

LEARN TO RELAX WHEN DEALING WITH TAXES—
AND MAKE MORE MONEY

TAX STRATEGIES FOR THE SMALL BUSINESS OWNER

REDUCE YOUR TAXES AND
FATTEN YOUR PROFITS



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Tax Strategies for the Small Business Owner: Reduce Your Taxes and Fatten Your Profits

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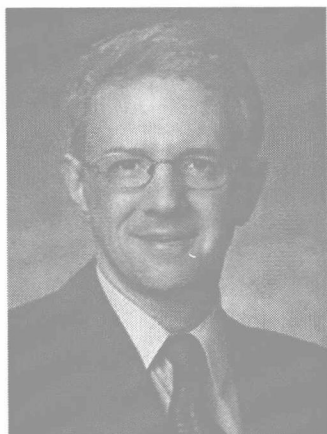
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*To Brett Fox
for his support throughout the years.*

About the Author



Russell Fox is an Enrolled Agent, a federally licensed tax professional. He's the founder and a principal at Clayton Financial and Tax and has been in the business since 1999. His tax practice (both preparation and representation) serves nearly 1,000 clients with emphases in small business and gambling. His tax blog, taxabletalk.com, has been named one of the ten best accounting and tax blogs. Previously, he was in financial and operations management for fifteen years working in various industries, including agriculture, telecommunications, and high technology. Co-author of three books on poker, he resides in Las Vegas, Nevada.

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Introduction

When I was just out of college, my father gave me Charles Adams's classic book on the history of taxes, *For Good and Evil: The Impact of Taxes on the Course of Civilization*.¹ Since then, I've been fascinated with taxes and am something of a tax nerd. As one of my clients said to me, "We're glad *someone* enjoys taxes."

That's not really accurate. I like working in tax, but I don't know anyone who truly enjoys paying taxes. I suspect we would all like to pay less. Meanwhile, many Americans are facing the specter of tax increases on the federal, state, and local levels.

That's where this book comes in. This is a commonsense, practical guide to taxes for the small business owner. The goal of the book is to give small business owners an understanding of what he or she needs to think about regarding taxes—from when the business is formed to when it is sold.

The book is divided into four parts. "Before the Business Opens" focuses on the types of business entities (and how they are taxed), the taxes a small business owner faces, and the start-up phase and record-keeping requirements. "Day-to-Day Expenses" looks at deductions you can take and what's required to take them. The third part, "Payroll, Payroll Taxes, and Benefit Plans," looks at paying yourself and employees, payroll taxes you must pay, retirement plans, and medical expenses (with a focus on the new Affordable Care Act). The final part, "Other Items," reviews the documentation you generally need for taxes besides the federal income tax, what to do when a tax agency contacts you, and other topics (including electronic filing, foreign issues, using a tax professional, and selling your business).

I tell my clients that tax is a combination of common sense and arcane rules. I've tried to keep the minutiae of the rules, regulations, and laws to a minimum in this text. I hope this book will set you on the course of paying the least amount of tax you legally can.

¹ Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization* (2nd Edition), (Toronto: Madison Books, 2001).

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Before the Business Opens

There are several different types of business entities for a small business owner to choose among, including sole proprietorships, partnerships, corporations (both C and S), and limited liability companies. This is perhaps the most critical decision a business makes, and Part I begins by exploring this important area.

Chapter 2 looks at the types of taxes a small business owner must pay, the definitions of income and expenses, and cash versus accrual accounting. The last chapter in Part I covers the rules of the start-up phase: that part of the business before you receive any revenue. The final part of Chapter 3 examines the recordkeeping requirements of a small business in dealing with tax agencies.

The Business Entity

The business of America is business.

—President Calvin Coolidge

You've been in business or you're just starting out. You've picked up this book because you're wondering how to deal with taxes. You might expect the book to start by looking at taxes; however, we won't look directly at them at all in this first chapter. That's because the most important decision a business owner can make is about the structure of the business.

You may have been told, "The best structure for a business is an LLC." Perhaps your buddy told you he has an S corporation, and it works great. If you choose your business entity based on someone else's business, you may be making a major mistake. *There is no one right business structure.* Like many things in tax (and business), the correct answer to "What is the best structure for a business?" is: "It depends."

Generally, all businesses calculate their income in the same manner: Figure out the gross income, subtract all ordinary and necessary business expenses, and whatever is left is profit. Of course, this is a simplification, but the general principle holds. Why, then, is the choice of business entity so important?

- *Different tax treatments.* Though *income* is generally calculated identically across business structures, the *tax* may not be.
- *Legal consequences.* Not only will different entities be treated differently under the law, but the treatment can vary state by state.

- *Your goals.* Depending on your goals, you may be able to only use one specific type of business entity.

In this chapter we take a look at the different types of business entities, the requirements for each, their pros and cons, and how they are taxed. We discuss how you can change your type of entity and conclude with how you should choose your form of business entity.

The Sole Proprietor

If you alone conduct your business without forming a separate legal entity, you are a *sole proprietor*. This is the simplest form of business entity. Any business conducted by an individual that is not another form of business entity will be a sole proprietorship.

