

Tax Basics for Small Business

Edition 18.2

Attorney Frederick W. Daily
Jeffrey A. Quinn, CPA

Table of Contents

Chapter 1 – Tax Basics	1
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).....	6
Review Questions.....	8
Review Answers	9
Chapter 2 – Deductible Business Expenses	11
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
Vehicles.....	14
Equipment and Furniture.....	14
Inventory.....	14
Home Office.....	14
Retirement Account Deposits	14
Hiring Help.....	14
Manufacturers.....	14
Rent.....	15
Costs of Going Into Business	15
Accounting, Legal, and Other Professional Fees	15
Office Supplies.....	17
Entertainment and Meals: The 50% Rule	17
Gifts to Clients and Customers.....	18
Travel	19
Moving Expenses	20
Health Insurance.....	20
Disability and Sick Pay.....	20
Education Expenses	20
Interest	21
Bad Debts.....	21
Charitable Contributions.....	22
Taxes	22
Advertising and Promotion	23
Business Licenses and Permits.....	24
Repairs and Improvements	24
Casualty Losses	24
Business Insurance.....	24
Research and Development Credits.....	25
Domestic Production.....	25
The General Business Credit	26
Vehicle Expenses	26

Table of Contents

Standard Mileage Method	27
Actual Expense Method	27
Commuting Costs	28
Special C Corporation Vehicle Rules.....	29
Other Vehicle-Related Deduction Opportunities.....	29
How and Where to Claim Expense Deductions	30
Review Questions.....	32
Review Answers	34
Chapter 3 – Writing Off Long-Term Business Assets	37
Learning Objectives	37
Introduction.....	37
Tax Treatment of Business Costs	37
Current Expenses	37
Capital Expenses.....	37
Section 179: Expensing Business Assets.....	38
Ineligible Assets.....	39
50% Business Use Requirement.....	39
Listed Property—Special Rules.....	39
Earned Income and Carryforward.....	40
Spending Cap.....	40
Married Couples	40
Multiple Owners	40
Passive Investors.....	40
Recapture.....	41
Trade-Ins.....	41
Combining Section 179 and Depreciation Deductions	41
Items Bought on Credit	41
Depreciating Business Assets.....	42
What Is Depreciation?.....	42
Depreciation Categories.....	42
Methods of Depreciation	43
Tax Rules for Business Vehicles	44
First-Year Depreciation Rules	47
How to Report Depreciation and Section 179 Deductions.....	47
Inventory	48
Tax Basis of Business Assets	49
Purchased Items—Cost Basis.....	50
Items Received as a Gift—Transferred Basis	50
Items Received for Services—Fair Market Value (FMV) Basis.....	50
Items You Inherit—Step-Up Basis	50
Items Exchanged for Other Items—Substituted Basis.....	51
Items Exchanged for Items and Money	51
Items Converted to Business Use	51
Leasing Instead of Buying.....	52
Vehicles Used for Business.....	52
Leasing Your Assets to Your C Corporation	53
When You Dispose of Business Assets: Depreciation Recapture	54
Sale of Business Equipment	54
Like-Kind Exchanges	55
Destroyed or Stolen Assets.....	55
Sale of Real Estate	55
Tax Errors in Depreciation	55
Review Questions.....	57
Review Answers	59

Table of Contents

Chapter 4 – Bookkeeping and Accounting..... 61
Learning Objectives 61
Introduction..... 61
Why You Need a Bookkeeping System 61
Should You Hire a Bookkeeper? 62
Bookkeeping Basics 62
 Manual Bookkeeping System..... 63
 Computerized Bookkeeping System..... 64
What Kinds of Records to Keep 65
 Income Records..... 65
 Expense Records 66
 Asset Records 67
How Long Records Should Be Kept..... 68
Bookkeeping Methods of Tracking Income and Expenses..... 69
 Single-Entry System 69
 Double-Entry System 69
Timing Methods of Accounting: Cash and Accrual..... 70
 Cash Method Accounting 70
 Accrual Method Accounting..... 70
 Hybrid and Special Accounting Methods 71
 Changing Accounting Methods..... 71
Accounting Periods: Calendar Year or Fiscal Year 71
 Calendar Year Period 72
 Fiscal Year Period..... 72
 Short Tax Years..... 72
Review Questions..... 74
Review Answers 75

