

# **Tax Basics for Small Business**

---

18<sup>th</sup> Edition

Attorney Frederick W. Daily  
Jeffrey A. Quinn, CPA

# Table of Contents

---

<b>Chapter 1 – Tax Basics.....</b>	<b>1</b>
Learning Objectives .....	1
Introduction.....	1
How Tax Law Is Made and Administered: The Short Course .....	1
Where to Find Tax Rules .....	2
Marginal Tax Rate and Tax Brackets .....	3
What Is—And Isn’t—Income .....	4
Things That Count as Taxable Income .....	4
Exclusions: Things That Aren’t Income.....	5
A Word About Tax Shelters.....	6
The Alternative Minimum Tax (AMT).....	7
Review Questions.....	8
Review Answers .....	9
<b>Chapter 2 – Deductible Business Expenses .....</b>	<b>11</b>
Learning Objectives .....	11
Introduction.....	11
What Is a Deductible Business Expense? .....	12
Ordinary and Necessary .....	12
Not Extravagant.....	13
Personal Expenses .....	13
Is It a Current or Future Year Expense? .....	13
Top Deductions for Businesses.....	14
The General Business Credit .....	26
Vehicle Expenses .....	26
Standard Mileage Method .....	27
Actual Expense Method .....	27
Commuting Costs .....	28
Special C Corporation Vehicle Rules.....	30
Other Vehicle-Related Deduction Opportunities.....	30
How and Where to Claim Expense Deductions .....	30
Review Questions.....	33
Review Answers .....	35
<b>Chapter 3 – Writing Off Long-Term Business Assets .....</b>	<b>39</b>
Learning Objectives .....	39
Introduction.....	39
Tax Treatment of Business Costs .....	39
Current Expenses .....	39
Capital Expenses .....	39
Section 179: Expensing Business Assets.....	40
Ineligible Assets.....	41
50% Business Use Requirement.....	41
Listed Property—Special Rules.....	41
Earned Income and Carryforward.....	42
Spending Cap.....	42
Married Couples .....	42
Multiple Owners .....	42
Passive Investors.....	43
Recapture.....	43
Trade-Ins.....	43
Combining Section 179 and Depreciation Deductions .....	43
Items Bought on Credit .....	44
Depreciating Business Assets.....	44

## Table of Contents

What Is Depreciation?	44
Depreciation Categories	44
Methods of Depreciation	45
Tax Rules for Business Vehicles	47
First-Year Depreciation Rules	49
How to Report Depreciation and Section 179 Deductions	49
Inventory	50
Tax Basis of Business Assets	51
Purchased Items—Cost Basis	52
Items Received as a Gift—Transferred Basis	52
Items Received for Services—Fair Market Value (FMV) Basis	52
Items You Inherit—Step-Up Basis	52
Items Exchanged for Other Items—Substituted Basis	53
Items Exchanged for Items and Money	53
Items Converted to Business Use	53
Leasing Instead of Buying	54
Vehicles Used for Business	54
Leasing Your Assets to Your C Corporation	55
When You Dispose of Business Assets: Depreciation Recapture	56
Sale of Business Equipment	56
Like-Kind Exchanges	57
Destroyed or Stolen Assets	57
Sale of Real Estate	57
Tax Errors in Depreciation	57
Review Questions	59
Review Answers	61
<b>Chapter 4 – Bookkeeping and Accounting</b>	<b>63</b>
Learning Objectives	63
Introduction	63
Why You Need a Bookkeeping System	63
Should You Hire a Bookkeeper?	64
Bookkeeping Basics	64
Manual Bookkeeping System	65
Computerized Bookkeeping System	66
What Kinds of Records to Keep	68
Income Records	68
Expense Records	69
Asset Records	70
How Long Records Should Be Kept	72
Bookkeeping Methods of Tracking Income and Expenses	72
Single-Entry System	72
Double-Entry System	72
Timing Methods of Accounting: Cash and Accrual	73
Cash Method Accounting	73
Accrual Method Accounting	74
Hybrid and Special Accounting Methods	74
Changing Accounting Methods	75
Accounting Periods: Calendar Year or Fiscal Year	75
Calendar Year Period	75
Fiscal Year Period	75
Short Tax Years	75
Review Questions	77
Review Answers	78
<b>Chapter 5 – Business Losses and Failures</b>	<b>81</b>
Learning Objectives	81

