Self Employed Tax Guide

The self-employed, the freelancers, the independent contractors, the small business owners: whatever your title, here is a guide to help you handle many of the tax considerations you'll be up against in running a successful business.

And there is a lot to consider for those self employed. We hope our little tax guide will help you navigate the often times troublesome, sometimes murky tax requirements, the ins and outs, the et ceteras of tax laws.

The Self Employed Tax Guide attempts to provides small business owners and the self-employed with a one-stop resource to staying in compliance with the filing requirements and minimizing the financial burden imposed by several layers of government. We touch on a lot of subjects related to tax planning, such as charitable contributions, depreciation, deductions in business travel & entertainment expenses . . . Well, you'll see.

And good luck with your enterprise, and good luck with your taxes. If you need any additional help, give us a call.

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Small Business Tax Returns Required & Due Dates

Federal. 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 partnership or multimember 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).

State. 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. For an explanation of Washington State's destination based sales tax, click here.

http://huddlestontaxconsulting.com/wordpress/CPA%20Article/washington-state-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.

Payroll Requirements for Small Business

Payroll. Federal Form 941. Life get's 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 employee 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 ($106,800 in 2010). 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 (Employers Guide ……) and the employees 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 and 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 employees 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 employees 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.

Employee or Independent Contractor; How Should I Pay?

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".

Estimated Tax Payments for Self-Employed Persons

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 usually withheld from the following types of income: interest and dividends, alimony, rent, sale of assets, and prizes and awards. So self-employed persons may very well 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 for 2010 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 refigure 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.

Entity Choice (S Corp, C Corp, LLC)?

Feature Question to Tax Accountant:
I have a service business in the Seattle Bellevue area with three employees. What type of entity should I adopt in order to minimize my tax obligations? I am a sole proprietor now. 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 $90,000 (for 2005). Profits beyond the first $90,000 are subject to a 2.9% self-employment tax. If the profits from your business are $200,000, you will pay self employment taxes of $16,516.

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-corporation 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, however, are at risk of paying penalties if they are 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 factors that are considered in determining 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, a greater allocation toward profit distribution is warranted. Also, if profits are attributable to the leverage offered by employees, rather than the owner's own professional services, again, a greater allocation toward profit distribution is warranted.

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.

Reasonable Compensation for S Corporation Owners-Officers

Subchapter or S corporations are corporations that pass corporate income, losses, deductions, and credits along to their shareholders for federal tax purposes. Each shareholder of an S corporation reports the income and losses on his or her personal tax return. The tax on this income is assessed at the shareholder's individual income tax rate.

The Internal Revenue Code includes corporate officers within the definition of "employee" for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding. Courts have consistently held that when corporate officers receive payments for more than minor services performed for the corporation their compensation should be considered wages subject to federal employment taxes, not as distributions or loans to shareholders. The fact that the employee is also a shareholder does not change that requirement. The compensation of S corporate officers should always be treated as wages. This is also stated in the instructions to Form 1120S.

The amount of compensation to the shareholder/employee assigned as wages cannot exceed the amount received by him or her either directly or indirectly from the corporation. If the shareholder/employee receives or is entitled to receive cash or property, then a reasonable salary amount must be determined. There are no specific guidelines for this. Factors used in determining the amount of compensation to a shareholder/employee can include: his or her duties, responsibilities and qualifications; the time he or she spent on the business; wages of non-shareholder employees or comparable wages for similar services; a legal agreement or the use of any other formula for calculation.

If an S corporation shareholder/employee owns more than 2 percent of the corporation, and the corporation pays his or her health and accident insurance premiums, these premiums are deductible by the S corporation as benefits and are reportable as wages on the shareholder/employee's Form W-2. They are not subject to Social Security, FICA or FUTA taxes. Therefore, this additional amount is included in Box 1 (Wages) of the W-2 but not in Boxes 3 or 5 of that form. This shareholder/employee is eligible for an AGI deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S corporation. This means that the medical care coverage must be in the name of the S corporation or that the S corporation either paid or reimbursed this shareholder for the premiums and reported that amount as wages on his or her W-2.