Chapter 5 – Business Losses and Failures..... 77
Learning Objectives 77
Introduction..... 77
Unincorporated Business Losses 77
 Owners’ Operating Losses and Carryovers 77
 NOL Rules..... 78
 Investors and Capital Losses 78
 Additional Tax Rules for Losses 78
Incorporated Business Losses 79
 Shareholder Losses 79
 C Corporation Operating Losses 80
Review Questions..... 82
Review Answers 83

Chapter 6 – Tax Concerns of Employers..... 85
Learning Objectives 85
Introduction..... 85
Employer Identification Numbers..... 85
What Are Payroll Taxes? 86
Reporting and Depositing Payroll Taxes..... 89
 Payroll Tax Forms..... 89
 Personal Responsibility for Payroll Taxes..... 94
 If You Get Behind on Payroll Tax Payments..... 95
Classifying Workers: Employee or Independent Contractor? 95
 Reporting Payments to Independent Contractors 96
 IRS Worker Classifications..... 96
Misclassifying Employees as Independent Contractors 98
 How the IRS Finds Out 98
 Penalties for Misclassifying Workers 99

Table of Contents

Avoiding Trouble with the IRS	99
Asking the IRS to Classify Your Workers.....	100
Appealing a Ruling That You Misclassified Workers	101
IRS Filing and Payment Requirements for Employers	101
Record Keeping for Your Workers.....	102
Review Questions.....	104
Review Answers	105
Chapter 7 – Sole Proprietorships—Solos, Freelancers, and Independent Contractors.....	107
Learning Objectives	107
Introduction.....	107
What It Means to Be a Solo—From a Tax Perspective	107
To Be or Not to Be—A Solo	107
Pros.....	107
Cons.....	108
Solo Income and Expenses	108
Income	108
Expenses.....	108
Business Income Minus Expenses: What's Left Gets Taxed.....	109
Solos' Tax Forms: Schedule C Is Your Friend	110
Schedule C (Schedule F for Agricultural Solos)	110
Getting Real Simple With Schedule C-EZ.....	113
Other Solo Tax Forms.....	114
What If My Solo Biz Loses Money?	114
How Solos Are Taxed	114
Figuring the Self-Employment Tax	115
Estimated Taxes: Pay as You Go.....	118
How to Make Estimated Tax Payments	119
Solos Hiring Help	119
Record Keeping for Solos	120
When a Solo Closes Up Shop.....	121
Death of a Solo.....	121
Outgrowing the Solo	121
Review Questions.....	123
Review Answers	124
Chapter 8 – C Corporations	127
Learning Objectives	127
Introduction.....	127
Types of Corporations.....	127
How C Corporations Are Taxed	129
Double Taxation of Profits.....	129
Corporate Operating Losses	130
Tax Reporting for C Corporations.....	130
Tax on Retained Earnings.....	131
Less Common Taxes	133
Tax Benefits of C Corporations	133
Income Splitting	133
More Fringe Benefits.....	133
Corporate Business Losses	134
Dividends Received From Other Corporations.....	134
Charitable Contributions.....	134
Incorporating Your Business	134
Putting Cash Into a New Corporation	134
Lending Money to Your New Corporation.....	135
Putting Assets Into a New Corporation	135
The Importance of Issuing Section 1244 Stock.....	137

Table of Contents

The Section 1244 Corporate Resolution.....	138
Claiming a Section 1244 Loss.....	138
Taking Money Out of a C Corporation.....	139
Compensation for Services.....	139
Dividends.....	139
Loans to Shareholders.....	140
Leasing Assets to Your Corporation.....	140
Selling Your Corporate Stock.....	141
Tax Pitfalls of C Corporations.....	142
Personal Holding Company Tax.....	142
Accumulated Earnings Tax.....	142
Corporate Alternative Minimum Tax.....	142
Dissolving a C Corporation.....	142
Tax Issues Upon Dissolution.....	142
Reporting the Dissolution to the IRS.....	143
Review Questions.....	144
Review Answers.....	145
Chapter 9 – S Corporations.....	147
Learning Objectives.....	147
Introduction.....	147
An Overview of S Corporations.....	147
Should You Choose S Corporation Status?.....	148
Qualifying for S Corporation Status.....	148
S Corporation Disadvantages.....	151
Tax Reporting for S Corporations.....	151
How S Corporation Shareholders Are Taxed.....	153
Profits.....	153
Losses.....	153
Social Security and Medicare Taxes.....	154
Electing S Corporation Status.....	156
Revoking S Corporation Status.....	156
Dissolving an S Corporation.....	157
Review Questions.....	159
Review Answers.....	160
Chapter 10 – Partnerships.....	161
Learning Objectives.....	161
Introduction.....	161
Partnership Tax Status.....	161
Tax Reporting.....	162
Annual Partnership Tax Returns.....	162
Partner’s Profit or Loss Statements (K-1).....	162
Partnership Federal Identification Number.....	163
Tax Obligations of Partners.....	163
Self-Employment Taxes.....	163
Estimated Income Taxes.....	163
Calculating and Reporting a Partner’s Income.....	165
Partnership Losses.....	167
Partnership Contributions.....	167
Keeping Track of Partners’ Contributions: Capital Accounts.....	167
Adjustments to Partners’ Capital Accounts.....	169
Partnership Liabilities.....	169
Getting Money Out of a Partnership.....	170
Taxation of Withdrawals.....	170
Loans to Partners.....	170
Partnership Expenses.....	170

