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Tax Savvy for Small Business

Year-Round Tax Strategies to Save You Money

by Attorney Frederick W. Daily
edited by Bethany Laurence

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Dedication

To my wife, Brenda, who has brought me everything that is good in life.

Acknowledgments

Trying to translate the tax code into plain English for the small business owner was a challenge that all but overwhelmed me. Without the help of many others I could not have done it.

Nolo has some of the most caring (and careful) editors on the face of this earth. First and foremost in both categories is Mary Randolph. Other Nolo folks with a hand in the project were Jake Warner, Robin Leonard, Lisa Goldoftas, and Steve Fishman. Stephanie Harolde, Ely Newman, Robert Wells, and Susan Cornell made valuable contributions in copyediting, proofreading, and production. Much thanks to Beth Laurence in updating the new editions. Thank you one and all for putting up with me.

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I

Introduction

If mastering the tax code were a prerequisite to starting a business, no one would dare. Luckily, the basics of federal taxes are right here in this book. And once you grasp the fundamentals, you can pick up the rest as you go along, perhaps with the help of a tax adviser. As the well-worn phrase goes, "It's not brain surgery."

A. Taxes for Small Businesses and the Self-Employed

Owning and operating a small business, full or part time, has been called the little guy's tax shelter. The self-employed get tax benefits for any number of expenditures not allowed to "wage slaves." In effect, you are sharing expenses (as well as profits) with Uncle Sam—and, in most cases, with your state as well.

Small business or independent contractor? Self-employed people often ask whether they are a "business." The answer is yes. Whether you run a flower shop or freelance as a website designer, you're a small business. When we talk about small businesses in this book, we're talking about all kinds of self-employed people, from independent contractors, consultants, and freelancers to the guy who owns the pizza parlor down the street.

1. The Typical Small Business

Everyone has their own idea of what a small business is. The typical small business in the United States grosses less than $1 million and has fewer than ten employees. That's the type of venture this book addresses, but most of the tax information here applies to any size operation, except a publicly traded company. As you might expect, when the dollars or employees increase, so do the tax complexities. Still, the book in your hands covers all the tax basics you need to know to get started.

The IRS does not require or issue business licenses. Whether you need any kind of license depends on your state and local authorities. For small business start-up issues, see *The Small Business Start-Up Kit*, by Peri Pakroo (Nolo).

Tax Advantages for Small-Time Operators

1. Personal expenses can become partially deductible: your home, car, computer, meals, education, and entertainment.
2. Retirement plans can shelter part of your venture's income from taxes, accumulate earnings tax-deferred, and provide for your retirement at a reduced tax rate.
3. Family members—young and old—can be put on the payroll to shift income to them and reduce a family's overall tax bill.
4. Travel and vacations can qualify in whole or in part as deductible business expenses.

Sound interesting? With all of these possibilities, your business can earn less than if you were working for someone else, and you still can come out ahead. Of course, by going into business you might be trading an 8-hour-a-day job for a 24-hour one. But for many of us, it is worth it.

Our country has 45 million small businesses and self-employed folks that the IRS knows about, and probably many more. (Unhappily, U.S. Chamber of Commerce statistics show that a venture has an 85% chance of closing its doors within its first five years. But our entrepreneurial spirit is strong, and many who fail go back and try again.)

Four out of five of these brave souls are what the tax code calls sole proprietors—one-person or mom 'n' pop operations. The rest are either partnerships, limited liability companies, or corporations. Ten million small businesses provide jobs only for the owners and their families—in other words, they have no outside employees.

Don't Forget About State and Local Taxes

While this book focuses on federal taxes, your business may also be taxed by your state and local tax laws and agencies. Unfortunately, it can be even more time-consuming to comply with state tax laws than with federal tax laws. Especially if your enterprise is a multistate affair, you might find yourself drowning in paperwork. At the very least, figure state tax compliance into your cost of doing business, including hiring bookkeeping and accounting help.

State tax enforcement agencies are often more bureaucratic, tough, and downright frustrating to deal with than the IRS. (For advice on dealing with state tax agencies see *Stand Up to the IRS*, by Frederick W. Daily (Nolo).) And many states have out-of-state enforcement offices or use private collection agencies to track you down anywhere in the U.S., so just because you live in Maryland, don't think the state of California can't get you.

Here are some state tax issues to watch out for:

- **Income taxes.** All but seven states impose income taxes. See Chapter 7, Section B3, and Chapter 8, Section C (corporate state income tax and franchise tax information); Chapter 10, Section A2 (LLC state income taxes); Chapter 9, Section B1 (partnership state income tax reporting); and Chapter 15, Section F (retirement plans).
- **Sales taxes.** Just about every state imposes a sales tax. But each state has different rules for collection and exemptions. Usually the seller is responsible for collecting and paying state sales tax whether it has been collected from the buyer or not.
- **Use taxes.** This is a tax on goods that you purchased out of state that were shipped into your state without paying sales tax.
- **Business transfer taxes.** Whenever a business changes hands, your state, county, or city may impose a transfer tax on the buyer, the seller, or both. (See Chapter 16, Section D.)
- **Inventory and other property taxes.** Some states and local governments impose an annual tax on the value of the personal (non–real estate) property used in the business, such as vehicles or equipment. And, most states or localities impose an annual tax on real estate, whether it is used for business or personal purposes.
- **Internet taxes.** There is a federal moratorium on states' imposing taxes on Internet transactions. However, some states impose a "use" tax for out-of-state purchases, which is perfectly legal.
- **Payroll taxes.** All states with income taxes have a payroll tax, deduction, and collection system similar to the federal system.
- **Telecommuter taxes.** New York is one of a growing number of states that tax you if you work from home in another state (for instance, Connecticut), if the main business location is in New York.
- **License fees.** There are myriad state and local licenses that a business must secure. Whatever they are called, these fees are really just taxes. Check with your local government agencies, your chamber of commerce, or your attorney.
- **Out-of-state taxes.** As an employer, you can be responsible for withholding state income taxes on your nonresident employees' income for their home states. Recently, a small incorporated consulting business owner came to me with a plan to open satellite offices in two surrounding states. After learning that he would have to learn and deal with three sets of state payroll, corporate, and other tax rules, he decided not to expand.
- **Death taxes.** Most states, as well as the federal government, tax the value of all of your assets, including your business, when the estate is large enough, on your death. (See Chapter 12, Section D.)

State and local agencies. To find your state tax and licensing agencies, go to www.statelocalgov.net for a listing of all the government agencies in your state, or look them up in your local phone book.

2. Knowing Your Taxes

No one likes paying taxes or dealing with the IRS, but operating a business without tax savvy is like skydiving without a parachute: certain to end in calamity. Many business failures stem from ignoring the record-keeping and tax side of the operation. Like it or not, the government is always your business partner.

Tax knowledge has powerful money-saving potential. It can give you a fatter bottom line than your competitors who don't bother to learn. For instance, there are several ways to write off car expenses. The right choice can mean a few thousand more after-tax dollars in your pocket each year.

What You'll Get From Reading This Book

1. Information on how to deduct business expenses and write off purchases.
2. An explanation of the tax benefits of each main type of ownership structure: sole proprietorship, partnership, limited liability company, or corporation.
3. Ways to minimize taxes and stay out of IRS trouble.
4. What to do if the IRS ever challenges your business tax reporting or sends you a tax bill you don't agree with.

Four different federal taxes affect small business owners:

- income taxes (everyone who makes a profit owes these)
- self-employment taxes (Social Security and Medicare taxes)
- payroll taxes (if your business has employees)
- excise taxes (only a few small businesses are subject to these).

Thousands of federal tax laws, regulations, and court decisions deal with these four categories. We will look only at the relatively few rules most likely to affect you, and translate them into plain English.

Do You Need a Tax Professional?

This is not a tax preparation manual. Because every small business's tax situation is different, we won't walk you, line by line, through each and every tax form you might have to file. Our goal is to explain the IRS rules in plain English so you will know how they apply to your business and where you can go for help.

As good as we hope this book is, nothing takes the place of a personal tax adviser. Everyone's tax situation is unique, and tax laws change annually. But the more you know, the better you can work with your accountant (referred to as a "tax pro" throughout this book), and the less you will have to pay him or her. (See Chapter 22 for tips on finding and using a tax pro.) Also, take a look at IRS Publication 1 for a summary of your rights as a taxpayer in dealing with the IRS.

B. How Tax Law Is Made and Administered: The Short Course

Think of this section as a high school government lesson, only try to stay awake this time—it could mean money in your pocket.

The federal government. Visualize a three-branched tree. Congress, the legislative branch of the federal government, makes the tax law. The executive branch, which includes the Treasury Department, administers the tax law through the IRS. The judicial branch comprises all the federal courts, which interpret the tax laws and overrule the IRS when it goes beyond the law.

The power to tax incomes was granted by the 16th Amendment to the U.S. Constitution; the first Income Tax Act was passed in 1913. Contrary to what fringe groups and con artists would like you to believe, income tax law and the IRS are legal and are not going to go away.

The code. Tax law begins with the Internal Revenue Code (referred to throughout this book as the tax code or IRC). Congress enacts and revises the tax code. The president signs it (usually), and it becomes law. One major reworking of the IRC was officially called the Tax Reform Act, but was known to tax pros as the Accountants' and Tax Attorneys' Relief Act. The tax code is now over 8,500 pages of exceedingly fine print.

The IRS. The Internal Revenue Service (IRS) is a division of the Treasury Department. It is headed up by the Commissioner of Internal Revenue, a presidential appointee. The IRS is charged with enforcing the tax code.

IRS tax administration policy is set in Washington, but it is doubtful you will ever deal directly with anyone there. The real work is done at IRS Service Centers and local offices.

The courts. The United States Tax Court is an arm of the federal court system that decides disputes between the IRS and taxpayers and interprets the tax code. It is pretty easy to go to tax court in most cases, even without an attorney. Tax disputes are also decided in U.S. District Courts and the Federal Court of Claims, but these require payment of the disputed tax first, unlike in the tax court. All decisions in those courts, for or against you, may be reviewed by higher courts, meaning the various U.S. Courts of Appeal and the U.S. Supreme Court. The exception is "small case" tax court decisions; see Chapter 20 for details.

See, that wasn't all that bad, was it? Now, venture forth into the rest of the book and into the entrepreneurial world, and may the small business gods be with you.

The tax code changes frequently. While we try our best to keep the material in this book up to date, Congress is forever tinkering with the tax code. Some changes are made retroactive, others become law on the date they are signed by the president, and some won't be effective until the next year or further into the future. Also, federal court decisions, which interpret the tax code, are released throughout the year and may change what is written here. Your best strategy is to make sure you have the most current edition of this book (check Nolo's website for updates to this book) and check with your tax adviser to see if anything has changed in your tax world.

C. Sources of Tax Law

How to research tax law questions is covered in Chapter 22, Help Beyond the Book, but here's a brief description of the main sources of federal tax law.

Federal statutes. Congress enacts tax laws, called codes, which make up the Internal Revenue Code. Each tax provision (called a "code section") has its own number and title. For example, IRC § 183 refers to tax code Section 183, titled "Activities Not Engaged in for Profit."

IRS publications. When Congress makes tax laws, it paints with a fairly broad brush. It's then up to the Treasury Department (the IRS is a part of it) to fill in the details of how the tax code is to be applied. The details are filled in by IRS publications, such as Treasury Regulations. Treasury Regulations or regs are numbered in the same order as their related tax code sections, but preceded by the numeral "1." For example, the regulation explaining IRC § 183 is Reg. 1.183. (Not all IRC sections have corresponding regulations.)

Both the IRC and IRS publications and Regulations are available at most public libraries, larger bookstores, and, of course, IRS offices. The IRC is online at www4.law.cornell.edu/uscode/26 and the regulations on the IRS's website at www.irs.gov.

Court cases. When the IRS and taxpayers go to court, a federal court may invalidate an IRS interpretation of the tax law. The judges' written opinions offer guidance on the correct interpretation of the tax code. You can research tax court opinions (from January 1, 1999 to the present) on the tax court's website at www.ustaxcourt.gov or at a law library with a tax section.

D. Marginal Tax Rate and Tax Brackets

In our graduated tax system, the more money you make, the higher your marginal tax rate. Often referred to as your tax bracket, your marginal tax rate is the rate at which the last dollar of income you earn will be taxed.

For example, Janice is single, lives in New York, and reports $100,000 in income on her 2005 tax return; her marginal tax rate, or tax bracket, is 28%. (The first $71,950 of income will be taxed in increments at the 10%, 15%, and 25% tax rates, and the remaining $28,050 will be taxed at 28%.) Every additional dollar Janice earns will be taxed at 28% until it reaches more than $150,150 in income, at which point her marginal tax rate, or tax bracket, will jump up to 33%.

If Janice factors in state and local income taxes and Social Security and Medicare tax, her actual tax rate may exceed 50%!

Use your marginal tax rate. The easiest way to determine the effect of additional business income or deductions is to use your marginal tax rate. For instance, if your marginal tax rate is 28%, 28¢ of every new dollar you earn goes to Uncle Sam. Conversely, you save 28¢ in taxes on every additional dollar that qualifies as a deductible expense.

Tax Rates*

Bracket	Married Filing Jointly**	Single
10%	Up to $14,600	up to $7,300
15%	$14,601 to $59,400	$7,301 to $29,700
25%	$59,401 to $119,950	$29,701 to $71,950
28%	$119,951 to $182,800	$71,951 to $150,150
33%	$182,801 to $326,450	$150,151 to $326,450
35%	Over $326,451	over $326,451

* These dollar amounts for 2005 are subject to annual IRS adjustments for inflation.

** Tax brackets for heads of households and married people filing separately are somewhat different.

This table does not take into account itemized or standard deductions or personal exemptions that every taxpayer gets.

E. The Alternative Minimum Tax (AMT)

As if the tax code weren't diabolical enough, there is something called the alternative minimum tax (AMT). The AMT is really a second (alternative) set of tax rates that potentially apply to everyone. The theory of the AMT is that higher-income people who take a lot of tax deductions or get a lot of tax credits should still have to pay a minimum amount of income taxes. About a quarter of taxpayers with incomes between $100,000 and $200,000, as well as 40% of those earning more than $200,000, are subject to the AMT.

Everyone must figure their income tax liabilities under both the regular (marginal) tax rates, and the AMT rates—and pay whichever is the *greater* number. Ouch! Fortunately, tax software will figure the tax, if any, for you. The AMT is reported on Form 6251, and filed with your individual tax return.

Without getting into details, the AMT works to deny upper-income people many tax deductions and credits otherwise allowed on their tax returns.

AMT is figured by adding back to their income many of the exemptions, deductions, and credits that lowered their taxable income in the regular system. The AMT is triggered by such things as:

- net operating loss deductions in a business
- interest deductions on home equity loans
- large itemized deductions for state and local taxes
- foreign tax credit
- passive income or loss
- certain installment sale income
- unreimbursed employee expenses
- exemptions for dependents
- child and education tax credits for Hope scholarships and Lifetime Learning
- interest income on certain tax-exempt bonds, and
- the exercise of incentive stock options.

The AMT is yet another reason for self-employed people to use a tax pro or a software program like *TurboTax* (Intuit).

Icons

Throughout the book, these icons alert you to certain information.

Fast Track
We use this icon to let you know when you can skip information that may not be relevant to your situation.

Warning
This icon alerts you to potential problems.

Recommended Reading
When you see this icon, a list of additional resources that can assist you follows.

Cross-Reference
This icon refers you to a further discussion of the topic elsewhere in this book.

See an Expert
Lets you know when you need the advice of an attorney or other expert.

Tip
A legal or commonsense tip to help you understand or comply with legal requirements.

CHAPTER

1

Deductible Expenses

"There is nothing sinister in arranging one's affairs as to keep taxes as low as possible … for nobody owes any public duty to pay more than the law demands."

—Judge Learned Hand

Small business owners and self-employed people want to maximize their tax savings. The key to legally cutting business taxes to the bone is knowing the best ways to deduct *business operating expenses* and knowing exactly what *taxable income* is. That's the focus of Chapter 1. Next, in Chapter 2, Writing Off Business Assets, we'll complete the picture with the rules for deducting assets purchased for your business.

First, how will your business income be taxed? The U.S. government taxes a business's profits—so the more you end up with after deducting your expenses, the more taxes you pay. And, it is a progressive tax, meaning the more you make, the higher percentage tax you pay.

Consequently, the American entrepreneur has a strong incentive to keep taxable profits as low as possible, while at the same time taking home as much money as possible and enjoying as many benefits of self-employment as possible.

Let's start with a simple illustration of how net taxable profits are determined in any kind of business operation.

> **EXAMPLE:** Homer quits his job at the nuclear power plant and goes into business selling an automated dog walker that Bart invented. Incredibly, Homer makes money, and at the end of the year determines his taxable profits as follows:

Gross sales	$35,000
Less cost of goods sold (manufacturing costs)	– $12,000
Gross profit (before operating expenses)	$23,000
Less deductible operating expenses (shipping, supplies, rent, utilities, etc.)	– $ 5,000
Net profit (taxable to Homer)	= $ 18,000

How much Homer will owe in federal (and maybe state) income tax on the $18,000 net profit depends on his family's total income, personal deductions, and exemptions for the kids.

Wondering what you must include in your reportable income? Sales only? Bartered goods? Foreign income? Gifts? Ill-gotten gains? Fringe benefits? Inheritances? To learn what exactly is included in your sales and income figures, see Section F, below.

Now let's quickly move to the heart of this chapter: the rules for the expenses you can deduct from your gross profits to get that net profit number as low as possible.

A. What Is a Deductible Business Expense?

The Internal Revenue Code (IRC) says that just about any expenditure to produce business income is deductible. Then, the tax code lays down about a million rules telling exactly how and when you can and can't deduct these expenses. Luckily, very few of these rules apply to the average self-employed small business owner. In this chapter we discuss the ones that do.

The IRS goes by three main principles. To be a deductible business expense, the expense must be:

- ordinary and necessary for the business
- not extravagant, and
- primarily for the business (not personal).

Basically, money you spend in a reasonable way, with an expectation of bringing in business revenue, is a deductible expense.

1. Ordinary and Necessary

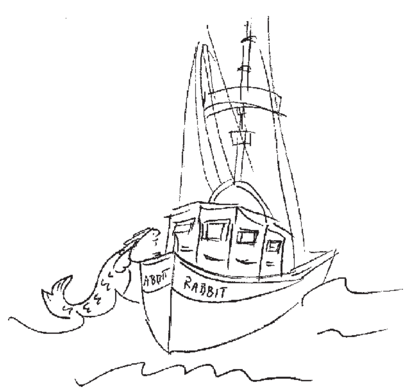
Okay, so what's an ordinary and necessary expense for a business? The tax code doesn't define it. This means we have to look at court decisions and IRS pronouncements for guidance. One court said necessary means "appropriate and helpful." Another court said that ordinary means "normal, common and accepted under the circumstances by the business community."

When you consider whether an expense is ordinary and necessary, start with a commonsense approach. Most enterprises need a fixed location, for instance, and paying rent or having a home office is appropriate, normal, and common, and is thus considered both ordinary and necessary.

Sometimes the answer is not as clear. For instance, let's say Fifi, a real estate agent, takes prospective clients to Chez Chez for $100 lunches and martinis to discuss properties for sale. For her business, this is an appropriate, helpful, and accepted business practice (and justified by the five-figure real estate commissions the lunch could generate). But, if Joe the plumber cleans out someone's kitchen drain for $75 and then takes his customer out to a $100 lunch, it hardly looks ordinary and necessary. You get the picture.

Some folks try to push the envelope, and the IRS has pushed back. Here's a tax court case that makes the point.

> **EXAMPLE:** Mr. Henry, an accountant, deducted expenses for maintaining his yacht. The IRS audited him and disallowed these costs. Henry contended that since his boat flew a pennant with the number "1040" on it, it brought him professional recognition and new clients. The court held that a yacht wasn't a normal expense for an accountant, and so it was neither ordinary nor necessary. In short, the yacht was a (nondeductible) personal expense.



Does your deduction pass the laugh test? Experienced tax pros can size up a client's potential tax deduction by asking themselves, "Can the expense be listed without provoking a snicker?" By this standard, you could say in the example above that the judge laughed Mr. Henry out of court.

2. Not Extravagant

Although there's no "too big" limitation on business expenses in the tax law, IRS auditors sometimes find deductions out of proportion to the nature of the business. The tax code (IRC § 162) frowns on "lavish and extravagant" expenses, but doesn't define these terms.

Again, it's more of a commonsense thing. For instance, it's fine for The Gap to lease a jet for travel between manufacturing plants, but not for a Sam's corner deli owner in Miami to fly to New York to meet with his pickle supplier.

3. Personal Expenses

The numero uno suspicion of the IRS when auditing small business owners is whether purely *personal* expenses are disguised as business deductions. Did you use business funds to pay for your son's Bar Mitzvah and deduct it as an "employee party" or as "advertising"?

Other times, it's not so easy to distinguish between business and personal. Would you think the costs of driving to your office and home again are personal or business expenses? Well, commuting costs are spent in pursuit of making money for your business, not for personal pleasure—but the tax code says these costs are not deductible. (For more on commuting expenses, see Section D3, below.)

Payments to relatives (or to businesses owned by relatives) are suspect. It's okay to hire your kids or parents to do work for you, but payments to them must be reasonable and they have to do real work. (For more info, see Chapter 12, Family Businesses.)

4. Expenses That Are Never Deductible

Some things aren't tax deductible even if they meet all the criteria because it would violate public policy to encourage these activities. These items include:

- government-imposed fines, like a tax penalty for making a late filing, a speeding ticket, or a parking citation
- bribes and kickbacks, whether to a local building official or an Arab sheik
- referral payments to get a client or customer, if illegal under a state or federal law
- costs of political lobbying or payments to purely social organizations.

