

# **Tax Basics for Small Business**

---

19<sup>th</sup> Edition

Attorney Frederick W. Daily

# Table of Contents

---

<b>Introduction .....</b>	<b>1</b>
<b>Chapter 1 – Tax Basics.....</b>	<b>3</b>
Learning Objectives .....	3
Introduction.....	3
How Tax Law Is Made and Administered: The Short Course .....	3
Where to Find Tax Rules .....	4
Marginal Tax Rate and Tax Brackets .....	4
What Is—And Isn’t—Income .....	6
Things That Count as Taxable Income.....	6
Exclusions: Things That Aren’t Income.....	7
A Word About Tax Shelters.....	8
The Alternative Minimum Tax (AMT).....	8
Review Questions.....	10
Review Answers .....	11
<b>Chapter 2 – Deductible Business Expenses .....</b>	<b>13</b>
Learning Objectives .....	13
Introduction.....	13
What Is a Deductible Business Expense? .....	14
Ordinary and Necessary .....	14
Not Extravagant.....	15
Personal Expenses.....	15
Is It a Current or Future Year Expense? .....	15
Top Deductions for Businesses.....	16
Vehicles.....	16
Equipment and Furniture.....	16
Inventory.....	16
Home Office .....	16
Retirement Account Deposits.....	16
Hiring Help.....	16
Manufacturers.....	16
Rent .....	17
Costs of Going Into Business .....	17
Accounting, Legal, and Other Professional Fees .....	17
Office Supplies .....	19
Entertainment and Meals: The 50% Rule.....	19
Gifts to Clients and Customers.....	20
Travel .....	21
Moving Expenses .....	22
Health Insurance.....	22
Disability and Sick Pay.....	22
Education Expenses .....	22
Interest .....	23
Bad Debts.....	23
Charitable Contributions.....	24
Taxes .....	24
Advertising and Promotion .....	25
Business Licenses and Permits.....	26
Repairs and Improvements.....	26
Casualty Losses .....	26
Business Insurance .....	26
Research and Development Credits.....	27
Domestic Production.....	27

## Table of Contents

The General Business Credit .....	28
Vehicle Expenses .....	28
Standard Mileage Method .....	29
Actual Expense Method .....	29
Commuting Costs .....	30
Special C Corporation Vehicle Rules.....	31
Other Vehicle-Related Deduction Opportunities .....	32
How and Where to Claim Expense Deductions .....	32
Review Questions.....	35
Review Answers .....	37
<b>Chapter 3 – Writing Off Long-Term Business Assets .....</b>	<b>41</b>
Learning Objectives .....	41
Introduction.....	41
Tax Treatment of Business Costs .....	41
Current Expenses .....	41
Capital Expenses.....	42
Section 179: Expensing Business Assets .....	42
Ineligible Assets.....	43
50% Business Use Requirement.....	43
Listed Property—Special Rules.....	43
Earned Income and Carryforward .....	44
Spending Cap.....	44
Married Couples .....	44
Multiple Owners .....	44
Passive Investors.....	45
Recapture.....	45
Trade-Ins.....	45
Combining Section 179 and Depreciation Deductions .....	45
Items Bought on Credit .....	46
Depreciating Business Assets .....	46
What Is Depreciation?.....	46
Depreciation Categories.....	46
Methods of Depreciation .....	47
Tax Rules for Business Vehicles .....	49
First-Year Depreciation Rules .....	50
How to Report Depreciation and Section 179 Deductions.....	51
Inventory.....	53
Tax Basis of Business Assets .....	54
Purchased Items—Cost Basis.....	54
Items Received as a Gift—Transferred Basis .....	55
Items Received for Services—Fair Market Value (FMV) Basis.....	55
Items You Inherit—Step-Up Basis.....	55
Items Exchanged for Other Items—Substituted Basis.....	55
Items Exchanged for Items and Money .....	56
Items Converted to Business Use .....	56
Leasing Instead of Buying.....	56
Vehicles Used for Business.....	57
Leasing Your Assets to Your C Corporation .....	58
When You Dispose of Business Assets: Depreciation Recapture .....	58
Sale of Business Equipment .....	59
Like-Kind Exchanges .....	59
Destroyed or Stolen Assets.....	59
Sale of Real Estate .....	60
Tax Errors in Depreciation .....	60
Review Questions.....	62
Review Answers .....	63