Table of Contents

Selling or Transferring a Partnership Interest	170
Selling Your Partnership Interest	170
When the Partnership Buys Out a Partner	171
Relief of Debt—Phantom Income	171
Date-of-Sale Adjustment	171
Ending a Partnership	172
Review Questions	174
Review Answers	175
Chapter 11 – Limited Liability Companies.....	177
Learning Objectives	177
Introduction.....	177
Taxes	177
Federal Tax Reporting	177
State Taxes	178
Unequal Allocations of Profit and Loss	178
Comparing LLCs With Other Entities.....	178
Operating Your LLC	179
Forming an LLC	179
Converting a Business to an LLC	180
LLC Members’ Rights	180
Transferring Ownership—Sale or Death.....	180
Terminating an LLC	181
Review Questions.....	182
Review Answers	183
Chapter 12 – Qualified Personal Service Corporations	185
Learning Objectives	185
Introduction.....	185
Qualified Personal Service Corporations	185
IRS Tests for a QPSC.....	185
QPSCs and Taxes	186
Accounting Method Elections	187
Section 1244 Stock.....	187
Fringe Benefits	187
Tax-Advantaged Retirement Plans.....	187
Health and Life Insurance Benefits.....	187
Other Fringe Benefits.....	187
Transferring Shares	187
Dissolving a QPSC	187
Review Questions.....	189
Review Answers	190
Chapter 13 – Family Businesses	191
Learning Objectives	191
Introduction.....	191
The Legal Structure of a Family Business	191
Income Splitting Lowers Taxes	191
Legality of Hiring Your Kids	191
Tax Benefits of Hiring Your Kids.....	192
Making Your Kids Co-Owners	193
Putting Older Parents on the Payroll	193
A Spouse in the Business	194
Letting Your Spouse Volunteer.....	194
File Taxes as Co-Sole Proprietors.....	194
Preserving a Family Business After Death	195
Death and Taxes	195

Table of Contents

Installment Plans for Estate Taxes	195
Transferring a Business Before Death.....	196
Review Questions.....	200
Review Answers	201
Chapter 14 – Home-Based Businesses	203
Learning Objectives	203
Introduction.....	203
Business Expenses Incurred at Home.....	203
The Home Office Deduction.....	205
Rule 1. Principal Place of Business	205
Rule 2. Separately Identifiable Space.....	206
Rule 3. Regular and Exclusive Use	206
Calculating Your Home Office Deduction	207
Renters.....	209
Owners.....	209
Other Home-Related Deductible Expenses	210
Safe Harbor Rule for the Home Office Deduction	210
Tax When Selling the Home Office	211
A Home Business as a Tax Shelter.....	211
Business Losses at Home.....	212
Hobby or Business?.....	212
The Profit Motive Requirement.....	212
Review Questions.....	215
Review Answers	216
Chapter 15 – Fringe Benefits	217
Learning Objectives	217
Introduction.....	217
How Fringe Benefits Save Taxes	217
Retirement Benefits	218
Motor Vehicles.....	218
Meals	218
Travel and Lodging	219
Mixing Business and Pleasure Travel.....	219
Business Meetings, Trade Shows, and Conventions	219
Taking the Family Along.....	220
Lodging at the Workplace.....	220
Clubs and Athletic Facilities	221
Health Benefits	221
The Affordable Health Care Act and Small Businesses.....	221
Deducting Health Insurance for Employees.....	221
Health Insurance Tax Credit.....	222
Health Savings Accounts (HSAs)	222
Flexible Spending Accounts (FSAs)	222
Group Plans Paid by Employees.....	222
Solos, Partnerships, LLCs, and S Corporations.....	222
C Corporations.....	223
Dependent Care Assistance Plan.....	223
Long-Term Care Insurance	224
Group Term Life Insurance	224
Education Benefits.....	224
Directly Related Education.....	224
Educational Assistance Program.....	225
Other Education.....	225
Dues and Subscriptions.....	225
Driver and Bodyguard Services.....	225

