to Self-Employed Taxes: Maximize Deductions, Minimize Payments

Being your own boss comes with great rewards, but tax season can be a whole different story. This guide equips you with the knowledge to navigate the self-employed tax landscape in 2024.

Essential Tax Forms:

- **Federal:** Understand forms like Schedule C (Profit or Loss from Business) and 1040 (U.S. Individual Income Tax Return).
- **State & Local:** Check your state and local requirements. Some states have income or sales tax for self-employed individuals.

Classifying Workers:

- **Employee vs. Contractor:** Knowing the distinction is crucial for tax withholding and payroll requirements.

Estimated Tax Payments:

- Avoid penalties by accurately estimating and paying your quarterly tax obligations throughout the year.

Choosing Your Business Entity:

- **Sole Proprietorship, LLC, or S Corporation:** Each has different tax implications. Consider factors like liability protection and tax benefits when making your choice.

Tracking Income and Expenses:

- **Accrual vs. Cash Method:** Understand which accounting method best suits your business.
- **Income Categories:** Keep track of income from various sources, including business revenue, rental income, and capital gains.

Maximizing Deductions:

- **Common Deductions:** Explore deductions for business expenses like retirement plans, home office use, travel, and meals (with limitations).
- **Specific Deductions:** Research deductions specific to your industry.
- **Charitable Donations:** Deduct qualified charitable contributions made throughout the year.

Understanding Tax Credits:

- **Self-Employment Tax (SE Tax):** Learn about the current SE tax rate and explore strategies to minimize its impact, like forming an S Corporation (consult a tax professional for guidance).

Year-End Tax Planning:

- **Review your finances:** Analyze your income, expenses, and deductions to identify tax-saving opportunities.
- **Consider tax-deductible contributions:** Maximize contributions to retirement accounts before deadlines.

Bonus Tips:

- **Keep meticulous records:** Maintain accurate financial records throughout the year for easy tax preparation.
- **Seek professional help:** Consider consulting a tax professional for personalized advice.

Don't let taxes slow you down! This guide provides a solid foundation for self-employed tax management. Remember, tax laws can change, so stay updated and consult a professional for specific situations.

Frequently Asked Questions

What tax do I pay if self-employed?

You pay the **self-employed tax rate** of 15.3% (as of 2022). It's a combination of 12.4% for social security and 2.9% for medicare. If you're employed by someone, usually that amount is split between both parties (the employee and the employer), so you wind up paying 7.65%. This is one of the reasons, we recommend forming an S Corp. An S Corp allows you to assign yourself a reasonable income vs the total net earnings of your business.

Why is self-employment tax so high?

It's less that it's so high and more that the independently operating entrepreneur is in a tough spot. While someone employed pays half and their employer pays half. The entrepreneur is in a unique situation wherein they are both, the employer and the employed.

However, the other reason it's so "high" is because you're able to deduct many expenses. Health insurance, ordinary (and necessary) business expenses, not to mention part of your income if you're an S Corp. It's one of the reasons it's important to [have a plan](#) going into your business.

Who is exempt from self-employment tax?

It's a narrow bracket, but anyone who earns less than \$400/year are exempt from the SE tax. This is part of the reason why the nebulous but *sticking* point of S Corps is in play, i.e. assigning yourself a "reasonable" salary.

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(425) 483-6600

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1.1 Federal, State & Local Tax Returns

Federal Taxes

If your gross self employment income is \$400 or more, you are required to [file a federal income tax return](#). If this income is from a sole proprietorship or single member LLC, you include this activity of Schedule C of your regular form 1040 (due April 15th). If your income is from a partnership or multi member LLC, include the income and expenses on form 1065 (due April 15th). If you have a corporation, file form 1120 (for C Corporations) or form 1120S (for S Corporations) (both due March 15th). Please remember that an LLC can be elect to be taxed as a [C or S corporation](#).

State Taxes

You will also need to file a state tax return. Most states have income tax returns and your self-employment activity needs to be included there, with your other income and deductions. Your income may also be subject to sales tax and various other state taxes. If you call the department of revenue for your state, they can list the state taxes you need to pay. Most states that collect sales tax have adopted a destination based sales tax.

Cities and other Local Governments

Many Cities and other small jurisdictions also have [filing requirements](#). Most cities will require you to get a city licenses in addition to the state license. Other smaller jurisdictions such as counties and school districts may have filing requirements.

Information Returns (1099s)

In the course of your self-employment, if you paid any non-corporate vendor \$600 or more during the year, you must issue them a 1099. You are supposed to mail the 1099 to the vendor by January 31. You then have until February 28 to mail copy A of all the 1099s to the IRS, along with copy A of a single 1096. Form 1096 is a summary of all the 1099s you have issued.

Washington State Requirements

In Washington State, you get a business license by completing the master business license application. The Washington State Department of Revenue requires business and self-employed persons to complete the combined sales/excise return. Your frequency in completing this return initially depends on the business type and projected revenue that you put down on the master business license application. You will be required to complete the return annually, quarterly or monthly—although some very low revenue businesses that do not collect sales tax are put on a non-filing basis.

Tax Tip: Be pessimistic when completing your master business license application and you will [not need to file as often](#).



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Payroll

Life gets more complicated if you have [employees](#). On the federal level, you must file W-2s & W-3, form 940 and form 941. Every quarter you must file a [Federal Employment Tax Return](#) (form 941) with the IRS. The return is due on the last day of the month following the quarter (January 31, April 30, July 31 and October 31). You are allowed to file the return 10 days later if you deposited all payroll tax when due.

Form 941 is used to report total wages, federal income tax withholding, social security tax and medicare tax.

Federal Deposit Requirements

If the total tax due on form 941 is less than \$2,500, you can just send a check along with the return. Otherwise, you must make timely deposits of payroll tax. The IRS will let you know your required deposit schedule. If you are a **monthly depositor**, you must deposit payroll tax by the 15th of the month following the month employees were paid. For example, if payday was on January 15th and 31st, all payroll tax and withholding related to those payrolls is due by February 15th. The relevant date is when the employee is paid not when the pay period ends.

Tip: For monthly depositors, paying employees on the 1st day of the month rather than the last day of the month will give you an extra month to make the payroll deposit.

When your monthly payroll deposit becomes large enough, the IRS will send you a notice that you need to deposit taxes as a **semi-weekly depositor**. Again, the [relevant date](#) is the date employees are paid.

If employees are paid on a Monday, Tuesday or Wednesday, the payroll tax for that payroll is due the following Friday. If employees are paid Thursday through Sunday, the payroll tax for that payroll is due on Monday.

Finally, if payroll tax ever reaches \$50,000, you are required to deposit that tax the following day.

How Much is Form 941 Tax?

Employers must withhold 6.2 percent of each employee’s social security wage as social security tax. Social security wage cannot exceed the wage base which is adjusted for inflation. Employers must also withhold 1.45% of each employee’s medicare wage as medicare tax. The employer is then required to match these amounts as payroll tax. Finally, employers are required to withhold federal income tax from the employee’s gross income in accordance with the tables on Circular E and the employee’s W-4.

The W-4 indicates the [employees filing status](#) (example married) and the number of exemptions the employee claim. Circular E contains different tables for filing status and payroll periods.

How to Deposit Payroll Tax?

You can pay your payroll tax at your bank or you can enroll in EFTPS (Electronic Funds Tax Payment System). Make sure you begin the enrollment process in EFTPS a couple weeks at least before you need to make a tax deposit. The system requires that you use a PIN that is mailed to you.

Payroll – Federal Form 940

The IRS also requires employers to file an annual Federal Unemployment Tax Return (form 940). This form is due on January 31st each year. Form 940 report each employee’s wages up to the wage base which is \$7,000 per employee. The federal unemployment tax is 6.2% of each employee’s wage up to the wage base (\$434 for a single employee that earned at least \$7,000). If you paid your state unemployment tax on time, you will likely earn a credit up to 5.4% of the employee’s form 940 wage. Thus, the form 940 tax would only be \$56 for a single employee that earned at least \$7,000. Form 940 tax can be paid with the return by January 31 so long as the total tax due is less than \$500. Otherwise, you must deposit form 940 tax using the same method used to file form 941 tax (i.e. at your bank or through EFTPS).

Payroll – Federal Form W-2 and W-3

The IRS requires employers to provide each employee a form W-2 by January 31. The W-2 reports the employee’s wage for federal income tax, social security and medicare. It also reports the amount of withholding for each type of tax (income tax, social security, medicare). The employer must provide copy A of all W-2s and with a single W-3 to the IRS by February 28. The W-3 summarizes the information contained on all the W-2s.

State Payroll Forms – Unemployment

Employers must pay unemployment insurance tax on behalf of each employee. Typically, these returns are due on the last day of the month following the end of the quarter (January 31, April 30, July 31 and October 31 – just like form 941). Your tax rate is typically dependant on your industry and your experience rating. If you have many former employees collecting unemployment insurance, your rates will go up.

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1.3 Employee or Independent Contractor

Hiring a Worker?

When [hiring someone](#) to do work for you, it's important to determine whether to hire him or her as an independent contractor or as an employee.

For employees, you must pay and withhold Federal income tax, Social Security and Medicare taxes, Federal Unemployment tax; and you must report their wages, file tax documents, and issue statements (one or more W-2 documents) to the employees themselves.