(For details, see IRC § 162.)

B. Is It a Current or Future Year Expense?

Tax rules cover not only *what* deductible business expenses are, but also *when* you can deduct them. Most business outlays are deductible right away (on the current year's tax return), but some must be spread into future years. Accountants divide this world of expenses into current and capital expenses.

Current expenses are the everyday costs of running a business, such as monthly phone, rent, and utilities bills. You deduct current expenses in full from your business revenues in the year they were paid or incurred. Simple.

Capital expenses are costs that will provide benefits to the business beyond the current year. Typically, assets purchased by the business (like machinery, computers, furniture) must be deducted over a number of years (capitalized). The rationale is that because these assets are used over several years, their costs are spread out to match to the business revenue they help earn. Asset purchases are subject to special tax rules explained in Chapter 2, Writing Off Business Assets.

Repair or improvement? Sometimes the line is blurry between a current expense and a capital expense. For instance, repairing a broken copier is a currently deductible expense, but rebuilding a printing press is a capital expense that must be deducted over a number of years.

A repair cost is considered a capital cost if it:

- adds to the asset's value
- appreciably lengthens the time the asset can be used, or
- adapts the asset to a different use.

EXAMPLE: Gunter owns a die-stamping machine used in his metal shop. The average annual maintenance costs have been $10,000, which Gunter has properly deducted as current expenses every year. After 15 years, the machine is falling apart. Gunter must decide whether to have the machine rebuilt at a cost of $80,000 or replaced for $175,000. He decides to rebuild, meaning the $80,000 cost must be capitalized—it can't all be deducted that year. The tax code says that metal-fabricating machinery costs are deductible over five years. (Chapter 2, Writing Off Business Assets, explains how long different types of assets must be deducted, or written off.)

C. Top 25 Deductions for Businesses

Now lets look at the top 25 current expenses and their deductibility rules. The first five are the biggest and are discussed at length in other sections in the book:

1. Vehicles

There are very specific rules and limits for deducting vehicle costs, discussed in Section D, below.

2. Equipment and Furniture

The costs of acquiring assets like equipment and furniture are discussed in Chapter 2, Writing Off Business Assets.

3. Inventory

Inventory costs have their own way of being deducted. See Chapter 2, Section A3.

4. Home Offices

Home offices can produce such large tax deductions that they are covered at length in a separate chapter: Chapter 13, Microbusinesses and Home-Based Businesses.

5. Retirement Savings

Contributions to retirement plans are also so important that they get their own chapter: Chapter 15, Retirement Plans.

6. Costs of Going Into Business

So, you've decided to take the plunge. What are the tax angles for the money spent for what are commonly called start-up costs before opening the doors of your new venture?

There are three tax rules to choose from, and one bonus rule:

Rule One. You can deduct up to $5,000 of preopening expenses in the first year you are in business. Anything over that must be deducted over the following 15 years. There are restrictions on this deduction, however, if your start-up expenses exceed $50,000. If your first year wasn't profitable and your second year looks iffy, then you might be better off choosing Rule Two or Three.

> **EXAMPLE:** Sasha starts up Rox, a shop catering to rock climbers. She spends $8,000 before opening Rox's doors. Sasha can deduct $5,000 in year one, and 1/15 of the remaining $3,000 ($200) each year thereafter.

Rule Two. You can deduct (amortize in tax lingo) your start-up costs over 60 months. Using Sasha's example above, she could choose to deduct $133.33 per month over 60 months ($8,000 divided by 60). So, if Rox was in business eight months in year one, Sasha's start-up deduction would be $1,066.40 for that year.

Rule Three. You can forgo deducting any start-up costs and then recover the cost instead when you sell or go out of business. Continuing with Sasha, let's say she sells Rox in two years for $10,000 more than her investment in the business. Tax result: Her start-up costs of $8,000 are a (nontaxable) return of her capital investment. Few folks ever choose this option over taking a deduction.

Bonus Deduction for Business Organizational Expenses. After October 22, 2004 there is an extra up-to-$5,000 deduction (in addition to the start-up deduction discussed above) for small business organizational expenses. This deduction is only for business entities—corporations, partnerships, and limited liability companies. And, the organizational expenses can't exceed $50,000. Here's how it works. If Sasha pays $1,250 to a lawyer to form Rox, Inc., and $440 in state fees for incorporating, and another $100 for a corporate records book, she gets an organization cost deduction of $1,790 in year one. This is in addition to her start-up cost deduction of $8,000.

7. Costs of Not Going Into Business

What happens if, after spending money to set up a new business, you back out before opening day?

Tax wise, your costs aren't deductible as business expenses, but they may be deductible as investment expenses. Expenses of trying, but failing, to go into business fall into two tax categories (IRC § 195).

Investigating a business to start or buy. The costs of a general search for a business to buy or of investigating whether to start a business are not deductible at all—not as business expenses *or* investment expenses.

> **EXAMPLE:** Bubba is thinking about opening a fried chicken restaurant, so he travels the state for two weeks stopping at every KFC, takes photos of the operation and samples all the menu items. After spending $1,244, and battling indigestion, gaining ten pounds, and thinking about the long hours, Bubba forgets about it. Result: No tax deduction.

Attempting to buy or start a specific business. The costs of attempting to acquire or start a specific business are deductible as investment expenses.

> **EXAMPLE:** Francine sees an ad for a Hair Today, Gone Tomorrow (HTGT) franchise for sale 600 miles away. She travels to meet with the owner, hires an attorney, and signs a contract to buy it. HTGT's home office doesn't approve the transfer because Francine isn't a licensed beautician. Francine is out of pocket $3,100. She can deduct this not as a business expense, but as an investment expense, on Schedule A of her individual tax return.

8. Accounting, Legal, and Other Professional Fees

Fees paid to accountants, lawyers, and business consultants are sometimes immediately deductible, sometimes not.

One-time deals. Professional fees regarding short-term business deals or sales or yearly taxes are deductible immediately.

> **EXAMPLE:** Yona hires Carlos, a CPA, to help her prepare payroll tax forms for her business. The $275 she pays Carlos is a deductible business expense.

Long-term benefits. Professional fees that provide a benefit beyond the present year—legal advice on a commercial lease or long-term service or supply contract, for example—must be deducted over the period of the expected benefit.

> **EXAMPLE:** Jackson pays a lawyer $600 to negotiate a two-year contract to provide cleaning services for the Oakland Coliseum. Jackson must deduct that fee over the 24 months that the lease will last. He can deduct 1/24 of the $600 per month, or $25 per month. That gives him a deduction of $300 for each of the two years that the contract will last.

Start-up costs. Professional fees incurred before opening for business, such as consultants,' lawyers,' and accountants' fees, are usually amortized over 60 months (unless they qualify as business organizational expenses—see Section 6, above).

> **EXAMPLE:** Maddy pays her attorney $600 to negotiate a five-year lease on a mall kiosk to sell Italian charm bracelets. The legal fee must either be deducted in equal monthly amounts of $10 over 60 months or added to the cost of establishing the business. If Maddy sells her business at a gain of $600 or more, this second choice would reduce the tax bite.

Business and personal tax advice. Small business folks' personal and business tax concerns are always inseparable, so their accountants can't help but combine personal and business advice. Both business and personal tax advice are deductible, but different rules apply. When the advice is given at the same time, the accountant's or tax pro's bill should split out the business and personal portions.

> **EXAMPLE:** Aaron goes to Bridget, his accountant, for tax preparation and advice on how to

reduce his family's income taxes. His self-employed income is from the model airplane newsletter he publishes, and his wife Clarinda's salary as architect. Bridget's statement for services of $800 shows $550 for Aaron's business and $250 for the couple's personal tax matters. Tax result: $550 is tax deductible for business (Schedule C) and $250 for miscellaneous items (Schedule A) on Aaron and Clarinda's joint tax return.

Ask your tax pro to apportion statements for services. Hopefully your tax pro will attribute the lion's share of his bill to the business portion. While you get a 100% deduction either way, the business portion always produces the largest tax savings.

9. Supplies

Supplies like paper clips and copy paper are tax deductible, but you can't deduct more than you use up in the year purchased. Of course, buying these items and being sure you use them all up by December 31 is all but impossible. The IRS knows it, too, and I've never seen an auditor push the point if the items purchased will be used in the following year. This deduction is rarely one that the IRS looks closely at.

10. Entertainment and Meals

Entertainment means any activity for amusement or recreation, including food and drink. Entertainment for customers, clients, or employees is deductible, with some strict requirements and limitations. For starters, only 50% of an entertainment expense is deductible, with a few exceptions discussed below. Here's the fine print.

Appropriate and accepted. To be deductible, entertainment must be *both:*

- common and accepted in your field of business, trade, or profession, *and*
- helpful and appropriate.

An entertainment expense does not have to be indispensable for your business to be deductible.

EXAMPLE: Barney's Building Supplies throws an annual golf tournament for local building contractors. Providing this type of outing—golf, baseball games, and the like—is fairly common in the industry, so Barney shouldn't have a problem deducting the expense.

Related to business. The entertainment also must be for the purpose of bringing in revenue. The entertainment must *either* be:

- *directly related* to your operation, meaning that business must be discussed during the entertainment. It must occur in a clear business setting and there must be more than a general expectation of business.

  EXAMPLE: Ginny, an independent housewares distributor, hosts a group dinner at a private dining room at Glutton's restaurant, where she demonstrates a new electronic toothpick to potential customers while they dine. This should meet the directly related rule.

- somehow *associated with* your business, meaning that business is discussed either prior to or immediately after the entertainment.

  EXAMPLE: Edmund holds a tax-planning seminar followed by a trip to the symphony. This clearly satisfies the associated with rule.

Extravagant entertainment. An IRS auditor can reject entertainment deductions that are lavish and extravagant under the circumstances. Use your common sense, and don't be excessive.

Home entertaining. You can deduct 50% of your costs for wining and dining existing or potential customers or clients in your home. For example, Denise holds a dinner party to show and sell MegaVega Vitamins, a multilevel marketing scheme she got suckered into by her brother-in-law.

Entertaining spouses. You can include the spouses of customers or clients in the entertainment and deduct the cost. And if other spouses are attending a social event, you can bring yours, too (and deduct the cost).

Exceptions to the 50% deduction rule. The following expenses are 100% deductible:

- **Transportation.** Getting to an event with a client or customer is 100% deductible. So, go ahead and hire that limo.
- **Employee parties.** Company parties and outings for employees and their families are 100% deductible. No business need be discussed, but everyone in the company must be invited—even the geeks in the back room.
- **Public entertainment.** Entertainment and meals for the general public are fully deductible as a form of advertising.

Keep good records of business entertainment deductions. Auditors are suspicious of fun-and-games deductions. Keep a guest list of people you entertain, and be ready to explain the business connection or nature of business discussed. At the same time, I've never seen the IRS contact a guest to see whether or not business was really discussed.

Corporate entertainment rules. While C corporations often allow an employee/shareholder to either pay the expenses and get reimbursed or have the corporation pay them directly, it's better if the corporation pays. If you aren't reimbursed, you can claim your out-of-pocket costs on your individual tax return as unreimbursed employee expenses (on Schedule A.) However, this results in less tax savings and increases your chances of being audited.

See Section 12, below, for more on meal expenses while traveling.

11. Gifts

Gifts to clients and customers are 100% deductible, up to a very stingy limit of $25 per recipient, per year. You can get around the limit, a little, by adding on the cost of engraving, wrapping, and mailing. Also, if the gift costs less than $4 and your business name is imprinted on it (like a calendar or pen) it doesn't count against the $25 limit and is fully deductible.

Gifts to employees can be much more generous. (See Chapter 14, Section K.)

12. Travel

Traveling for business is deductible as long as it is ordinary and necessary.

a. Types of Deductible Travel Expenses

Travel deductions are broadly allowed, with some special rules and limits.

Transportation. Whether plane, train, or automobile, public or private, transportation is 100% deductible—except for commuting from home to work. This includes taxis, buses, and limos and cash tips. It also includes vehicle costs for your personal car, according to the rules in Section D, below, along with rental cars, tolls, and parking.

Baggage and shipping. The cost of transporting items, like sample or display material and personal luggage, is 100% deductible as long as it is all needed for business travel.

Lodging. When a trip takes you away from home overnight, or you need to be able to rest to be able to perform your job, you can deduct 100% of the costs of overnight lodging.

Meals. Only 50% of the costs of food, beverages, and tips are deductible when you're on the road. Lawmakers reason that you would still have to eat if you were at home and home-cooked dinners aren't deductible.

Tips. Gratuities for services while on business are fully deductible, except for the 50% limit for food servers of your meals.

Laundry. Expenses for cleaning your clothes are 100% deductible as long as you are staying overnight on business.

Miscellaneous. Charges for telephone, Internet access fees, and anything else directly related to your business travel are 100% deductible. Catching a movie while you're out of town comes out of your pocket, though.

b. Deducting Travel Expenses

You have a choice of how to deduct your living expenses while traveling away from home on business. Travel costs (other than transportation to your destination, which is deducted separately) are termed "lodging, meals and incidental" by the IRS.

Use either the *actual expense* or the *per diem expense* method to deduct travel costs. You will want to figure it both ways and use the one that gives you the biggest tax break.

With the actual expense method, you must keep track of every cent you spend for travel, including food and lodging on the road. So, keep a running tally and don't throw away your receipts and credit card slips.

The per diem expense method is simpler—just take an IRS approved dollar deduction for each day you are on the road. How much you can take depends on where in the world you are traveling. With the per diem rule, you can choose either the high-low method or the regular federal per diem rate method. Generally, you are better off using the high-low method, but check both. Note that these figures are changed every September-October by Uncle Sam.

To find the per diem rate for where you are going, see IRS Publication 1542, *Per Diem Rates*. This publication can be found on the IRS's website at www.irs.gov. The tables for each method show rates ranging from $91 in the lowest cost localities (like the Dakotas) to $246 in places like Aspen and Santa Monica.

The per diem method relieves you of keeping close track and records of your expenses, although you still must be able to document the business nature of the travel. So, keep your calendar, day-timer, or appointment book showing the business purposes. And, if you travel on the cheap—dining at Mickey Ds and staying at Motel 3 or on a friend's sofa—this is one of the few opportunities in the tax code to get a legal deduction larger than your out-of-pocket expenses.

Sole proprietors can't use the per diem method for lodging expenses. However, solos may use the IRS per diem meal rates ($31 to $51 per day depending on the locale) and then claim the actual expense for their Holiday Inn stay. Who knows why Congress apparently discriminates against sole proprietors?

Combining business and pleasure travel is discussed in Chapter 14, Fringe Benefits.

13. Moving Expenses

If you move your household a significant distance because of a change in your workplace, you can deduct your expenses if you meet one of the following rules:

- The relocated business site must be at least 50 miles farther from your old home than your old business site was, or
- If you're starting up a new business instead, it must be more than 50 miles from your former home.

Personal moving costs are not business expenses but are claimed on Schedule A of your personal tax return. (See IRS Publication 521, *Moving Expenses,* for details.)

14. Health Insurance

Premiums for health insurance for employees are now 100% deductible.

There are two catches:

- The health insurance deduction can't be greater than the business's net profit.
- Owners who could have been covered by a spouse's health plan cannot claim a deduction.

A business owner's health insurance premiums are personal, not business, expenses. You claim the expense on page one of Form 1040, your individual tax return. For details, see Chapter 14, Fringe Benefits.

15. Disability and Sick Pay

Many small businesses keep a sick worker on the payroll. Wages paid to sick or disabled employees (but not to you the owner) are deductible. Technically, there should be a written wage continuation plan in order to get the deduction. Any sick pay the worker gets is fully taxable to them, just like wages.

16. Education Expenses

Tuition, fees, and supplies are business deductions if they are related to an *existing* business, trade, or occupation (IRC § 162). The education must be *either*:

- to maintain or improve skills required in your present work, *or*
- required for your work by law or by your employer.

EXAMPLE: Horatio is required by his state to complete 24 hours of continuing education before renewing his electrical contractor's license. The course fee and workbooks cost $720, and the course requires a trip 420 miles away from Horatio's hometown, including two nights' stay in a hotel. Horatio's total outlay of $1,130 is a deductible education expense, under either of the two rules above.

Education that qualifies you for a new job or different business isn't deductible. If you are trying to improve your skill set to change jobs or start a new business, the expenses are not deductible. The IRS and the courts interpret this rule quite strictly.

EXAMPLE: Mary, a public school teacher, wants to open a small private school for learning disabled children. Her state requires special college-level courses before she can be certified to establish her school. She spends $5,000 on the classes. Tax result: No deduction for Mary, because the education is for a new job or business, even though it's in a related field and would no doubt help her in her current job. However, Mary might get a partial deduction because up to $3,000 annually in college tuition and related fees for you, your spouse, and dependents is deductible whether you're in business or not. Note: If your adjusted gross income exceeds $130,000 (married filing jointly) or $65,000 (single), you cannot take a deduction at all.

Also see Chapter 14, Section J, for rules on educational fringe benefits.

17. Interest

Interest charges paid on credit for the business (on loans or goods or services) are deductible if the credit is used for the business. This is true whether the credit was extended to the business or the owner.

EXAMPLE: Zee Zee maxes out her Visa card with a $5,000 cash withdrawal and uses it to fund her House of Pain Piercing & Tattoo Salon. The 21% credit card interest that Zee Zee pays is deductible—but she should be prepared to show an auditor that the cash advances went into the business. Otherwise, the interest could be considered a (nondeductible) personal expense.

Consider a home equity loan or line of credit first. Loans secured by real estate always carry lower interest rates than credit cards, and they allow longer periods for repayment. These loans can be used to finance a business—the interest is deductible no matter what the loan is used for (up to $100,000 on a second mortgage or home equity loan). The downside is the bank fees and costs in getting the loan. If this looks promising, run the numbers by a tax pro first.

18. Bad Debts

Anyone in business long enough will be stiffed, and it may even happen pretty frequently. When you can't collect payments on money lent for business reasons or credit provided for goods, you can usually deduct your loss. This is not true, however, for credit provided for services. (IRC § 166, Reg. 1.166.)

Goods. The costs of goods sold by your business and not paid for can be claimed as a bad debt deduction. You can deduct only your cost of the goods, not any lost profits.

> **EXAMPLE:** Tom's Tires sells a set of Brimstone tires to Bianca for $450. She pays $50 down and talks Tom into letting her pay the balance "next month." Bianca moves out of town and Tom is stuck. Tom paid $350 for the tires, and so he gets to deduct $300 (counting the $50 he got from Bianca) as a bad debt.

Services. You can never deduct the value of services that you performed but weren't paid for: consulting, medical treatment, legal work, and so on. (I don't like this rule, either). Uncle Sam's apparent rationale is that if you could deduct the value of your unpaid services, it would be easy to inflate your bills and claim large bad debt deductions—and too hard for the IRS to catch you.

Loans. Money loaned and not repaid can be deducted as a bad business debt, if both of the following are true:

- The loan was made for business (not a personal loan to Regis, your ex-best friend before he ran off with your wife).
- You have taken reasonable steps to collect it—such as a written demand for payment, going to court, or turning the bill over to a collection agency.

> **EXAMPLE:** Print It Now made a $2,000 loan to Susan, a friend and long-time customer, to keep her Flowers To Go business afloat. Several months later Susan declared bankruptcy. Print It Now filed a claim in the bankruptcy and received a $300 repayment of its loan. Tax result: As long as Print It Now made the loan to protect a business relationship—and not just to help a friend—$1,700 is deductible as a bad debt ($2,000 minus $300).

Nonbusiness bad debts may be deductible, too. Personal bad debts without any business connection may be deductible too. Because this is a small business tax book, we won't go into details. Instead see IRS Publication 550, *Investment Income and Expenses.*

19. Charitable Contributions

Only C corporations can claim donations to charity *directly* as business expenses.

However, taking charitable contribution deductions isn't a problem for other business owners. Sole proprietorships, partnerships, LLCs, and S corporation owners can claim charitable deductions made by the business on their personal tax returns. The owners deduct charitable contributions on Schedule A of their Form 1040 tax returns.

> **EXAMPLE:** Belinda, a sole proprietor, buys a new nail gun and air compressor for her drywall contracting business. She donates her old equipment to Habitat for Humanity. Belinda originally paid $2,000 for the donated items and claimed $1,100 in deductions on them over the past three years. Belinda can claim $900 as a charitable contribution on her personal tax return—as long as the old nail gun is still worth at least $900.

20. Taxes

Most taxes paid by a business are deductible—with a few exceptions. Here are the rules:

Employment taxes (Social Security and Medicare). Fifty percent of the total Social Security and Medicare taxes paid on behalf of your workers is deductible. The other 50% is withheld from the employees' wages and paid over to Uncle Sam by your business, so it doesn't come out of your business's pocketbook.

Income taxes. Income taxes are *not* deductible. (This applies mainly to C corporations, since other types of businesses don't pay income taxes; their owners pay them.) Owners of all businesses, like everyone else, *can* deduct *state and local income taxes* on their individual income tax returns (on Schedule A)—assuming they itemize their personal deductions rather than taking the standard deduction.

Self-employment taxes (Social Security and Medicare). Fifty percent of the Social Security and Medicare taxes paid by a self-employed business owner are deductible. (See page one of the Form 1040 individual income tax return.)

Real estate taxes. Taxes on business property are fully deductible, and so are nonbusiness property taxes, which you claim on Schedule A of your personal tax return.

Special assessments. State and local taxes for improvements to your business property are not immediately deductible. Instead, they must be amortized and deducted over a period of years. For instance, taxes to pay for a new sidewalk or sewer must be added to the cost basis of the property and deducted over a 15-year period. (For more on deducting improvements, see Chapter 2, Writing Off Business Assets.)