## Table of Contents

Introduction.....	81
Unincorporated Business Losses.....	81
Owners' Operating Losses and Carryovers.....	81
NOL Rules.....	82
Investors and Capital Losses.....	82
Additional Tax Rules for Losses.....	82
Incorporated Business Losses.....	83
Shareholder Losses.....	83
C Corporation Operating Losses.....	84
Review Questions.....	86
Review Answers.....	87
<b>Chapter 6 – Tax Concerns of Employers.....</b>	<b>89</b>
Learning Objectives.....	89
Introduction.....	89
Employer Identification Numbers.....	89
What Are Payroll Taxes?.....	90
Reporting and Depositing Payroll Taxes.....	93
Payroll Tax Forms.....	93
Personal Responsibility for Payroll Taxes.....	98
If You Get Behind on Payroll Tax Payments.....	99
Classifying Workers: Employee or Independent Contractor?.....	100
Reporting Payments to Independent Contractors.....	100
IRS Worker Classifications.....	101
Misclassifying Employees as Independent Contractors.....	103
How the IRS Finds Out.....	103
Penalties for Misclassifying Workers.....	103
Avoiding Trouble With the IRS.....	104
Asking the IRS to Classify Your Workers.....	105
Appealing a Ruling That You Misclassified Workers.....	105
IRS Filing and Payment Requirements for Employers.....	105
Record Keeping for Your Workers.....	106
Review Questions.....	108
Review Answers.....	109
<b>Chapter 7 – Sole Proprietorships—Solos, Freelancers, and Independent Contractors.....</b>	<b>111</b>
Learning Objectives.....	111
Introduction.....	111
What It Means to Be a Solo—From a Tax Perspective.....	111
To Be or Not to Be—A Solo.....	111
Pros.....	111
Cons.....	112
Solo Income and Expenses.....	112
Income.....	112
Expenses.....	112
Business Income Minus Expenses: What's Left Gets Taxed.....	113
Solos' Tax Forms: Schedule C Is Your Friend.....	114
Schedule C (Schedule F for Agricultural Solos).....	114
Getting Real Simple With Schedule C-EZ.....	117
Other Solo Tax Forms.....	118
What If My Solo Biz Loses Money?.....	118
How Solos Are Taxed.....	118
Figuring the Self-Employment Tax.....	119
Estimated Taxes: Pay as You Go.....	122
How to Make Estimated Tax Payments.....	123
Solos Hiring Help.....	123
Record Keeping for Solos.....	124