For independent contractors, generally no withholding is required, although a [1099-MISC](#) may be filed. A 1099-MISC must be filed with the IRS and issued to the worker for wages over \$600.

There are simple common-law rules to determine whether someone is an employee or an independent contractor. Generally, a person who does work for you is an employee if you have control over his or her duties: behavioral control, financial control, and type of relationship. For example, if you can control or direct what is to be done and how, like a maintenance employee with regular hours who handles all landscaping projects during his or her shift, then he or she is most likely an employee.

On the other hand, if you can direct or control only the result but not how it is accomplished, such as hiring a maintenance person to trim the shrubs and mow the lawn weekly, the person is probably an independent contractor.

Another example would be a mail room clerk with a specific shift and access to a company vehicle for deliveries versus a delivery person who makes daily deliveries but keeps his or her own expense records and his or her own vehicle.

Form SS-8

If you are unsure about how to classify a worker, you or the worker can file a form SS-8 with the IRS. That agency will review the facts and circumstances and officially determine the worker's status. Please note that it can take at least six months to get a determination. If you continually hire the same kind of worker, it may be a good idea to file an SS-8 for future reference.

Once a determination is made by the business or by the IRS, you must file the appropriate forms and pay the associated taxes.

Misclassification of Workers

There is no set rule for classifying a worker. So it may seem preferable to simply hire workers as independent contractors, but there can be serious penalties for misclassifying them. If you misclassify a worker as an independent contractor instead of an employee without a reasonable basis, you may be liable for his or her employment taxes and can end up with substantial IRS tax bills. You might also face penalties for failing to pay employment taxes and for failing to file required tax forms.

If, on the other hand, you do have a reasonable basis for not treating a worker as an employee, there may be some relief from having to pay employment taxes for that worker. To get this relief, you must file all required federal information on a basis consistent with your treatment of the worker; and this treatment should be consistent with the treatment of other workers who have performed the same duties since 1977. Publication 1976 (Section 530 Employment Tax Relief Requirements) on the IRS web site has more information about this.

Workers, too, can avoid higher tax bills and lost benefits by being classified correctly. Workers who believe they have been misclassified as independent contractors by an employer can use Form 8919 (Uncollected Social Security and Medicare Tax on Wages) to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. You would be responsible for this amount.

Paying a worker as an independent contractor versus an employee also has important similar implications under state law. Each state may have different laws to determine the appropriate classification. Your state's Office of Employment Security will be able to provide you the information regarding appropriate standard(s) in your state.

This information and more can be found at www.irs.gov in Publications 1779, 15-A and 1776, and on the pages titled "Independent Contractor or Employee".



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1.4 Estimated Tax Payments

Every taxpayer is responsible for the payment of his or her [federal income tax](#) and Social Security and Medicare taxes. These taxes are usually withheld by an employer from an employee's paycheck and reported on his or her W-2, but are not usually withheld from a contractor's income and therefore not reported as [deductions on a 1099-MISC](#) nor are they withheld from the following types of income: interest and dividends, alimony, rent, sale of assets, and prizes and awards. So self-employed persons may need to make estimated income tax payments.

You use estimated tax to pay both income tax and [self-employment tax](#), as well as other required taxes that you report on your tax return. A taxpayer who expects to owe \$1000 or more when he or she files his or her tax return is generally required to make estimated tax payments. The IRS may charge you a penalty if you do not pay enough through withholding or estimated tax payments. And you will be charged a penalty if you do not pay enough by the due date of each payment period, even if you are due a refund for the tax year.

A corporation is generally required to make estimated tax payments if it is expected to owe tax of \$500 or more when its return is filed, and uses [Form 1120-W \(Estimated Tax for Corporations\)](#) to figure and pay the tax. Estimated tax requirements are also different for farmers and fishermen.

You do not have to pay estimated tax provided that: you had no tax liability for the previous tax year which covered a 12-month period; and you were a US citizen or resident for the whole year. Having no tax liability means that your total tax was zero or that you did not have to file an income tax return.

You must pay estimated tax if the following 2 conditions apply: you expect to owe at least \$1,000 in tax for 2010 after subtracting your withholding and credits; and you expect your withholding and credits to be less than 90% of the tax to be shown on your current year's tax return or less than 100% of the tax shown on your previous annual tax return. These percentages may differ for farmers, fishermen and higher income taxpayers.

Use Form 1040-ES (Estimated Tax for Individuals) to figure and pay your estimated income tax. The year is divided into four payment periods for estimated tax purposes. Each period has a [specific payment due date](#), usually on or around the 15th of April, the 15th of June, the 15th of September and the 15th of January.

In order to know the amount of estimated tax to pay, you must reasonably accurately figure your expected adjusted gross income, taxable income, taxes, deductions, and credits for the year. It may be helpful to use your last tax year's tax return to help calculate this year's income, deductions, and credits. If at any time you realize that you have estimated your earnings too high, simply complete another Form 1040-ES worksheet to figure out your estimated [tax for the next quarter](#). If you realize your earnings have been estimated too low, you should likewise complete another 1040-ES worksheet to [recalculate your estimated taxes](#) for the next quarter. You should estimate your income as accurately as possible in order to avoid penalties. You must make adjustments for changes in both your own situation and current tax law(s).

Estimated tax can be paid by check or money order using the Estimated Payment Voucher. Or you can pay it electronically using a credit card, debit card, Electronic Funds Withdrawal, or [Electronic Federal Tax Payment System \(EFTPS\)](#). Using the EFTPS system is an easy way to pay your business(es)' federal taxes. There is an option of paying the tax weekly, bi-weekly, or monthly, as long as you have paid enough in by the end of the quarter. This system also allows you to access a history of your payments, so you know when you paid them and how much you paid.

As with federal income tax, there are similar regulations regarding the timely payment of each state's income tax (if any) through estimated tax payments. Your state's department of revenue should be able to answer any questions you might have.

Additional information can be found at www.irs.gov in [Publication 505 \(Tax Withholding and Estimated Tax\)](#).



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2.1 Entity Choice: S Corp, C Corp, or LLC

Question: I have a services-based business in the Seattle-Bellevue area with three employees. What type of entity should I adopt in order to minimize my tax obligations? S Corp, C Corp, or LLC? Right now, I am a sole proprietor. My previous tax accountant said I would save money as a limited liability company (LLC).

Answer: As a sole proprietor, 100% of your profits are subject to [self-employment taxes](#). The self-employment tax is 15.3% of all profits up to \$137,700 ([for 2020](#)).

Owners of [limited liability companies](#) (LLCs) who are active in the company operations are generally subject to the same self-employment tax.

Your business can reduce its self-employment tax obligation by creating an S-corporation. S Corp profits are not subject to employment taxes. The owners' wages, however, will be subject to employment taxes like any other employee.

Many S-corporation owners don't pay wages to themselves for this reason. They take profit distributions only, thereby avoiding all employment taxes. These taxpayers are at risk of paying penalties if [audited by the IRS](#). The IRS requires that S-corporation owners who operate their business pay themselves a "reasonable wage."

Now you realize that you can maximize your tax savings by creating an S-corporation and paying yourself the smallest wage that qualifies as "reasonable." So what is reasonable? The IRS does not give specific figures. Also, there is very little case law to provide guidance by example. There are numerous factors to [determine a reasonable wage](#).

Courts would look at the work done by the owner compared to other persons performing similar duties. Courts will also look at the capital contribution by owners. If profits are attributable to capital investments rather than the owner's efforts, then there needs to be a greater allocation of profit distribution. Also, if profits are attributable to the leverage offered by employees, rather than the owner's professional services, then (again) there needs to be a greater allocation of profit distribution.

Assuming that \$50,000 per year is a reasonable salary, you could save \$9,451 in employment taxes by creating the S-corporation and paying yourself this wage from the \$200,000 profit.

Call us if you need advice from a good tax accountant. We serve [Seattle](#), [Bellevue](#) and the surrounding area.

For some fast insights, visit our [self-employed tax calculator](#) page.

Frequently Asked Questions

What is the difference between C Corp and S Corp?

C corporations pay taxes on their income plus whatever income you receive as an owner of a company. Meanwhile, S Corp are more versatile in that you only need to report business income. This enables you to deduct up to 20% of your income.

S Corps tend to be scrutinized much more by the IRS whereas C Corps are effectively double taxation. C Corp tends to hurt smaller companies, making it less ideal. But because S Corp is more scrutinized, it's worth working with a CPA to make sure you're doing it right.

Why would you choose an S Corporation?

One of the main reasons to transition from a sole proprietorship to an S Corp is your personal assets are protected. Knock on wood, but if a client were to sue you as a sole proprietor, you could wind up losing a lot more than your business. By changing your entity to an S Corp, you keep your personal assets safe from litigation.

Is LLC or S Corp Better?

If you have more than one person running the company, then an S Corp would be ideal as everyone receives tax benefits, not to mention dividends: it's a win/win. An LLC provides some protection from litigation and tend to be taxed better than a sole proprietorship (or C Corp), but the business practice is far more simple. In other words, the laws an LLC must abide by are much more loose whereas to qualify as an S Corp, there's a few more terms and conditions.



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2.2 Determining Reasonable Compensation for S Corp Owners

For businesses structured as [S corporations](#), one critical area that demands careful consideration is the compensation paid to owner-employees. The Internal Revenue Service (IRS) closely scrutinizes this aspect to ensure that corporations do not attempt to avoid employment taxes by disguising compensation as distributions or loans.