Table of Contents

**Chapter 4 – Bookkeeping and Accounting..... 65**  
Learning Objectives ..... 65  
Introduction..... 65  
Why You Need a Bookkeeping System ..... 65  
Should You Hire a Bookkeeper? ..... 66  
Bookkeeping Basics..... 66  
    Manual Bookkeeping System..... 67  
    Computerized Bookkeeping System..... 68  
What Kinds of Records to Keep ..... 70  
    Income Records..... 70  
    Expense Records ..... 71  
    Asset Records ..... 72  
How Long Records Should Be Kept ..... 73  
Bookkeeping Methods of Tracking Income and Expenses ..... 74  
    Single-Entry System ..... 74  
    Double-Entry System ..... 74  
Timing Methods of Accounting: Cash and Accrual..... 74  
    Cash Method Accounting..... 75  
    Accrual Method Accounting..... 75  
    Hybrid and Special Accounting Methods ..... 76  
    Changing Accounting Methods..... 76  
Accounting Periods: Calendar Year or Fiscal Year ..... 76  
    Calendar Year Period ..... 77  
    Fiscal Year Period ..... 77  
    Short Tax Years..... 77  
Review Questions..... 78  
Review Answers ..... 79

**Chapter 5 – Business Losses and Failures..... 81**  
Learning Objectives ..... 81  
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

**Chapter 6 – Tax Concerns of Employers..... 89**  
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..... 93  
    If You Get Behind on Payroll Tax Payments..... 99  
Classifying Workers: Employee or Independent Contractor? ..... 99  
    Reporting Payments to Independent Contractors ..... 99  
    IRS Worker Classifications..... 100  
Misclassifying Employees as Independent Contractors ..... 102  
    How the IRS Finds Out ..... 102  
    Penalties for Misclassifying Workers ..... 102

## Table of Contents

Avoiding Trouble with the IRS .....	103
Asking the IRS to Classify Your Workers.....	104
Appealing a Ruling That You Misclassified Workers .....	104
IRS Filing and Payment Requirements for Employers .....	104
Record Keeping for Your Workers.....	105
Review Questions.....	107
Review Answers .....	108
<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
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.....	134
Less Common Taxes.....	135
Tax Benefits of C Corporations .....	137
Income Splitting .....	137
More Fringe Benefits.....	137
Corporate Business Losses .....	137
Dividends Received From Other Corporations.....	137
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

## Table of Contents

The Section 1244 Corporate Resolution.....	142
Claiming a Section 1244 Loss.....	142
Taking Money Out of a C Corporation.....	142
Compensation for Services.....	142
Dividends.....	143
Loans to Shareholders.....	143
Leasing Assets to Your Corporation.....	144
Selling Your Corporate Stock.....	145
Tax Pitfalls of C Corporations.....	145
Personal Holding Company Tax.....	145
Accumulated Earnings Tax.....	146
Corporate Alternative Minimum Tax.....	146
Dissolving a C Corporation.....	146
Tax Issues Upon Dissolution.....	146
Reporting the Dissolution to the IRS.....	147
Review Questions.....	148
Review Answers.....	149
<b>Chapter 9 – S Corporations.....</b>	<b>151</b>
Learning Objectives.....	151
Introduction.....	151
An Overview of S Corporations.....	151
Should You Choose S Corporation Status?.....	152
Qualifying for S Corporation Status.....	152
S Corporation Disadvantages.....	155
Tax Reporting for S Corporations.....	155
How S Corporation Shareholders Are Taxed.....	157
Profits.....	157
Losses.....	157
Social Security and Medicare Taxes.....	158
Electing S Corporation Status.....	160
Revoking S Corporation Status.....	160
Dissolving an S Corporation.....	161
Review Questions.....	163
Review Answers.....	164
<b>Chapter 10 – Partnerships.....</b>	<b>165</b>
Learning Objectives.....	165
Introduction.....	165
Partnership Tax Status.....	165
Tax Reporting.....	166
Annual Partnership Tax Returns.....	166
Partner’s Profit or Loss Statements (K-1).....	166
Partnership Federal Identification Number.....	167
Tax Obligations of Partners.....	167
Self-Employment Taxes.....	167
Estimated Income Taxes.....	167
Calculating and Reporting a Partner’s Income.....	169
Partnership Losses.....	171
Partnership Contributions.....	171
Keeping Track of Partners’ Contributions: Capital Accounts.....	171
Adjustments to Partners’ Capital Accounts.....	173
Partnership Liabilities.....	173
Getting Money Out of a Partnership.....	174
Taxation of Withdrawals.....	174
Loans to Partners.....	174
Partnership Expenses.....	174