Sales taxes. State and local sales and use taxes that you pay for items related to business operation are deductible as part of the cost of the item. For instance, $25 of office supplies with $2 sales tax is deductible as $27; you don't deduct the sales tax separately. However, sales taxes on assets you purchase for the business must be deducted over the life of the asset. (See Chapter 2, Section D1.)

Don't include sales taxes collected by you in your gross receipts. Sales taxes you collect as a seller and pay over to the state or local tax collectors aren't deductible, since they shouldn't be included in your gross receipts.

Penalties and fines. Sorry, no deductions for penalties and fines paid to the IRS and other governmental entities. This includes speeding and parking tickets.

Excise and fuel taxes. Few businesses, other than trucking and transport, pay excise and fuel taxes, but they are fully deductible. The most common excise taxes are:

- Manufacturers' excise taxes on vehicle accessories, such as tires and inner tubes, gasoline, lubricating oils, coal, fishing equipment, firearms, shells and cartridges sold by manufacturers, producers, or importers.
- Fuel excise taxes imposed at the retail level on diesel fuel and special motor fuels.

For details, see IRS Publication 3536, *Excise Tax Guide*.

Sales taxes you pay on long term assets are capitalized along with the cost of the asset. State and local sales and use taxes paid on assets used in the business—such as a vehicle—must be added to the asset's tax basis and claimed as depreciation deductions over future years. (See Chapter 2, Writing Off Business Assets.)

21. Advertising and Promotion

Marketing costs are fully deductible. This covers the costs of ordinary things like business cards and Yellow Pages listings, as well as customer prize drawings or sponsoring a Little League team. As long as there is a clear business connection between the advertising or promotional activity, it's deductible. For instance, putting "Southwest Autoparts" on the back of a team's jerseys works.

Note: Signage, which will have a useful life beyond one year, is a business asset and must be deducted over future years. (See Chapter 2, Writing Off Business Assets.)

Don't get too creative with "marketing" costs. Primarily personal things, like the cost of inviting clients or customers to your daughter's wedding reception, aren't deductible, even if it may help your business's visibility.

22. Repairs and Improvements

Everyday repairs to business assets can be fully deducted in the year performed, but improvements to an asset can't be fully deducted in the current year. (See Section B, above, and Chapter 2, Writing Off Business Assets.)

> **EXAMPLE:** The electrical system in Pat's Postal & Shipping's building is outdated and frequently blows fuses. The service can be upgraded to a breaker box and new wiring throughout at a cost of $4,700. A repair to keep things going awhile longer costs $425. Tax result: The $425 repair would be currently deductible as an operating expense. To replace the old system with new electrics for $4,700 would be only partly deductible this year, and the balance of the cost could be depreciated over future years.

Improving accessibility or restoring historic buildings may qualify for instant deductions or tax credits. Special tax breaks are granted for rehabilitating historic and older buildings, adding elderly or disabled access, and removing architectural and transportation barriers. Check with your tax pro or see the instructions for IRS Form 3800, *General Business Credit*; Form 3468, *Investment Tax Credit;* and Form 8826, *Disabled Access Credit.*

23. Business Insurance

Businesses can deduct 100% of the premiums they pay for insurance, including:

- vehicle insurance
- fire, theft, and flood insurance
- liability insurance
- malpractice or errors and omission insurance
- workers' compensation insurance
- business interruption insurance, and
- life insurance (deductible for C corporations only).

24. Research Expenditures

Business research costs may qualify for a special business tax credit. We haven't explained credits yet, but they are similar to deductions, only more valuable. A credit is a dollar for dollar reduction of your tax bill.

Very few small enterprises qualify for the research credit, so don't get your hopes up. To qualify, the research must be "technological in nature … useful in your new or improved business component … constitute elements of a process of experimentation." (IRC § 174, IRC § 41.) If you are in technology, check with an accountant to see if you qualify.

25. The General Business Credit

The general business credit (GBC) is not just one kind of tax credit; it covers a number of different tax breaks. Because the GBC applies to few small business owners, we won't go into detail. Many of the individual credits have to do with hiring certain employees, as you'll see below.

You claim the GBC on IRS Form 3800 (along with other appropriate forms listed in the chart below) with your tax return. **Note:** The GBC can be used only to reduce a tax liability, not to claim a tax refund.

Credit and Purpose	IRS Form
Welfare-to-work credit. For hiring and paying wages to long-term family assistance recipients.	IRS Form 8861, *Welfare-to-Work Credit*
Work opportunity credit. For providing jobs to certain unskilled workers.	IRS Form 8845, *Indian Employment Credit*
Indian employment credit. For hiring certain Native Americans.	IRS Form 5884, *Work Opportunity Credit*
Child care facility credit. For providing a day care facility for your employees' children.	IRS Form 8882, *Credit for Employer-Provided Childcare Facilities and Services*
Low-income housing credit. For building and providing housing to folks falling under certain income levels.	IRS Form 8586, *Low-Income Housing Credit*
Investment tax credit. Composed of credits for rehabilitating property, energy, and reforestation.	IRS Form 3468, *Investment Tax Credit*
Alcohol fuels credit. For using alternative fuels in your business equipment and vehicles.	IRS Form 6478, *Credit for Alcohol Used as Fuel*
Community development credit. For contributions to qualified community development corporations.	IRS Form 8847, *Credit for Contributions to Selected Community Development Corporations*

To see if you qualify for any of these credits, check with your accountant or the IRS website at www.irs.gov.

D. Vehicle Expenses

Vehicles are well-known money-eaters—America's third-biggest expense behind housing and food. The good news is that vehicle costs for business can yield one of your largest expense deductions.

Tax rules for claiming car and truck expenses are tricky, but well worth knowing. Here are the three basic rules.

Rule One: Keep records. Use a trip or mileage log to record vehicle use (see sample below), and save gas and repair receipts or credit card statements. You'll need this data when you do your tax return and to prove your deductions in case you ever get audited.

Rule Two: Allocate business/personal use. If you use your business vehicle for pleasure driving, the IRS requires you to keep track of your use. This is really just another record-keeping issue, but it deserves special mention. You can record either your personal miles or your business miles and your total mileage. For your tax return, you'll need to come up with numbers like "62% business," leaving 38% personal. IRS auditors can get very testy if you can't produce backup data.

I track my business miles, not my pleasure driving. At tax-time, I subtract the business miles from what shows on the speedometer, and I figure that any miles not driven for business must be nondeductible personal ones.

Note: Minimal personal use, like occasionally heading a few miles out of your way for lunch while driving for business, is not going to excite the IRS—you don't have to account for it.

Do you own or lease just one vehicle? As a rule of thumb, if you only have one car or truck, don't claim over 80% business use and expect it to fly with an IRS auditor. The auditor will suspect that your personal miles are a lot higher than you're admitting.

Rule 3: Choose a deduction method. You can use the standard mileage method or the actual expense method to deduct your vehicle expenses—whichever gives the biggest deduction. We'll explain both next. Generally you should run the numbers using both methods and then choose. With tax preparation software or an accountant, this comparison can be done automatically.

You are allowed to switch back and forth between the two methods every year, with some limitations discussed below in Section 2.

1. Standard Mileage Method

The absolute simplest way to deduct business vehicle expenses is called the mileage or standard mileage method. You can choose the mileage method whether you own or lease your auto or truck.

To the lazy folks out there: Don't automatically choose this method until you have considered the second alternative—it could cost you a bundle at tax time, because you can't deduct any of the purchase price of your vehicle if you use the mileage method. (This is discussed in Section 2, Actual Expense Method, below.)

Steps for using the mileage method. Here's how it works:

1. At the end of the year, you total up the number of business miles you drove.
2. You enter that number on your tax return and multiply by 40.5 cents (in 2005).
3. You add in the costs of parking, tolls, and any state property taxes paid for the vehicle.

EXAMPLE: Dr. Morris, a veterinarian, buys a specially equipped GMC pet hospital truck for $25,000 and drives it 10,000 miles in 2005 to care for the animal kingdom. The doc chooses the mileage method, giving him a deduction of $4,050 for the miles driven (10,000 miles x 40.5 cents). He also spends $350 for highway and bridge tolls, $100 for the property tax portion of his state vehicle registration, and $250 for parking. Tax result: Doc Morris's total vehicle deduction is $4,750 ($4,050 + $350 + $100 + $250). This assumes that the doc uses the pet hospital van 100% for business.

When you can't use the mileage method. You must use the actual expense method of deducting vehicle costs instead of the mileage method when any of the following conditions apply:

- You used more than one vehicle in one business simultaneously.
- You used the actual expense method on this same vehicle in prior years, and also claimed an accelerated depreciation method to deduct the cost of this vehicle (explained in Chapter 2, Section C).
- You used IRC Section 179 to write off all or part of the vehicle's purchase price (explained in Chapter 2, Section B).

2. Actual Expense Method

The actual expense method requires more record keeping, but it is usually well worth it. For most newer vehicles, the actual expense method produces a bigger deduction than the mileage method. That said, the mileage method may produce bigger deductions if you drive a lot in a gas miser or a faithful old clunker.

A good rule of thumb is that if you paid more than $15,800 for your vehicle, you'll be able to deduct more by using the actual expense method. But, as I've said, you should run the deduction numbers both ways and use the most advantageous one.

Steps to using the actual expense method. Here's what you do:

1. Track your operating expenses: gas, repairs, tires, licensing, maintenance, insurance, and so on.
2. Add the depreciation deduction (discussed briefly below, and in Chapter 2, Section C). This gives you your annual tax deduction for your vehicle.
3. If you use the vehicle for personal purposes as well as business, you must determine the percentage-of-business-use figure, such as 62% business use. (See Rule 2 in the introduction to this vehicle section.)

Record Keeping for Business-Used Vehicles

No matter which method you use to claim auto expenses, you will need to keep accurate records. The best way to keep auto use records is with a logbook, sold at office supply stores. Or just keep a notepad in your glove compartment. If you're tech savvy, store the vehicle data in a handheld personal digital assistant (PDA). However you do it, whenever you drive a personal car for business, record:

- the date of the trip
- your destination
- your mileage (round-trip), and
- whom you visited and your business relationship with that person.

Below is a sample page from a logbook showing vehicle expense entries.

Also, keep vehicle-servicing receipts showing the mileage at the first and last servicing of the year. This is one way to prove the total annual miles you drive. If using the actual expense method, you should save all of your other car expense receipts, too.

Vehicle Expense Log

January 2006			Odometer Readings			Expenses	
Date	Destination (City, Town or Area)	Business Purpose	Start	Stop	Miles this trip	Type (Gas, oil, tolls, etc.)	Amount
1/18/06	Local (St. Louis)	Sales calls	8,097	8,188	91	Gas	$18.25
1/19/06	Indianapolis	Sales calls	8,211	8,486	275	Parking	2.00
1/20/06	Louisville	See Bob Smith (Pot. client)	8,486	8,599	113	Gas/ Repair flat tire	16.50
1/21/06	Return to St. Louis		8,599	8,875	276	Gas	17.25
1/22/06	Local (St. Louis)	Sales calls	8,914	9,005	91		
1/23/06	Local (St. Louis)		9,005	9,005	0	Car wash	8.50
///	MONTHLY TOTAL	///	8,097	9,005	846	///	$62.50
TOTAL JANUARY, 2006		Business miles driven			846	Expenses	$62.50

4. Multiply the sum of Steps 1 and 2, above, by the percentage of business use.

We'll go through all the calculations in an example below, but first let's see how to determine the vehicle depreciation deduction.

Figuring depreciation. Depreciation deductions are the main topic of Chapter 2, Writing Off Business Assets. But here's a preview to help you understand the example below.

Depreciation is a tax term for deducting the cost of any business asset that wears out over time—as your car goes from New & Shiny to Dented & Smelly. The IRS publishes tables to show the dollar amount you can deduct for vehicle depreciation each year, based on variables like whether you bought new or used and how much you paid for it.

Vehicles purchased in 2005 have a first-year deduction limit of $3,060. (To find out how much you can deduct after the first year, and for some tricks for getting around the depreciation limit, head over to Chapter 2, Section C.*)*

Now, here's an example of the actual expense method:

> **EXAMPLE:** Samina, wife of the veterinarian in the example above, does floral arrangements for weddings. She buys a Dodge minivan in 2005 for $25,000 (coincidentally, the same amount her hubby paid for his pet hospital truck). Samina drives 10,000 business miles and spends $700 for gas, insurance, maintenance, and parking—the same as hubby's out-of-pocket costs. She chooses the actual expense method. Tax result: Samina gets a depreciation deduction of $3,060. Adding this to Samina's $700 operating expenses, she has a total of $3,760 in vehicle deductions. Her husband wins household bragging rights—his vehicle deductions were $4,750 using the mileage method.

Run the math both ways each year and switch back and forth. You may switch between the two methods every year, with two limitations:

- If you use the actual expense method in the first year you use your car in your business, you can't switch to the mileage method in any later year.
- If you use the mileage method in the first year you use your car in business, you can switch to the actual expense method only if you take "straight line" depreciation deductions instead of accelerated depreciation deductions. (This distinction is covered in Chapter 2.)

3. Commuting Costs

Whether you drive, fly, or use a magic carpet, you can't deduct the cost of getting to work. Commuting expenses, such as gas to get to and from work, are considered personal, with two minor exceptions.

- **Home office.** If your business is home-based (you lucky dog), all trips from your house to a jobsite or client, or to buy supplies, are fully deductible. Keep a log.
- **Temporary workplace.** Trips to a temporary work site are deductible *if* you have a permanent regular workplace.

Do some business on your way home. If you make a business-related stop en route (hint), like at Office Depot to pick up a toner cartridge, or to say hello to a customer or client, it could make your driving costs deductible. Note the business purpose in your vehicle log.

4. Special C Corporation Vehicle Rules

Unless your business is operating as a C corporation, you don't need to know this stuff. Skip ahead to Section 5, below. If you don't know whether you should become a C corporation, see Chapter 7, C Corporations.

The tax rules for deducting vehicle expenses for C corporations depend on whether the company owns the car or the employee (or employee/owner) owns it.

Corporation-owned vehicles. A company car, say a new BMW, is a nifty perk for employees, including company owners—especially when they can drive it to impress their friends off-hours. Assuming the corporation uses the actual expense method for writing off a company vehicle, all expenses are tax-deductible. The catch is that the value of any *personal* use of the car is taxable income to the driver. This means the driver must keep a usage log. If this sounds promising, see a tax pro or IRS Publication 917, *Business Use of a Car,* for details.

Employee-owned vehicles. C corporation employees (including shareholders) can use their personal cars for business and get reimbursed by the corporation for their actual vehicle expenses. The corporation pays for the vehicle expenses only for the business use of the car. The company can also pay depreciation costs of the vehicle. Tax result: The vehicle reimbursements are 100% deductible to the company and are not counted as income to the owner.

> **EXAMPLE:** Ralph's C corporation, Chrome Dome, Inc., which manufactures head wax for bald men, reimburses Ralph $3,812 for his costs of driving his new Infinity on sales calls. Chrome Dome also pays Ralph $10,710, the amount of first year depreciation allowed (in 2005). Total reimbursement to Ralph by the corporation is $14,522.
>
> Ralph's auto log shows he uses the Infinity 80% for business. So, Ralph reports 20% of the total corporate payments, $2,904, as income on his 2005 personal tax return. Depending on Ralph's tax bracket, the added tax won't likely add more than $1,000 to his tax bill. Considering the real costs of owning a nice car, the tax addition is a bargain.

5. Other Vehicle-Related Deduction Opportunities

Expenses for special commuter vehicles, vehicle taxes, and loan interest can yield more tax deductions:

- **State vehicle taxes.** Often called a vehicle license fee or registration and tag fees, state property taxes for cars and trucks are deductible. If the vehicle is used strictly for business, then it's a 100% deduction; otherwise, it's according to the business/personal proportion of use (for example, 80% business/20% personal).
- **Special commuter vehicles.** If your business has a vanpool or similar large SUV or minivan that holds at least six passengers, you might be eligible for a tax deduction for commuting expenses. The rules are restrictive, however, and the law forbids a corporate shareholder to be the driver.
- **Loan interest.** If you're using the actual expense method (see Section 2, above), interest on your auto loan is deductible in proportion to the business use of the vehicle. For instance, if you pay $1,000 annually in interest on your car loan and you use the car 60% of the time for business, you can take a $600 interest deduction.
- **Qualified Electric Vehicle Credit.** You may take a 10% tax credit of the cost of an electric vehicle, up to $4,000.

E. How and Where to Claim Expense Deductions

How and where you claim expense deductions depends on the item you are deducting and what form of business entity you have (sole proprietorship, partnership, limited liability company, or corporation).

Sole proprietors. Sole owners, independent contractors, and statutory employees. (see Chapter 5, Section C) report most business-operating expenses on Schedule C of their individual tax returns. (There's a filled-in sample of Schedule C in Chapter 6, Sole Proprietorships.)

S corporations, partnerships, and limited liability companies (LLCs). These businesses file their own tax returns listing expense deductions. S corporations file Form 1120S, partnerships file Form 1065, and LLCs file Form 1065. Each of these entities also issues each shareholder, partner, or LLC member a Schedule K-1 form showing each individual's share of the business's profits and losses. (There's a filled-in sample of Schedule K-1 in Chapter 9, Partnerships.)

Nonowner/employees. Employees can deduct their out-of- pocket business expenses as unreimbursed employee expenses on Schedule A of their individual tax returns. Tax-wise, it's better for the business to reimburse these expenses to the employee.

Are you missing paperwork to substantiate your deductions? Throughout the book, you'll read about keeping records to back up business deductions. But if you just can't find the paperwork, you might be able to claim a deduction using several "escape hatches." First, business expenses of less than $75 each don't require written proof to be deductible (except for lodging expenses). Second, missing documents may be "reconstructed" if you are ever audited. (See Chapter 19, Section F, for details).

F. What Is—And Isn't—Income?

"Except as otherwise provided … income means all income from whatever source derived." That's how the tax code defines income. (IRC § 61.) Not too helpful, is it? Paraphrased, the IRC means, "You Make It, We'll Tax It." It can't get much broader than that.

1. Things That Count as Taxable Income

For the most part, Uncle Sam doesn't care whether your income is from self-employment, wages, investments, or organized crime. If it's income it is taxable.

First, anything of value received by you or your business is income *unless* it falls within the exclusions created by Congress—discussed in Section 2, below. Following are common noncash sources of taxable income.

Barter or trade. Goods and services received in a business deal are income unless they are consigned to you. When you barter (trade your goods or services), the fair market value of the item or service received is income.

> **EXAMPLE:** Marvin designs a brochure for Beeline Mortgage Brokers, for which he would normally charge $500. In return, Beeline gets Marvin a new home mortgage without charging its customary $500 fee. No money changed hands, but both Marvin and Beeline should report $500 income.

A lot of bartering goes on with small businesses and self-employed folks, and the IRS is none the wiser. But getting away with something doesn't make it legal, does it?

Constructive income. Constructive income is a legal doctrine that taxes things that you don't actually have in your hands, but that you have a right to. Whether you grab it or not, it's income the moment it's available.

> **EXAMPLE:** On December 1, 2006, Raylene gets a $5,000 check from BigCo for her Web design services performed in November. Raylene looks at her books and sees she has already made so much in 2006 that this $5,000 will be taxed at the highest individual tax rate (35%). Raylene is planning on taking a lot of time off traveling in 2007, and her income will be drastically reduced. She would like to hold off cashing the check until after January 1, 2007, to be taxed at a lower tax rate. Can she do it? Sorry, Raylene. The $5,000 was constructively received in 2006, and so is income in 2006, not 2007.

Illegal income. The tax law is morally neutral, not distinguishing between the fruits of your labor or ill-gotten gains, so even dirty money is taxable. As the IRS is fond of telling us, the legendary Al Capone wasn't sent to jail for murder, bootlegging, or racketeering. He went to Alcatraz for not reporting income from all those activities.

> **EXAMPLE:** Rico is a hit man for the Soprano family. The cash, Cadillac, Italian suits, and Cuban cigars he receives for his "work" are all taxable, and reportable, income.

You don't have to list the *source* of your illegal income for the IRS—you can claim your constitutional right against self-incrimination. If this sounds like something you might try, see a tax attorney first.

Foreign income. Worldwide income is taxable for American citizens and most residents, with two exceptions noted below.

EXAMPLE: While traveling in Hong Kong, Juliana, an antique dealer from California, spotted a rare Ming vase. She paid $200 for it and sold it to another dealer in Hong Kong for $4,800. Result: Julia must report $4,600 of taxable income to the IRS. Silver lining: If the primary purpose of the trip was for business transactions like this one, Juliana should be able to deduct at least some of her travel expenses.

Exception one: An American residing out of the U.S. for most of the year can exclude $80,000 from her income taxes. To get this foreign tax exclusion, a tax return must be filed in the U.S. every year claiming the exclusion.

Two additional key points:

- Social Security tax must still be paid on all foreign earnings.
- Income taxes must be paid on any investment income made while living outside the country.

EXAMPLE: Charlene works as an English teacher in Spain for two years and earns $45,000 per year. She moves to Spain for the contract, not returning to her home in Vermont until three years later. Charlene's income isn't taxable in the U.S. (This doesn't mean that Charlene doesn't pay taxes in Spain, though.)

Exception two: If taxes are paid to another country on income not covered by the $80,000 exclusion, the taxpayer may still get a credit.

EXAMPLE: Stanley, a Texan, goes to Norway for three months to extinguish an oil fire on an offshore rig in the North Sea. The Norwegian government takes $40,000 from Stanley's pay of $100,000 for Norwegian income tax. Tax result: The $100,000 is U.S. taxable income, but Stanley gets a tax credit for the $40,000 paid to Norway. This likely means he won't pay any U.S. income taxes.