S corporations are pass-through entities, meaning that their income, losses, deductions, and credits are passed along to shareholders, who report and pay taxes on this income at their individual tax rates. However, the IRS has consistently held that payments made to corporate officers for services rendered should be treated as wages subject to employment taxes, regardless of their shareholder status.

The Reasonable Compensation Requirement

The IRS requires S corporation owners who perform more than minor services for the business to receive reasonable compensation in the form of wages. This compensation is subject to federal employment taxes, including FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act), and federal income tax withholding.

Determining what constitutes “reasonable compensation” can be a complex task, as there are no specific guidelines provided by the IRS. Instead, various factors are considered, such as the owner-employee’s duties, responsibilities, qualifications, time spent on the business, wages of non-shareholder employees performing similar services, and any legal agreements or formulas used for calculation.

Navigating the Complexities

One area that adds complexity to the reasonable compensation issue is the treatment of health and accident insurance premiums paid by the S corporation for owner-employees. If an owner-employee owns more than 2% of the corporation, these premiums are deductible by the S corporation as benefits and must be reported as wages on the owner-employee’s Form W-2. However, they are not subject to Social Security, FICA, or FUTA taxes.

Additionally, owner-employees may be eligible for an adjusted gross income (AGI) deduction for medical care premiums paid during the year, provided the medical care coverage is established by the S corporation and in its name, or the corporation either paid or reimbursed the owner-employee for the premiums and reported that amount as wages on their W-2.

Ensuring Compliance and Avoiding Penalties

Failure to properly report and pay employment taxes on reasonable compensation can result in substantial penalties and interest charges from the IRS. It is crucial for S corporations to seek professional guidance from experienced tax advisors to ensure compliance with the reasonable compensation requirements.

Tax professionals can assist in determining the appropriate level of compensation based on the specific circumstances of the business and owner-employees, as well as ensuring proper reporting and payment of employment taxes. By proactively addressing this issue, S corporations can avoid potential conflicts with the IRS and maintain a clean tax record.

In the world of S corporations, reasonable compensation is not just a formality – it’s a legal obligation that demands careful attention and adherence. By understanding the nuances of this requirement and seeking expert guidance, S corporation owners can navigate this complex area with confidence and ensure fair play in their tax compliance efforts.

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3.1 Accrual Vs Cash Method

Each taxpayer must figure out their [taxable income](#) on an annual accounting period called a tax year. The calendar year is the most common tax year, but others are the fiscal year and the short tax year. Each taxpayer must use a consistent set of rules for [reporting income and expenses](#).

The most commonly used accounting methods are the **cash method** and the **accrual method**.

You can account for business and personal items using different methods. Business expenses, for instance, are not deductible until the tax year they are reported in.

The accounting method you choose when you file your business’ first tax return should reflect your business’ income and expenses. You must continue to use the same accounting method every year. You do not need IRS approval to choose the method, but you do need IRS approval to change your accounting method in a later year.

In general, you must file a current Form 3115 to request this change. If you do not use an accounting method that clearly reflects your income, the IRS will choose a method and refigure your income under that method. IRS approval is not required for the correction of a math or posting error; you can correct such an error by filing an amended return.

The Cash Method

Most individuals and many [small businesses](#) use the cash method of accounting. Using this method, you generally report income for tax year in which it occurs. If you [receive property and services](#), you must include their fair market value (FMV) in your gross income. Income is considered constructively received when an amount is credited to your account or made available to you without restriction, not necessarily when you take possession of it. If you authorize someone to receive income for you, you are considered to have received it when that agent receives it. You cannot hold checks or postpone taking possession of similar property from one tax year to another to postpone or avoid paying tax on the income.

Under the cash method, generally, you also [deduct expenses](#) in the tax year in which you actually pay them, regardless of whether or not you are contesting the liability of those expenses. You can deduct expenses paid in advance only in the applicable year, unless the expense qualifies for the 12-month rule.

Under the 12-month rule, amounts for certain benefits for the 12-month period right after payment, or if the benefits expire at the end of the following tax year are deductible. For example, if you pay \$1000 on September 1st of 2020 for a business insurance policy that is effective for only one year beginning on that date, the 12-month rule applies and the full \$1000 is deductible in 2020.

The following businesses cannot use the cash method: a tax shelter, a corporation, a partnership with a corporation (other than an [S corporation](#)) with average annual gross receipts over \$5 million. A qualified personal service corporation (PSC) is exempt from this requirement and can use the cash method. Consult the IRS if you are unsure whether or not your business falls under this category.

Businesses With Inventory

Tracking inventory is necessary to clearly show an income that depends on the production, purchase, or sale of merchandise. To figure your taxable income, you must know the value of your inventory at the beginning and end of each tax year. You need a method for identifying and assigning a value to the items in your inventory. Not all businesses use the same rules and methods. The ones you use must clearly reflect your income and expenses and be consistent from year to year.

Generally, **you must use an accrual method of accounting for your purchases and sales if you account for inventory in your business**. However, some taxpayers can use the cash method of accounting even if they produce, purchase, or sell merchandise and account for inventory.

An individual taxpayer qualifies to do so if his or her average annual gross receipts for each test year are \$1 million or less. Eligible businesses include those that provide services and property incidental to those services, and those that fabricate or modify tangible personal property upon demand according to customer design or specifications (such as building contractors). Businesses other than mining, manufacturing, wholesale or retail trade or information industries may also qualify.

The Accrual Method

Under this method of accounting, you generally report income in the year earned and deduct expenses in the year incurred, regardless of when the money actually changes hands. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

Under an accrual method of accounting, you generally deduct an expense when both the following apply: the all-events test has been met (meaning that all conditions relating to the liability have occurred); and economic performance has occurred (property or services paid for have been provided or used).

Other liabilities for which the matching requirement is considered to have been met as payments are made include: taxes, workers’ compensation, violations of law, rebates and refunds, awards, insurance, and warranty and service contracts.

As in cash accounting, an expense you pay in advance is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule. If you have employees that earn and accrue vacation pay, you can take a current deduction for it if you pay it during the year or 2½ months after the end of the year. If you pay it later than that, it must be deducted in the year actually paid.

Gross income is generally reported in the tax year in which all events that fix your right to receive it have occurred and you can reasonably accurately determine the amount. You report a gross income amount on the earliest of the following dates: when you receive payment, when you earn the income, or when the amount is due to you.

If you estimate an income amount and the exact amount turns out to be different, take the difference into account in the tax year it is noted. If you perform services for a basic specified contract rate, you must accrue the income at that rate even if the payments are at an agreed-upon reduced rate. Continue this procedure until you complete the services, then account for the difference.

Recurring items are allowed to be treated as incurred during the tax year even though economic performance has not occurred. This exception applies if it occurs either 8½ months after the close of the year, or the date you file a timely return (including extensions) for the year, whichever is earlier.

Generally, advance income for services to be performed in a later tax year are reported as income in the year you receive the payment. However, if you receive an advance payment for services to be performed by the end of the next tax year, you can elect to postpone reporting the income until the next tax year. However, you cannot postpone any income beyond the end of the following tax year, even if you are to perform services after that date. In the case when receiving a payment one tax year and shipping the goods the following tax year, you can report the income in either year.

Advance income received from property you sell, lease, build, install, or construct can be postponed, including income received incidental replacement of parts or materials. However, this applies only if there is no service agreement. Generally, you cannot postpone reporting income you receive under a guarantee or warranty contract. However, you cannot postpone reporting income from prepaid rent. Rent does not include payment for the use of a room or other space when a significant service is also provided for the occupant, such as a hotel or other lodging.

Any advance income you include on your tax return for the year must not be less than income reported for that year in all other financial reports and statements, such as those to shareholders, partners and beneficiaries.

Additional information can be found at [www.irs.gov](#) in [Publication 538 \(Accounting Periods and Methods\)](#).

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3.2 Gifts & Donations

In regards to gifts, generally, there’s a limit of \$25 given to each person during your tax year. A gift to a customer’s family member is considered to be an indirect gift to that customer, unless you have a separate independent business connection with *that* person.

You and your spouse are treated as one taxpayer. So even if you run separate businesses, gifts given by either of you are treated as having been given by one taxpayer.

Incidental costs (such as packaging or mailing) that do not add value to the item are not included in the determining the cost of the gift for the purposes of the \$25 limit.

Items that cost less than \$4, that have your name engraved permanently on them, and are regularly handed out (such as pens or other desktop items) are not considered gifts. Neither are promotional materials (such as display cases) considered gifts.

Entertainment

An item that can be considered a gift or “entertainment” is usually considered entertainment. Packaged food to be consumed at a later date is treated as a gift. Tickets to a theater performance or sporting event which you do not attend with the customer can be treated as either a gift or entertainment, and you can change that treatment later by filing an amended return if you desire. If you go with the customer to the event, however, you must treat the cost of the tickets as an **entertainment expense**, not a gift.

Donations

Donations your business makes to a [qualified charity](#) (such as houses of worship or government agencies) can be deducted on your tax return. Most organizations will be able to tell you if they qualify. The deduction is made the year the donation is made, even if the check clears or the credit card bill is paid the following year.