## Table of Contents

Selling or Transferring a Partnership Interest .....	174
Selling Your Partnership Interest.....	174
When the Partnership Buys Out a Partner.....	175
Relief of Debt—Phantom Income .....	175
Date-of-Sale Adjustment.....	175
Ending a Partnership .....	176
Review Questions.....	178
Review Answers .....	179
<b>Chapter 11 – Limited Liability Companies.....</b>	<b>181</b>
Learning Objectives .....	181
Introduction.....	181
Taxes .....	181
Federal Tax Reporting .....	181
State Taxes .....	182
Unequal Allocations of Profit and Loss .....	182
Comparing LLCs With Other Entities.....	182
Operating Your LLC.....	183
Forming an LLC.....	183
Converting a Business to an LLC.....	184
LLC Members’ Rights .....	184
Transferring Ownership—Sale or Death.....	184
Terminating an LLC .....	185
Review Questions.....	186
Review Answers .....	187
<b>Chapter 12 – Qualified Personal Service Corporations .....</b>	<b>189</b>
Learning Objectives .....	189
Introduction.....	189
Qualified Personal Service Corporations .....	189
IRS Tests for a QPSC.....	189
QPSCs and Taxes.....	190
Accounting Method Elections .....	190
Section 1244 Stock.....	191
Fringe Benefits .....	191
Tax-Advantaged Retirement Plans.....	191
Health and Life Insurance Benefits.....	191
Other Fringe Benefits.....	191
Transferring Shares .....	191
Dissolving a QPSC .....	191
Review Questions.....	193
Review Answers .....	194
<b>Chapter 13 – Family Businesses .....</b>	<b>195</b>
Learning Objectives .....	195
Introduction.....	195
The Legal Structure of a Family Business .....	195
Income Splitting Lowers Taxes.....	195
Legality of Hiring Your Kids.....	195
Tax Benefits of Hiring Your Kids.....	196
Making Your Kids Co-Owners .....	197
Putting Older Parents on the Payroll .....	197
A Spouse in the Business .....	198
Letting Your Spouse Volunteer.....	198
File Taxes as Co-Sole Proprietors.....	198
Preserving a Family Business After Death.....	199
Death and Taxes .....	199

## Table of Contents

Installment Plans for Estate Taxes .....	199
Transferring a Business Before Death.....	200
Review Questions.....	204
Review Answers .....	205
<b>Chapter 14 – Home-Based Businesses .....</b>	<b>207</b>
Learning Objectives .....	207
Introduction.....	207
Business Expenses Incurred at Home.....	207
The Home Office Deduction.....	209
Rule 1. Principal Place of Business .....	209
Rule 2. Separately Identifiable Space.....	210
Rule 3. Regular and Exclusive Use .....	210
Calculating Your Home Office Deduction .....	211
Renters.....	213
Owners.....	213
Other Home-Related Deductible Expenses .....	214
Safe Harbor Rule for the Home Office Deduction .....	214
Tax When Selling the Home Office.....	215
A Home Business as a Tax Shelter .....	215
Business Losses at Home.....	216
Hobby or Business?.....	216
The Profit Motive Requirement.....	216
Review Questions.....	219
Review Answers .....	220
<b>Chapter 15 – Fringe Benefits .....</b>	<b>221</b>
Learning Objectives .....	221
Introduction.....	221
How Fringe Benefits Save Taxes .....	221
Retirement Benefits .....	222
Motor Vehicles.....	222
Meals.....	222
Travel and Lodging .....	223
Mixing Business and Pleasure Travel.....	223
Business Meetings, Trade Shows, and Conventions .....	223
Taking the Family Along.....	224
Lodging at the Workplace .....	224
Clubs and Athletic Facilities .....	225
Health Benefits .....	225
The Affordable Health Care Act and Small Businesses .....	225
Deducting Health Insurance for Employees.....	225
Health Insurance Tax Credit.....	226
Health Savings Accounts (HSAs) .....	226
Flexible Spending Accounts (FSAs) .....	226
Group Plans Paid by Employees.....	226
Solos, Partnerships, LLCs, and S Corporations.....	226
C Corporations .....	227
Dependent Care Assistance Plan.....	227
Long-Term Care Insurance .....	228
Group Term Life Insurance .....	228
Education Benefits.....	228
Directly Related Education.....	228
Educational Assistance Program.....	229
Other Education.....	229
Dues and Subscriptions .....	229
Driver and Bodyguard Services.....	229