Payments made by the S corporation of the shareholder/employee's health and accident insurance premiums may be further identified in Box 14 (Other) of the Form W-2. Neither a Schedule K-1 (Form 1120S) nor a Form 1099 should be used as an alternative to the Form W-2 to report this additional compensation.

Additional information can be found at www.irs.gov in article FS-2008-25 titled "Wage Compensation for S Corporation Officers,"and Form 1120S (U.S. Income Tax Return for an S Corporation).

Accrual Versus Cash Method of Accounting

Each taxpayer must figure his or her 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 for his or her tax year.

The most commonly used accounting methods are the cash method and the accrual method. There are also special methods (such as for farmers); and you can use a hybrid or combination of methods. Any combination that includes the cash method is treated as the cash method. And if you use the cash or accrual method for reporting your income, you must use the same method for reporting your expenses.

However, you can account for business and personal items using different methods. Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until the tax year they are reported in the related person's income. You can use a different accounting method for each of several businesses provided that you maintain a complete and separate set of books and records for each business to prove that they are separate and distinct. If you use different accounting methods to create or shift profits or losses between businesses so that your income is not clearly reflected, the IRS will not consider them as separate and distinct.

The accounting method you choose when you file your business' first tax return should clearly 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.

<u>Cash Method</u>

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 2010 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 2010.

The following businesses cannot use the cash method: a tax shelter; or a corporation or 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 and his or her business is not a tax shelter. A small business qualifies to do so if: its average annual gross receipts for each test year is $10 million or less; it is not prohibited from using or ineligible to use the cash method; and its principle activity is an eligible business. 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.

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.

Gifts and Donations

Gifts

There is generally a limit of $25 for business gifts given to each person during your tax year. A gift to a customer's family member is generally considered to be an indirect gift to that customer, unless you have a separate independent business connection with that other person. You and your spouse are treated as one taxpayer, regardless of whether you have separate businesses, is separately employed, or whether each of you has an independent connection with the recipient. Gifts given by a partnership and its partners 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 either a gift or entertainment is generally 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 that 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. IRS Publication 78 lists most qualified organizations or you can call the IRS at 1-877-829-5500. 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.

Rental Tax Guide

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 real 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 and travel expenses related to your rental income or property, mortgage or rental payments and points, tax return preparation fees, and utilities.

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).

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, and 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).

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).

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 one that 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.

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 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. Please note 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).

Retirement Plan Deductions

Like large businesses, 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).

Home Office Deduction

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).

Renting a Building to Your Own 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 own 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).

Vehicle Mileage Deductions

If you claim a deduction for vehicle expenses for your business, you must provide certain information on the use of your car, truck, van or other vehicle. This information will include the make, model and year of the vehicle, and the date placed in service. It will also include the total number of miles driven for the year including and excluding the business mileage, as well as your verification of keeping and possessing accurate records of mileage and any vehicle expenses. You will provide this information and report your expenses on your Schedule C or C-EZ, Schedule F, or Form 4562. If you are both self-employed and an employee, you must keep separate records and report the expenses for your work as an employee only on a Form 2106 or 2106-EZ.

If you claim a deduction based on the standard mileage rate instead of your actual expenses, you are allowed to also deduct parking fees and tolls that apply to the business use of that vehicle. For example, when filing a Form 2106-EZ, you would complete Part I, line 1, calculating the standard mileage rate; then you would enter the amount of parking fees and tolls on line 2. For 2010 beginning on January 1st, the standard mileage rates for the use of a vehicle will be 50 cents per mile for business miles driven, 16.5 cents per mile driven for medical or moving purposes, and 14 cents per mile driven in service of charitable organizations.

Taxpayers always have the option of calculating the actual costs of using their vehicle rather than using the standard mileage rates.