For deductions regarding the donation of any amount of money, a taxpayer must have proper documentation. This can be a bank record such as a cancelled check or credit card or bank statement, or a written communication from the charity. The record(s) should show the name of the charity and the date and amount of the donation.

For donations of less than \$250, you will need only your own documentation. For donations of at least \$250 but not more than \$500, you will need a written acknowledgement from the charity at the time of the donation. This statement must include the name of the charity, a description of the donation, and the fair market value of the item(s) less any goods or services given in exchange.

Donations other than cash (such as furniture and electronics) must be in good condition or better to be deductible. If you include a qualified appraisal with your tax return, however, donations for which you are claiming a deduction of more than \$500 do not have to meet this standard.

For a donation of items having a value of more than \$500, you will need to attach a Form 8283 (Noncash Charitable Contributions) to your tax return.

If you claim a deduction of more than \$500 for the donation of a vehicle, you will need to attach the following documents to your tax return:

- Copy B of [Form 1098-C](#) (Contributions of Motor Vehicles, Boats, and Airplanes);
- Section A of [Form 8283](#) (Noncash Charitable Contributions);
- A written acknowledgment from the charity that includes your name and taxpayer identification number, the vehicle identification number, the donation date, and a an estimate of the fair market value of goods or services you received from the charity in exchange for the donation (if any).

If you claim a deduction of more than \$5,000 for the car or other donation, you will need to complete Section B of [Form 8283](#), which generally requires an appraisal by a qualified appraiser, instead of Section A.

It is necessary to obtain and keep evidence of your car or other donation and be able to substantiate its fair market value. Generally the amount you can deduct is equal to the gross proceeds of the sale of the item instead of the fair market value. For donations with a value of over \$5000, you will need a written acknowledgment by a qualified appraiser. Do not attach this evidence or any appraisals to your tax return; keep them with your records to substantiate all of your donations.

This information and more can be found at www.irs.gov in Publication 463 (Travel, Entertainment, Gift, and Car Expenses) and Publication 526 (Charitable Contributions).



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3.3 Running a Rental

Generally, you report income and deduct expenses related to real estate rental property on a [Schedule E](#). Rental income can be cash or the fair market value of property you receive in exchange for the use or occupation of your own property. If you partially own a rental property, report your percentage of the rental income from it. If you sometimes use your rental property for personal purposes, divide your expenses between [rental and personal use](#). There are special rules relating to the rental of property that you also use as your main home or your [vacation home](#).

If you use the [cash method of accounting](#), you report the income for the tax year in which it is received and deduct expenses in the year they are paid. This includes any rent you receive in advance. You cannot deduct uncollected rents as an expense because the rents have not been reported as income. If you use an accrual method of accounting, report the income when you earn it. Uncollected rent may qualify as a business bad debt deduction if you use this method.

A payment to cancel a lease is also considered rental income. However, a security deposit is not considered income if you plan to return it to the tenant at the end of the lease. But if any of it is kept due to damaged property or a broken lease, this money is taxable income to be reported when assessed. A deposit to be used as the tenant’s final month’s rent is reportable when received, not when applied to the last month’s rent.

You can deduct your ordinary and necessary expenses for managing, conserving, or [maintaining rental property](#) from the time you make it available for rent. If a property held for rental purposes is vacant, you may still be able to deduct these expenses until it is rented. However, you cannot deduct any loss of rental income for the period the property is vacant. If you sell property you held for rental purposes, you can deduct the same expenses you would ordinarily deduct until the property is sold.

Deductible expenses can include depreciation, insurance, taxes, interest, repair costs, maintenance and other operating expenses including rental equipment. The following is a short list of other common expenses:

- advertising
- commissions
- legal fees
- local transportation
- travel expenses

Mortgage points (also called loan origination fees or premium charges) are prepaid interest. These are generally not wholly deducted in the year paid, but over the term of the loan. Certain mortgage expenses such as mortgage commissions, abstract fees, and recording fees, are capital expenses and can be amortized over the life of the mortgage.

Repairs and Improvements

It is important to keep separate the costs of your repairs and improvements. Repairs keep your property in good operating condition but do not materially add to the value of your property, substantially prolong its life, or prepare it for other uses. Examples of repairs are repainting walls or fixing broken windows or plumbing. Repair costs can be deducted as rental expenses.

Improvement costs, on the other hand, must be capitalized. They can generally be depreciated as if the improvement were separate property. For example, the cost of a new roof is an improvement. And if you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Examples of improvements are generally obvious, such as storm windows, heating and insulation, septic tanks, security systems, swimming pools and landscaping, and room additions. Some examples are not so evident, such as flooring or wall-to-wall carpeting. For example, replacing an already existing carpet might be considered a repair or even a casualty loss depending on the reason for the replacement.

Use Form 4562 to report depreciation of your acquisitions and improvements in order to recover some of your original costs, beginning the year in which they occur. If you use your personal vehicle for rental activities, you can deduct the expenses using the actual expenses or the standard mileage rate; keep accurate records and report these expenses on Form 4562, as well.

Additional information can be found at www.irs.gov in [Publication 527 \(Residential Rental Income\)](#), Publication 535 (Business Expenses), [Publication 946](#) (How To Depreciate Property), and [Topic 415](#) (Renting Residential and Vacation Property).



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3.4 Capital Gains and Losses

Almost everything owned and used for personal or investment purposes is a **capital asset**. Capital assets include but are not limited to:

- homes,
- household furnishings,
- stocks and bonds.

When you sell a capital asset for more than your basis (usually what it cost you), you have a capital gain. If you sell it for less, you have a **capital loss**.

You must report all capital gains on a Schedule D. You may deduct capital losses only on **investment property**, not on property held for strictly personal use such as a car or a home (unless they **qualify as business property**).

If you sell the property after owning it for over a year, your capital gain or loss is long-term. If you have held the property a year or less, your capital gain or loss is short-term.

If your capital losses exceed your capital gains, the excess can be deducted on your tax return and used to reduce your other income, such as wages, up to an annual limit of \$3,000 (or \$1,500 if you are married filing separately). If your total net capital loss is more than the yearly limit, you can carry over the unused portion and treat it as if you incurred it in the next tax year. If your loss continues to exceed future annual limits, you can continue to carry the excess loss forward to later years. Use the Capital Loss Carryover Worksheet to figure the amount to be carried forward.

The tax rates for net capital gain are generally lower than the tax rates that apply to other kinds of income. Currently, the capital gains rate for most people is 15%, but may be 0% on some or all of the net capital gain for taxpayers with lower incomes. Three exceptions to the lower tax rate(s) are as follows:

- **a gain from selling** qualified small business stock is taxed at a maximum 28% rate;
- **net capital gain from selling** collectibles (such as coins or art) is taxed at a maximum 28% rate;
- and the capital gain resulting from having to recapture depreciation from **the sale of real property** may be taxed at up to a maximum of 25 percent.

Additional information can be found at www.irs.gov in Publication 550 (Investment Income and Expenses), [Publication 544](#) (Sales and Other Dispositions of Assets), and [Publication 523](#) (Selling Your Home).



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3.5 Miscellaneous Income

Generally, all income received in the form of money, property or services are to be reported as [taxable income](#). This naturally includes wages, salaries, interest, dividends, tips and commissions, as well as income from the sale of product or merchandise. However, other forms of income can include but are not limited to: [cash or credit](#) earned from a side business or businesses; [barter exchanges](#) of goods or services; and royalties, awards, prizes, contest winnings and gambling proceeds.

All income earned through business as an [independent contractor](#) or from informal side jobs is self-employment income. No amount of income may be excluded from your gross income, even if you do not receive a [1099-MISC](#) or a W-2. You must report the income and may deduct expenses from each business on a separate Schedule C. It should not be reported as Other Income on your tax return. You will need to prepare a Schedule SE for [self-employment taxes](#) if the net profit from these businesses exceeds \$400 during your tax year.

The fair market value of property or services exchanged, or bartered, is fully taxable and must be reported as income by both parties at the time received. Generally, the cash value of prizes or awards won in a drawing or other event must be reported as taxable income. This includes the fair market value of merchandise or products won, such as cars and trips.

Likewise, if you receive fringe benefits in connection with the performance of your services, they are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. You are considered to be the recipient even if the benefit or gift is given to another person, such as your spouse or child or other family member.

Gambling winnings (such as from raffles and horse races) are also fully taxable, even if a W-2G is not issued. Royalties from copyrights, patents, and oil, gas and mineral properties are taxable as ordinary income, and are generally reported on Schedule E (Supplemental Income and Loss), but may also sometimes be reported on the Schedule C of your business.

A partnership shareholder may receive a distributive share of the partnership's income, gains, losses, deductions, and credits. Your share of these items must be reported on your income tax return whether or not is actually distributed to you. However your losses for the year are limited to your interest in the partnership for that applicable year. A partnership generally pays no tax but must file an informational return on Form 1065 (U.S. Return of Partnership Income) showing the partnership's annual operations and the items passed through to its partners.

Additional information can be found at www.irs.gov in [Publication 525 \(Taxable and Nontaxable Income\)](#).



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4.1 General Business Deductions

Expenses related to carrying on your trade or businesses are [generally deductible](#) if the business is operated to make a profit. To qualify as a deduction, a business expense must be reasonable and “ordinary and necessary”.