For more info on these two exceptions, see IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Note: Even if you give up your U.S. citizenship and move abroad, you are still subject to U.S. tax law on income and gains for ten years. So much for off-shore tax havens.

2. Exclusions: Things That Aren't Income

Some income isn't taxable because it falls into the "except as otherwise provided" section of the tax law. (IRC § 61.) Here are the main legal exclusions—things that don't have to be reported to the IRS.

Gifts and inheritances. Income tax never has to be paid by the recipient of gifts or inheritances, no matter how much you receive. Prizes and lottery winnings aren't considered gifts, and are taxable.

EXAMPLE 1: Aunt Sophie leaves Ralphie, her favorite nephew, her mansion on Maui, her Kentucky Derby-winning horse, and $70 million. Tax result: Ralphie owes nothing to the IRS—but Aunt Sophie's estate most likely paid a hefty estate tax.

EXAMPLE 2: The Publisher's Clearing House Prize Patrol drops off a $10 million check at Mallory's house. This windfall is *not* a gift, since Mallory had to do something for it: fill in the form, place about a hundred different stickers on it, and mail it in. Uncle Sam is due his share of the $10 million.

Fringe benefits. Many fringe benefits provided by businesses to owners and employees are not taxable income, but a few are. (See Chapter 14, Fringe Benefits.)

Return of capital. Getting back what you put into a business doesn't have any tax consequences.

EXAMPLE 1: Elaine decides to move to New Zealand and sells her partnership interest in the Doggy Donut business to Marina for $15,000. She had owned a share of the business for only a few months and had $12,500 invested in it. Tax result: Elaine has to account for a $12,500 return of capital and $2,500 of income (the gain on her investment in the partnership) on her tax return.

EXAMPLE 2: Roxanne pays $40,000 cash for the small warehouse building she uses to store and ship costume jewelry. She refinances the building and takes out a mortgage of $30,000. This is a tax-free way for Roxanne to take money out of her business.

For more details on exclusions from income, see IRS Publication 525, *Taxable and Nontaxable Income.*

Commonly Overlooked Business Expenses

Even though most people keep a sharp eye out for deductible expenses, it's easy to miss a few. And some folks mistakenly don't list a deduction because they can't find what category it fits into. Some routine, overlooked deductions include:

- advertising giveaways and promotions
- audio- and videotapes related to business skills
- bank service charges
- business association dues
- business gifts
- business-related magazines and books (like the one in your hand)
- casual labor and tips
- casualty and theft losses
- coffee and beverage service
- commissions
- consultant fees
- credit bureau fees
- education to improve business skills
- office supplies
- online computer services related to business
- parking and meters
- petty cash funds
- postage
- promotion and publicity
- seminars and trade shows
- taxi and bus fare, and
- telephone calls away from the business.

Resources

- IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*. This 50-page booklet is a must-read if you are doing your own tax preparation and need more details than we can provide here.
- IRS Publication 525, *Taxable and Nontaxable Income*.
- IRS Publication 529, *Miscellaneous Deductions*.
- IRS Publication 535, *Business Expenses*.
- *Master Tax Guide* (Commerce Clearing House). A one-volume tax reference book with a lot of tax deduction materials for individuals and small business owners. Many IRS auditors use this book for quick answers to tax questions, too.
- *Small-Time Operator,* by Bernard Kamoroff (Bell Springs). A good small business guidebook, written by a CPA, that has tips on maximizing deductions.
- *Deduct It!,* by Stephen Fishman (Nolo). A comprehensive guide to deductions for small businesses.
- Small Business Development Centers (SBDCs) have small business tax publications and personal counseling available. Go to www.sba.gov/sbdc to find an SBDC near you.
- IRS Publication 1542, *Per Diem Rates.*
- IRS Publication 334, *Tax Guide for Small Businesses.* This booklet explains federal tax laws that apply to sole proprietorships.
- IRS Publication 225, *Farmers' Guide.* This publication identifies the kinds of farm income and different deductions peculiar to agricultural activities.

■

CHAPTER

2

Writing Off Business Assets

"Of all debts, men are least willing to pay the taxes."
—Ralph Waldo Emerson

As a business person, one of the few joys of spending money on a new computer, a photocopier, or even that great rosewood desk is knowing that the government is paying part of the cost—maybe as much as 40% or 50% through tax write-offs.

Equipment, buildings or other fixed assets are not deducted as current business expenses (which are deductible in the year they are incurred—see Chapter 1). Instead, you must capitalize the costs of these assets. (IRC § 263.)

This means you must write off or spread the cost of these expenditures by taking tax deductions over a number of years (depreciating the assets). In other words, you recover the costs for these assets as tax deductions as they wear out over the years. (IRC §§ 167 and 168.) Just how many years it takes to recover the costs depends upon which category of the tax code the particular asset falls into—it may be as few as three years or as many as 39 years.

Section 179 is an important exception. Section 179 of the tax code lets you immediately write off many capital expenditures, up to a maximum of $105,000. See Section B, below, for more information.

This chapter explains how to best use the depreciation rules and Section 179 to lower your tax bill. Let's find out how.

Writing Off Business Assets in a Nutshell

1. The tax code divides expenditures for business into current expenses and capital expenses, and treats each type differently.
2. Capital expenditures for business assets usually are deducted over a number of years under regular depreciation rules. Typically, assets are deducted using one of two methods—accelerated or straight-line depreciation. No matter which method is used, the entire cost of the asset is written off over a number of years.
3. A special tax code provision, IRC Section 179, allows most business owners to deduct in one year up to $105,000 of capital expenditures (other than real estate) as if they were current expenses.
4. There are special rules for deducting the business-use portion of a vehicle.

A. When Various Expenses May Be Deducted

Again, all business expenditures must first be divided into two categories, called current expenses and capital expenses.

1. Current Expenses

Generally, costs of things used up within one year are current expenses. These include ordinary operating costs of a business such as rent, equipment repair, and telephone and utility bills for the current year.

Garden-variety supplies, such as stationery and postage stamps, are also considered expenses, even though they may be around from one year to the next. All of these items can be fully deducted in the year in which they are purchased. (See Chapter 1, Deductible Expenses.)

2. Capital Expenses

Capital expenses, on the other hand, are usually for things with a useful life of more than one year—equipment, vehicles, and buildings are the most common examples. See "Business Assets That Must Be Capitalized," below, for more examples.

A capital expense may be either to acquire an asset or to improve one so as to substantially prolong its life or adapt it to a different use. In Chapter 1, Section B, we discussed how to determine whether improvement costs should be categorized as current or capital expenses.

Business Assets That Must Be Capitalized

Here are some common assets that must be capitalized, but the list is not inclusive. (IRC § 263 and Reg. 1.263 provide more details about items that must be capitalized.)

- Buildings
- Cellular phones and beepers*
- Computer components and software*
- Copyrights and patents
- Equipment*
- Improvements to business property
- Inventory
- Office furnishings and decorations*
- Small tools and equipment*
- Vehicles
- Window coverings*

*May be subject to immediate deduction under Section 179 at your option. See Section B, below.

3. Inventory

Businesses selling goods (rather than services) usually maintain stock, called inventory. Money spent on inventory is neither a current expense nor a capital expense. Instead, inventory is an asset and is expensed as it is sold or discarded.

In effect, what you spend for inventory (called your costs of goods sold) is deducted, as the inventory is sold, from the revenue generated. What's left is your gross profit. From this figure, your general business expenses are deducted to determine your net profit. It is the net profit that is taxed as income.

Valuing your inventory. The higher your cost of goods sold is, the lower your profit—and thus your taxes—will be. For this reason, you must figure your cost of goods sold using an IRS-approved inventory accounting method. Inventory generally must be listed at the *lower* of its cost or its fair market value.

EXAMPLE: During its first year of operation, Rick's Music Store purchased $300,000 of inventory. At the end of the year, he has an inventory of compact discs that cost $50,000 and cassette tapes that cost $30,000. Using the cost method, Rick has an ending inventory worth $80,000. Here is Rick's cost of goods sold:

$0	beginning inventory
+ $300,000	inventory purchased during year
– $80,000	ending inventory at cost method
= $220,000	cost of goods sold

Unsaleable inventory. You may reduce (write down) the value of any inventory that has become unsaleable. For IRS purposes, this needs to be documented. For instance, if you discard or destroy dead stock, keep evidence of the destruction—photos, videos, receipts, or the statement of a reputable third party who can certify the goods were destroyed.

EXAMPLE: At inventory time, Rick knows his inventory of CDs has held its value, but his cassettes hardly sell any more. Rick asks his music distributor to appraise the cassettes. The distributor says their fair market value is only $8,000. Accordingly, Rick reduces the retail prices for the cassettes and lowers the inventory on his books to $8,000. Now Rick's cost of goods sold looks like this:

$0	beginning inventory
+ $300,000	inventory purchased during year
– $58,000	ending inventory
= $242,000	cost of goods sold

The difference between the two examples is the method of valuing the inventory. Using fair market value instead of cost will reduce Rick's income for tax purposes by $22,000. It is improper to reduce the book value of the inventory without clear evidence of the loss in value and without reducing the retail price of the goods. With the taxes saved from the inventory write-down, Rick can build up his CD inventory.

B. Section 179: Expensing Business Assets

You don't need to learn the Internal Revenue Code by section number, but every small business owner should be familiar with Section 179. This little gem allows a small business owner or small C corporation to deduct up to $105,000 of asset purchases each year as if they were current operating expenses. This produces an immediate write-off of capital assets.

Using Section 179 is referred to as expensing an asset. Within the annual limit, a business may buy assets and deduct the costs in full—as long as the assets are placed in service in that same year. I once bought, set up, and started using a new computer on December 31, for $3,000, and wrote it off 100% that year.

EXAMPLE: In December, Hal, a self-employed management trainer, realizes he will owe $4,000 more than the estimated quarterly tax payments he made that year. Hal was planning to buy a $12,000 color printer the next year. If, instead of waiting, Hal purchases and starts using the printer by December 31, he qualifies under Section 179 to write off $12,000 and wipe out all of his tax balance for that year.

It works out like this: Hal is in approximately a 30% combined federal and state income tax bracket and pays self-employment taxes of 15.3%. This means that for Hal's tax bracket every dollar he takes in business deductions saves him roughly 45¢ in taxes. So the tax savings resulting from the $12,000 printer purchase (about $5,000) wipes out Hal's projected $4,000 tax balance. Of course, Hal had to spend $12,000 to get the tax savings. As long as he needs the printer, this is still the next best thing to a free lunch. And he could have bought the printer on credit and still have gotten the full write-off.

The Section 179 deduction limit will be adjusted for inflation each year. The current amount is $105,000.

Section 179 deductions are reported on IRS Form 4562, *Depreciation and Amortization*. See Section C5, below.

Time your deductions wisely. When would you not want the fast deduction of Section 179? Answer: When you don't get much, if any, immediate tax benefit from it. This can happen when you are in a low tax bracket or your business isn't profitable. For instance, say your income for the year puts you in the 15% tax bracket and you buy a $30,000 piece of equipment. But you expect big things to happen soon, and you count on being in the 35% tax bracket for the next few years. If you delay taking the $30,000 deduction until your tax bracket rises, you will save almost $6,000 more in taxes than if you claimed it when you were in the 15% tax bracket.

A few other tax code sections let you choose to expense all assets, similar to Section 179. These special provisions affect only small businesses involved in research (IRC § 174), agriculture (IRC §§ 175, 180, and 193), publishing (IRC § 173), or mining (IRC §§ 615 and 616). (See IRC § 263 and Reg. 1.263 or a tax pro for details.)

1. Ineligible Property

For some types of assets, and in some circumstances, you can't use Section 179's quick write-off. *Ineligible* property includes:

- real estate
- inventory bought for resale to customers (discussed in Section A3, above)
- property received by gift or inheritance

- property bought from a close relative—grandparent, parent, child, sibling, or in-law—or from another business in which you have an ownership interest, or
- property you already own. Assets can't be converted from personal to business use under Section 179; instead, they must be depreciated, as explained in Section C, below.

2. Property Must Be Used More Than 50% for Business

To deduct purchases under Section 179, you must use the asset more than 50% for business. For instance, if you use a computer 60% for personal use and 40% for business use, you cannot use Section 179 to write it off—you have to write it off using regular depreciation rules (and even then you can only deduct 40% of the cost).

You must continue to use the property that you deduct under Section 179 for your business at least 50% of the time for several years. The number of years you must continue to use it at least 50% for business purposes equals the number of years it would have taken to depreciate the items under regular depreciation rules—three to seven years for most assets.

> **EXAMPLE:** Joan paid $3,000 for a computer and uses it 60% of the time for business. Using Section 179, she can write off $1,800 as a business expense (60% business usage x $3,000 cost).
>
> If Joan used it only 45% of the time for business, she could not use Section 179. Instead, Joan would have to take depreciation deductions for the portion of the computer used for business (45% business usage x $3,000 cost = $1,350) over the five-year period the tax code prescribes for computers.

3. Listed Property—Special Rules

The tax code designates certain assets as listed property, and these items are subject to different rules under Section 179. The most common listed property items include:

- vehicles
- cellular phones, and
- computers and peripherals.

Listed property items have a potential for personal as well as business usage, so the IRS enforces strict record-keeping rules for listed property. (See Chapter 3, Section D, for how to keep such records.)

Vehicles. Cars and trucks used for business can't benefit from using Section 179 (unless they weigh over 6,000 pounds; see below). The depreciation deduction for vehicles is limited to a certain amount each year—even if you use Section 179. For 2005, the first-year depreciation deduction is limited to $3,060.

See Section C4, below, for the limits on depreciation deductions taken after the first year.

Depreciation limit doesn't apply to heavy vehicles. For heavy vehicles, such as delivery trucks, vans, and SUVs, exceeding 6,000 pounds gross weight when loaded, the depreciation limits don't apply. Instead, there is a Section 179 limit of $25,000. See Section C3c, below, for details.

4. Other Tax Rules for Using Section 179

Assuming you qualify under all of the rules discussed above, there are other limitations on using Section 179.

a. Income Limit and Carryforward

Your Section 179 deduction can't exceed your total taxable earnings. However, your earnings aren't limited to the business for which the asset was purchased. You may also count wages that you or your spouse earned as an employee somewhere else (if filing jointly)—or income from other self-employment. For instance, if Sonja's parrot-training enterprise loses money, she can still use Section 179 to offset some of her day job earnings as an undertaker.

If your Section 179 expenditures exceed your total earned income from all sources, you can carry the excess over to a future year's tax return. You can carry forward the unused portion indefinitely, until it has all been deducted.

> **EXAMPLE:** Joy is a sole proprietor who establishes an acting school. After deducting all operating expenses, her earned income is $6,000. Joy buys $15,000 worth of furnishings and stage props using her credit card. Result: Joy can deduct at least $6,000 of the costs using Section 179.
>
> If Joy earns an additional $9,000 from managing a health food store, she could deduct the whole $15,000. Otherwise, Joy can carry the $9,000 unused excess over to her next year's tax return and claim it along with any other Section 179 expenses—as long as she has enough income that year.

b. Rules for Married Couples

Being married can work against you when it comes to Section 179. A married couple is limited to an annual total write-off of $105,000. This is true even if both spouses have separate businesses and even if they file tax returns separately. (If spouses file separately, each is limited to half of the Section 179 deduction.)

However, sometimes being married can help. In Subsection a, above, I mentioned that, if the cost of the business assets you purchased in any year exceeds your earnings for that year, the cost can be deducted from your spouse's income under Section 179.

c. For Small Businesses Only

Section 179 is really just for *small* businesses. The deduction is reduced if you spend more than $420,000 on depreciable items.

d. Multiple Owners Must Split the Deduction

Partners, limited liability company members, and shareholders in an S corporation can use Section 179 in proportion to their ownership share. The $105,000 limit applies to the business as a whole.

> **EXAMPLE:** A four-person operation buys $120,000 of qualified Section 179 equipment in 2005. Each owner can claim one-fourth of the $105,000 deduction on his or her Form 1040 individual tax return.

With C corporations, only the corporation (not the shareholders) takes the Section 179 deduction.

e. Investors Cannot Use Section 179

Owners may use Section 179 only if they are *active* in the business. They can't use Section 179 if they are passive investors, unless they are employed or active in some other business. The next three examples show how this works.

> **EXAMPLE 1:** W & W Partnership buys a $16,000 injection molding machine for manufacturing plastic toys. The partnership allocates $8,000 of the Section 179 deduction to each of the two partners, Wanda and Willie. Since they are both active in the business and earn at least $8,000, each can write off $8,000 against earned income.

> **EXAMPLE 2:** Willie becomes totally disabled in the year W & W Partnership buys the machine. He is still a partner in W & W but no longer works for or gets an income from the partnership. He lives on his Social Security and monthly payments from the state lottery. He can't take a Section 179 deduction of any amount, because he is not active in any business.

> **EXAMPLE 3:** Willie stops working actively in W & W Partnership. He takes an outside job as a part-time toy designer for ToyCo and earns $30,000. He can take his share of the Section 179 deduction of $8,000 from the W & W Partnership, because he is employed in another business.

f. Recapture

You must use an asset written off under Section 179 in your business for *at least* the period over which it would have been deducted had you used regular depreciation. (See Section C, below.) Also, the asset must be used for business purposes at least 50% of all of that time.

If you don't meet these two rules, you face recapture—meaning you have to pay back to the IRS your earlier Section 179 deduction. You have to report the portion of the deduction that would remain if you had depreciated the asset instead of using Section 179. Let's do an example.

> **EXAMPLE:** In year one, Hal used Section 179 to write off a $4,000 computer for his business. The amount of depreciation deduction Hal would have gotten had he not used Section 179 that year is $400 (if he had used regular depreciation). The next year, he got a new computer and took the year-old computer home for video games. Hal must report recapture income of $3,600. So, he must give back $3,600 of the Section 179 deduction in his tax return for that year.

IRS auditors usually look at your purchase contracts and proofs of payment, but they rarely check whether or not equipment is currently being used for business. Let your conscience be your guide.

g. Trade-Ins Reduce the Benefit

The Section 179 deduction is reduced by any trade-in allowance toward the new asset purchase.

> **EXAMPLE:** Sacajawea buys new showcases for her crafts store, at a cost of $24,800. She is allowed a trade-in credit of $9,750 on her old cases, and she pays the difference of $15,050 on credit. She may claim a Section 179 deduction of $15,050.

5. Combining Section 179 and Depreciation Deductions

You can use Section 179 to immediately write off part of the cost of assets and take regular depreciation deductions for the balance.

As this next example shows, it can sometimes be better to not use the full Section 179 deduction.

> **EXAMPLE:** Miranda buys and starts using a $34,000 instant printing press. Her tax pro tells her that taking the full Section 179 deduction would not produce a tax savings, so she elects Section 179 to write off only $10,000 of it. She can claim the remaining $24,000 as depreciation expenses in the following years.

6. Items Bought on Credit

You can purchase an asset on credit and still get a full write-off under Section 179. This means you can get a tax deduction larger than your cash outlay in that year!

> **EXAMPLE:** With $10,000 down, Jack buys and starts using $35,000 worth of machinery for Jack's Tool and Die Shop. The balance of $25,000 is to be paid to the seller over the next five years. Jack is nevertheless allowed to deduct $35,000 in the year of purchase, using Section 179. (Also, Jack can deduct any interest paid on the unpaid balance each year.)

C. Depreciating Business Assets

Small business owners should look first to Section 179 to write off asset purchases. But you must take regular depreciation deductions instead if any of the following are true:

- you don't have enough business or nonbusiness earned income to offset the Section 179 deduction
- the asset doesn't meet Section 179 qualifications (see Section B, above), or
- you've already used up your Section 179 dollar limit that year.

1. What Is Depreciation?

Almost everything wears out over time. Recognizing this, the tax code gives assets used in a trade or business an annual tax deduction called depreciation. This is commonly called a write-off or cost recovery. For a few special types of assets, this deduction is called amortization or depletion.

A depreciation deduction works like this: Derek buys a copy machine for $1,000 to use in in his business. Under the tax code, a copier is assigned a (rather arbitrary) five-year life expectancy. (IRC § 168, Reg. 1.168.) This means Derek can write off part of the cost of the copier in the year he bought it and the rest over the following five years. (Yes, I know this is a total of six years, not five, as the tax code seems to indicate. We'll discuss this further below.) Eventually, the whole $1,000 cost of the copier will have been deducted from Derek's business income. The amount that Derek can take each year and how the deduction is claimed are explained next.

Important exceptions to the normal depreciation rule. Land costs can never be deducted. Also, special rules apply to business inventories and natural resources which are beyond the scope of this book.

Keeping Up With Depreciation Rules

Congress changes the depreciation rules frequently—nine times in the last two decades. If the rules change after you acquire something, the old rules still apply. So, you may end up tracking depreciation of different business assets—computers, buildings, or whatever—under several sets of rules. A tax pro can keep the process straight and even compare different depreciation methods available to see which one produces the best result for you. Software such as *TurboTax* (Intuit) also can help track depreciation under multiple schedules.

2. Depreciation Categories

The tax code establishes depreciation classes or categories for all business assets. Each category is assigned a useful life, meaning the time period over which the cost of an asset can be deducted—for example, five years for a computer. In tax lingo, this is called the recovery period. IRS Publication 534 lists the categories and the depreciation periods for different assets.

