Small Business Tax

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Background

There are several important tax issues that arise for owners and managers of small businesses. These issues occur at the federal, state, and local levels. Because the state and local issues vary so widely, this entry focuses primarily on federal tax issues.

To understand the many tax issues that arise for small businesses, one must first know the different types of business entities one may create. The Internal Revenue Service (**IRS**) and the U. S. tax laws— codified in the Internal Revenue Code (IRC)—treats each of these entities in significantly different ways. The four basic forms of businesses are:

1. Sole proprietorships
2. Partnerships (general and limited)
3. CORPORATIONS (C and S)
4. Limited liability companies

Generally, taxpayers who own their businesses alone can form any one of these types of businesses except partnerships. Multiple owners of a business may form any type of business except a SOLE PROPRIETORSHIP.

Most of the many kinds of business income are taxable. The Internal Revenue Service (IRS) taxes the income generated by a business the same as it does an individual's income. Similarly, businesses can minimize their tax liabilities through deductions and credits the same way individuals can.

Business Income

Regarding the topic of small business taxes, it is necessary to understand the IRS definition of "income" before turning to a discussion of deductions, credits, or other aspects of small business taxes. It may actually

be better to understand the concept of "gross income." In section 61 of the Internal Revenue Code (IRC), the phrase is defined thus: "Except as otherwise provided . . . gross income means all income from whatever source derived." Obviously, this is a very broad definition.

Section 162 of the IRC is the section of the Tax Code used to determine the deductibility of business expenditures. This is a lengthy section, but the first sections contain the most important language. Here are the principal provisions:

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

1. A reasonable allowance for salaries or other compensation for personal services actually rendered;
2. Traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business;
3. Rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Apparently, the IRC can be quite vague at times. For example, the IRC does not go on to define "ordinary" or "necessary," even though these terms are very important concepts in small business TAXATION. In the most general sense, a business's NET income is the product of "ordinary and necessary expenses" subtracted from "gross receipts." In an effort to define these important concepts, the federal courts have held "ordinary" to mean "normal, common and accepted under the circumstances by the business community." And according to the courts, "necessary" means "appropriate and helpful." Thus, the two terms generally mean the purpose for which an expense is made.

Basically, gross receipts are all the money earned by the small business entity. And although "ordinary and necessary" expenses are left up to the courts to define, they are not particularly abstract or unusual concepts. Practically every expense that a small business owner reasonably needs to run a business qualifies as "ordinary and necessary." Rent, wages, marketing, and office supplies are some typical examples. But other expenses such as interest on business-related loans and insurance premiums can also qualify.

For tax purposes, income can take many forms. It need not be just cash. Services, good, and other types of property received in exchange for goods or services may qualify as income. If the business owner exchanges goods or services for someone else's goods or services (a process also known as bartering) the owner needs to report the FAIR MARKET VALUE of the goods or services received. Basically, anything of value the owner or the business receives is income, unless it specifically falls within one of the following IRS exclusions such as gifts and inheritances and some "fringe benefits" provided by businesses to owners and employees.

It is particularly important to owners and investors of businesses that the return of a capital investment is not taxed as income. If a business owner sells a business or an asset and receives money for the asset, the business has not earned any TAXABLE INCOME. Only the profit, if there is any, will be taxed.

When the IRS audits business deductions, one of its primary concerns is that personal expenses are claimed as business expenses. Because these tactics are so common among taxpayers, the IRS auditors are especially vigilant when it comes to business expense deductions.

Small Business Tax Deductions

Business owner/taxpayers can deduct most of what they spend in the course of conducting their businesses which makes an enormous difference in their final tax bills. The IRC allows business owners and investors to deduct the costs of conducting the business from their GROSS INCOME. What remains is the net business profit, the amount subject to taxation. The taxpayer/business owner who can legitimately claim the most DEDUCTIBLE business expenses will lower his taxable profits. Generally, if something is necessary for the business, it can be deductible. There are, of course, limitations. Home telephone expenses, traffic tickets, and clothing (except required uniforms) that are worn on the job are not deductible expenses.

The type of business entity can make a big difference when a taxpayer sits down to calculate and file a small business TAX RETURN. Some expenses may or may not be deductible, depending on the type of business entity. A common example is that of charitable contributions, which can be deducted by a C corporation, but not by other types of business entities.

Home businesses offer other potential for deductions. A taxpayer can deduct the portion of the taxpayer's home used for a business as long as the taxpayer conducts administrative or management activities of the business there. And whether the home is owned or rented, the taxpayer can also deduct certain related costs such as utilities, insurance, and remodeling expenses.

Other Deductions

Business taxes will be lower depending on the number of tax deductions the business can legitimately take. How successful the business owner is at reducing business's tax liability depends largely on paying strict attention to IRS rules on just what is and what is not deductible.