## Table of Contents

When a Solo Closes Up Shop .....	125
Death of a Solo .....	125
Outgrowing the Solo .....	125
Review Questions .....	127
Review Answers .....	128
<b>Chapter 8 – C Corporations .....</b>	<b>131</b>
Learning Objectives .....	131
Introduction .....	131
Types of Corporations .....	131
How C Corporations Are Taxed .....	133
Double Taxation of Profits .....	133
Corporate Operating Losses .....	134
Tax Reporting for C Corporations .....	134
Tax on Retained Earnings .....	135
Less Common Taxes .....	137
Tax Benefits of C Corporations .....	137
Income Splitting .....	137
More Fringe Benefits .....	137
Corporate Business Losses .....	138
Dividends Received From Other Corporations .....	138
Charitable Contributions .....	138
Incorporating Your Business .....	138
Putting Cash Into a New Corporation .....	138
Lending Money to Your New Corporation .....	139
Putting Assets Into a New Corporation .....	139
The Importance of Issuing Section 1244 Stock .....	141
The Section 1244 Corporate Resolution .....	142
Claiming a Section 1244 Loss .....	142
Taking Money Out of a C Corporation .....	143
Compensation for Services .....	144
Dividends .....	144
Loans to Shareholders .....	144
Leasing Assets to Your Corporation .....	145
Selling Your Corporate Stock .....	146
Tax Pitfalls of C Corporations .....	146
Personal Holding Company Tax .....	147
Accumulated Earnings Tax .....	147
Corporate Alternative Minimum Tax .....	147
Dissolving a C Corporation .....	147
Tax Issues Upon Dissolution .....	147
Reporting the Dissolution to the IRS .....	148
Review Questions .....	149
Review Answers .....	150
<b>Chapter 9 – S Corporations .....</b>	<b>153</b>
Learning Objectives .....	153
Introduction .....	153
An Overview of S Corporations .....	153
Should You Choose S Corporation Status? .....	154
Qualifying for S Corporation Status .....	154
S Corporation Disadvantages .....	157
Tax Reporting for S Corporations .....	157
How S Corporation Shareholders Are Taxed .....	159
Profits .....	159
Losses .....	159
Social Security and Medicare Taxes .....	162

## Table of Contents

Electing S Corporation Status .....	162
Revoking S Corporation Status .....	162
Dissolving an S Corporation.....	163
Review Questions.....	165
Review Answers .....	166
<b>Chapter 10 – Partnerships.....</b>	<b>167</b>
Learning Objectives .....	167
Introduction.....	167
Partnership Tax Status .....	167
Tax Reporting .....	168
Annual Partnership Tax Returns .....	168
Partner’s Profit or Loss Statements (K-1) .....	169
Partnership Federal Identification Number.....	169
Tax Obligations of Partners.....	169
Self-Employment Taxes .....	170
Estimated Income Taxes.....	169
Calculating and Reporting a Partner’s Income.....	171
Partnership Losses .....	173
Partnership Contributions.....	173
Keeping Track of Partners’ Contributions: Capital Accounts .....	173
Adjustments to Partners’ Capital Accounts .....	175
Partnership Liabilities.....	175
Getting Money Out of a Partnership .....	176
Taxation of Withdrawals.....	176
Loans to Partners .....	176
Partnership Expenses.....	176
Selling or Transferring a Partnership Interest .....	176
Selling Your Partnership Interest.....	176
When the Partnership Buys Out a Partner.....	177
Relief of Debt—Phantom Income .....	177
Date-of-Sale Adjustment.....	177
Ending a Partnership .....	178
Review Questions.....	180
Review Answers .....	181
<b>Chapter 11 – Limited Liability Companies.....</b>	<b>183</b>
Learning Objectives .....	183
Introduction.....	183
Taxes .....	183
Federal Tax Reporting .....	183
State Taxes .....	184
Unequal Allocations of Profit and Loss .....	184
Comparing LLCs With Other Entities.....	184
Operating Your LLC.....	185
Forming an LLC .....	185
Converting a Business to an LLC .....	186
LLC Members’ Rights .....	186
Transferring Ownership—Sale or Death.....	186
Terminating an LLC .....	187
Review Questions.....	188
Review Answers .....	189
<b>Chapter 12 – Qualified Personal Service Corporations .....</b>	<b>191</b>
Learning Objectives .....	191
Introduction.....	191
Qualified Personal Service Corporations.....	191