Table of Contents

Moving Expenses	225
Retirement Planning Services	225
Gifts, Awards, Discounts, and Free Services	225
Small Gifts to Employees	226
Employee Awards	226
No-Added-Cost Services	226
Discounts	226
Commuter Transportation and Parking	227
Working Condition Fringes	227
De Minimis Benefits	227
Adoption Assistance	227
Job Placement Assistance	227
Cafeteria Plans	227
Special Benefits for C Corporation Employees Only	228
Loans to Shareholders	228
Entertainment and Vacation Facilities	228
Stock Options and ESOPs	228
Review Questions	230
Review Answers	231
Chapter 16 – Retirement Plans	233
Learning Objectives	233
Introduction	233
Advantages of Retirement Plans	233
Overview of Retirement Plan Types	234
Details About Each Type of Retirement Plan	235
Individual Retirement Accounts (IRAs): Traditional and Roth IRA Plans	235
SIMPLE IRAs	238
Simplified Employee Pensions (SEPs)	239
Qualified Retirement Plans (ERISA)	240
Defined Contribution Profit-Sharing Plans (PSPs)	241
Money Purchase Plan (MPP)	241
Traditional 401(k) Plans	241
Roth 401(k) Plan	242
Defined Benefit Plans (DBPs)	242
Where to Go for a Retirement Plan	243
Tax Credit for Professional Help	243
Potential Tax Problems With Retirement Plans	243
Excess Contributions	244
Overfunded Plans (Defined Benefit Plans Only)	244
Affiliated Service Groups and Controlled Groups	244
Withdrawing Money From Retirement Plans	244
Avoiding Withdrawal Penalties	245
Tax Withholding on Withdrawals	245
Mixed Contribution Plan Withdrawals	245
Loans From Some Retirement Plans	245
Lump Sum Withdrawals	246
Mandatory Withdrawals by 70½	246
What Happens at Death	246
Closing Your Business or Leaving Your Employer	246
Review Questions	248
Review Answers	249
Chapter 17 – Buying a Business	251
Learning Objectives	251
Introduction	251
Buying the Assets of a Business	251

Table of Contents

Unincorporated Businesses	252
Small Business Corporations	252
Buying Shares of Stock.....	252
Investigation	253
Indemnification.....	254
Holdbacks and Offsets.....	254
Assigning a Price to Business Assets.....	255
Classifying Assets for the IRS	255
Allocation to Seven IRS Classes	255
Assigning Dollar Values to the Classes	258
State and Local Transfer Taxes	258
Review Questions.....	260
Review Answers	261
Chapter 18 – Selling or Closing a Sole Proprietorship	263
Learning Objectives	263
Introduction.....	263
Reporting the Sale of a Sole Proprietorship.....	263
Figuring Your Gain or Loss	264
How Your Gain or Loss Is Taxed.....	264
The Importance of an Arm’s-Length Deal	265
How to Protect Yourself From IRS Challenges	265
Set Reasonable Price and Terms.....	265
Observe the Formalities	266
Allocate Asset Values Fairly	266
Keep Your Records After the Sale.....	266
Review Questions.....	268
Review Answers	269
Chapter 19 – When You Can’t Pay Your Taxes	271
Learning Objectives	271
Introduction.....	271
Low IRS Priority—Less Than \$50,000.....	271
Getting More Time to Pay	272
Paying in Installments	272
Interest and Penalties Keep Running	272
Under \$10,000 Payment Plans.....	273
\$10,000 to \$50,000 Payment Plans.....	273
Over \$50,000 Payment Plans.....	273
If You Fall Behind on Your Payments.....	273
What to Expect When the IRS Gets Serious.....	274
The Sneak Attack	274
Meeting With the Collector	274
Actions the Tax Collector Can Take	275
Cooperating With the Collector.....	276
Dealing With a Monster Tax Bill	276
The Offer in Compromise.....	276
Bankruptcy.....	277
When the IRS Can Take Your Assets	277
Federal Tax Liens	277
Federal Tax Levies: Seizing Assets.....	277
Getting Liens and Levies Released	278
Review Questions.....	280
Review Answers	281
Chapter 20 – Audits.....	283
Learning Objectives	283