Most assets fit into one of four classes as follows:

- **Three-year property.** Manufacturing equipment (for plastics, metal fabrication, glass).
- **Five-year property.** Cars, trucks, small airplanes, trailers, computers and peripherals, copiers, typewriters, calculators, manufacturing equipment (for apparel), assets used in construction activity, and equipment used in research and experimentation.
- **Seven-year property.** Office furniture, manufacturing equipment (except types included in three- and five-year categories above), fixtures, oil, gas, and mining assets, agricultural structures, and personal property that doesn't fit into any other specific category.
- **Real estate (varying periods).** The tax code dictates much longer periods to write off real property than personal property. This makes sense. Real estate improvements—structures—wear out more slowly than personal property, such as cars and computers. Land itself never wears out, and so is nondeductible and nondepreciable.

  Commercial buildings are depreciated over 39 years using the straight-line method (discussed below).

  Residential rental real estate is allowed a 27.5-year recovery period.

  Some types of land improvement costs (sidewalks, roads, drainage facilities, fences, and landscaping) are depreciable over 20 years.

  Some building components, like a special wiring system, may be depreciated in as few as seven years. (For details, see IRS publication 946, *How to Depreciate Property*.)

There are also classes with ten- , 15- , and 20-year recovery periods for agricultural or unusual businesses, like breeding horses or operating tugboats. See IRC § 168 and IRS Publication 534 for more information on all asset classes, or check with your tax adviser.

3. Methods of Depreciation

Once you have figured out an asset's depreciation period, look for the most advantageous depreciation method to use.

Depreciation methods fall into two general types:

- **straight-line depreciation,** and
- **accelerated depreciation.**

The tax code has four methods for depreciating most business assets, all of which result in the same total amount of deductions in the end. The difference is in how quickly the complete cost of the asset can be deducted. An additional method, for farm equipment only, isn't covered here. (See IRS Publication 946.)

a. Straight-Line: The Slowest and Simplest Tax Depreciation Method

The straight-line method allows an asset to be deducted in equal amounts every year, except for the first and last years. (In those two bookend years, you get only half of a year's tax deduction.)

For instance, with a $10,000 business machine (a five-year asset), straight-line tax code depreciation allows these deductions:

Year 1	$1,000	(one half year)
Years 2, 3, 4, & 5	$2,000	each year
Year 6	$1,000	(one half year)
Total deductions	$10,000	

Assuming you use the machine for all six years, you can deduct 100% of its cost.

See Section 4, below, for other first-year depreciation rules, which may limit the amount of your tax deduction in the first year, depending on how late in the year you acquire an asset.

b. MACRS: The Fastest Accelerated Tax Depreciation Method

The tax code accelerated depreciation system is known as MACRS (pronounced "makers" by tax folks). This stands for modified accelerated cost recovery system.

Technically, MACRS covers all of the accelerated depreciation methods. Typically, it refers to the most widely chosen method: MACRS 200% Declining Balance. This is the fastest—most accelerated—way to write off assets (except for Section 179).

MACRS allows greater deductions in the early years than in later ones. For instance, using this method to depreciate a $10,000 business machine produces $7,120 in depreciation deductions in the first three years, versus $5,000 with the straight-line method.

To find the exact yearly deduction amounts, check the IRS tables that show the deduction as a percentage of the asset's cost. MACRS tables are in your annual Form 1040 instruction booklet, IRS Publication 946, the IRS website (www.irs.gov), and privately published tax preparation guides. Tax software such as *TurboTax* (Intuit) will automatically compute these amounts, too, or you can leave it to your tax pro.

The fastest depreciation method may not be the best. Don't automatically conclude that the quicker you can take a deduction, the better. Many start-up businesses are not immediate money-makers, so they don't benefit by using accelerated depreciation. For them, the straight-line method, with smaller deductions in their formative years, gives the best long-term tax benefit.

c. Special Depreciation Rules for Cars and Trucks

Special tax code depreciation rules apply to vehicles used in business. These rules are called alternative ACRS depreciation.

There are caps (annual dollar limits) on vehicle depreciation deductions, as shown in the table below. The caps extend the period for deducting the cost of most cars and trucks to five years or longer. If you use your vehicle for business more than 50% of the time, then you qualify for faster write-offs. If you use it for business less than 50% of the time, you must use straight-line depreciation rules. But whether you use the accelerated or straight-line depreciation method, the annual cap is the same.

What if you use your vehicle partly for pleasure and partly for business? The percentage of personal use reduces the amount of your depreciation deduction each year.

Figuring depreciation on vehicles can get tricky. IRS tables guide you, but tax software like *TurboTax* (Intuit) is better.

Should you lease a vehicle? Because of these annual depreciation limits, it may take longer than your life expectancy to fully write off a luxury car. Leasing often provides a better tax deduction. Section E, below, discusses leasing versus buying business assets.

Selling the vehicle. What happens when you dispose of a business vehicle? If you sell it, the difference between its tax basis and the sale price produces either a taxable gain or a loss. If the car was used for both business and pleasure, you report only the business portion as a gain or loss. (See Chapter 4 for information on taking losses for tax purposes.)

Trading in the vehicle. What if you trade in your car for another you'll use in your business? Your tax basis in the new car is increased by the remaining basis of the old one. So there isn't any gain or loss to report with a trade-in. (See Chapter 1 for details and examples.)

Loophole for Big Sport Utility Vehicles (SUVs) and Trucks

Buying a truck or heavy sport utility vehicle (gross vehicle weight when loaded of over 6,000 pounds) gets around the vehicle deduction limitations discussed above. Road yachts such as a Toyota Land Cruiser, a Chevy Avalanche, a Hummer, or a Mercedes-Benz ML, among others, qualify. Lighter SUVs, such as Ford Explorers, Chevy Blazers, and Toyota 4Runners, do not qualify—check the manufacturer's specifications.

If your business vehicle falls into this category, you may elect Section 179 to deduct in one year up to $25,000 of the cost, you can fully write it off in six years using regular depreciation, or you can use a combination of both provisions.

Using regular depreciation, assuming you use the vehicle 100% for business, here is the amount of depreciation you can take for heavy vehicles:

Year 1	20%*
Year 2	32%
Year 3	19.2%
Year 4	11.52%
Year 5	11.52%
Year 6	5.76%

*You can deduct 20% of the cost of the vehicle in the first year only if you buy the vehicle in the first nine months of the year. If you don't buy it until the last three months of the year, you can take only a 5% deduction the first year.

Two more tax benefits:

- SUVs are exempt from the federal luxury tax on new vehicles over $36,000.
- SUVs are exempt from the IRS lease add-backs. (See Section E, below.)

EXAMPLE: Benecia buys a heavy SUV for $44,000 and uses it 60% for PMC, her successful property management company. The rest of the time Benecia uses her SUV for shopping and camping trips. Her tax basis in the vehicle is $26,400 ($44,000 x 60% business use). Benecia may use Section 179 to deduct $15,840 ($26,400 x 60%). She can also claim a first-year depreciation deduction of $1,836 (first-year depreciation of $3,060 x 60%), giving her a total Section 179 and depreciation deduction of $1,767.

Depreciation Limits for Autos

The tax code imposes absolute dollar maximums on depreciation deductions for each year that you own a passenger car used for business. Qualified electrically powered vehicles enjoy a special tax break, as do SUVs.

Date New Vehicle Purchased	First-Year Depreciation Amount	Second-Year Depreciation Amount	Third-Year Depreciation Amount	Fourth-Year Depreciation Amount
2005	$3,060	$4,900	$2,950	$1,775

d. Writing Off Computers and Electronics

Ever do work on your computer at home? The tax code allows you a deduction for computers you use for business, no matter where they are kept.

Section B, above, discusses how to get a fast write-off using Section 179. But for a long-term write-off, the tax code says computers have a five-year depreciable life. You can use the MACRS method to write them off (explained above in Section C3b).

If you use your computer for personal as well as business purposes, keep a diary or log. Record the dates, times, and reason you use your computer to distinguish between personal and business use in case an IRS auditor comes calling. Keep a simple paper pad next to your computer or use your day-timer to keep track of your computer use.

Other electronics not ordinarily tax-deductible can be deductible under the right circumstances. I have a great stereo in my home office, and if the volume is cranked up enough, it sounds throughout the rest of the house (to my wife's displeasure). My clients and I enjoy the background music while we ponder their tax problems. It sounds even sweeter knowing that I deducted the entire cost. My home office also contains two aquariums, oriental rugs, and pricey furniture.

All these items can be tax deductible if you use them in your business.

EXAMPLE: Herb owns and operates "Olde Tyme Quilts" to sell quilts that he makes and takes on consignment from other quiltmakers. To improve his skills, he buys and uses a VCR to watch tapes on quilt-making. Later Herb buys a camcorder to make tapes of quilt designs at craft shows, a video catalogue of his stock, and himself doing a quilt-making demonstration. These items are all depreciable or deductible under Section 179. But if he also uses the VCR and camcorder for vacations to Hawaii, he must apportion his costs between business and personal use.

You might have to defend asset purchases at an audit. You are on the honor system when it comes to claiming most business asset purchases—no one from the IRS is watching to see how you really use your camcorder. Just be ready to prove its business purpose. Otherwise, an auditor can reclassify it as a (nondeductible) personal expense.

4. First-Year Depreciation Rules

Whether you use a straight-line or accelerated depreciation method, the following rules apply:

a. Asset Must Be Placed in Service

Depreciation starts when an asset is placed in service. This means that you must start using the asset in your business before you may claim a depreciation deduction. In other words, if you buy equipment in December 2005 but don't take it out of the box until January 2006, you may not take a deduction for it in 2005. This rule requires you to note the date of first use.

b. The Half-Year Convention

When during the year does the depreciation period begin? Generally, assets are treated as if you bought them in the middle of the year—July 1. This rule is called the half-year convention.

Bottom line: You get only six months depreciation deduction in the first year (unless you are using Section 179). Your final tax deduction comes in the year that follows the last year of the asset's useful life. So the final year of deductions for five-year property, such as a computer, is really the sixth year. In case I've lost you, the example should help.

> **EXAMPLE:** Julie buys a color copier to use at her boutique for $2,000. If Julie depreciates it over five years on a straight-line basis, her annual full-year deduction will be $400 ($2,000 divided by five years). Her half-year deduction for the first and the last years is $200. Here is a schedule of her deductions for six years, at which point the entire cost will have been written off:

Year One	$200
Year Two	$400
Year Three	$400
Year Four	$400
Year Five	$400
Year Six	$200
Total	$2,000

c. The Last Quarter Limitation

Another tax quirk can further reduce your first-year depreciation deduction. If you make more than 40% of all your asset purchases in the last three months of a year, you get only 1.5 months of depreciation on the asset purchases made in the last three months. So unless you are using Section 179 to deduct the cost, don't buy equipment near the end of the year—if you're looking for the highest deductions.

> **EXAMPLE:** Julie, from the example above, also purchases $25,000 of new display cases—classified as five-year property—in May. If she uses the straight-line method of depreciation, the tax write-off for the first year is $2,500 for the cases (½ year x $25,000 x ⅕). In November, Julie buys $20,000 of racks and shelving (also five-year property). Since Julie's November purchase is more than 40% of the total assets bought during the year, she can write off only 1.5 months of 60 months (1⁄40) of the cost of the racks and shelving ($20,000), which means a first-year depreciation of $500.

5. How to Report Depreciation and IRC Section 179 Deductions

With either depreciation or Section 179 or both, the deduction is claimed on IRS Form 4562, *Depreciation and Amortization*. Sole proprietors, partners, LLC members, and S corporation shareholders file Form 4562 with their individual returns, and C corporations file it with their corporate income tax returns.

Form 4562 must be used if you are:

- depreciating any assets acquired that year
- depreciating certain types of assets (such as vehicles, computers, cellular phones, and a few others named in the tax code) acquired in a previous year, or
- operating as a C corporation and are depreciating any assets.

A sample Form 4562 is shown below. The amounts listed in Part 1 are for 2004 and don't reflect the new higher limits in effect for 2005. (The 2005 forms were not available at the time this book went to press.) For the latest forms, see the IRS's website at www.irs.gov or call the IRS at 800-829-FORM and request forms by mail.

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172

20XX

Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number

Part I **Election To Expense Certain Property Under Section 179**
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See page 2 of the instructions for a higher limit for certain businesses	1	$102,000
2	Total cost of section 179 property placed in service (see page 3 of the instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$410,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 3 of the instructions	5	

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6			
7	Listed property. Enter the amount from line 29	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2003 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2005. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II **Special Depreciation Allowance and Other Depreciation (Do not** include listed property.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see page 3 of the instructions)	14	
15	Property subject to section 168(f)(1) election (see page 4 of the instructions)	15	
16	Other depreciation (including ACRS) (see page 4 of the instructions)	16	

Part III **MACRS Depreciation (Do not** include listed property.) (See page 5 of the instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2004	17	
18	If you are electing under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2004 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2004 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV **Summary** (see page 8 of the instructions)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2004)

Depreciation Worksheet

Description of Property	Date Placed in Service	Cost or Other Basis	Business/ Investment Use %	Section 179 Deduction	Depreciation Prior Years	Basis for Depreciation	Method/ Convention	Recovery Period	Rate or Table %	Depreciation Deduction
Computer	3/31/01	3,200	100%	3,200	0	0	200DB/MY	5	20%	0
Cellular Phone	6/26/01	300	40%	0	0	120	SL/MY	5	10%	12
Chevy Pick-Up	11/1/99	10,500	20%	0	525	2,100	SL/MQ	5	20%	420
Total				3,200						432

The sample forms are for illustrative purposes only. Throughout this book we provide sample, filled-out IRS forms so you can see what they might look like for a typical small business. However, keep in mind that these forms are just that: examples. Your completed, filled-out tax form will probably look a lot different. Always check the IRS website to see if there are updated forms, and if you're unsure of how to complete a form see a tax pro or relevant IRS publications.

Watch out for depreciation recapture. Depreciation deductions may come back to bite you if you quit using business property. You may have to report income for past tax deductions for depreciation (called recapture) when an asset is no longer used for business.

> **EXAMPLE:** Rusty, a self-employed flooring contractor, closes his shop and sells his Dodge pickup for $7,500. The truck cost $11,000, and Rusty took a total of $4,200 of depreciation deductions in past years (this means his tax basis in the truck is $6,800). He must report $700 as recapture income (the difference between his tax basis of $6,800 and the sale price of $7,500) on his tax return.
>
> See Section F, below, for more detail.

Show the IRS how you figure depreciation. While not required, it's a good idea to attach a separate depreciation schedule or worksheet to your tax return whenever you claim depreciation or Section 179 deductions. This shows the IRS how the deduction was calculated and it may ward off a further IRS inquiry or audit. It indicates that you are careful and aware of the tax rules on depreciation. Tax preparation software such as *TurboTax* makes depreciation schedules and the required tax forms and worksheets. See our example above.

D. Tax Basis of Business Assets

Tax basis, or just plain basis, is the amount the tax code says you have invested in an asset—which may be quite a different figure from what you think.

Your basis in an asset is the starting point to determine how much you can deduct each year for it. Basis is also used to determine your taxable gain or loss when you sell or dispose of the asset. (See Section F, below.)

IRS Publication 551, *Basis of Assets,* is a 12-page explanation of the law on basis that goes beyond the summary that follows.

1. Basis of Things You Purchase

As a general rule, the beginning tax basis of asset is its original cost to you. (IRC § 1012.) So, if Billie Bob pays $3,000 for a dry cleaning machine for his store, Clean World, that's his beginning basis. Related costs, such as $200 for freight to get it to Clean World and $150 for installation, are added to the beginning basis, making it $3,350.

Basis also includes state and local taxes (meaning that any state or local sales-type taxes you pay are deductible along with the item itself). Sales taxes become part of the basis of the asset, meaning that sales tax cannot be completely written off in the year the item was bought (unless it qualifies for Section 179 treatment; see Section B, above). For instance, an 8% state sales tax on a truck bought for $10,000 ($800) must be added to its basis ($10,800) and written off over the period the truck is depreciated, usually five years. (See Section C, above.)

2. Basis of Things You Receive as a Gift

If you receive something as a gift, you take the same tax basis as the person who gave it to you. This is called a transferred basis. (IRC § 1015.)

EXAMPLE: Ralph's father, Josiah, gives him a building worth $60,000. Josiah's tax basis in the property was $15,000; Ralph has a transferred basis the same as his father's: $15,000. So if Ralph immediately sells the building for its fair market value of $60,000, he will owe tax on a $45,000 gain (the sales price, $60,000, less his tax basis, $15,000).

3. Basis of Things You Receive for Services

If you receive something in exchange for your services, your basis is its fair market value. (IRC § 7701.) The value of the asset is taxable income. If the asset is then used in your business, it may be deducted under the depreciation rules.

EXAMPLE: In 2005, Woody refinished four antique chests for Zeke; in exchange, he received one of them. Because it could be sold for $250, its fair market value was $250, which became Woody's tax basis in the chest. He should report $250 as income on his 2005 tax return. When Woody sells the chest for $350 in 2007, he has a further taxable gain of $100 (less any costs of making the sale, such as a newspaper classified ad).

4. Basis of Things You Inherit

If you inherit something and put it to use in your business, the tax basis of the item is its fair market value on the date of death of the person who left it to you. (IRC § 1014.) That means you get a big tax break when you sell, because your taxable profit is based on the date-of-death value, which could be considerably more than the former owner paid for it.

Business owners often use land or buildings that they have inherited.

EXAMPLE: Beth dies and leaves a warehouse to her son, Charles. She bought the property in 1970 for $50,000, and it was worth $200,000 on the real estate market when Beth died. When Charles inherits the warehouse, his basis in it is $200,000.

Charles, who has an insurance agency, can't use the warehouse, but needs a small office building for his business. Charles sells the warehouse for $200,000. He has no taxable gain or loss, because $200,000 was his tax basis. Charles can then buy a new building with the proceeds and begin taking depreciation deductions as soon as he starts using it for his insurance business.

5. Basis of Things You Receive in Exchange for Other Assets

If you trade an asset for something else, the basis of the newly acquired asset is usually the same as the property you traded. This is called substituted basis.

EXAMPLE: Janet, a cabinet maker, trades a table saw with a tax basis of $250 to Boffo for his industrial shop vac. Her basis in the shop vac is $250.

The tax code doesn't allow substituted basis for all exchanges. To be nontaxable, the trade must be for a "like kind" property. For instance, if you trade away real estate, you must receive real estate in exchange. And if you trade tangible property (such as Janet's table saw, above), you can't get intangible property, such as a copyright, in return.

If you trade different types of property, the tax code says this is a sale of one item (normally resulting in a taxable profit), followed by the purchase of another item, and not a tax-free exchange of like kind property.

6. Basis of Things Exchanged for Assets and Money

If you trade something and throw in money to boot, your basis in the newly acquired property equals the basis of the asset you exchanged plus the amount you paid in cash—called "boot" in tax lingo.

EXAMPLE: Kevin trades his old Ford pickup (tax basis of $3,000) and $10,000 cash (the boot) to Truck City for a new Chevy. Kevin's basis in the new truck is $13,000.

Conversely, if you receive an asset plus money, your basis in the item is reduced by the amount of the cash.

7. Basis of Things You Convert to Business Use

When you convert personal, nonbusiness property to business use, you must determine its basis at the time you make the switch. The tax basis of converted property is the *lesser* of:

- the fair market value of the asset on the date you convert it to business use, *or*
- your adjusted basis in that property. (IRC § 167.)

EXAMPLE 1: Jacob bought a $2,500 computer a year ago for fun and games, but now starts using it in his snowboard shop. The tax basis of the computer is the lesser of Jacob's cost or its current fair market value. Jacob finds its fair market value is now $1,000, which becomes its tax basis as a business asset.

EXAMPLE 2: Theresa pays $60,000 to have a home built on a lot valued at $10,000. She lives in the home five years and spends $20,000 for improvements. One year Theresa claims a $2,000 tax deduction for a casualty loss when a runaway car hits her living room. Over time, Theresa's house comes to have a fair market value of $125,000. Theresa moves out and converts the house into a health food store. The tax basis of the converted building is computed as follows:

	$60,000	cost to build home
+	20,000	improvements over the years
–	2,000	deduction taken for casualty loss
=	$78,000	tax basis at time of conversion

(The $10,000 cost of the land is not part of the basis of the building; as land, it is never depreciable under the tax code.)

Theresa must use $78,000 as her tax basis because it is less than the fair market value of $125,000, according to the tax rule discussed above. (IRC § 167.)

EXAMPLE 3: Going back to Theresa's situation, if the building's fair market value had decreased to $50,000 at the time of the conversion, Theresa's basis would have decreased to $50,000 as well. That's because she must use the fair market value as her basis whenever it is lower than her adjusted basis. (IRC § 167, Reg. 1.167.)

E. Leasing Instead of Buying Assets

Consider leasing autos instead of buying them. Leasing typically provides larger tax deductions. Lease payments are deductible as current business expenses, like electricity or office supplies. (See Chapter 1, Deductible Expenses.)

There are some special tax code rules for leasing.

1. Vehicles Used for Business

Both tax and nontax considerations determine whether it's best to buy or lease a car or truck for your business. Here are some tax angles to consider.

a. Keeping Track of Personal Use

Most small business people use their car both for business and personal purposes. This requires records tracking each use, whether you lease or buy. You can find a simple logbook for keeping track of your use at office supply stores or from a tax pro. Or, you can simply use a spiral notebook.

b. Tax Rules Favor Leasing

The tax advantage of leasing starts when your business usage is 50% or more and the vehicle cost exceeds $15,500. Part of the reason is that if you lease, your lease payments are immediately deductible in full, assuming the vehicle is used 100% for business. On the other hand, if you buy a vehicle, your tax write-off using depreciation is frequently much less than a lease payment. In effect, leasing gets around the stingy depreciation deduction limits for most newer vehicles. (See Section C3c, above.)

However, if you lease a car for business, you can deduct the lease payments, but you have to reduce the deduction by an inclusion amount for vehicles costing more than $18,000. This provision is in the tax code in an attempt to reduce the tax advantage for leasing.