When business owners calculating their business's expenses, they need to keep these 13 business deductions in mind:

1. Advertising and Promotion: The costs associated with advertising the business are deductible as a current expense.
2. Auto Expenses: If a vehicle is used for the business, the business owner can deduct the cost of owning, maintaining, and operating it.
3. Bad Debts: The rules differ depending on whether the business sells goods or services. If the business sells products, the owner can deduct the cost of goods that sell but for which the owner has not been paid. If, however, the business sells services, the owner may not deduct the loss associated with a transaction for which a client or customer has not paid.
4. Business Entertaining: Owners may deduct 50 percent of the cost of entertaining either present or prospective clients or customers.
5. Business Start-up Expenses: The costs of starting a business are capital expenses for tax purposes. These expenses must be deducted over the first five years of the business's operation.
6. Charitable Contributions: Limited liability businesses and S corporations (corporation that have elected to be taxed like a partnership) can make charitable contributions and pass the deductions through to the business owner(s). These can be claimed on the owner(s) individual tax returns. If the business is a standard (C) corporation, the deduction does not pass through and the corporation itself deducts the charitable contributions.
7. Computer Software: The general rule states that the business owner must depreciate software over a 36-month period for use in that is bought for the business. There are some important exceptions to this rule, however. Owners may want to check with their tax advisor or IRS publications for more

complete information.

8. Education Costs: Owners may deduct the expense to maintain and enhance their qualifications for their present job, or training required by their employers. Owners may NOT deduct the expenses of a degree or other education program that qualifies them for a new job.
9. Interest: Owners can deduct the interest charges incurred to finance business purchases.
10. Legal and Other Professional Fees: Generally, owners can deduct in the year they incur them, attorney fees and fees they pay to tax professionals or consultants.
11. Moving Expenses: To claim this deduction, the move must have been made in connection with work, the new workplace is at least 50 miles farther from the old home than the old home was.
12. Taxes: Generally, owners may deduct the taxes they incur from running their business. There are many exceptions to this generality though. Taxpayers should check with their tax advisor or IRS publications for more detailed information.
13. Travel: Many expenses from business travel are deductible, including airfare, ground transportation, meals and lodging, mailing or shipping business materials, clothes cleaning, telephone calls, faxes, and gratuities. If others accompany the owner on a business trip, the owner may only deduct the owner's own travel.

Types of Expenses

Knowing whether a business expense is current or capitalized will help to determine when owners may deduct the expense from their business's taxes. The IRC dictates what expenses can be deducted and even in what year they can be deducted. Owners can deduct some business expenses the year they incur them; these are called "current" expenses. They can deduct other business expenses in increments over a certain number of years in the future; these are known as "capitalized" expenditures. It is important to understand the differences between the two types of expenses and the tax rules that apply to each.

Current Expenses

Basically, current expenses include the common expenses of running a taxpayer's business. These include costs such as utility bills, MORTGAGE or rent expenses, copy paper supplies, and so on. The IRC rules for deducting current expenses are fairly clear. In most cases, a taxpayer merely subtracts the amount spent on current expenses from the business's gross income in the year the expenses were incurred.

Capitalized Expenses

Some business owner purchases are meant to help the business create revenue in future years. These are known as "capitalized" expenses because they actually become assets of the business over time. As a business uses capitalized assets, the assets' cost is "matched" to the revenue they help the business to earn. In theory, this helps the business to more accurately account for its real profitability from one year to the next.

Sometimes it is unclear which kind of expense rules to apply to a particular expense. For example, routine costs for equipment repairs seem to be obvious current expenses. But, the IRC states that the cost of making improvements to a business asset must be capitalized if the improvement

- Adapts it to a different use
- Increases its value
- Significantly extends the time a business can use it

If the routine repair to, say, a computer or phone line does any of the above three things, then the expense

should be capitalized

The costs associated with acquiring business equipment are usually considered capital expenses if the equipment will have a useful life of more than one year. However, Section 179 of the IRC permits taxpayers to deduct a certain amount (up to $24,000 in 2001) of its capital assets per year against the business's income. Taxpayers should check with their tax advisor about the rules, advantages, and disadvantages for making this sort of deduction.

Depreciation or Amortization of Expenses

Generally, taxpayers cannot deduct the cost of items with a ldquo;useful life"—at least not in the same way as they can deduct current expenses. Instead, when they buy an asset for their business, the IRS treats the purchase as an investment in their business. Taxpayers must deduct the cost over a number of years, specified in the tax code (with one important exception, discussed below). This deduction is usually known as "depreciation." It is occasionally known as a "depreciation expense" or an "amortization expense." Despite the terminology, these terms describe the same thing: spreading out the deduction of these types of asset purchases over the course of several annual tax cycles.

The rules for depreciating or amortizing expenses can be confusing, and taxpayers need to know the rules that apply to each different type of property. The IRC sets absolute limits for some DEPRECIATION deductions, and it sets the number of years that businesses can depreciate assets. IRC § 179 contains an important exception to the long-term write-off rules: small businesses can deduct most of their capital expenditures in one year.