An **ordinary expense** is common and accepted in your trade or business. A **necessary expense** is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary.

Separate Business & Personal Expenses

It is important to separate your business expenses from other expenses such as personal expenses. Generally, you cannot [deduct your personal expenses](#). However, if an expense for something used for both personal and business purposes, you can deduct expenses related to the business portion of its use. For example, if you borrow money and use three quarters of it for your business and the other quarter for personal use, you can deduct three quarters of the interest paid that tax year as a business expense.

Costs and Capital Expenses

Costs related to your investment in your business must also be treated differently than business expenses. [Capital expenses](#) are considered assets and must be capitalized rather than deducted. There are generally three types of costs that are capitalized:

- business start-up costs related to creating or acquiring an active trade or business (including franchise fees);
- business assets including equipment and land;
- and improvements to your business.

Another set of expenses that should not be included in your business deductions are expenses for the cost of goods sold. Businesses that manufacture products or purchase them for resale must value inventory at the beginning and end of each tax year to determine the cost of goods sold. This cost is deducted from gross receipts to figure the gross profit for the year. Cost of goods sold expenses include:

- the costs of raw materials and their storage and transportation;
- direct labor to produce the product(s);
- and factory overhead.

These expenses have already been deducted and therefore cannot be deducted again as a business expense.

The uniform capitalization rules indicate that the direct costs and part of the indirect costs for certain production or resale activities must also be capitalized. This rule does not apply to personal property acquired for resale for taxpayers with an average gross income of less than \$10 million for the preceding 3 tax years.

The following are some of the most common types of business deductions:

- Business Use of Your Car & Home;
- Employees’ Pay;
- Retirement Plans;
- Rent Expense;
- Interest, Taxes and Insurance.

Some other less common types of expenses qualify as deductions. For example, bad debts directly related to sales or services provided by your business and previously reported as income qualify as business deductions.

Note however, that if such an expense is deducted but the amount is subsequently recovered, that amount must be then considered as income for the tax year in which it was collected. Other qualified business expense deductions include [amortization](#) of the costs of pollution-control facilities, research and experimentation, other intangibles including goodwill, and Gulf Opportunity Zone clean-up costs.

Additional information can be found at www.irs.gov in Publication 535 (Business Expenses).



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4.2 Retirement Plan Deductions

As a [sole proprietor](#) you are also able to set up a qualified retirement plan for yourself and your employees. There are tax incentives for employers that establish and maintain qualified [retirement plans](#) such as: Simplified Employee Pension (SEP) plans; Savings Incentive Match Plan for Employees Individual Retirement Account (SIMPLE IRA) plans; and other qualified plans (also called H.R. 10 plans or Keogh plans when covering self-employed individuals), including 401(k) plans.

One tax incentive is that you can deduct contributions you make to the plan for yourself and your employees from your gross income on your federal income tax return. You can also deduct additional trustee fees not covered by contributions. Limits apply to the amount deductible; for example, it cannot be more than half your [self-employment tax](#) calculated on Schedule SE. The maximum compensation used for figuring contributions and benefits is currently \$245,000.

Special rules apply to the use of retirement funds by qualified individuals who suffered an economic loss as a result of the Kansas and Midwestern disasters. See Publication 4492-A (Information for Taxpayers Affected by the May 4, 2007, Kansas Storms and Tornadoes) and Publication 4492-B (Information for Affected Taxpayers in the Midwestern Disaster Areas) at www.irs.gov for more details if this may apply to you.

SEP Plans

SEPs provide a simplified method for you to make contributions to a [retirement plan](#) for yourself and your employees. Instead of setting up a profit-sharing or money purchase plan with a trust, you can adopt a SEP agreement and make contributions directly to a traditional individual retirement account or a traditional individual retirement annuity (SEP-IRA) set up for yourself and each eligible employee.

You can deduct up to 25% of all participants' compensation, provided that you make contributions by the due date of your tax return (including extensions). Your eligible contributions are the smaller of \$49,000 or 25% of each participant's compensation, and you can set up the plan anytime up to the due date of the employee's tax return.

If the SEP is maintained on a calendar year basis, you deduct the yearly contributions on your tax return for the year within which the calendar year ends. If you file your tax return and maintain the SEP using a fiscal year or short tax year, you deduct contributions made for a year on your tax return for the applicable year.

SIMPLE Plans

Generally, you can set up a SIMPLE plan if you had 100 or fewer employees who received at least \$5,000 in compensation last year. Under this plan, employees can choose to have contributions deducted from their wages and you contribute matching or non-elective contributions. The current limit on salary reduction contributions is \$11,500. There are two types of SIMPLE plans: the SIMPLE IRA plan and the SIMPLE 401(k) plan.

You may deduct contributions made to this kind of plan as long as each contribution is made within 30 days of the applicable month's end. There is an annual limit of 3 salary reduction contributions. Matching or non-elective contributions must be made by the due date of your income tax return ([including extensions](#)).

An employee can make a salary reduction contribution up to \$11,500, \$14,000 if he or she is 50 years old or older. An employer can make either dollar-for-dollar matching contributions, up to 3% of each employee's compensation, or fixed non-elective contributions of 2% of each employee's compensation. Your eligible deduction amount would be the same as your contribution amount.

This kind of plan can be set any time between the beginning of the calendar year and the 1st of October. If you are starting your business after this date, you can set up the plan and start making contributions as soon as administratively feasible.

Qualified Plans

The qualified plan rules are more complex than the SEP plan and SIMPLE plan rules, but there are advantages such as increased plan flexibility and increased contribution and deduction limits.

Under a 401(k) plan, employees can have you deduct contributions from their wages before tax (after tax in the case of a Roth IRA). These amounts and the earnings on them are generally tax free until plan distributions are received.

Contributions for a Defined Benefit Plan must be paid in quarterly installments and are due 15 days after the end of each quarter. The maximum amount contributed must be the smaller of \$195,000 or 100% of the participant's highest 3-year average compensation. Your deduction is based on actuarial assumptions and computations. The plan must be set up by the end of the tax year.

Contributions to a Defined Contribution Plan must be made by the due date of your income tax return (including extensions). An employee can contribute elective deferrals up to \$16,500 or \$22,000 if age 50 or over. An employer can contribute by money purchase or profit sharing in the maximum amount of the lesser of \$49,000 or 100% of the participant's compensation. Your deduction can be up to 25% of all participants' compensation plus the amount of elective deferrals made. This plan can be set up anytime by the end of the tax year.

Please Note: Participants who are age 50 or over at the end of the calendar year can make catch-up contributions in addition to elective deferrals and salary reductions. The catch-up contribution limitation is currently \$2,500 for SIMPLE plans and \$5,500 for other plans. And certain plans subject to Department of Labor rules may have an earlier due date for salary reduction contributions and elective deferrals.

Tax Credits

In addition to being eligible to make tax return deductions, retirement plan participants (including self-employed individuals) who make contributions to their plan may qualify for the retirement savings contribution credit. The credit is based on a maximum contribution of \$2,000. Use Form 8880 (Credit for Qualified Retirement Savings Contributions) to calculate the credit.

Another [tax credit](#) may be claimed for part of the ordinary and necessary costs of starting a SEP, SIMPLE, or qualified plan. This credit equals 50% of the cost to set up and administer the plan and educate employees about it, up to \$500 per year for each of the first 3 years of the plan (including, if you wish, the tax year before the tax year in which the plan becomes effective). In order to be eligible to claim this credit, you must have had 100 or fewer employees who received at least \$5,000 in compensation from you for the preceding year, and at least one participant must be a non-highly compensated employee. Also, the participants of this new plan generally cannot be substantially the same employees in plans administered by you or your company for whom contributions were made or benefits accrued within the previous 3 years.

This credit is part of the [general business credit](#), and can be carried backward or forward to other tax years if it cannot be used in the current tax year. If you elect to take the credit for a certain tax year, you cannot deduct the part of the startup costs equal to the credit claimed for that year. Use Form 8881 (Credit for Small Employer Pension Plan Startup Costs) to take this credit.

Additional information can be found at www.irs.gov in [Publication 560 \(Retirement Plans for Small Business\)](#), Publication 590 (Individual Retirement Arrangements, IRAs), Publication 575 (Pension and Annuity Income), and Publication 571 (Tax-Sheltered Annuity Plans, 403(b) Plans).



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4.3 Home Office Deductions

If you use your home or part of it for your business, you can deduct qualified expenses for the [business use of your home](#). These expenses may include mortgage interest, insurance, utilities, repairs, and depreciation. The home office deduction is available for homeowners and renters, as well as for any kind of structure including apartments and mobile homes.

You also may take deductions if you [rent out your residence](#). In order to qualify, this part of your home must be used exclusively and regularly as your principal place of business or a place to meet or deal with patients, clients or customers in the normal course of your trade or business. This portion also qualifies if it is a separate structure, not attached to your home.

(An exception for qualified daycare providers and the storage of business inventory or product samples requires regular use but not exclusive use of the property.)

First, you must determine that your home is the principal place of your trade or business. This would be where your most important activities are performed and most of your time is spent. For example, if you have an office elsewhere where you keep regular hours but use a portion of your home occasionally for business, you cannot [deduct the expenses](#) for your home. Nor can you deduct business expenses for any part of your home that you use for both personal and business purposes, nor for portions of your home with random pieces of business equipment.