The inclusion amount is a percentage of part of the fair market value of the leased car. You can find it in the IRS inclusion tables included in Appendix A of IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.

You do not add this extra inclusion amount to your income. Instead, you reduce the deduction for your lease payment. This is not as complicated as it sounds

However, the extra imputed income is relatively insignificant, as shown in the example below.

EXAMPLE: Phil, an independent sales representative for a furniture manufacturer, leases a $70,000 BMW. If Phil used the car 100% for business, he could deduct his $780 monthly lease payments as a business expense. The IRS lease table directs Phil to report $185 of extra income in the first year, rising to $835 in the fifth year.

If Phil uses the car 20% of the time for business calls, he could deduct only 20% of his $780 monthly lease payments. He would also discount the lease inclusion amount by 20%. Even if he were in the highest tax bracket, Phil's additional income tax would be less than $75 for the first year.

The IRS inclusion tables are adjusted annually for cost of living changes. Tax pros and software can easily make the lease inclusion calculations for you.

A further consideration in weighing a lease versus a purchase are the tax benefits you get deducting the interest on a car loan. For instance, if you buy a car and pay $2,000 in interest over a year and drive it 80% for business, $1,600 of the interest is deductible as a business expense. The other $400 is non-deductible personal interest.

c. The Mileage Method

Alternatively, you may elect to use the mileage method (see Chapter 1, Section D1) for leased vehicles. The deduction rate is 40.5¢ per mile in 2005.

However, once you start using the mileage method, you must continue to use it for the rest of the lease. Before choosing, compare the tax deduction allowed under the mileage method with the regular lease deduction rules. (See Subsection b, above.)

d. End of the Lease

Leasing avoids potential tax issues you may encounter when you dispose of an owned car or truck. That's because turning in a leased car is a nontaxable event.

Whether to lease or buy should not be just a tax decision. First, do a purely economic analysis of the lease. Start with the stated gross capitalized cost (value or purchase price of the vehicle). Then find the stated residual value (what the car will be worth) at the end of the lease. Next, use a buy vs. lease calculator (check the Internet—many car sites have these kinds of programs) to compare the costs.

Analyzing leases is a little simpler now, due to a recent federal law mandating clarity in lease disclosures. While leasing costs are still far more complex to figure out than purchasing, they can produce big tax savings, so it is often worth the effort to investigate them.

All leases limit the total miles you can drive and all punish you for terminating the lease early. Manufacturers frequently have the best lease deals, so start there. Never rely on a car salesperson for advice on lease or own. Salespeople push leases because they get higher commissions; dealers like leases because they can disguise the true sales price in the lease agreement mumbo jumbo.

2. Leasing Your Assets to Your C Corporation

A business doesn't have to own all of its operating assets. Leasing your *personally owned* property—your building, vehicle, or equipment—to your C corporation may provide a tax savings.

Alternatively, an asset leased to your C corporation may be owned by another corporation, a partnership, or a family business in which you have an ownership interest. (As discussed in Chapter 12, Family Businesses, such arrangements can result in "income shifting"—transferring income to people in lower tax brackets to reduce overall taxes for the family unit.)

To pass IRS scrutiny, leases between an individual and his corporation must be arm's length deals, not merely tax-motivated schemes—this means the terms must be commercially reasonable.

Leasing assets can offer protection from business creditors. Apart from taxes, shareholders—especially in endeavors where lawsuits are a hazard—don't want their corporation to hold substantial assets. Leasing insulates the assets from potential creditors of the corporation.

Lease payments are deductible expenses to the corporation. Lease income is taxable to the asset's owner, who in turn deducts costs of ownership—mortgage interest, property taxes, maintenance, repairs, and depreciation. The overall result may be a wash—no money savings—but in some cases, it might work, as the following example shows.

EXAMPLE: Sam bought a store building in June 2006 for $100,000. The land has a fair market value of $20,000, and the structure a fair market value of $80,000. Sam does some minor repairs and leases the building to Sam Smith, Inc., a C corporation, in 2007 for $16,000 per year. Sam's out-of-pocket expenses of ownership are $15,000, and he is entitled to a $2,052 depreciation deduction in 2007 (the second year's write-off of the building as allowed in the tax code). Tax result: Sam is ahead $1,000 in cash after expenses ($16,000 – $15,000). This is canceled out by his $2,052 depreciation deduction. Sam has a tax loss of $1,052. This paper loss can shelter some of Sam's other earned income in 2007, such as his salary from Sam Smith, Inc. Before structuring his affairs in this manner, Sam sat down with his tax adviser—and so should you.

F. When You Dispose of Business Assets: Depreciation Recapture Tax

Chances are that at some point you'll no longer have a need for a business asset, whether it's a vehicle, a machine or an office building. Things wear out, become obsolete, or you no longer need them.

It's also likely that you have been taking annual depreciation deductions for the asset, and may even have written it off entirely. Uh, oh—the disposition might trigger tax pay-back, or recapture. Let's look at the rules here for all (noncorporate) business entities. IRC § 1231 and IRC § 1245 are the two guiding tax code provisions.

1. Sale of Business Equipment

Selling is the most common way to get rid of an unwanted business asset (assuming it still has some value to someone). What are the tax consequences?

a. A Gain Triggers Depreciation Recapture Tax

Any gain you make over your tax basis in the asset is taxed. Your tax basis is figured by subtracting the depreciation deductions you've taken on it from what you paid for it.

EXAMPLE: Bonnie sells a 20-foot custom teak conference table that doesn't fit into her new office space. She paid $10,000 for it, and over several years took $8,000 in depreciation deductions. Her tax basis is $2,000 in the table. Bonnie sells it to Regina for $2,500. Tax result: Bonnie owes income tax on $500 ($2,500 – $2,000), the gain the tax law says she had on the transaction because of the recapture of previously claimed tax deductions.

b. Recapture Taxed at Ordinary Income Tax Rates

If a gain on a sale is entirely attributable to the recapture of depreciation deductions, all of the gain is taxed at ordinary income tax rates. (The gain does not get taxed at lower capital gains tax rates.)

EXAMPLE: Returning to Bonnie's situation, her $500 gain represents a recapture of depreciation deductions taken in past years. If Bonnie's individual income tax rate is 25%, her income tax on the gain from the sale of the desk is $125. Depending on her state of residence, Bonnie may owe state income taxes as well.

c. Gain Other Than Recapture May Be Taxed at a Lower Rate

If a business asset was sold for more than the total depreciation deductions taken in past years, the tax is figured at the Section 1231 tax rate. Generally, this means a tax rate is lower than the ordinary income tax rate for an individual. (See IRS Publication 544, *Sales and Other Dispositions of Assets,* for details on how this tax calculation is made.)

EXAMPLE: Let's say Bonnie, from the examples above, sells the table to Regina for $12,500. Remember Bonnie's original outlay was $10,000. Her tax basis was $2,000, as she had taken $8,000 in deductions over several years. Tax result: Bonnie is treated as having a $10,500 taxable gain on the sale. Out of Bonnie's gain, $8,000 is attributable to depreciation deduction recapture and is taxed at her ordinary income tax rate of 25%. But the remaining $2,500 is taxed at the special Section 1231 tax rate, which in her case is 15%. Her capital gain tax is $375 ($2,500 x 15%).

2. Like-Kind Exchanges

Like-kind exchanges are not taxable events, and they avoid depreciation recapture. Essentially, you are allowed to trade in a business asset for another one with no tax consequences.

EXAMPLE: Rusty, a drywall contractor, trades in his three-year-old small Ford pickup for a new full-sized Chevy truck. Rusty also pays the dealer the $10,000 difference in value. No matter how much depreciation Rusty took on his Ford in the past, he won't have any taxable gain (or loss). The tax code considers this a like-kind exchange of business assets.

3. Destroyed or Stolen Assets

If a business asset becomes damaged, destroyed, or stolen, the IRC terms this an involuntary conversion. If the loss was fully reimbursed by insurance, there is no tax consequence, as long as all of the insurance proceeds are used to replace the asset. The involuntary conversion avoids depreciation recapture.

EXAMPLE: Rusty, in the example above, wrecks the Ford pickup on the way to the Chevy dealer. Allsnake Insurance declares the truck a total loss and pays him $9,000. This is $2,200 more than Rusty's tax basis in the Ford, which would normally mean he would owe income tax on a $2,200 gain from recapture of depreciation. But, if Rusty buys the Chevy for at least $9,000, there's no taxable gain.

4. Sale of Real Estate

If your business owns real estate that was depreciated in prior years, special tax recapture rules apply.

The income taxation of real estate is beyond the scope of this book. See a tax professional or IRS Publication 544, *Sales and Other Disposition of Assets,* for details on real estate tax rules.

G. Tax Errors in Depreciation

It's easy to miscalculate your depreciation deductions—a good reason to use a tax preparer or software such as *TurboTax*.

The good news is that if you catch a mistake after you have filed a tax return, it can be corrected. This could result in a tax refund or a tax bill—depending on which direction the error was made in. Make the correction by filing Form 3115 or a Form 1040X amended tax return. It is best to have a tax pro do this for you. If an IRS auditor catches the mistake, it will likely cost you a tax penalty.

Final thought: *"A tax loophole is something that benefits the other guy. If it benefits you, it's tax reform."*

—Senator Russell Long

Resources

- IRS Publication 946, *How to Depreciate Property*.
- IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.
- IRS Publication 551, *Basis of Assets*.
- IRS Publication 544, *Sale or Other Disposition of Assets*.
- IRS website, www.irs.gov. Here you can download the latest tax forms and publications.
- IRS small business website. This is a promising community website for the nation's 45 million business and self-employed taxpayers. The IRS's stated aim is to improve IRS service by providing greater access to helpful information. The site provides:
  - answers to basic tax questions
  - a calendar of tax deadlines for small businesses
  - industry-specific tax info for industries such as construction and food service
  - tips to avoid common tax problems
  - links to court opinions and to rulings and regulations on specific industries
  - links to other websites for general tax information, and
  - links to helpful small business resources.

  You can access this site by going to the IRS home page at www.irs.gov and clicking on "Business" and then "Small Business and Self-Employed."
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs). This CPA-written self-help book covers the fundamentals of depreciating business assets and keeping depreciation records.
- *Deduct It!*, by Stephen Fishman (Nolo). A comprehensive guide to tax deductions for small business owners that covers depreciation rules and Section 179.

■

CHAPTER

3

Bookkeeping and Accounting

"The income tax has made more liars out of the American people than golf has."

—Will Rogers

Most ventures are started by enthusiastic people with ambition. Whether they are hoping to build the next Fortune 500 company or simply supplement their day job, it's what the business will buy, sell, make, or fix that drives them. They aren't intrigued by the paperwork, but the law mandates some basic record-keeping know-how. And, in the long run, keeping good records can save you money at tax time.

The good news is that the IRS does not require business records to be kept in one uniform fashion. Any format is okay, as long as it paints a true picture of income and expenses. Since no two enterprises are alike, no two record-keeping systems are exactly alike.

The first commandment of the tax code is: Thou shalt keep "records appropriate to your trade or business." (IRC § 6001.) And, of course, they must be accurate. (Reg. 31.6001-1(a).)

This chapter outlines the minimum record keeping required, and tips for setting up an easy system. We'll also cover some common record-keeping pitfalls and how to avoid them. Never forget that the IRS (and state tax agencies, too) have the right to audit you and inspect your records.

Record Keeping in a Nutshell

1. The IRS doesn't prescribe any particular format for keeping your business's records, as long as they clearly reflect your income and expenses.
2. You can choose a manual or computerized record-keeping system, but a computer saves time and is usually more accurate.
3. Small businesses are usually required to keep records and report taxes on a calendar-year basis.

Record Keeping If You Have Several Small Businesses

How do you report income from more than one business on a tax return? Let's say you are a part-time coin dealer and you own a bicycle shop, and your spouse has a sideline home decorating business. You'll need three sets of records, because each venture requires separate tax reporting. Three sole proprietorships require three IRS Schedule C forms with your tax return each year. (See Chapter 6, Sole Proprietorships.)

A. Why You Need a Bookkeeping System

Operating without records is like flying in dense fog with no instruments. You may be thinking, "I'll skip this section; I hate bookkeeping. After all, if my business takes in enough money, all these paperwork matters will resolve themselves. If they don't, I'll hire someone to clean them up later." Think twice, please.

Some fledgling entrepreneurs think that if there is money in their business checking account at the end of the month, they must be making a profit. But only by keeping accurate records will you really know if your business is making or losing money.

A record-keeping system is also crucial for preparing your annual federal and state income tax returns.

Take record keeping seriously. If you get only one thing out of this book, go away knowing that ignoring record keeping is inviting disaster. If the IRS ever audits you or your business and finds insufficient records or significant mistakes in your record keeping, it can disallow significant deductions. The IRS can also impose hefty fines and penalties, possibly forcing you out of business and wiping out your life savings as well.

Record keeping must become part of your everyday business routine. I hate paperwork as much as any of you. But I also hate shaving every morning, keeping fat out of my diet, and carrying out the garbage in the rain, and these tasks never seem to go away. However, I've discovered record-keeping shortcuts I'll share with you. The first one is that you don't need to keep track of every last penny.

Random Business Record Inspections

You may be audited after written notice, but there are no IRS inspectors roaming around spot-checking to see that records are being kept. In many states, however, employment or sales tax auditors can show up unannounced and demand to see records. So, just like the Boy Scouts, "be prepared."

B. Should You Hire a Bookkeeper?

When it comes to keeping records, you can either do it yourself, or hire someone.

Maybe you can't afford a bookkeeper when you're starting out, but keep it in mind if and when your business succeeds. Some folks actually like doing other people's paperwork, leaving you with more time to focus your talents on your enterprise.

Typically, bookkeepers charge $15 to $50 per hour or may charge a flat monthly fee. They can take care of a small business for as little as $50 to $100 a month. Because this is a tax deductible expense, Uncle Sam is paying part of the bookkeeper's salary.

⚠ **Don't just hire anyone claiming to be a bookkeeper.** Check references and learn enough about your records so that you can see the bookkeeper knows her stuff. Accountants can recommend a bookkeeper, or they may have folks on staff to do the job (accountants themselves are not bookkeepers). The American Institute of Professional Bookkeepers is also a possible source of information if you're looking to hire someone (www.aiph.org.).

Whomever you choose, keep in mind that the IRS holds you responsible for any bookkeeper screw-ups. The following is a sad but true story of an entrepreneur who didn't pay attention to what his bookkeeper was up to, and paid the price.

> **EXAMPLE:** Barney owned T-Wrecks, an auto body shop. He had no patience for bookkeeping, so he hired Lorraine to do it for him. She came in once a week to do T-Wrecks's books, pay the bills, and file various tax reports. Lorraine was a faithful worker, and so Barney was upset when she suddenly quit after two years and moved to parts unknown. Shortly thereafter, an IRS collector came calling about unfiled and unpaid payroll taxes. Barney discovered that sweet Lorraine had embezzled $38,000, including unpaid federal taxes. Barney had to go into his savings for the unpaid taxes—plus hefty penalties—or face the padlocking of his body shop by the IRS.

It may be possible to insure your business against a bookkeeper's dishonesty. Check with your insurance agent.

C. Manual or Computer System?

There are two ways to keep business records: manually—the pencil and paper way—and with a computer. The IRS doesn't care which system you use, as long as it accurately reflects your business's transactions. If you just throw papers in a shoebox and forget them, you're an audit waiting to happen.

A microbusiness, such as a home-based consultant, independent contractor, or freelancer, might get by with a check register, adding-machine tapes, and an accordion file for paid bills.

Every time you incur an expense (or once a week or month), you'll note in your records the following:

- a brief description of the business purpose of the transaction (office rent, new stapler, gas, and so on)
- the amount
- the date, and
- whom you paid (Chevron, Kinko's).

Whether you use a computer or pencil, the basics of bookkeeping are the same. You must keep accounts showing your enterprise's financial activities. "Accounts" refer to the categories where transactions are noted in your records—such as "advertising," "rent," and "utilities."

Organize your receipts by category. Paid business receipts should be organized by category—rent, entertainment, travel, equipment, and so on—and not by week or month. This allows you to total up the different types of expenses at the end of the year for tax preparation—and you'll be ready if the IRS comes calling.

Run it by a tax pro. Have a tax pro review your system early on to make sure it is okay. This can avoid headaches when it comes time for filing tax returns or when the auditor calls. And the tax pro's fees are tax deductible business expenses.

1. Manual Bookkeeping System

The manual system works fine for very small enterprises and costs only $5 to $20 for ledger paper or a simple business record booklet, both of which can be found at an office supply store.

An adequate record-keeping system for a small business (without employees) typically includes:

- checkbook register—preferably from a separate bank account for your business
- summary of receipts of gross income—totaled daily, weekly, or monthly
- monthly summary listing of expenses
- disbursements record (check register or expense journal) showing payments of bills, and
- asset purchase listing (equipment, vehicles, real estate used in business).

Keep income and expense records using ledger sheets listing your income and expense items. A sample ledger sheet is shown below.

The chart below is called an expense journal. Gross receipts are recorded on an income journal, which is similar.

As the Jumbalaya Enterprises example below illustrates, the first three columns of an expense journal list how your business paid for a certain transaction—such as cash, credit charge, or check pay-

(Sample Ledger Sheet)
Jumbalaya Enterprises—Expense Journal—April 20xx

Ck	Cash	Cred	Date	Transaction	Advert	Util	Supplies	Rent
		VISA	4/1	Daily News	48.00			
122			4/15	Prop. Mgmt. Serv.				782.75
	$		4/21	Office World			62.44	
123			4/30	City Electric		91.50		
124			4/30	KFOO Radio	95.00			
April 20xx				TOTALS	143.00	91.50	62.44	782.75

ments. Next is the date an expense was paid or incurred.

Next you enter what the expense item was, under "transaction." (Ideally, every expense item should be taken directly from an invoice, receipt, cash voucher, check register, or other document showing it was incurred by the business.)

Going across the top of the right side of the paper are headings for listing the category of each type of expense, such as "rent," "supplies," or "utilities."

After each item of current expense or income is entered, all of the columns are periodically totaled. Typically, totals are run weekly or monthly. Finally, the 12 months are added up at the end of the year for tax reporting.

Prepare sheets at least once a month. It's better to do it daily or weekly, when everything is fresh in your mind.

Retain old records. Ledger sheets (and your receipts for expenses) should be kept at least three years after you file your tax return. This is the period in which the IRS or state tax agency is most likely to audit your business. Better yet—save them for six years if space permits. And keep in mind that if you ever sell your business, a buyer may want to see old records to verify its financial history.

A Shortcut for Expense Records

File paid bills, canceled checks, and other business documents where you can easily find them. Some people use manila folders or an accordion file divided into "car," "utilities," "entertainment," and so on.

At a minimum, stuff receipts in the proper folders throughout the year and total them up at tax time. Staple the adding machine tape to each folder or stack of receipts. If this works, good for you.

2. Computerized Bookkeeping System

Record keeping on a computer works on the same principles as the manual system, but the computer automates the process. A simple software program like *Quicken* (Intuit) or *MS Money* (Microsoft) eliminates the need for a handwritten set of books. With *Quicken* or *MS Money*, you can print out records such as a profit and loss statement in a flash.

These inexpensive and tax deductible programs ($50 or less) are fine for most small service businesses. I use *Quicken* in my tax law practice. For businesses with inventories, a more sophisticated software program like *QuickBooks* or *Peachtree Accounting* is necessary.

Checkbook register format. *Quicken* and *MS Money* work like a checkbook register, as shown below. Each transaction, usually a business expense or an item of income, is typed in. Typically, the item is either a check out of, or deposit into, your bank account. (You can also record cash and credit card expenses in *Quicken* or *MS Money* using separate accounts, as shown in the illustration below.)

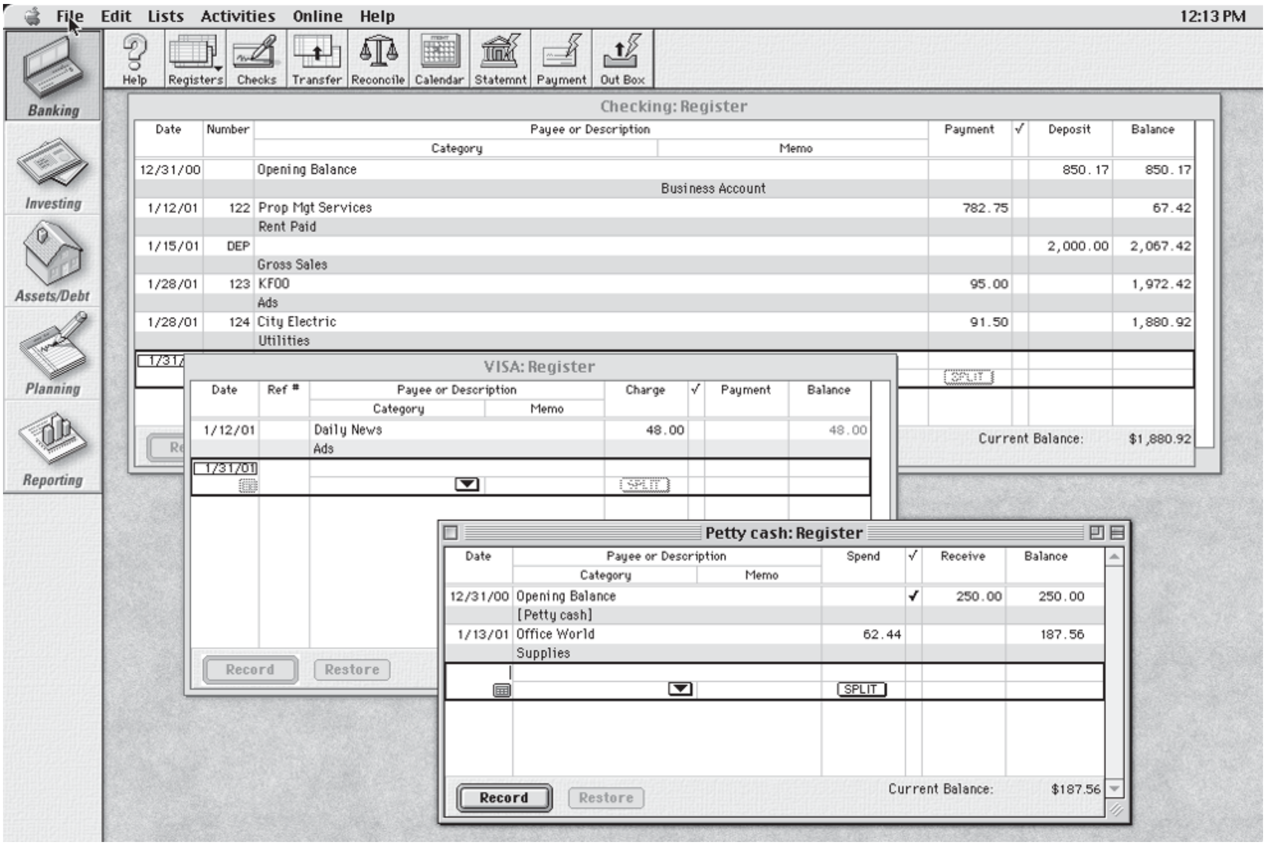
Assign a number or category name to each transaction and type it in. For instance, you could call "201" office rent, or type "rent," which tells the computer to group together all rent payments. Category 202 could be "supplies," and so on. You could track "advertising" as category 301, or break it into subcategories such as 302 for "ads—Yellow Pages," 303 for "ads—newspaper."