Table of Contents

Introduction.....	283
Who Gets Audited?.....	283
Computer Picks	283
Market Segment Specialization Programs.....	283
Informants' Tips	284
Follow-Up Audits.....	284
Prior Audits.....	284
Criminal Investigations.....	284
Amended Returns and Refund Claims	284
Filing Extensions.....	284
How Long Do You Have to Worry About an Audit?.....	285
How the IRS Audits Small Businesses	285
Office and Correspondence Audits.....	285
Field Audits.....	285
The Auditor's Powers.....	286
Inspecting Business Premises.....	287
Viewing Home Offices.....	287
Scrutinizing Your Records.....	287
Summoning Records Held by Others	287
Should You Get Audit Help?	287
Preparing for Your Audit	288
What to Bring to an Audit.....	289
Don't Rush a Field Audit	290
What an Auditor Looks for When Examining a Business	291
The Income Probe	294
Bank Deposit Analysis	294
Is It a Legitimate Business Expense?	294
How to Behave at an Audit.....	294
Keep Chitchat to a Minimum	294
Answer Questions Concisely.....	295
Don't Be Hostile or Phony.....	295
Complain If the Auditor Is Abusive.....	295
How to Negotiate With an Auditor	296
Don't Just Sit There	296
Talk Percentages, Not Dollars.....	296
Arguing Issues.....	297
Adjustments in Your Favor—Taking the Offensive.....	297
Don't Try to Negotiate Based on Inability to Pay.....	297
Your Options After Getting an Audit Report.....	298
Agree.....	298
Argue.....	298
Do Nothing.....	298
When Your Audit Is Final	299
Review Questions.....	300
Review Answers	301
Chapter 21 – Appealing IRS Audits	303
Learning Objectives	303
Introduction.....	303
IRS Appeals	303
Writing an Appeal Letter.....	303
Settling Without a Hearing.....	304
The Appeals Hearing	305
Payment After an Appeals Settlement.....	306
Contesting an Audit in Court	306
About Tax Court.....	306
Can You Do It Yourself in Tax Court?.....	306

Table of Contents

Filing Your Petition in Tax Court.....	306
Tax Court Pretrial Procedure.....	307
Settling Before Trial.....	307
Your Tax Court Trial.....	307
Tax Court Decisions.....	308
Review Questions.....	310
Review Answers.....	311
Chapter 22 – Penalties and Interest.....	313
Learning Objectives.....	313
Introduction.....	313
Common Reasons for Penalties.....	313
Inaccuracies.....	313
Civil Fraud.....	313
Late Payment.....	313
Late Filing.....	314
Filing and Paying Late.....	314
Underpaying Estimated Taxes.....	314
Interest on Tax Bills.....	314
Understanding Penalty and Interest Notices.....	315
How to Get Penalties Reduced or Eliminated.....	315
How to Request a Penalty Abatement.....	315
If Your Abatement Request Is Rejected.....	317
How to Get Interest Charges Removed.....	317
Designating Payments on Delinquent Tax Bills.....	317
Review Questions.....	319
Review Answers.....	320
Chapter 23 – Help Beyond the Book.....	321
Learning Objectives.....	321
Introduction.....	321
Finding Answers to Tax Questions.....	321
IRS Publications.....	322
Free IRS and Social Security Telephone Information.....	322
Free IRS Programs.....	323
IRS Written Advice.....	323
Internal Revenue Code.....	323
IRS Interpretations of the Tax Code.....	324
Court Cases.....	325
Federal Small Business Programs.....	325
Private Tax Guides and Software.....	326
Trade Association Publications.....	326
Tax Info Online.....	326
Review Questions.....	328
Review Answers.....	329
Appendix A – Answers to Frequently Asked Questions.....	331
Appendix B – Forms Checklist and Due Dates.....	337
Glossary.....	341
Index.....	353