In order to figure out how much to deduct, figure the entire amount of expenses attributable solely to the portion of the home used in your business, and the percentage of your home used for business. This percentage may be figured by dividing the number of square feet used for business by the total square feet in your home, or by dividing the number of rooms used for business by the total number of rooms in your home (if they are all about the same size). Then apply this percentage to the total of each expense. The remaining amount of expenses such as [real estate taxes](#) and mortgage interest can be carried over to your Schedule A, if you itemize such deductions on your tax return. Qualified daycare providers who do not use any area exclusively for daycare can use as a percentage the ratio of the number of hours of daily use.

Your deduction cannot result in a business loss. Your home business expenses are limited and cannot be less than your income. However, some expenses such as mortgage interest, taxes, casualty losses that cannot be deducted because of the gross income limitation can be carried forward to the next year, and will be again subject to the deduction limits for that year.

Deductible expenses for the business use of your home include but are not limited to the business percentage of real estate taxes, deductible mortgage interest, rent, casualty losses, utilities, insurance, depreciation, and maintenance and repairs. In general, lawn care expenses are not deductible. If you do claim depreciation deductions, you should also be aware of depreciation recapture rules when you sell your assets at a later date.

Additional information can be found at www.irs.gov in Publication 587 (Business Use of Your Home), and Form 8829 (Expenses for Business Use of Your Home).



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4.4 Renting a Building to Your Business

Ordinarily, if you actively participate in a normally passive [rental real estate](#) activity such as renting out a building, you can deduct up to \$25,000 of nonpassive loss from your income for that activity. This is a special exception to the general rule of disallowing losses in excess of income from passive activities or from renting out personal property. You can thereby also [offset the taxes](#) you would have paid on this lost amount.

If you rent a building to your business however, you may not be renting the building to make a profit. The general rule for presumption of profit entails your rental income exceeding your [rental expenses](#) for at least 3 years out of a period of 5 consecutive years. If this is not the case, you can deduct your rental expenses only up to the amount of your rental income. You cannot deduct a loss or carry forward to the next year any rental expenses that are more than your rental income for the year.

Report your not-for-profit rental income as “Other Income”. If you itemize your deductions, you can include your mortgage interest and any qualified mortgage insurance premiums, real estate taxes, and casualty losses on the appropriate lines of Schedule A. Your other [rental expenses](#) may be claimed as [miscellaneous deductions](#), subject to the limit of being over 2% of your adjusted gross income. You can report your state or local real estate taxes on Schedule L if you do not itemize your deductions.

Additional information can be found at www.irs.gov in [Publication 527 \(Residential Rental Income\)](#), [Publication 535 \(Business Expenses\)](#), [Publication 925 \(Passive Activity and At-Risk Rules\)](#), [Publication 334 \(Tax Guide for Small Business\)](#).



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4.5 Travel Expenses

Similar to other [costs of doing business](#), you can claim income tax deductions for any travel expenses you personally incur in order to service your customers. However, it’s important to plan your trips so that you can maximize your deduction. You can only deduct your travel expenses if they are ordinary in nature and necessary for servicing the customer. Costs one could consider extravagant or lavish do not qualify for the deduction. While not guaranteed, the following types of travel expenses are usually deductible:

- [Transportation costs](#) incurred while travelling from your personal home to the client site
- Fuel and other automotive costs you pay while working at the client’s location
- [Meals and hotel costs](#)
- Dry cleaning and laundry expenses incurred during business travel

Transportation costs incurred while travelling from your personal home to the client site. Fuel and other automotive costs you pay while working at the client’s location. Meals and hotel costs. Dry cleaning and laundry expenses incurred during business travel.

Additionally, you cannot incur your travel expenses for personal reasons, but instead must incur them in the process of providing your services to clients. There is no concrete rule on when a travel expense is business-related. However, as a result of this rule, you cannot claim a deduction for the cost of your daily commute between your personal residence and the office. Instead, this is considered a personal expense.

You have to travel a substantial distance to deduct your travel expenses. During your trip, you must leave your “tax home,” i.e. your main place of business. And, you have to travel more than just a short distance from your office building to meet with a client. This usually means that you have to leave the city in which your business is located or, for smaller towns, its general surrounding area.

You must also travel for such a length of time that you are away from your tax home for longer than an ordinary work day. Generally, this means that you have travelled for such a long period of time that you must rest or even sleep overnight.

However, you cannot stay away from your tax home for too long, or else you risk losing the deduction. You can deduct travel expenses incurred while temporarily working away from your tax home. However, if you provide your services at a client location for an indefinite amount of time, you cannot claim the deduction. This usually means that you can stay at a client site and claim travel expense deductions for up to a year. When you realistically expect to work there for over a year, however, you may no longer claim a deduction for any future expenses of travelling to that location.

Finally, successfully claiming the travel expense deduction requires recordkeeping. To support your deduction, you should keep all related receipts. It is also helpful to use a log, notebook, or other type of written record to [track your expenses](#).

Additional information on this topic can be found at www.irs.gov in Publication 463 ([Travel, Entertainment, Gift and Car Expenses](#)).



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4.6 Meals and Entertainment: Ordinary and Necessary Expenses

As a [Small Business Owner](#), you have some excellent IRS tax deductions that can be used to keep your employees happy and productive. In so doing, you can create a business environment which is not only efficient it also is cost effective. So it is best to take advantage of these benefits whenever possible.

Let's go over the IRS basis for these deductions and provide some real-world examples. The General Rule is you can deduct expenses which are **ordinary** and **necessary** to entertain to the following:

- **Client** – this case would be once you have secured a meeting with a new business prospect, the meeting place, meals and associated costs can be deducted within reason.
- **Customer** – You have a customer with whom you want to expand your services, review current service, etcetera and you have a meeting in which a meal and entertainment may be provided.
- **Employee** – One example here would be the celebration of a milestone for an employee(s) such as Performance goals have been met or exceeded favorably, accident free time, efficiency measures are met, birthday, tenure, promotion, etc.

The term “**Ordinary**” expense would be a cost in which the industry in which you are in is considered standard. An example here would be a Conference Meeting of your peers which would have a training seminar and the cost of the meals and entertainment would be out of your pocket. Of course the cost of the training would be deductible, and the meals and entertainment would also be deductible under a separate category.

A “**Necessary**” expense would be one which is considered appropriate such as a barber shop which has a Drink Barista available for waiting customers. These costs can be deducted in this category.

We now have to consider what is called a “**Directly Related test**” and an “**Associated Test.**” The guidelines here are:

- With **Directly Related costs**, they must have been in a **business setting**, the purpose of the entertainment was the **active conduct of business**, and there was an engagement of business with an expectation of a relationship to follow.
- Concerning the **Associated Test**, this type of entertainment is considered standard practice within your peer group, and it was a part of the function before and/or after the meeting.

Another point to consider for the business owner is to beware of ***double dipping business expenses!*** You may ***not deduct*** any of these expenses if you are also using them as a ***travel expense***. An example here would be a meal expense **incurred during the trip** to a business meeting with a client. The in-flight meal and its associated expenses before the actual client meeting would be considered a travel cost. Also remember expenses that are considered excessive or lavish cannot be deducted.

The IRS guidelines with reimbursement expenses are such that you can only deduct 50 % of your **unreimbursed expenses**. It is important to remember to segregate your expenses **into** the above categories to test reasonableness and qualifications.

For more detailed guidelines please review IRS Publication 15, Publication 535, Publication 463 and Publication 334.



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Business Gift Deductions: Gifts, Indirect Gifts & Incidental Costs

Building strong client relationships is crucial for any business. Gifts can be a thoughtful way to show appreciation and foster loyalty. But navigating the tax implications of business gifting can be tricky. Let’s break down some key points to consider, updated with the latest information.

Understanding Business Gifts & Entertainment Expenses

- **Gifts:** Tangible items of nominal value given to promote goodwill.
 - Example: A branded water bottle for a new client.
- **Entertainment Expenses:** Activities or events intended to entertain clients or potential clients, often associated with business discussions.
 - Example: Taking a client to a sporting event (and attending the game with them).

The key distinction lies in **your attendance**. If you’re not attending with the recipient, it’s typically considered a gift.

Gift Deduction Limits: Keep it Under \$25

The IRS allows a tax deduction for business gifts, but with a significant limitation: **only up to \$25 per recipient, per year**. This applies to the total cost of the gift, excluding incidental costs (more on that later).

The Seattle Mariners Ticket Example: A Case Study

In the scenario you provided, gifting one ticket to the client falls under the \$25 gift deduction if you’re not attending the game with them. However, if you were using the ticket for a business meeting at the game, it would become an entertainment expense (no gift deduction applies).

Indirect Gifts: When Your Family Gets a Treat

An “indirect gift” is one given to someone who isn’t a business contact, like a client’s family member. The IRS generally disallows deductions for these. In the example, gifting the second ticket to a family member wouldn’t qualify for a deduction.

Spousal Gifts: A Shared Expense

If you and your spouse (even if not involved in the business) jointly purchase a business gift, it’s considered a shared expense. However, only one of you can claim the deduction.

Incidental Costs: Don’t Sweat the Wrapping Paper

Incidental costs are minor expenses associated with a gift that don’t add to its value. Examples include gift wrapping, engraving, or a simple gift box. The good news? These costs **don’t** count towards the \$25 deduction limit. So, go ahead and personalize those pens!