Independent Contractors and Employees

There are certain financial and tax advantages that arise from having workers classified as independent contractors instead of employees. For example, a business with employees must pay payroll taxes, keep employee records, and file payroll tax forms for its employees. A business need not perform these tasks for its workers who are independent contractors.

The IRS pays careful attention to the classification of workers in a business. Generally, if the business owner or manager instructs its workers when, where, and how to do their jobs, the business owner is treating these workers as employees. Business owners or managers may treat workers as independent contractors only if the workers have their own businesses and offer their services to several contractors. If a business owner or manager is unsure of the status of its workers, it is best to treat them as employees.

It may be tempting to classify workers as independent contractors. Owners might even save money in the short run. However, doing so may get them into big trouble in an IRS AUDIT. The IRS may decide that their "independent contractors" really are employees. This could result in their having to pay an ASSESSMENT of back taxes, penalties, and interest.

Employee Taxes

There are two types of employee-related taxes:

1. Taxes paid by the employer (employer taxes)

2. Employee taxes withheld by the employer (withheld taxes)

While the employer pays these taxes to the IRS, note that employee taxes actually come out of the employees salary or wages. Most employers deposit these amounts with a bank every month. Once every three months, the employer reports on IRS Form 941 the amounts paid and withheld to the IRS.

The employer taxes come from the business income. Employer taxes include the employer's share of Social Security and MEDICARE, as well as an amount for federal unemployment taxes.

Self-employed business owners do not have the same tax liabilities—such as Medicare and Social Security—as a business's employee. Instead, self-employed persons must pay the self-employment tax, which amounts to the combined portion of taxes for employees. Self-employed individuals report their taxes on Form 1040 under the "Other Taxes" category. In addition, self-employed people must also file quarterly ESTIMATED TAX payments for both their individual income and self-employment taxes. When they file their annual INCOME TAX returns, if they have not paid enough estimated tax, they may have to pay a PENALTY to the IRS.

Partnerships

If a taxpayer is in business with other people and all of them share the expenses and profits (even unequally), the IRS deems these people to be in a partnership. This is true whether the parties have entered a formal agreement or not. Consequently, the business must file a yearly partnership tax return (Form 1065). In addition to individual tax returns, the taxpayer and the other people involved in the business must file Form 1065, the annual partnership tax return. A formalized partnership agreement will not affect a taxpayer's tax status, but it is a good idea to consult an attorney and to prepare a partnership agreement in order to clarify the various partners' rights and responsibilities in the business.

Getting Help

The federal tax laws that apply to most small businesses are fairly straight-forward, although they can be confusing in some cases. Keeping good financial records, following directions carefully, and preparing complete and honest tax returns is the best way to avoid trouble with the IRS. For many businesses this can be done without the advice of legal or tax professionals.

In most cases, it is not necessary for taxpayers to hire a legal or tax professional to help them establish a sole proprietorship or to start operating their business. If they plan to establish a general partnership or a C corporation, they may need to seek professional tax advice, especially concerning the many state and local laws with which their business may need to comply. However, it may be a good idea to hire a tax expert if they expect to need complex tax advice. This is a good general guideline, but it is especially true if they plan to do minute comparisons between the various types of business entities.

Additional Resources

Don't Let the IRS Destroy Your Small Business: Seventy-Six Mistakes to Avoid. Savage, Michael, Perseus Publishing, 1998.

422 Tax Deductions for Businesses & Self-Employed Individuals, 3rd Edition. 3rd ed., Bernard B. Kamoroff, Barnard B., Bell Springs Publishing, 2001.

J. K. Lasser's New Rules for Small Business Taxes. Barbara Weltman, Barbara, John Wiley & Sons, 2001.

"Small Business/Self-Employed" Internal Revenue Service, 2002. Available at http://www.irs.gov/businesses/small/display/0,,i1=2&i2=23&g... .

Small Time Operator: How to Start Your Own Business, Keep Your Books, Pay Your Taxes, and Stay Out of Trouble 25th ed., Kamoroff, Barnard B., Bell Springs Publishing, 2000.

"Tax Information for Businesses" Internal Revenue Service, 2002. Available at http://www.irs.ustreas.gov/businesses/display/0,,i1%3D2%26g... .

Tax Savvy for Small Business: Year-Round Tax Strategies to Save You Money, 5th Edition. 5th ed., Nolo Press, 2001.

Organizations

American Small Businesses Association (ASBA)

8773 IL Rte. 75E. NW
Rock City, IL 61070 USA
Phone: (800) 942-2722
URL: http://www.asbaonline.org/index.html

Council On State Taxation

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URL: http://www.statetax.org/index.html

Federation of Tax Administrators (FTA)

444 N. Capital St., NW, Suite 348 NW
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Phone: (202) 624-5890 URL: http://www.taxadmin.org/

National Tax Association (NTA)

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