The software will group the entries like a manual system ledger sheet and does the math. You are now only a keystroke away from up-to-date expense journals, which are the heart of your bookkeeping system.

Take it from someone who did not grow up in the computer age—*Quicken* and *MS Money* are easy to use, even if you type like a snail. An hour should get you up and running, no kidding. No more math errors that always plagued me when I kept books by hand.

Avoiding computation mistakes isn't the best reason to use *Quicken* or *MS Money*—the categorization feature is my favorite. It eliminates the chore of going through (or paying someone to organize) a

Sample *Quicken* Check Register (Along With Credit Card and Petty Cash Registers)



jumble of paper. A computerized system allows you to see your income and expenses—by category—instantly.

Plus, your profit and loss statement is a snap and you can whip out a financial statement for a bank or creditor at any time.

You'll also have at least 90% of the data needed to prepare your business's annual tax schedule or return. If you do your own tax preparing, this feature is a godsend. *Quicken* and *MS Money* are compatible with tax preparation programs like *TurboTax*. You can move your financial data from *Quicken* or *MS Money* into *TurboTax* without having to reenter the same figures. *TurboTax* (in one of its several versions) will prepare any type of business tax return: sole proprietor, C or S corporation, partnership, or limited liability company. Balance Your Books offers online bookkeeping services at balanceyourbooks.com.

Sample *Quicken* Income Statement

Jumbalaya Enterprises
Income Statement
1/1/06 Through 1/31/06

Category	**1/1/06-1/31/06**
Inc/Exp	
Income	
Gross Sales	2,000.00
Total Income	2,000.00
Expenses	
Ads	143.00
Rent Paid	782.75
Supplies	62.44
Utilities	91.50
Total Expenses	1,079.69
Total Inc/Exp	920.31

> **EXAMPLE:** Jack Johnson is a medical technology consultant with only one client, who pays him monthly. Keeping track of gross receipts is no problem. Expenses are more troublesome. Jack has a home office and occasionally hires help. He travels worldwide, drives his car for business, pays insurance, and so on. He writes business checks or uses credit cards. Over the course of a year, Jack incurs hundreds of different expenses, so he needs a good record-keeping system. Jack keeps a business checking account plus a personal account. Jack is an ideal candidate for *Quicken* or *MS Money*.

Businesses with inventories. Simple programs like *Quicken* or *MS Money* are not adequate for sellers of goods that maintain an inventory. *QuickBooks* (Intuit) handles inventory, billing, and more complex small business bookkeeping tasks. It sells in the $100 to $200 range, depending on the features needed.

D. What Kinds of Records to Keep

Business records can be divided into three categories: income, expenses, and capital expenditures. Let's look at each category.

1. Income Records

Your operation may take in money from one or many sources. For goods or services sold, these inflows are called gross receipts.

Business records should list payments received and the source of each item—for instance, "retail sales." Identifying payments received is necessary because money you put into your business's bank account may not always be gross receipts or income.

There are lots of valid explanations why a deposit may not be taxable income. For instance, you might deposit $10,000 from your personal bank account into your business bank account to buy inventory. Or maybe you take out a loan or sell your Harley or receive an inheritance from Aunt Bea, and you put that money into your business.

Write down the source of the deposit on the deposit slip or in your checkbook while it is fresh in your mind. I make photocopies of all my bank deposit items and write notes to explain any that aren't obvious.

There are numerous ways to track gross receipts. Retail stores typically use cash registers with tapes and credit card services to record sales. Small service-type businesses use bank deposit records, keeping copies of deposit slips identifying the sources of funds put into a business bank account as well as the bank statements showing total monthly deposits.

Keep notes on *all* income. Make notes explaining the origin of *all* money in both your business and personal bank accounts. This is important because if the IRS audits you, the first thing they want to see is bank statements, deposit slips, and canceled checks for all business and all personal accounts. If your total bank deposits are greater than your reported income, you must show why; otherwise, the auditor will assume the difference was unreported income—and assess tax, interest, and penalties.

If you sell services to another business, you might receive Form 1099s from the payors showing how much you were paid. Don't forget this 1099 income on your tax return. The IRS computer routinely matches Form 1099 and W-2 reported payments to tax returns. If the Form 1099 is wrong, make sure you get the issuer to send a corrected form to you and the IRS.

> **EXAMPLE:** Dr. No was snagged by the IRS on a computer check of Form 1099 payments. He had claimed less gross income than Medicare alone had reported to the IRS that it paid him—not even taking into account his non-Medicare patients! (How Dr. No thought he could get away with this is beyond me.) He was audited and the

IRS added heavy penalties and interest to his audit bill. Dr. No could also have been charged criminally with tax evasion.

2. Expense Records

As the old saying goes, to make money you have to spend money. The good news is that ordinary and necessary business expenditures are deductible against your gross receipts. (See Chapter 1, Deductible Expenses.)

Asset purchases for your business are also deductible, but under different rules. (See Chapter 2, Writing Off Business Assets.)

Get organized. Keep a business diary and calendar, like a Day Planner or handheld personal digital assistant (PDA). You need a permanent tax record of expense items. An organizer lists appointments and helps you note tax-related things like travel, names of business contacts entertained, and out-of-pocket cash expenses for bridge tolls and parking. For expense items that are not obviously business-related (travel, entertainment), make notes to explain the business purpose. (See "Business Entertainment, Meals, and Travel Records," below.)

Jotting down expenses is only part of the job. You also need proof that the bills were paid—such as receipts, invoices, credit card charge slips, bank statements, and rent receipts. Microbusinesses can get by with saving receipts and invoices in accordion folders or envelopes by expense category ("supplies," "travel," and so on). Larger businesses need more paperwork organization and backup.

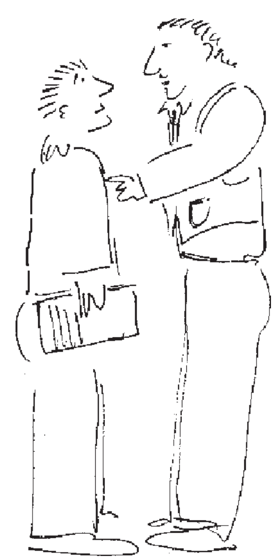
Business Entertainment, Meals, and Travel Records

The tax code requires more stringent record keeping for travel, meals, and entertainment expenses. (IRC § 274.) In tax lingo, these are called T&E items.

For each T&E expense you must document five elements:

1. Date
2. Amount
3. Place
4. Business purpose, and
5. Business relationship.

Get in the habit of making notes of these five items on the back of receipts and in your business diary or calendar. For example, write on your calendar or appointment book, "May 11, Lunch with Bill Jones, client, to discuss new advertising campaign. Ritz Restaurant, $60 with tip." If you used your American Express card, write "Bill Jones" and the topic discussed ("television advertising on Channel 5") on the back of the charge slip.



Sample Travel and Entertainment Form

Date	Type of Expense	Place	Business Purpose	Amount: Travel	M & E*	Other	Mileage	Reimbursed
8/23/06	Meal	Ritz	Discuss New Advertising	—	$60	—	12 miles	—
			with Bill Jones					
			Totals 8/2006	—	$60	—	12 miles	—

* Meals and Entertainment

Canceled checks and paid receipts are the standard documents that back up your business expenses. But the IRS now accepts statements from financial institutions showing check clearing or electronic funds transfers, without the actual canceled checks or charge slips, in most cases. This rule recognizes that banks no longer always return canceled checks. To satisfy an IRS auditor, the financial institution's statement must show the date, name of the payee, and amount of expense. You may have to produce copies of the charge slips or canceled checks if the auditor is not satisfied with the bank's statements.

No receipts are necessary for expense items less than $75. The IRS no longer requires you to keep any paid receipts, canceled checks, bills, or other proof of single-expense items of less than $75 each. However, each cost must appear reasonable, ordinary, and necessary for your business. There is one exception: For lodging expenses, you must have a receipt regardless of the amount.

3. Asset Records

Whenever a business purchase offers a benefit that will last for longer than one year—like a fax machine, a building, a car, office furniture, or the like—the IRS classifies it as a business asset or capital item. These assets must be tracked separately from current business expense records. (Accountants call assets records the fixed asset schedule or asset log.)

You don't have to know the terminology—just keep a separate file for each kind of asset. Show the date of purchase and the type of asset: computer, truck, machinery, and so on. And, unless it is obvious, write a short explanation of how the asset is used in the business.

Long-term assets are not immediately deductible like everyday operating expenses (such as rent or telephone bills, as discussed in Chapter 2). Generally, you can't deduct the entire cost of the asset in the year of purchase; instead, you must take depreciation or amortization deductions over several years. There is one important exception to this rule: Up to $105,000 (in 2005) worth of assets may be written off in the year of purchase under a special tax code provision, IRC Section 179.

Life is much simpler for leased assets. With the limited exception of vehicles, you simply deduct lease payments as current expenses instead of maintaining an asset log for them.

a. How to Keep Asset Records

For business assets, keep records showing:

- **A description of each item, the date acquired, and how you acquired it (usually by purchasing it).** Typically, this data appears on an invoice or receipt from the seller. The description is important because the tax code has different rules for different assets. For instance, office furniture is deductible over seven years, and computers over five. (These categories are discussed in Chapter 2, Section C2.)
- **The date you started using the asset in your business—the month and year it was placed in service.** Ordinarily you start using something as soon as you acquire it, but not always, so note it.
- **Your tax basis in the asset.** Your beginning basis is how much you paid for an asset, including sales tax, installation, and delivery. Your basis can increase if you later make improvements or modifications—such as adding more memory to a computer. (See Chapter 2, Section D, for a discussion of determining the basis of assets.) Conversely, the basis decreases whenever you claim depreciation deductions on your tax return.
- **The sales price of the asset when you dispose of it.** If the asset became worthless or obsolete, include the date you discarded it.
- **Any costs of selling the asset.** For instance, you may have had to take out a newspaper ad to sell your old computer.

Keep track of assets and their tax bases by hand, using ledger sheets or asset log books, or with a computer program such as *QuickBooks*, discussed above.

b. Special Records for Mixed-Use Property

Congress has designated certain assets, such as cell phones and laptop computers, as mixed-use property—items with a high potential for personal as well as business use. These items are called listed property.

If you use listed property strictly for business and keep it on the premises, you do not need to keep special records. But if any listed property provides you with a personal benefit, or if you keep it at your home, you must track your personal use. Of course, you can't claim any tax deduction for the personal use portion.

Listed property. Listed items include:

- autos, airplanes, and other forms of transportation
- entertainment-type property such as VCRs, cameras, and camcorders
- cellular telephones and similar communications equipment, and
- computers and related peripheral equipment (if not used exclusively at a regular business location).

Satisfy the special record-keeping requirement by keeping a logbook showing dates, times, and business purpose. Or write notes in a calendar or business diary. (For more information on listed property, see IRS Publication 946, *How to Depreciate Property*.)

> **EXAMPLE:** Joan buys a laptop computer. She uses it 60% of the time for her direct marketing business. Her son, Jason, uses it the rest of the time for school projects and video games. Joan should keep a log by the computer, showing

the times it was used for her business and for personal purposes, in case the IRS comes calling.

IRC Section 179 rule. You may immediately deduct the cost of listed property under Section 179 if it is used more than 50% for business. (See Chapter 2, Section B, for a full explanation of Section 179.)

EXAMPLE: Joan pays $3,000 for her computer that she uses 60% for business. She can write off $1,800 ($3,000 x 60%) as a Section 179 expense. But if Joan only used it 45% of the time for business, she could not claim any of its cost it as a Section 179 write-off. (Instead, she would have to take depreciation deductions over six years.)

E. How Long Records Should Be Kept

The IRS normally has three years to audit you and your business, starting from the date you file a tax return. (Note that if you never file a return for a given tax year, all bets are off—you can be audited forever.) So, three years is the absolute minimum period for record retention. However, for serious tax reporting misstatements, the IRS can go back six years—and for outright fraud, it can go back for an unlimited period of time.

State tax agencies can inspect your records, too. Some state agencies have statutes of limitations for auditing that are longer than the IRS's. Considering all the laws here, the best thing to do is keep your regular tax-related documents—receipts, invoices, bank statements—for six years.

Asset records on equipment, vehicles, and real estate should be kept for six years *after the asset has been disposed of.*

EXAMPLE: In 1996, Calista bought a building for her insurance agency. She deducted all expenses of maintaining the building and took annual depreciation deductions. Calista sold her agency, including the real estate, in 2005. She filed her tax return reporting the sale of the business on April 15, 2006. Calista should keep her 1996 documents on the purchase of the building until six years after the date of the sale—2012.

F. Bookkeeping Methods of Tracking Income and Expenses

There are two manual methods for keeping your books, called single-entry and double-entry bookkeeping.

If you are doing books by hand and don't have a lot of transactions, the single-entry method is okay. A more accurate way is the double-entry method. Let's briefly look at each manual method, and then move quickly into the advantages of using a computer. These manual methods are horse and buggy era artifacts.

1. Single-Entry System

Single-entry bookkeeping is the easiest way to go. Single-entry, like it sounds, means you write down each transaction once, indicating the type of expense or income. You can use ledger paper or just a lined notebook. Easy, huh? The Jambalaya Expense Journal shown in Section C1, above, is an example of single-entry bookkeeping.

A single-entry system, however, does not work for tracking inventory, loans, assets, and liabilities. For this, you need a double-entry system, which is a little more complicated.

2. Double-Entry System

In a double-entry system, each transaction requires an entry first as a debit and the second time as an equal credit. For instance, if you buy a cell phone for $500, it will be recorded as a debit on one side of your records because you spent money. It will be recorded as a credit on the other side because you've acquired an asset.

A double-entry system is easily handled by a computer, but is time-consuming if done by hand because everything is recorded twice. This requires a formal set of books: journals and ledgers. As illustrated below, all transactions are first entered into a journal, then are totaled and posted (written) on a ledger sheet—the same amount is written on a line in the journal and then again in the ledger by category.

Here is a sample of a double-entry system, showing a payment of rent by Sam's Computer Shop.

General Journal of Sam's Computer Sales & Service

Date	Description of Entry	Debit	Credit
10/5/06	Rent Expense	$1,000	
	Cash		$1,000

As you can see, payment of rent resulted in two separate journal entries—a debit to rent expense of $1,000, and an equal credit to cash of $1,000. The debits in a double-entry method (here, $1,000) must always equal the credits ($1,000). If they don't, you know there is an error somewhere. So, double-entry allows you to balance your books, which you can't do with the single-entry method.

Computers make it easy. With an accounting software program, the double-entry is done automatically. You enter the new data only once, and the computer makes the second entry. Programs such as *Quicken* and *QuickBooks* (Intuit) and *MS Money* (Microsoft) create a set of double-entry books for you. The computer eliminates the extra step or the need to comprehend debits and credits—and it doesn't make math errors.

G. Timing Methods of Accounting: Cash and Accrual

There are two accounting methods for recording income and expenses, called the cash and accrual methods. These are two sets of rules for the *timing* of income and expenses.

A venture's income and expenses must ordinarily be reported in the year in which they occur. (Normally the period is a calendar year, but for a few businesses it may be a fiscal year that doesn't end on December 31.)

> **EXAMPLE:** Monique buys $7,000 in supplies for her hairdressing salon in January 2006. Monique hasn't filed her 2005 income taxes yet—can she deduct the $7,000 expense on her 2005 tax return? No, because the expense was incurred in 2006.

Less clear-cut is the question: What if Monique had bought the supplies in 2005, but didn't pay for them until 2006? In which year does Monique take the deduction? To answer, you need to know the difference between cash and accrual methods of accounting and which one Monique's business uses.

1. Cash Method Accounting

Cash method refers to recording an item of income or expense when it is paid. Don't take the word cash here literally; it covers any kind of payment—checks, barter, credit cards—as well as the green stuff.

The cash method makes sense even to us non-accountants. You simply report income in the year you receive it and an expense in the year you pay it.

The cash method seems simple, but there are a few special tax rules to watch out for. The doctrine of constructive receipt requires counting some items as income before you actually receive them. This means you have income, for tax purposes, as soon as it is available or credited to your account—even if you don't take it.

> **EXAMPLE:** Ray gets a $3,000 check for consulting in early December 2006, but doesn't deposit it until January 2007. Because Ray could have cashed it in 2006—the banks were open and the check was good—2006 is the tax year in which Ray constructively received the $3,000.

Conversely, you are not allowed to take a deduction in the current year for items paid for but not yet received.

> **EXAMPLE:** Ray got a special deal on *Consulting Times*, a monthly business publication. He paid $360 for a three-year subscription in July of 2006. He can deduct only $60 in 2006 (1/6 of the total); the balance must be prorated over the term of the subscription. Ray can deduct $120 (1/3) in 2007, $120 (1/3) in 2008, and $60 (1/6 in 2009.

Most businesses that sell services use the cash method of accounting for income and expenses.

You can prepay some expenses. The IRS allows some flexibility in prepaying and deducting expenses at the end of the year. For instance, if you pay January's office rent on December 27, you'll get the deduction a year earlier. (As long as you don't prepay an expense more than 30 days in advance, you're okay.)

2. Accrual Method Accounting

Businesses with inventories of goods, manufacturers, and many C corporations must use either the accrual method of accounting or a hybrid method. (See Section 3, below.)

However, most small businesses qualify to use the cash method instead if they are either:

- unincorporated with inventories but have annual gross receipts of less than $1 million, or
- corporations with annual gross receipts of less than $5 million.

The accrual method is contrary to most folks' way of thinking. With accrual accounting, income is treated as received when it is earned—regardless of when it is actually received. On the other side, an expense is recorded at the time the obligation arises—which is not necessarily when it is paid.

In accountant's lingo, business expenses and income accrue the moment they become "fixed." Accrued income and expenses must meet the "all events" test to become fixed. This means that everything required to earn the income, or to cause an expense to be owed, must have happened. At that point in time the income or expense becomes fixed, whether or not any cash has changed hands.

> **EXAMPLE:** George's Foundry, which uses the accrual method, receives a $4,500 deposit in 2005 for custom ironwork to be manufactured in 2006. George won't report $4,500 as income in 2005 because it hasn't been earned yet. On the expense side, if the foundry incurs a $250 charge in 2005 for lawyer's fees relating to the contract, it is accrued and tax deducted in 2005—even if not paid for until 2006.

Get help setting up accrual accounting. If you want or are required to use the accrual method, consult an accountant. One reason is that there are two inventory accounting methods (LIFO, "last in, first out," and FIFO, "first in, first out") to choose from. Discuss these choices with a CPA or enrolled agent who is familiar with your industry, whether it is a gas station, a loan company, or a medical practice.

3. Hybrid and Special Accounting Methods

It often makes sense to use a combination of the cash and accrual methods. For instance, Waldo's electronics store may sell and repair items. Waldo may use the cash method for repairs, but Waldo's inventory may be accounted for on an accrual basis. Both methods may be used simultaneously, creating a hybrid accounting system.

If Waldo's business grosses more than $5 million, he needs permission from the IRS to adopt a hybrid or special method of tax accounting. (See a tax pro or IRS Publication 538, *Accounting Periods and Methods*.) But if his gross receipts are less than $5 million, he doesn't need permission to adopt a hybrid or special method of tax accounting. (IRS Notice 2001-76.)

Other special accounting methods, beyond the scope of this book, apply to farmers and certain businesses working on long-term contracts, manufacturers, and building contractors.

4. Changing Accounting Methods

A business must choose an accounting method and tell the IRS which method it is using on its tax return (a box on the form must be checked).

You must use the same accounting method in all subsequent tax returns unless the IRS grants you permission to switch to another accounting method.

The IRS is concerned that whenever an accounting method is changed the business could obtain an unfair tax advantage—or some expenses or income could get "lost" in the transition.

To get IRS permission for changing methods, file Form 3115, *Application for Change in Accounting Method*. File it within 180 days before the end of the year for which you want to make the change. There is a $500 application fee, but the IRS may waive the fee in some circumstances. (See Rev. Proc. 97-27 or a tax pro for further details.)