Planning is Key

Understanding the distinction between gifts and entertainment expenses is crucial. Consider your purpose and attendance before purchasing a gift. This will help you maximize potential tax benefits.

Tax regulations can change. For the latest guidance on business gift deductions, consult [IRS Publication 463](#) or speak with your tax advisor.

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4.8 Depreciation and Amortization of Tangible Property and Assets

You generally cannot deduct in one single year the entire cost of property you purchase for business if the property has a useful life substantially beyond the tax year. Instead, you can depreciate it.

Depreciation recovers the cost over a number of years by deducting a part of the cost each year. Depreciation thereby accounts for annual wear and tear, deterioration, or obsolescence of a property.

You can depreciate most kinds of tangible property such as buildings, machinery, vehicles, furniture, and equipment. Likewise, you can depreciate (amortize) certain intangible property such as patents, copyrights, and computer software. Property can be depreciated subject to the following requirements: the property must be owned or leased by the taxpayer; it must be used for business or an income-producing activity; and it must have a determinable useful life of more than one year.

Even if a property meets these requirements, a taxpayer cannot depreciate equipment used to build [capital improvements](#). Allowable depreciation on this equipment during the period of construction must be added to the basis of the improvements. You cannot depreciate land nor claim depreciation on property held for personal purposes. For example, if you use a car for both business or investment and personal purposes, only the business or investment use portion may be depreciated.

Depreciation begins when a taxpayer places the property in service for his or her business or to produce income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first. Generally, if you are depreciating property you placed in service before 1987, you must use the **Accelerated Cost Recovery System** (ACRS) or the same method you used in the past. For property placed in service after 1986, you generally must use the **Modified Accelerated Cost Recovery System** (MACRS). These systems dictate what percentage of the cost a taxpayer can deduct each year.

You must identify several items to ensure the proper depreciation of a property, such as the class life and basis of the asset, the depreciation method to be used, whether it is "Listed Property", and what portion of the cost is to be depreciated. For example, you may choose to deduct portions of the cost as a business expense. Instead of taking depreciation deductions, you may also elect under Internal Revenue Code Section 179 to recover all or part of the cost of qualifying property, up to a limit, by making this deduction in the year you place it in service.

Use [Form 4562](#) (Depreciation and Amortization) to report depreciation on a tax return.

Additional information can be found at www.irs.gov in Publication 946 (How to Depreciate Property), and in Publication 534 (How to Depreciate Property Placed in Service Before 1987).



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4.9 Hiring Your Children: Earning Income or Tax-Free Allowance

This topic can be a very confusing discussion and sometimes it can be a subject of much debate and speculation. It is always important to note that the terms “**employee**” and “**dependent**” will be used and in some cases the lines between the two can be confusing.

Let’s begin by defining the term “**employee**” as it fits to the taxation of a business. For federal tax purposes an employee is classified as a worker whom services are performed by and for your company. The employee’s services are directly controlled by you the employer at all times.

The term “**dependent**” can also have several different meanings as applicable to taxation; however for this discussion we will focus on dependents that meet the dependency test as your children.

- The child must be under the age of 18.
- The business is a Sole Proprietor or Partnership entity

The income paid to the child is **not** required to have Social Security and Medicare taxes applied to it. However, if the child is working in this same situations and the work performed is considered **Domestic work in the parent’s home**, then the age is up to 21 years old.

Please note that even though this income is not subject to the SS & Medicare, **they are subject** to federal income tax withholding, **but not** subject to FUTA (Federal Unemployment Tax) unless the payments are for domestic work. In both cases, the payments need to be under \$50 in each quarter to qualify.

In the situation where the income for a child falls under the following:

- The entity is a corporation controlled by the parents
- The entity is a Partnership and a parent is a partner
- The entity is an Estate

In this instance the income is subject to Social Security, Medicare, FUTA, and income tax withholding rules.

Let’s have a couple of examples to clarify the scope of this. You have 2 children and you are both owners of Company A. MFG. Inc. in which you have hired your children of ages 17 (S) and 22 (D) to work last year. Child S was paid \$2,500 for work performed and Child D was paid \$15,000 for work performed.

Due to the fact that you are both owners of this company, the children are performing non domestic work; the income for Child S would be completely taxable in all tax tables. As for Child D, the income is also subject to taxation and you may want to review the dependency test for this child based upon the age and income earned.

You have a child whom is age 15, and you pay this child \$45 to assist you with some work at home during summer break. You then, use the child to work with you on your normal business of an interior designer in which you are the sole owner of the business and it is not a corporation. The child works with you for the rest of the year and you pay \$550 in wages.

In this case the wages are subject to Federal Income withholding only, due to the age of the child, amount, and the business entity. The \$45 is not subject to any taxation at all.

Please review IRS Publication 15 Circular E and your State Department of Revenue for more details.



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4.10 Charitable Donations

Charitable donations are good for everyone: they benefit the organization, person or society so they can continue to support their cause; they benefit you as a small business owner by providing a tax deduction; and they benefit your brand/business (which could be dozens of employees) as it “puts your money where your mouth is” and shows the company is willing to show up for the cause.

Here are some of the ways this can benefit your company:

Goods and Services

The value of your contributions is usually at Fair Market Value (FMV) and must be substantial in nature. An example of this would be the donation of inventory to a Good Will Store with a value of at least \$250. Your company has some excess clothing in inventory that it purchased in bulk, but cannot be moved through a sale. These items can be placed up for a charitable contribution to a Good Will Store or used by an Outreach program for its clients who are in need of clothing in order to progress in their lives. Upon transaction of this donation, the organization will give a receipt to confirm the acceptance of the goods.

(This receipt should be attached to the bill of goods to verify the purchase, as well as the accounting transaction which reduces your inventory and records the contribution.)

Another example would be for services that you provide to the public. This is an excellent area to perform community service and also receive a tax deduction as well.

Many organizations frequently have events where low income persons assemble to receive services they could not afford or wouldn’t otherwise have access to. Your service would classify as a **charitable contribution at fair market value** and the organization would give you a receipt stating the value of these services for tax purposes. Any materials used as well would be considered deductions.

Other examples may include:

- donating scrap from your finished goods product
- unused fruit and vegetables
- a product that does not meet your standards and therefore could not be sold

Once again the fair market value rules apply.

Cash Contributions

This type of contribution is the most common and is the easiest to maintain. Per IRS regulations, a receipt is needed for any single contribution over \$250 in order to claim the deduction.

Another method is planned giving to an organization. This can be done monthly, quarterly, or annually. Usually, pledge donations are made at events such as a Gala and paid throughout the year until the target has been met. As a self-employed person, this is a good way to plan your annual charitable deduction and maintain your cash flow reserves.

These are just a few examples of how your business can benefit the community, expand your marketing reach, and receive a tax break as well.

Consult our accountants for guidelines on your Schedule C tax forms as well as what limitations apply to these types of deductions.



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What is the Hobby Loss Rule?

Ever dreamt of turning your passion into profit? The good news is, some business expenses are tax-deductible. But the IRS has a “hobby loss rule” to prevent people from deducting losses on activities they don’t truly intend to make money from.

Here’s the key: Can you prove your activity is a real business, [not just a hobby](#)?

Signs You’re Running a Business:

- **Profits in Past Years:** Consistently earning a profit in at least 3 out of the last 5 years is a strong indicator.
- **Dedication and Expertise:** Demonstrate you have the skills and actively pursue success.
- **Time and Effort:** Invest [significant time](#) and resources into running the business.
- **Reasonable Expectation of Profit:** Show evidence of future profitability or past success in similar ventures.
- **Adaptability:** Are you willing to change strategies to improve profitability?

If It’s a Hobby:

Losses can’t be deducted beyond the income generated by the activity. However, some deductions are still allowed on Schedule A (Form 1040).

Consult a tax professional to determine if your activity qualifies as a business. The [IRS website](#) offers additional resources on the hobby loss rule.

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4.12 Can I Deduct the Time I Donate?

In recent years this has been a topic of much discussion due to the fact that many companies and organizations are cash-strapped and need to find new ways of attracting goods and services at minimal cost. If you are considering this type of deduction for planning in future periods or you have performed this type of service in the current tax filing period, here are some guidelines.

Value of Service:

The IRS specifically states that the **value of your time and services are not considered a charitable contribution**, however you can count the costs of materials used in the time you donated as a deduction. For example, if you are an Electrician and you volunteer your time to work on a special project for a Not-For-Profit group, your time is not allowed in the deduction but the materials are deductible.

Expenses incurred:

During the course of these donated services, there may be costs that are associated with the donation. The costs may include the [mileage](#) to go to the service site such as a church, hospital, or even an event gathering in the organization is sponsoring. The **mileage rate** is currently at **\$.14** for charitable deductions. You may also consider the value of the supplies and materials which are used in the course of this event. Please note that in situations such as this, it is a very good idea to retain the purchasing documents as back up for proof of the value. There are also some accounting rules that come into play here pertaining to the inventory valuation of the items withdrawn for charitable use.

Documentation:

The organizations included in the procurement and receipt of these services need to maintain accurate and detailed records in accordance with generally accepted accounting principal (GAAP) and IRS requirements for back up documentation. This receipt should include the name of the organization, date of the donation as well as the reported value.