## Table of Contents

IRS Tests for a QPSC .....	191
QPSCs and Taxes .....	192
Accounting Method Elections .....	193
Section 1244 Stock .....	193
Fringe Benefits .....	193
Tax-Advantaged Retirement Plans .....	193
Health and Life Insurance Benefits .....	193
Other Fringe Benefits .....	193
Transferring Shares .....	193
Dissolving a QPSC .....	193
Review Questions .....	195
Review Answers .....	196
<b>Chapter 13 – Family Businesses .....</b>	<b>197</b>
Learning Objectives .....	197
Introduction .....	197
The Legal Structure of a Family Business .....	197
Income Splitting Lowers Taxes .....	197
Legality of Hiring Your Kids .....	197
Tax Benefits of Hiring Your Kids .....	198
Making Your Kids Co-Owners .....	199
Putting Older Parents on the Payroll .....	199
A Spouse in the Business .....	200
Letting Your Spouse Volunteer .....	200
File Taxes as Co-Sole Proprietors .....	200
Preserving a Family Business After Death .....	201
Death and Taxes .....	201
Installment Plans for Estate Taxes .....	201
Transferring a Business Before Death .....	202
Review Questions .....	206
Review Answers .....	207
<b>Chapter 14 – Home-Based Businesses .....</b>	<b>209</b>
Learning Objectives .....	209
Introduction .....	209
Business Expenses Incurred at Home .....	209
The Home Office Deduction .....	211
Rule 1. Principal Place of Business .....	211
Rule 2. Separately Identifiable Space .....	212
Rule 3. Regular and Exclusive Use .....	212
Calculating Your Home Office Deduction .....	213
Renters .....	215
Owners .....	215
Other Home-Related Deductible Expenses .....	216
New Safe Harbor Rule for the Home Office Deduction .....	216
Tax When Selling the Home Office .....	217
A Home Business as a Tax Shelter .....	217
Business Losses at Home .....	218
Hobby or Business? .....	218
The Profit Motive Requirement .....	218
Review Questions .....	221
Review Answers .....	222
<b>Chapter 15 – Fringe Benefits .....</b>	<b>223</b>
Learning Objectives .....	223
Introduction .....	223
How Fringe Benefits Save Taxes .....	223

## Table of Contents

Retirement Benefits .....	224
Motor Vehicles .....	224
Meals .....	224
Travel and Lodging .....	225
Mixing Business and Pleasure Travel .....	225
Business Meetings, Trade Shows, and Conventions .....	225
Taking the Family Along .....	226
Lodging at the Workplace .....	226
Clubs and Athletic Facilities .....	227
Health Benefits .....	227
The Affordable Health Care Act and Small Businesses .....	227
Deducting Health Insurance for Employees .....	227
Health Insurance Tax Credit .....	228
Health Savings Accounts (HSAs) .....	228
Flexible Spending Accounts (FSAs) .....	228
Group Plans Paid by Employees .....	228
Solos, Partnerships, LLCs, and S Corporations .....	228
C Corporations .....	229
Dependent Care Assistance .....	229
Long-Term Care Insurance .....	230
Group Term Life Insurance .....	230
Education Benefits .....	230
Directly Related Education .....	230
Educational Assistance Plan .....	231
Other Education .....	231
Dues and Subscriptions .....	231
Driver and Bodyguard Services .....	231
Moving Expenses .....	231
Retirement Planning Services .....	231
Gifts, Awards, Discounts, and Free Services .....	231
Small Gifts to Employees .....	232
Employee Awards .....	232
No-Added-Cost Services .....	232
Discounts .....	232
Commuter Transportation and Parking .....	233
Working Condition Fringes .....	233
De Minimis Benefits .....	233
Adoption Assistance .....	233
Job Placement Assistance .....	233
Cafeteria Plans .....	233
Special Benefits for C Corporation Employees Only .....	234
Loans to Shareholders .....	234
Entertainment and Vacation Facilities .....	234
Stock Options and ESOPs .....	234
Review Questions .....	236
Review Answers .....	237
<b>Chapter 16 – Retirement Plans .....</b>	<b>239</b>
Learning Objectives .....	239
Introduction .....	239
Advantages of Retirement Plans .....	239
Overview of Retirement Plan Types .....	240
Details About Each Type of Retirement Plan .....	241
Individual Retirement Accounts (IRAs): Traditional and Roth IRA Plans .....	241
SIMPLE IRAs .....	244
Simplified Employee Pensions (SEPs) .....	245
Qualified Retirement Plans (ERISA) .....	246