A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System (MACRS) or after claiming a Section 179 deductions for that vehicle. Also, the business standard mileage rate cannot be used for any vehicle used for hire, or for more than four vehicles used simultaneously. If you claim a deduction based on actual car expenses using Form 2106, complete Part II, Section C and do not use a 2106-EZ. In addition, unless you lease your car, you must complete Section D to show your depreciation deduction and any section 179 deduction and special depreciation allowance you claim. If you are still using a car that is fully depreciated, continue to complete Section C and enter zero on the appropriate line since you have no depreciation deduction.

If you are an employer who reimburses employee business expenses, your treatment of this reimbursement on your employee's Form W-2 depends in part on whether you have an accountable plan or not. Reimbursements treated as paid under an accountable plan are not reported as pay. Reimbursements treated as paid under non-accountable plans are reported as pay. Employers need to tell employees what method of reimbursement is used and what records must be provided. Publication 15 (Circular E) (Employer's Tax Guide) has more information on employee pay.

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 occurred 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 occurred 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.

Meals and Entertainment

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 deductable, and the meals and entertainment would also be deductable 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.

Business Gifts

During the course of business, it is a common practice for business owners to give out gifts to its clients and customers. These can be excellent marketing tools for new services, however many of these items do fall into the category of “Gift.”

Let’s explore some examples:
You have a customer who has demonstrated brand loyalty and you want to thank them with a gift of appreciation. It has been decided that a pair Seattle Mariners tickets is a fitting way of saying thank you for your service. Now you purchase these tickets at a value of $100 each for a total of $200. You decide to give the first ticket to the business owner and the second ticket to family member whom you have met as a gift.

Let’s now determine what category the first ticket is under. Since the ticket is intended for future use, and you are not in attendance, this is considered a gift for tax deduction purposes. However, if this ticket was to be used in connection with a meeting or if you are in attendance, then this would be considered an entertainment expense. In this case you should weigh the consequences of whether or not to call it a gift or entertainment expense beforehand. It is best to take advantage of the tax break that you would have if you prepared to treat this as an Entertainment expense which has a larger benefit than a gift expense. The key here is planning before purchasing and giving.

The second ticket in which you gave to the family member has some points to consider. If the family member is not an employee of the parent company or your company does not have a business agreement specifically between you and that family member this is called an “Indirect Gift.”

Gifts are also expenses in which they are considered joint expenses if you and your spouse give them together even if your spouse is not a part of your business. So as you can see, it is best to plan and forecast any gifts in which the amounts can add up to a sizable amount and use the deduction to the best of your advantage.

Limitations on Business Gifts:
In the normal course of business, gift deductions are limited to $25 per gift. So as you can see in the aforementioned example if you were to choose the gift deduction instead of the Entertainment deduction you are limited to the $25 rule.

Incidental Cost:
If you are giving a gift in which there are certain costs associated with it such as engraving, personalized messages, etc. there are certain limitations for this category. The definition of incidental cost is a cost which is a part of the gift but does not add value to it. With that in mind, please note that these costs are not applicable to the $25 rule for gift deductions. An example would be a box of pens or calendars which you purchase for your customers at $25.00 and you have a cost of $5.00 to add an engraving a message to it. The $5.00 is exempt for the $25.00 rule and is deducted in full as an incidental cost to the gift. Other examples include gift wrapping and packaging the gift.

Please review IRS Publications 463 for more guidelines.

Depreciation and Amortization

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).

Hiring Your Children

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.

When a child is employed by their parents, there are a few factors to consider:

- The child should be under age 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 case 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.

Charitable Donations

Charitable Contributions

As a Self-Employed Small Business owner, this is one of the best marketing tools available as well as an excellent planned tax deduction when prepared and executed properly. What better way to get your services and goods noticed by a large audience and receive the taxation benefits to boot! This may sound too good to be true! Let's look closely at some of the many ways this can benefit your company and the organizations and its clients.