## Table of Contents

Moving Expenses .....	229
Retirement Planning Services .....	229
Gifts, Awards, Discounts, and Free Services .....	229
Small Gifts to Employees .....	230
Employee Awards .....	230
No-Added-Cost Services .....	230
Discounts .....	230
Commuter Transportation and Parking .....	231
Working Condition Fringes .....	231
De Minimis Benefits .....	231
Adoption Assistance .....	231
Job Placement Assistance .....	231
Cafeteria Plans .....	231
Special Benefits for C Corporation Employees Only .....	232
Loans to Shareholders .....	232
Entertainment and Vacation Facilities .....	232
Stock Options and ESOPs .....	232
Review Questions .....	234
Review Answers .....	235
<b>Chapter 16 – Retirement Plans .....</b>	<b>237</b>
Learning Objectives .....	237
Introduction .....	237
Advantages of Retirement Plans .....	237
Overview of Retirement Plan Types .....	238
Details About Each Type of Retirement Plan .....	239
Individual Retirement Accounts (IRAs): Traditional and Roth IRA Plans .....	239
SIMPLE IRAs .....	242
Simplified Employee Pensions (SEPs) .....	243
Qualified Retirement Plans (ERISA) .....	244
Defined Contribution Profit-Sharing Plans (PSPs) .....	245
Money Purchase Plan (MPP) .....	245
Traditional 401(k) Plans .....	245
Roth 401(k) Plan .....	246
Defined Benefit Plans (DBPs) .....	246
Where to Go for a Retirement Plan .....	247
Tax Credit for Professional Help .....	247
Potential Tax Problems With Retirement Plans .....	247
Excess Contributions .....	248
Overfunded Plans (Defined Benefit Plans Only) .....	248
Affiliated Service Groups and Controlled Groups .....	248
Withdrawing Money From Retirement Plans .....	248
Avoiding Withdrawal Penalties .....	249
Tax Withholding on Withdrawals .....	249
Mixed Contribution Plan Withdrawals .....	249
Loans From Some Retirement Plans .....	249
Lump Sum Withdrawals .....	250
Mandatory Withdrawals by 70½ .....	250
What Happens at Death .....	250
Closing Your Business or Leaving Your Employer .....	250
Review Questions .....	252
Review Answers .....	253
<b>Chapter 17 – Buying a Business .....</b>	<b>255</b>
Learning Objectives .....	255
Introduction .....	255
Buying the Assets of a Business .....	255

## Table of Contents

Unincorporated Businesses .....	256
Small Business Corporations .....	256
Buying Shares of Stock.....	256
Investigation .....	257
Indemnification .....	258
Holdbacks and Offsets.....	258
Assigning a Price to Business Assets.....	259
Classifying Assets for the IRS .....	259
Allocation to Seven IRS Classes .....	259
Assigning Dollar Values to the Classes .....	262
State and Local Transfer Taxes .....	262
Review Questions.....	264
Review Answers .....	265
<b>Chapter 18 – Selling or Closing a Sole Proprietorship .....</b>	<b>267</b>
Learning Objectives .....	267
Introduction.....	267
Reporting the Sale of a Sole Proprietorship.....	267
Figuring Your Gain or Loss .....	268
How Your Gain or Loss Is Taxed.....	268
The Importance of an Arm’s-Length Deal .....	269
How to Protect Yourself From IRS Challenges .....	269
Set Reasonable Price and Terms.....	269
Observe the Formalities .....	270
Allocate Asset Values Fairly.....	270
Keep Your Records After the Sale .....	270
Review Questions.....	272
Review Answers .....	273
<b>Chapter 19 – When You Can’t Pay Your Taxes .....</b>	<b>275</b>
Learning Objectives .....	275
Introduction.....	275
Low IRS Priority—Less Than \$50,000.....	275
Getting More Time to Pay .....	276
Paying in Installments .....	276
Interest and Penalties Keep Running .....	276
Under \$10,000 Payment Plans.....	277
\$10,000 to \$50,000 Payment Plans.....	277
Over \$50,000 Payment Plans .....	277
If You Fall Behind on Your Payments.....	277
What to Expect When the IRS Gets Serious.....	278
The Sneak Attack .....	278
Meeting With the Collector.....	278
Actions the Tax Collector Can Take .....	279
Cooperating With the Collector.....	280
Dealing With a Monster Tax Bill .....	280
The Offer in Compromise.....	280
Bankruptcy .....	281
When the IRS Can Take Your Assets .....	281
Federal Tax Liens .....	281
Federal Tax Levies: Seizing Assets.....	281
Getting Liens and Levies Released .....	282
Review Questions.....	284
Review Answers .....	285
<b>Chapter 20 – Audits .....</b>	<b>287</b>
Learning Objectives .....	287