There is no such thing as wages or salary with a sole proprietorship. You are the business, so wages would just be moving money from your left hand to your right hand.

This is by far the simplest form of business entity. It's just you conducting a business. Of course, you must truly be conducting a business and not just trying to make a hobby into a business.

Hobby Loss Test

Most of us have hobbies—activities we pursue for enjoyment, not to make money. Many individuals attempt to turn their hobbies into businesses; after all, activities we pursue for enjoyment can make the best businesses. That said, to have a business for tax purposes, you *must* be trying to make money at it. The Internal Revenue Service (IRS) is naturally skeptical of a “business” that loses money year after year. A nine-factor test is used by the IRS and the courts to determine whether an activity is being conducted as a business or a hobby:¹

1. The manner in which the taxpayer carried on the activity;
2. The expertise of the taxpayer or his or her advisers;
3. The time and effort expended by the taxpayer in carrying on the activity;
4. The expectation that the assets used in the activity may appreciate in value;

¹ Treasury Regulation §1.183-2(b).

5. The success of the taxpayer in carrying on other similar or dissimilar activities;
6. The taxpayer's history of income or loss with respect to the activity;
7. The amount of occasional profits, if any, which are earned;
8. The financial status of the taxpayer; and
9. Elements of personal pleasure or recreation.

The effect of these rules for a business that's considered a hobby is that gross income is taxable but the expenses might not be deductible. Most of the time you do *not* want your business to be considered a hobby.

One of the most important ways of avoiding this is to *document all of your expenses*. My mother, a realtor, says that the cliché that real estate is location, location, and location is true. Similarly, the most important thing for a business owner is to document, document, and document.

■ **Tip Keep good records!** I cannot overemphasize this. You will see this point recurring throughout this book because it really is that important.

Let's look at a business that is a hobby. Say you've decided to buy a lot of cosmetics, and you decide to become a distributor for a multilevel marketing (MLM) company. By becoming a distributor for an MLM that markets cosmetics, you can make a little bit of money on the side. MLMs typically pay a residual to you for every product you order (and for product ordered by others you recruit to the company). However, in this example you do not have a profit motive: Your goal is solely to purchase cosmetics for your own use. This "business" would clearly be a hobby.

I deliberately chose an MLM for this example because they have a reputation for abuse with tax agencies. That does *not* mean that you should avoid MLMs as your choice when starting a business. On the contrary, many people have done quite well with businesses that are structured as MLMs. If you honestly conduct your business with the goal of making money, you will likely be considered to be running your business for the purpose of making a profit, not as a hobby.

Sole Proprietorship: The Advantages

The main reason for choosing a sole proprietorship is its ease. The moment you "hang up your shingle," you've formed a sole proprietorship. Other than

a local business license² and/or a fictitious business statement,³ there are usually no other requirements to form a sole proprietorship.⁴ This makes it one of the easiest businesses to create.

From a tax perspective, a sole proprietorship reports its income and expenses on a Schedule C. This is part of your personal tax return, so no separate business entity tax return is required.

A sole proprietorship is usually one of the least expensive businesses to run from an organizational standpoint. Because there are few (if any) legal filings required, legal costs are usually limited. Because there's no separate tax return required, there can be a savings on tax preparation costs.

It's also easy to close a sole proprietorship: You simply stop working in that business and don't include the Schedule C on your tax return (though you may need to cancel your business license or fictitious business statement).

Sole Proprietorship: The Disadvantages

The ease of forming a sole proprietorship is also one of its negatives. A sole proprietorship is you conducting a business. You can be held personally liable for anything that is conducted by your business.

Indeed, protection from legal liability is one of the main reasons that people form business entities. I am not an attorney, and nothing written in this book is meant as legal advice. That said, it's safe to say that most individuals do not want to be exposed to potential liability issues.

Second, a sole proprietorship is, by definition, you conducting a business by yourself. With one exception,⁵ there cannot be any other owners if you file as a sole proprietorship.

Finally, according to IRS statistics, a business that files a sole proprietorship has on average five to ten times the audit risk of a corporation or a partnership.⁶

² Business licenses are generally issued by cities and counties, though some states (such as Nevada) also require them.

³ A *fictitious business statement* is required when you conduct a business in anything other than your own name. In most jurisdictions, these statements are issued by counties.

⁴ A business conducted out of a home may be subject to zoning and/or homeowners association restrictions. Consult an attorney familiar with your jurisdiction and legal issues to determine whether this is a concern.

⁵ A married couple living in a community property state jointly conducting a business can file their business as a sole proprietorship. The income and expenses of the business would be split onto two Schedule C's. I discuss this in the note in the next section.

⁶ 2011 Internal Revenue Service Data Book: October 1, 2010, to September 30, 2011, accessed at <http://www.irs.gov/pub/irs=soi/11databk.pdf>, page 22.

Why is this the case? The IRS has found that tax returns for sole proprietorships tend to have more errors than do corporate or partnership returns. The IRS is a collection agency; they go where the money is. They get more bang for their buck by examining sole proprietorships than investigating other business entities (except for the largest C corporations). Audits are covered in detail in Chapter 17.