## Table of Contents

Defined Contribution Profit-Sharing Plans (PSPs) .....	247
Money Purchase Plan (MPP) .....	247
Traditional 401(k) Plans .....	247
Roth 401(k) Plan .....	248
Defined Benefit Plans (DBPs) .....	248
Where to Go for a Retirement Plan .....	249
Tax Credit for Professional Help .....	249
Potential Tax Problems With Retirement Plans .....	249
Excess Contributions .....	250
Overfunded Plans (Defined Benefit Plans Only) .....	250
Affiliated Service Groups and Controlled Groups .....	250
Withdrawing Money From Retirement Plans .....	250
Avoiding Withdrawal Penalties .....	251
Tax Withholding on Withdrawals .....	251
Mixed Contribution Plan Withdrawals .....	251
Loans From Some Retirement Plans .....	251
Lump Sum Withdrawals .....	252
Mandatory Withdrawals by 70½ .....	252
What Happens at Death .....	252
Closing Your Business or Leaving Your Employer .....	252
Review Questions .....	254
Review Answers .....	255
<b>Chapter 17 – Buying a Business .....</b>	<b>257</b>
Learning Objectives .....	257
Introduction .....	257
Buying the Assets of a Business .....	257
Unincorporated Businesses .....	258
Small Business Corporations .....	258
Buying Shares of Stock .....	258
Investigation .....	259
Indemnification .....	260
Holdbacks and Offsets .....	260
Assigning a Price to Business Assets .....	261
Classifying Assets for the IRS .....	261
Allocation to Seven IRS Classes .....	261
Assigning Dollar Values to the Classes .....	264
State and Local Transfer Taxes .....	264
Review Questions .....	266
Review Answers .....	267
<b>Chapter 18 – Selling or Closing a Sole Proprietorship .....</b>	<b>269</b>
Learning Objectives .....	269
Introduction .....	269
Reporting the Sale of a Sole Proprietorship .....	269
Figuring Your Gain or Loss .....	270
How Your Gain or Loss Is Taxed .....	270
The Importance of an Arms-Length Deal .....	271
How to Protect Yourself From IRS Challenges .....	271
Set Reasonable Price and Terms .....	271
Observe the Formalities .....	272
Allocate Asset Values Fairly .....	272
Keep Your Records After the Sale .....	272
Review Questions .....	274
Review Answers .....	275

## Table of Contents

<b>Chapter 19 – When You Can’t Pay Your Taxes .....</b>	<b>277</b>
Learning Objectives .....	277
Introduction.....	277
If You Owe Less Than \$50,000.....	277
Getting More Time to Pay .....	278
Paying in Installments .....	278
Interest and Penalties .....	278
Under \$50,000 Payment Plans.....	279
Over \$50,000 Payment Plans.....	279
If You Fall Behind on Your Payments.....	279
What to Expect When the IRS Gets Serious.....	280
The Sneak Attack .....	280
Meeting With the Collector .....	280
Actions the Tax Collector Can Take .....	281
Cooperating With the Collector.....	282
Dealing With a Monster Tax Bill .....	282
The Offer in Compromise.....	282
Bankruptcy.....	283
When the IRS Can Take Your Assets .....	283
Federal Tax Liens .....	283
Federal Tax Levies: Seizing Assets.....	283
Getting Liens and Levies Released .....	284
Review Questions.....	286
Review Answers .....	287
 <b>Chapter 20 – Audits .....</b>	 <b>289</b>
Learning Objectives .....	289
Introduction.....	289
Who Gets Audited?.....	289
Computer Picks .....	289
Market Segment Specialization Programs .....	289
Informants’ Tips .....	290
Follow-Up Audits.....	290
Prior Audits.....	290
Criminal Investigations.....	290
Amended Returns and Refund Claims .....	290
Filing Extensions.....	290
How Long Do You Have to Worry About an Audit?.....	291
How the IRS Audits Small Businesses .....	291
Office and Correspondence Audits.....	291
Field Audits.....	291
The Auditor’s Powers.....	292
Inspecting Business Premises.....	293
Viewing Home Offices.....	293
Scrutinizing Your Records.....	293
Summoning Records Held by Others .....	294
Should You Get Audit Help? .....	294
Preparing for Your Audit .....	295
What to Bring to an Audit .....	295
Don’t Rush a Field Audit .....	296
What an Auditor Looks for When Examining a Business .....	297
The Income Probe .....	300
Bank Deposit Analysis .....	300
Is It a Legitimate Business Expense? .....	300
How to Behave at an Audit.....	300
Keep Chitchat to a Minimum .....	300
Answer Questions Concisely.....	301