## Table of Contents

Introduction.....	287
Who Gets Audited?.....	287
Computer Picks .....	287
Market Segment Specialization Programs.....	287
Informants' Tips .....	288
Follow-Up Audits.....	288
Prior Audits.....	288
Criminal Investigations.....	288
Amended Returns and Refund Claims .....	288
Filing Extensions.....	288
How Long Do You Have to Worry About an Audit?.....	289
How the IRS Audits Small Businesses .....	289
Office and Correspondence Audits.....	289
Field Audits.....	289
The Auditor's Powers.....	290
Inspecting Business Premises .....	291
Viewing Home Offices.....	291
Scrutinizing Your Records.....	291
Summoning Records Held by Others .....	291
Should You Get Audit Help? .....	291
Preparing for Your Audit.....	292
What to Bring to an Audit .....	293
Don't Rush a Field Audit .....	294
What an Auditor Looks for When Examining a Business .....	295
The Income Probe .....	298
Bank Deposit Analysis .....	298
Is It a Legitimate Business Expense?.....	298
How to Behave at an Audit.....	298
Keep Chitchat to a Minimum .....	298
Answer Questions Concisely.....	299
Don't Be Hostile or Phony.....	299
Complain If the Auditor Is Abusive .....	299
How to Negotiate With an Auditor .....	300
Don't Just Sit There .....	300
Talk Percentages, Not Dollars.....	300
Arguing Issues.....	301
Adjustments in Your Favor—Taking the Offensive.....	301
Don't Try to Negotiate Based on Inability to Pay.....	301
Your Options After Getting an Audit Report.....	302
Agree.....	302
Argue.....	302
Do Nothing .....	302
When Your Audit Is Final .....	303
Review Questions.....	304
Review Answers .....	305
<b>Chapter 21 – Appealing IRS Audits .....</b>	<b>307</b>
Learning Objectives .....	307
Introduction.....	307
IRS Appeals .....	307
Writing an Appeal Letter.....	307
Settling Without a Hearing .....	308
The Appeals Hearing .....	309
Payment After an Appeals Settlement.....	310
Contesting an Audit in Court .....	310
About Tax Court.....	310
Can You Do It Yourself in Tax Court? .....	310

## Table of Contents

Filing Your Petition in Tax Court.....	310
Tax Court Pretrial Procedure.....	311
Settling Before Trial .....	311
Your Tax Court Trial.....	311
Tax Court Decisions.....	312
Review Questions.....	314
Review Answers .....	315
<b>Chapter 22 – Penalties and Interest.....</b>	<b>317</b>
Learning Objectives .....	317
Introduction.....	317
Common Reasons for Penalties.....	317
Inaccuracies .....	317
Civil Fraud .....	317
Late Payment .....	317
Late Filing.....	318
Filing and Paying Late .....	318
Underpaying Estimated Taxes .....	318
Interest on Tax Bills .....	318
Understanding Penalty and Interest Notices.....	319
How to Get Penalties Reduced or Eliminated .....	319
How to Request a Penalty Abatement.....	319
If Your Abatement Request Is Rejected.....	321
How to Get Interest Charges Removed.....	321
Designating Payments on Delinquent Tax Bills.....	321
Review Questions.....	323
Review Answers .....	324
<b>Chapter 23 – Help Beyond the Book.....</b>	<b>325</b>
Learning Objectives .....	325
Introduction.....	325
Finding Answers to Tax Questions.....	325
IRS Publications .....	326
Free IRS and Social Security Telephone Information.....	326
Free IRS Programs.....	327
IRS Written Advice.....	327
Internal Revenue Code .....	327
IRS Interpretations of the Tax Code .....	328
Court Cases .....	329
Federal Small Business Programs .....	329
Private Tax Guides and Software.....	329
Trade Association Publications .....	330
Tax Info Online .....	330
Review Questions.....	332
Review Answers .....	333
<b>Appendix A – Answers to Frequently Asked Questions.....</b>	<b>335</b>
<b>Appendix B – Forms Checklist and Due Dates .....</b>	<b>341</b>
<b>Glossary.....</b>	<b>345</b>
<b>Index .....</b>	<b>357</b>