Please review IRS Publications 8283, Publication 561, and Publication 334.



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4.13 Do I get a Tax Break for the Client that Didn't Pay?

In a word, no.

During the course of your business life, this will affect just about everyone at one time or another. In good faith you enter into an agreement with a client for goods and services. You receive the sale and post it into your accounts receivable as income. As time goes by 30, 60, 90, and finally 120 days have passed and no payment is received from a client. Attempts were made to discover the problem and the client has been non-responsive. After a certain period of time has passed, you involve a collections service to recover this unpaid debt and still no reply. Finally, after all has been done to recover the debt it has been determined that this will be a **“Bad Debt”** to your company. There are **2 types** of bad debts:

— **Business Bad Debt** – This is a goods and services loss that was created during the course of your business with an expectation of compensation in return for the product sold.

— **Non Business Bad Debt** – This type of losses is usually associated with short term [capital gains](#) and are sometimes offset by Income received under the same category.

We need to also consider the process of how the debt transaction was accounted for during the business cycle. Let's review the **2 methods of accounting** most commonly used by businesses:

— **Accrual Method** – [This method](#) is used primarily in conjunction with Accounts Receivable and Accounts Payable accounts. You allow your client to have use of a service or product **in advance of payment**. This allows for your company to record the sale in Accounts Receivable as Income with an expectation to pay under certain agreed terms.

— **Cash Method** – [This method](#) has less risk than the Accrual method since **cash is paid at the time of purchase**. However, **checks can be returned, credit cards can have charges declined or refused, even cash can be found to be counterfeit** and therefore you are faced with a loss.

Now that it has been determined that a loss has occurred, we need to determine whether or not it qualifies as a deductible bad debt. First, the debt in question must have been accounted for as Income prior to the write off. This means that **you reported this as Income during the course of your business** and perhaps applied sales taxes and other levies against it in your business reporting. This is usually not a problem in “Accrual” accounting method, but in the “Cash” accounting method, the burden of proof requires a little more back up.

For record keeping and back up purposes, bad debt expenses that were paid in cash, check, and credit card charges that turn out to be fraudulent payments you can use your financial institutions notification as proof. Also you should file a report with local law enforcement to show an attempt to collect from the client. The bad Debt can now be applied to your tax form under the appropriate business return.

As you can see, clients who do not pay can cause as much expense as the bad debt that was incurred.

Please review IRS Publication 535 and Publication 334 for more guidelines.



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5.1 Small Business Tax Credits

Your general business credit for the year consists of what business credits you have carried forward from prior years plus the total of your current year business credits. In addition, your general business credit for the current year may be increased later by carrying back business credits from later years. You subtract this credit directly from your tax.

The following are part of the general business credit, except the electric vehicle credit:

- [Form 3800](#): General Business Credit
- [Form 3468](#): Investment Credit (comprising Rehabilitation, Energy, and Reforestation credits)
- [Form 5735](#): American Samoa Economic Development Credit
- [Form 5884](#): Work Opportunity Credit
- [Form 6478](#): Credit for Alcohol Used as Fuel
- [Form 6765](#): Credit for Increasing Research Activities
- [Form 8586](#): Low-Income Housing Credit
- [Form 8611](#): Recapture of Low-Income Housing Credit
- [Form 8820](#): Orphan Drug Credit
- [Form 8826](#): Disabled Access Credit
- [Form 8834](#): Qualified Electric Vehicle Credit
- [Form 8835](#): Renewable Electricity Production Credit
- [Form 8844](#): Empowerment Zone Employment Credit
- [Form 8845](#): Indian Employment Credit
- [Form 8846](#): Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips
- [Form 8847](#): Credit for Contributions to Selected Community Development Corporations
- [Form 8864](#): Biodiesel and Renewable Diesel Fuels Credit
- [Form 8874](#): New Markets Credit
- [Form 8881](#): Credit for Small Employer Pension Plan Startup Costs
- [Form 8882](#): Credit for Employer-Provided Childcare Facilities and Services
- [Form 8896](#): Low Sulfur Diesel Fuel Production Credit
- [Form 8900](#): Qualified Railroad Track Maintenance Credit
- [Form 8906](#): Distilled Spirits Credit
- [Form 8907](#): Nonconventional Source Fuel Credit
- [Form 8908](#): Energy Efficient Home Credit
- [Form 8910](#): Alternative Motor Vehicle Credit
- [Form 8911](#): Alternative Fuel Vehicle Refueling Property Credit
- [Form 8923](#): Mine Rescue Team Training Credit

To claim a general business credit you have to fill out the applicable forms. In addition to the specific credit form, in most cases you will also need to file Form 3800 (General Business Credit).

Additional information can be found at www.irs.gov in Publication 334 (Tax Guide for Small Business), and by searching for the form specific to the applicable credit.



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5.2 Self-Employment Tax

Self-employment tax is how individuals who work for themselves pay their social security and Medicare taxes. These taxes are normally withheld from the pay of most wage earners and are reflected as deductions on their W-2s. You may still have to pay this tax if you are an employee and these taxes are withheld from your wages, and you also have income from an additional business or trade. People in professional trades such as [physicians](#), [accountants](#) and contractors who offer their services to the general public are generally independent contractors whose earnings are also subject to SE tax. You must pay SE tax and file Schedule SE if either of the following applies:

- your net earnings from self-employment were \$400 or more, or
- you had church employee income of \$108.28 or more.

Figure your SE tax using Schedule SE. Social security and Medicare taxes of most wage earners are figured by their employers, who pay half and deduct the other half. The self-employment tax rate is 15.3% and consists of two parts: 12.4% for social security and 2.9% for Medicare. Only the first \$106,800 (the limit changes annually) of your combined net earnings is subject to the 12.4% social security part of the SE tax. All your net earnings are subject to the 2.9% Medicare part of the SE tax.

If you use a tax year other than the calendar year, use the tax rate and maximum earnings limit in effect at the beginning of your tax year. If the tax rate or maximum earnings limit changes during your tax year, continue to use the same rate and limit throughout your tax year. If your income tax, including your SE tax, is expected to exceed \$1,000 when you file your return, you generally need to make estimated payments. If you don't make quarterly payments, you can be penalized for underpayment at the end of the tax year.

You can deduct half of your SE tax as an [adjustment to your gross income](#). This deduction only affects your income tax. It does not affect either your net earnings from self-employment or your SE tax.

Special rules apply to caregivers, workers who perform in-home services for elderly or disabled individuals. Caregivers are typically employees of the individuals for whom they provide services, because they work in their homes and these individuals have control over how and when the caregivers work. Sometimes, however, the caregivers are independent contractors. If the caregiver is a family member, the employee may or may not be subject to employment taxes even though his or her income is reported on a Form W-2 or 1099-MISC.

For example, if someone is paid by a state agency to take care of their permanently disabled spouse (despite no formal medical training), versus someone who runs an assisted living home and is paid by the state to also take care of their grandparent. The person in the first example reports the income as **“Other Income”**, while the woman in the second example is subject to SE and other income taxes.



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Contact

18208 66th Ave Ne, Ste 100
Kenmore, WA 98028
(425) 483-6600

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6.1 Year-End Tax Strategies

As another year comes to an end, now is the best time to start preparing your reporting requirements. These requirements consist of (but are not limited to) the following:

- Sales and revenue
- Marketing
- Operating expenses
- Business milestones

[Self-employed entrepreneurs](#) should always have their finger on the pulse of your [businesses income and expenses](#). An accountant can compile this information into reports for filing and public review, you, however, are responsible for the details therein. Let's touch base on some key points to consider:

Sales and Revenue

If your business is required to pay **Sales and Use taxes** on its services and products, this would be a great time to do a **"reverse sales review"** to determine your tax liability for the year. Even though you may in some cases report monthly, now is the time to look closely at your final report. Please note that the IRS requires this year (2011) that merchant card (Credit cards) and third party entities (PayPal) payments must be reported separately on a 1099 (k). See instructions for form 1099-K for details.

Marketing

There are always plenty of places to advertise your business services during the holiday events, however at this time you should focus on the previous marketing plan you had in place. Ask yourself if you had a rate of return that was what you expected. Mark the successes and make note of the shortfalls so that moving forward you can learn to earn from the past.

Operating Expenses

Even though you may have a lean mean budget in place, the purpose here for year end is to take advantage of some tax situations that would benefit your company such as the following:

- **Payroll** – if there is available cash, now is the best time max out your retirement contributions to a 401 (k), SEP, IRA, etc. Remember that these financial instruments can greatly reduce your business and personal income tax bite as well if planned properly. Finally, ensure that tax deposits for your payroll are in the correct pay periods. This you can do by reviewing your EFTPS (Electronic Federal Tax Payment System) report. Also, start marking your due dates for wage reporting (W-2's, 1099's, 940, 944, 945 schedules to the Federal government).
- **Vendors** – you should ensure that all vendor information is current and payments are up to date to avoid having to make corrections to your 1099's.
- **Customers**—touch base with your customers to verify service and product quality, as well as preparing for next year's sales. Since many businesses are preparing their sales and forecasting schedules at this time, this is a golden opportunity to ensure that you are part of their goals.

Business Milestones

[Strategize](#), enjoy your successes, and learn for the short comings.

For more detailed information, please review Publication 509, as well as your state tax agencies.



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