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 and such time has passed where the product may no longer have a market value as far as styling trends goes. 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. The United Way and organization like this frequently have events where low income and indigent persons assemble to receive, on a large scale, services that they could not afford or 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. On your side this receipt as well as any of the materials used would be considered deductions. Please note that these events have such a large gathering of people that through word of mouth and publicity your business will be seen by many individuals.

Other examples may include donating scrap from your finished goods product. This could be something as simple as unused fruit and vegetables, or a product that does not meet your standards and therefore could not be saleable. 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 depending upon your preference. 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. Please remember whenever possible, consult your accountant for guidelines on your Schedule C tax form as limitations apply to this types of deduction.

The above information can be found in Publication 526 and guidelines for disclosure in Publication 1771.

Hobby Loss Rules

We know taxpayers are generally allowed to deduct the ordinary and necessary expenses needed to conduct a trade or business or for the production of income. These activities are intended to make a profit. However, taxpayers must understand how to determine whether an activity is engaged in for profit or as a hobby. There are tax implications for incorrectly treating hobby activities as activities engaged in for profit. Internal Revenue Code Section 183 (Activities Not Engaged in for Profit) limits deductions for non-business activities, and is sometimes referred to as the “hobby loss rule.”

An activity is presumed for profit if it makes a profit in at least three of the last five tax years, including the current year (or at least two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses).

Some factors strongly indicate that your engagement in the activity is for profit and not a hobby, such as your dependence on income from the activity. You should be qualified and have the knowledge needed to run the activity as a successful business. The time and effort you put into the activity should show intention to make a profit. Any business losses should occur during a business’ start-up phase or be due to circumstances beyond the business’ control. And a business should show past profit or future profitability, or you may even have changed methods of operation to improve profitability. Another indication would be if you have made a profit from similar activities in the past.

If an activity is determined to not be for profit, losses may not exceed the gross receipts for the activity. The limit for not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations, but not to other kinds of corporations.

Deductions for hobby activities are claimed as itemized deductions on Schedule A, Form 1040. These deductions must be taken in the following order:

1. Personal deductions, such as home mortgage interest and taxes, may be taken in full.
2. Deductions that do not change the basis of property, such as advertising, insurance premiums and wages, may be taken next.
3. Deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent that gross income for the activity exceeds the previous deductions.

Time Donated

Can I deduct the Time I Donated?
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 in not allowed in the deduction but the materials are deductable.

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.

The Client That Didn't Pay

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:

1. **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.
2. **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:

1. **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.
2. **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 counterfei**t and therefore you are faced with a loss.

Now that is has been determined that a loss has occurred, we need to determine whether or not it qualifies as a**deductable 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.

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

Self-Employment (SE) 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. Two examples would be a woman who is not a nurse paid by a state agency to take care of her permanently disabled husband, versus a woman who runs an assisted living home who is paid by the state to also take care of her own grandmother. The woman 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.

Year End Strategies

Entity Choice (S Corp, C Corp, LLC)?

Feature Question to Tax Accountant:
I have a service business in the Seattle Bellevue area with three employees. What type of entity should I adopt in order to minimize my tax obligations? I am a sole proprietor now. 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 $90,000 (for 2005). Profits beyond the first $90,000 are subject to a 2.9% self-employment tax. If the profits from your business are $200,000, you will pay self employment taxes of $16,516.

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-corporation 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, however, are at risk of paying penalties if they are 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 factors that are considered in determining 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, a greater allocation toward profit distribution is warranted. Also, if profits are attributable to the leverage offered by employees, rather than the owner's own professional services, again, a greater allocation toward profit distribution is warranted.

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.

Year-End Tax Strategies

As another year comes to an end, now is the best time to start preparing for your upcoming reporting requirements. These requirements can consist of, but not be limited to, the following:

- Sales and Revenue
- Marketing
- Operating Expenses
- Business milestones

You, as a self employed person, should always have your finger on the pulse of your businesses Income and Expenses. While you may have an Accountant who will assemble and compile this information into reports for filing and the public review, you 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:

1. 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).
2. 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.
3. 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.