## Table of Contents

Don't Be Hostile or Phony .....	301
Complain If the Auditor Is Abusive.....	301
How to Negotiate With an Auditor .....	302
Don't Just Sit There .....	302
Talk Percentages, Not Dollars.....	302
Arguing Issues.....	303
Adjustments in Your Favor—Taking the Offensive.....	303
Don't Try to Negotiate Based on Inability to Pay.....	303
Your Options After Getting an Audit Report.....	304
Agree.....	304
Argue.....	304
Do Nothing.....	304
When Your Audit Is Final .....	305
Review Questions.....	306
Review Answers .....	307
<b>Chapter 21 – Appealing IRS Audits .....</b>	<b>309</b>
Learning Objectives .....	309
Introduction.....	309
IRS Appeals .....	309
Writing an Appeal Letter.....	309
Settling Without a Hearing.....	310
The Appeals Hearing .....	311
Payment After an Appeals Settlement.....	312
Contesting an Audit in Court .....	312
About Tax Court.....	312
Can You Do It Yourself in Tax Court?.....	312
Filing Your Petition in Tax Court.....	312
Tax Court Pretrial Procedure.....	313
Settling Before Trial .....	313
Your Tax Court Trial.....	313
Tax Court Decisions.....	314
Review Questions.....	316
Review Answers .....	317
<b>Chapter 22 – Penalties and Interest.....</b>	<b>319</b>
Learning Objectives .....	319
Introduction.....	319
Common Reasons for Penalties.....	319
Inaccuracies .....	319
Civil Fraud .....	319
Late Payment .....	319
Late Filing.....	320
Filing and Paying Late.....	320
Underpaying Estimated Taxes .....	320
Interest on Tax Bills .....	320
Understanding Penalty and Interest Notices.....	321
How to Get Penalties Reduced or Eliminated.....	321
How to Request a Penalty Abatement.....	321
If Your Abatement Request Is Rejected.....	323
How to Get Interest Charges Removed.....	323
Designating Payments on Delinquent Tax Bills.....	323
Review Questions.....	325
Review Answers .....	326
<b>Chapter 23 – Help Beyond the Book.....</b>	<b>327</b>
Learning Objectives .....	327

## Table of Contents

Introduction.....	327
Finding Answers to Tax Questions.....	327
IRS Booklets and CD-ROM.....	328
Free IRS and Social Security Telephone Information.....	328
Free IRS Programs.....	329
IRS Written Advice.....	329
Internal Revenue Code.....	329
IRS Interpretations of the Tax Code.....	330
Court Cases.....	331
Federal Small Business Programs.....	331
Private Tax Guides and Software.....	332
Trade Association Publications.....	332
Tax Info Online.....	332
Finding and Using a Tax Pro.....	332
Types of Tax Advisers and Preparers.....	333
How Tax Pros Can Help.....	333
Choosing the Right Tax Pro for Your Business.....	334
Tax Pros Aren't Cheap.....	334
Review Questions.....	336
Review Answers.....	337
<b>Appendix A – Answers to Frequently Asked Questions.....</b>	<b>339</b>
<b>Appendix B – Forms Checklist and Due Dates.....</b>	<b>345</b>
<b>Glossary.....</b>	<b>349</b>
<b>Index.....</b>	<b>361</b>