Partnerships

A *partnership* is when two or more persons conduct a trade or business. Note that I did *not* say “two or more individuals”; a partner in a partnership can be a business entity, such as a corporation or an LLC (though this is rare). A business does not have to have a written agreement to be considered a partnership. Most states do not require partnerships to register with the state; however, partnerships have the same requirements as sole proprietorships in obtaining business licenses and fictitious business statements.

Partnerships file an *information return* (Form 1065) noting their income and expenses, but they generally do not pay income tax.⁷ The income and expenses from a partnership flow through to the partners’ own tax returns. Thus, a partnership is a *flow-through entity*. A partnership issues Schedule K-1’s noting each partner’s share of the income and expenses so that these items can be reported on each partner’s personal tax returns.

As in sole proprietorships, individual owners in a partnership cannot be paid wages. Instead, owners take *draws* of money from the business. Note that a draw is *not* an expense; rather, it is the movement of earnings from the partnership to the partners.

■ **Note The married couple exception in community property states.** There is one business with two owners that can, if it wishes, file a Schedule C (sole proprietorship) rather than a partnership return: a business operated by a married couple in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin; Alaska and Puerto Rico allow for community property but it is not the default status). Such a business can file a partnership return (Form 1065) or two Schedule C’s on their individual return (Form 1040). If the owners choose to file Schedule C’s, the income and expenses would be split equally on the two Schedule C’s. The pros and cons of this should be carefully considered before choosing a filing method. Be aware that community property law is *not* identical in each community property state.

⁷ A few jurisdictions, such as Illinois, do charge tax on partnerships. Illinois calls its tax the “Partnership Replacement Tax.”

Partnerships: The Advantages

The positives of a partnership are similar to those of a sole proprietorship. If two individuals go into business together, they have formed a partnership. I recommend that a business partnership create a written partnership agreement; it will make things far easier if the partnership should dissolve.

First, a partnership is easy to form. Although you *should* have a written partnership agreement (ideally, reviewed by an attorney), you don't have to. Two individuals who go into business together absent some other form of business entity will have a partnership.

A partnership is usually easy to dissolve. The partners simply dissolve (close) the entity.

Partnerships have a low audit risk. In fiscal year 2011, only 0.4% of partnership returns were examined by the IRS.⁸ Compare that to 3.6% of sole proprietorship returns with income of \$200,000 to under \$1 million and you can see why you might prefer a partnership return to a Schedule C.

Finally, a partnership is a flow-through entity. The partnership itself generally does not pay tax; rather, each partner pays tax based on his or her share of the income. Thus, a partner pays tax on the partnership income based on his or her marginal tax rate.

Partnerships: The Disadvantages

The ease of forming a partnership can also be a negative. When a partnership splits, it can be messy—especially if there was not a written partnership agreement.

There are other potential legal issues. A partnership does not give a business liability protection. Additionally, each partner can be held personally liable for another partner's actions.

A business entity that is similar to a partnership—a limited liability company (LLC)—gives liability protection while usually allowing for a partnership tax return. However, an LLC does require an operating agreement; the operating agreement should be prepared by an attorney. I discuss LLCs in more depth in the “LLCs” section of this chapter.

⁸ 2011 Internal Revenue Service Data Book, page 22.

Corporations

Corporations are separate legal entities that have their own rights, privileges, and liabilities distinct from those of their owners. Most corporations are creatures of state laws. A corporation has its own life; it has rights and responsibilities just like you and me. Most corporations issue stock, have a board of directors, and have limited liability. In general, a stockholder will not be liable for the actions of a corporation *assuming the corporation is properly run*. If you own the stock of a publicly traded entity, it's probably a corporation.⁹

For tax purposes, all corporations start as *C corporations*. The other type of corporation is an *S corporation*. A *C corporation* files a *tax election* to become an *S corporation*. From a legal perspective, generally all corporations have the same legal rights as any other corporation in that state (irrespective of their *C* or *S* status).

One of the major advantages of a corporation is the separation of legal liability. A properly structured corporation has its own legal liability. This doesn't mean that owners and officers of a corporation cannot be sued, nor does it mean there aren't circumstances in which they can be held liable for a corporation's actions—these circumstances definitely exist. That said, *generally* a corporation is treated separately from the owners of the corporation.

There are disadvantages to corporations, too. Because a corporation is a separate legal entity, it files its own tax return. The corporation will need to have annual stockholders and board of directors meetings. You have to document and keep the minutes of these meetings. There will be filings with the agency in your state that handles corporations. This involves additional work (though your attorney may be willing, for a fee, to handle the additional work).

Though *C* and *S* corporations start the same, there are significant differences in these entities. *C corporations* are thought to be the province of large entities, but they can be right for some small businesses. On the other hand, many small businesses choose to become *S corporations*.

C Corporations

As noted earlier, all corporations start as *C corporations*. If you own the stock of a public corporation, you own the stock of a *C corporation*. Though most small business owners rarely think of using a *C corporation* form for their business, it could be the right choice for you. Although there are some disadvantages of a *C corporation*, there are several advantages. These include

⁹ There are a few publicly traded partnerships.