Exception: If there is a fundamental change in the operation of your business—say, from selling goods to offering only services—then IRS permission is not required.

> **EXAMPLE:** Kate's Lamp Repair Service, which had been using the cash method, starts stocking and selling lamps. Kate now has an inventory, so she wants to use an accrual accounting method for her retail sales. She doesn't need to get permission from the IRS because there was a fundamental change in operation.

H. Accounting Periods: Calendar Year or Fiscal Year

All enterprises must keep their books based on accounting periods, called tax years. For individuals, the tax year is the same as the calendar year—starting on January 1 and ending on December 31. Most small businesses are required to use the calendar year, too.

Some enterprises may choose an alternative tax-reporting period called a fiscal year. This is defined as any one-year period that does not end on December 31.

A business notifies the IRS of its accounting period by checking the designated box on its annual tax return form. Once chosen, the accounting period usually cannot be changed without written approval from the IRS.

Regardless of which accounting tax year is used, a business's payroll taxes must be reported on a calendar year basis.

1. Calendar Year Period

Sole proprietors, partnerships, limited liability companies, S corporations, and personal service corporations must report as calendar-year entities unless they can convince the IRS they qualify to use a fiscal year. (See Section 2, below.)

2. Fiscal Year Period

Small enterprises may sometimes use a fiscal year instead of a calendar tax year. A fiscal year is a one-year period ending on the last day of any month except December.

Sole proprietors, partnerships, limited liability companies, S corporations, and personal service corporations can use a fiscal year only by showing the IRS a business reason for it, such as a cyclical or seasonal business—for instance, farming. For IRS permission, file Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year*. Consult an accountant first to see if using a fiscal year really makes sense.

Individual taxpayers are never allowed to report on a fiscal year basis.

3. Short Tax Years

A short tax year occurs when a business starts up during a calendar year on any day but January 1. For instance, if Sandra's Sunshades opens on July 15 and uses a calendar tax year reporting period, her first tax year is only five and a half months and ends on December 31. Likewise, a short year occurs if Sandra closes her doors at any time other than the year end.

A short tax year is significant because it requires Sandra to prorate certain tax deductions, such as depreciation of assets, to match the short period in that first or last year of operation.

Resources

- IRS Publication 552, *Recordkeeping for Individuals*. This publication is helpful especially if you are new in business or keeping your own books. It discusses kinds of records to keep and how long to keep them.
- IRS Publication 583, *Starting a Business and Keeping Records*; Publication 551, *Basis of Assets*; Publication 946, *How to Depreciate Property*; Publication 538, *Accounting Periods and Methods*; and Publication 535, *Business Expenses*. These booklets can get fairly technical, but if you are hungry for tax knowledge or are bent on preparing your own tax return, this is stuff you must know.
- *Keeping the Books*, by Linda Pinson (Dearborn Trade Publishing). A primer for those of you keeping your books without a computer.
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs Publishing). A wealth of practical record-keeping and accounting tips from a longtime CPA.
- *Business Owner's Guide to Accounting & Bookkeeping*, by Jose Placencia, Bruce Welge, and Don Oliver (Oasis Press). A more detailed and complex small business accounting book for those who are really serious about the subject.
- *Accounting and Recordkeeping Made Easy for the Self-Employed*, by Jack Fox (John Wiley & Sons). This book offers case studies, worksheets, and sample forms to help you work through basic accounting in a small business.
- Basic accounting system information is available free through the Small Business Administration (SBA). Send for the *Resource Directory for Small Business Management* from SBA, Mail Code 7111, 409 Third St., SW, Washington, DC 20416, or go to the SBA's website at www.sba.gov.

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CHAPTER

4

Business Losses and Failures

"There is no such thing as justice—in or out of court."

—Clarence Darrow

The term "risky business" comes to mind whenever I see another brave soul take the plunge into a new venture. Most operations lose money during their start-up phase. Some folks hang in there until the business turns the corner, while most others throw in the towel after a year or two. A majority will go under because they run out of cash, and a few do so badly that they will be forced to file for bankruptcy.

Fortunately, the tax code softens the blow for people who lose money in business. Congress evidently believes that one way to encourage new enterprises is to give a tax break to those who try. After all, when the business flourishes, the government shares in profits (through taxation), so why shouldn't it absorb part of the losses as well? The amount of tax relief from Uncle Sam, however, depends on things like whether your business is incorporated, and whether you are active in the business or just an investor.

Taking tax benefits from business losses is the subject of this chapter. By losses, we are not talking about bad debts that you incur when you don't get paid. That's covered in Chapter 1.

Business Losses in a Nutshell

1. The law limits some tax losses that can be claimed by owners and investors in a business.
2. Tax benefits for a business loss may depend on whether or not your business is incorporated, a sole proprietorship, LLC, or partnership.
3. Because a C corporation is a separate tax entity, its operating losses belong to the corporation, not the shareholders.
4. C corporation shareholders get a tax break for their business's losses only in the year that the corporation fails or when they sell their stock at a loss.

A. Unincorporated Business Losses

The tax law allows struggling sole proprietors, partners, limited liability company members, and shareholders of S corporations to reap a tax benefit from business losses. Complex rules dictate how much and when you can claim business operating losses.

1. Owners' Operating Losses

Owners of an unincorporated business—a sole proprietorship, partnership, or limited liability company—can claim their business operating losses on their annual individual tax returns.

This type of loss is called a net operating loss, or NOL. It occurs when a business's expenses and deductions are higher than its income.

An NOL can be used to offset your other income, which results in a tax savings. However, an NOL can't reduce your income to below zero for tax purposes. Instead, the law allows unused NOLs to be taken in other tax years, as we explain below.

> **EXAMPLE:** John Jones Hardware, a sole proprietorship, shuts its doors in 2006. The business had profits in its first two years, 2004 and 2005, but lost $100,000 in its third and final year of operation. In 2006, John's wife, Jean, worked at the phone company to keep the family afloat and earned $25,000. The Joneses also sold mutual funds they had owned for several years at a $10,000 gain, so their total family taxable income was $35,000. The Joneses can claim $35,000 of the hardware store net operating loss on their tax return in 2006. The balance of $65,000 must be used to offset income in other tax years.

The following is a summary of the NOL rules for most small businesses. Special provisions for farming aren't covered here.

- An NOL is first taken to offset your other income in the year it occurred.
- For losses from 2003 and later, if the loss exceeds your other income for the year, you can amend tax returns from the past two years to get a tax refund. This is called an NOL carry-back.
- If there's still more unused loss, you can carry the loss forward for 20 years. The overall effect can be to spread out the tax benefit of business losses over many years. This is called an NOL carry-forward.

EXAMPLE: Harry started Nebula Graphic Designs in 2005, and his expenses exceeded his gross receipts by $40,000 that year. On the side, Harry worked as a printer's representative, netting $12,000 in commissions. Harry can claim $12,000 of the business operating loss to wipe out his commission income in 2005. Then Harry can carry the balance of the net operating loss of $28,000 back two years by amending his past tax returns. If he still has any unused loss, Harry can keep claiming the loss against income until it is fully used up or until the 20-year period expires in 2025.

How to claim your business operating losses. You must notify the IRS on your Form 1040 tax return that you intend to carry over your outfit's net operating loss. Either attach a written statement to the loss year's tax return, or attach IRS Form 3621, *Net Operating Loss Carry-Over*. This form also shows how much loss is left over after the first tax year. See a tax pro if you're not sure what to do or see IRS Publication 536 for more information on NOLs.

2. Investors' Operating Losses

If you are an investor in someone else's sole proprietorship, partnership, or limited liability company, the tax result of an operating loss is not pretty. An investor is *not* entitled to any tax benefit from operating losses of an *ongoing* business. Sorry—it's the law.

However, if the venture goes bust, you may be able to claim a capital loss. Capital losses are deducted from your capital gains, if any. (A capital gain results from an investment held for more than one year before it is sold—for example, an $8,000 capital gain from selling Microsoft stock which was bought three years earlier.)

Any *excess* capital loss (after offsetting your capital gain) can then be deducted against ordinary income (compensation earned from your labor), but only up to $3,000 in any year.

Any capital loss left over can be carried forward in future years (at $3,000 per year), until your death. (You *cannot* carry the investment loss back to prior years.) If we've lost you, here's an example:

EXAMPLE 1: Jake and Mona Willow invest $45,000 in Jake Jr.'s digital imaging business. The business fails, and the Willows lose their entire investment—a $45,000 capital loss. If they have other income but no capital gains to offset this loss, it will take them 14 more years (at $3,000 per year) to deduct the whole amount.

EXAMPLE 2: As in the above example, the Willows lose their entire $45,000 investment in 2006. They deduct $3,000 as a tax loss against their ordinary income in 2006. Then, in 2007, the Willows sell Microsoft stock, realizing an $8,000 capital gain. In 2007, they can claim $11,000 of the investment loss from Jake Jr.'s digital imaging business (the $8,000 capital gain plus $3,000 of ordinary income from their jobs). After taking $3,000 as a tax loss in 2006 and $11,000 in 2007, the Willows have $31,000 in capital losses to claim in 2008 and beyond. They can deduct only $3,000 per year, unless they have some more capital gains in the future, like their sale of Microsoft stock.

There is a way to get beyond the $3,000 annual loss limitation—if the business is incorporated. See Section B, below.

3. Additional Tax Rules for Losses That Might Limit Your Loss Deductions

In addition to the normal tax rules for deducting operating business losses (NOLs), there are three more hurdles to clear before you get a tax break. However, with the possible exception of the hobby loss rules, none of these laws affect most small-time operators, so we won't go into much detail about them.

- **Hobby loss rules.** You cannot deduct an NOL from a venture unless it was operated with a profit motive—in other words, if it was a true business that you were trying to make income from, rather than just a hobby. (See Chapter 13, Microbusinesses and Home-Based Businesses, for a full explanation of how this rule works.) This tax law is aimed mainly at folks who race cars or yachts, or breed show horses and then claim tax loss benefits—but the IRS uses it to go after common folk as well.
- **At-risk rules.** You may deduct no more than your economic investment in the venture. This law targets so-called tax shelter investments.

  EXAMPLE: In exchange for a one-third partnership interest, Manny puts $5,000 cash into ABC Partners along with a $10,000 promissory note—a promise to put more money into the partnership in the future. Manny doesn't ever pony up the additional $10,000 and the business goes belly up. Manny's tax loss is limited to $5,000, not $15,000, under the at-risk rules.
- **Passive activity loss rules.** Do you have ownership in, but do not materially participate in, a business venture? Welcome to the complicated passive activity loss rules. In essence, nonworking investors may not deduct an operating loss from the business in excess of the income produced.

EXAMPLE: ABC partnership takes in $30,000, but spends $40,000 (the business loses $10,000). Manny, a nonworking one-third partner, doesn't get to claim a loss of $3,333 on his tax return. (Note: There are different passive activity rules for closely held C corporations and for rental real estate investments. Both of these topics are beyond the scope of this book.)

B. Incorporated Business Losses

Can tax benefits from a small business corporation's losses be taken by the shareholders individually or only by the corporation? The answer depends on several factors, discussed below.

1. Shareholder Losses

If you incorporate, one tax code provision to know by number is IRC § 1244. This provision allows shareholders in small business corporations—whether active in the business or not—to more quickly deduct their investment loss if the business fails or when they sell their stock.

IRC § 1244 allows individual shareholders to take losses *beyond* the $3,000 annual limit that normally applies to individual investors. (See Section A, above.) Section 1244 allows a tax loss of up to $100,000 (for a married couple filing jointly or a single taxpayer), or $50,000 for a married person filing separately. The loss is claimed on the Form 1040 tax return for the year of the loss, reducing or eliminating their tax bill.

Also, any excess loss (over $100,000) can be carried forward and claimed in future years. However, for future years, the regular $3,000 per year limit applies. Over $3,000, the loss can be used only to offset any capital gains from investments, not ordinary income from earnings.

EXAMPLE: Gordon and Joella Hall buy $150,000 in stock in LowTech, a Section 1244 corporation. LowTech does poorly (customers apparently wanted high-tech), and the Halls sell their stock for $20,000, losing $130,000 of their investment. The Halls have other income of $100,000 that year, so they can offset $100,000 of their $130,000 loss as a tax loss.

The remaining $30,000 of the Halls' loss is classed as a capital loss carryforward and can be claimed on the Halls' future tax returns. However, if the Halls don't have any capital gains in future years to absorb the loss carryforward, they are limited to an annual loss deduction of $3,000 per year. In this case, it takes the Halls ten years to use up the excess capital loss of $30,000.

IRC § 1244 only applies if, when the corporation was formed, the total money or property it received in return for stock was less than $1 million.

Make sure your corporation qualifies for Section 1244 treatment. Your corporation must pass a resolution stating its intent to be a Section 1244 corporation when it is made. The details are in Chapter 7, Section E.

a. How to Claim a Section 1244 Loss

If you take a loss under IRC § 1244, you must file a statement with your individual tax return telling the IRS you are claiming the loss. If the IRS audits you and finds that IRC § 1244 wasn't applicable, your loss is treated under the capital loss rules discussed in Section A, above. This means you wouldn't be able to take your loss against ordinary income beyond the $3,000 capital loss annual limit. (See the example above.)

b. Related Party Rule

Sales of Section 1244 stock between related parties are suspect to the IRS. So, if you claim a tax loss from a transaction with someone related to you, an IRS auditor may disallow it. Related parties are parents, children, and in-laws, as well as other businesses controlled by family members.

To be safe, sell stock to nonrelatives. For instance, if the corporation stock you own is worthless, sell it to a friend for a dollar. Your buddy has nothing to lose by helping you out—except the dollar.

2. C Corporation Operating Losses

C corporation shareholders cannot claim operating losses on their individual tax returns. The losses are locked in the C corporation, because it is a separate tax entity from its shareholders.

Instead, corporations themselves can claim a tax loss. For instance, if corporate income taxes are paid in one year, they can be refunded in a future year that the corporation loses money. This is called a corporate net operating loss (NOL).

Alternatively, a corporate NOL can be carried back to get refunds of corporate income taxes paid in the past.

How to get your corporate tax refund. The fastest way to get a C corporate tax refund is to file IRS Form 1139, *Corporation Application for Tentative Refund*. The IRS is required to act within 90 days and issue a refund. However, if your corporation hasn't yet filed its prior year's tax return, use Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback*, instead.

Resources

All of the following IRS publications shed light on the topic of reaping tax benefits from business losses.

- IRS Publication 550, *Investment Income and Expenses*.
- IRS Publication 925, *Passive Activity and At-Risk Rules*.
- IRS Publication 536, *Net Operating Losses*.
- IRS Publication 541, *Partnerships*.
- IRS Publication 908, *Bankruptcy Tax Guide*.
- IRS Publication 3991, *Highlights of the Job Creation and Worker Assistance Act of 2002*. This pub covers the net operating loss rules created by Congress in early 2002.

■

CHAPTER

5

Tax Concerns of Employers

"If there isn't a law, there will be."

—Harold Farber

Chances are, if your venture is successful, you won't be able to do it alone. Hiring workers carries a whole new set of tax responsibilities. With employees, the IRS (and your state) will be looking over your shoulder to see if you are filing payroll tax returns and making employer's tax deposits.

Every employer must:

- withhold payroll taxes from employees' wages
- remit withheld employee taxes, together with the business's share of employment taxes, to the IRS and the state, and
- make periodic employment tax reports to the IRS (IRC § 3509) and the state.

According to the IRS, the majority of small businesses fall behind in filing reports or making federal tax deposits. While many delinquencies are oversights—like missing a deadline—others reflect poor financial management or misunderstanding of employer tax obligations.

It is tempting, in a cash crunch, to pay rent, utilities, and key suppliers instead of making a payroll tax deposit. Folks rationalize that since it takes the IRS months (if not years) to find out, employment taxes can wait. Not true.

Pay your payroll taxes, in full and on time. If you don't, the IRS will knock at the door, and it won't be a tap. The IRS tacks on interest and large penalties to delinquent payroll taxes. The bill can skyrocket so fast that businesses often fail as a result. And unlike ordinary debts, payroll taxes survive the death of the business or bankruptcy of the enterprise. Payroll taxes are also personal liabilities of business owner(s).

Using independent contractors instead of employees avoids payroll taxes and paperwork hassles. Contractors make quarterly estimated tax payments to the IRS and pay the self-employment tax. (See Chapter 6.) However, the IRS or your state may audit you to see if anyone you call an independent contractor rather than an employee is classified correctly. If you lose, the consequences can be very expensive, as we shall see in Section D, below.

Checklist for Employers

- ☐ Obtain a federal employment identification number by filing IRS Form SS-4 (if you don't already have one).
- ☐ Register with your state's employment department or similar agency for payment of unemployment compensation taxes.
- ☐ Have each employee fill out IRS Form W-4, *Employee's Withholding Allowance Certificate*.
- ☐ Set up a payroll system for withholding taxes and making regular payroll tax payments to the IRS.
- ☐ File IRS Form 941, *Employer's Quarterly Federal Tax Return*, after the end of each quarter.
- ☐ File IRS Form 940 or 940-EZ to report your federal unemployment tax each year.
- ☐ File a Form W-2 for each employee annually to report wages.
- ☐ File a Form 1099-MISC to report the wages for each independent contractor to whom you pay over $600.
- ☐ Familiarize yourself with the difference between independent contractors and employees. IRS auditors are on the alert for businesses that misclassify workers as independent contractors, and they can levy heavy penalties on violators.

A. Taxpayer Identification Numbers

If your business is a sole proprietorship with employees or if you are a partnership, limited liability company, or corporation, you must get a federal employer identification number (EIN). You will use this number on all business-related forms you send to the IRS.

To get an EIN, send IRS Form SS-4, *Application for Employer Identification Number,* to the IRS address in the instructions to the form. This form is in the appendix of this book, on the IRS's website at www.irs.gov, or at all IRS and Social Security offices. There is no charge to get an EIN.

If you apply for your EIN by mail, it usually takes several weeks to process your application. If any tax filings are due before you get your number back, write "applied for" on the filing in the space for the EIN.

Get an EIN fast. Call the IRS at 866-816-2065 and request an EIN (make sure you fill out the form first; you'll have to read the answers over the phone). You will then mail the filled-out SS-4 form to the IRS.

If you have more than one business, you need a different EIN for each. If you change the form of your entity, such as from a sole proprietorship to a corporation, or from a partnership to a limited liability company, you must get a new EIN.

B. Payroll Taxes

The term payroll taxes covers three different taxes that every employer is responsible for:

- **Income tax.** Owners must withhold the proper amount of income tax from each employee's paycheck throughout the year.

  By January 31 of each year, owners must send an IRS W-2 form to each employee showing the total payments and tax withholdings from their wages in the previous year.

  By February 28, employers must file IRS Form W-3 (summary and transmittal form) and copies of all the W-2s to the Social Security Administration.

  IRS Publications 15 and 15A, *Circular E, Employers' Tax Guide,* show you how to figure tax withholding for employees, and Form W-4 (*Employee's Withholding Allowance Certificate*) shows how much to withhold from employees' paychecks for federal income tax purposes. But one look at Circular E (64 pages of fine print) might convince you to hire a payroll tax service or get your accountant to do the calculations and prepare the forms.
- **Social Security and Medicare tax (FICA).** Owners must withhold the employee's share of FICA taxes from each paycheck, and must match this amount. The total FICA tax rate is 15.3% of wages paid up to $90,000 (in 2005). All income over this amount is taxed and withheld at 2.9% for Medicare.
- **Federal Unemployment Tax (FUTA).** This tax goes to the unemployment insurance system and is paid by the employer. The employee pays no part of FUTA. The maximum FUTA is $56 per employee per year. A credit toward FUTA is allowed for any state unemployment taxes paid, but you don't get any credit unless you paid the state unemployment tax on time. (A sample form 940-EZ follows.)

States Have Payroll Taxes, Too

Most states that tax income also require employers to withhold employees' taxes, similar to the federal law. Some cities, such as New York City, have payroll taxes, too. Also, all states impose unemployment taxes, which can be significant. Check with your state's unemployment tax agency for your state's rate.

Verify Social Security numbers. Workers do not always give their correct Social Security numbers when filling out a Form W-4. Employers should call the Social Security Administration (SSA) to verify the the worker's correct number. You can contact the SSA at 800-772-1213.

Form **SS-4**
(Rev. December 2001)
Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

► See separate instructions for each line. ► Keep a copy for your records.

EIN

OMB No. 1545-0003

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested
Alpha Bean Cromwell

2 Trade name of business (if different from name on line 1)
ABCD Plumbing

3 Executor, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box)
1234 Rooter Place

5a Street address (if different) (Do not enter a P.O. box.)
1234 Rooter Place

4b City, state, and ZIP code
Nowheresville, CA 95555

5b City, state, and ZIP code
Nowheresville, CA 95555

6 County and state where principal business is located
Somewhere, California

7a Name of principal officer, general partner, grantor, owner, or trustor
Alpha Bean Cromwell

7b SSN, ITIN, or EIN

8a Type of entity (check only one box)
- [X] Sole proprietor (SSN) 555 55 5555
- [ ] Partnership
- [ ] Corporation (enter form number to be filed) ►
- [ ] Personal service corp.
- [ ] Church or church-controlled organization
- [ ] Other nonprofit organization (specify) ►
- [ ] Other (specify) ►
- [ ] Estate (SSN of decedent)
- [ ] Plan administrator (SSN)
- [ ] Trust (SSN of grantor)
- [ ] National Guard
- [ ] State/local government
- [ ] Farmers' cooperative
- [ ] Federal government/military
- [ ] REMIC
- [ ] Indian tribal governments/enterprises

Group Exemption Number (GEN) ►

8b If a corporation, name the state or foreign country (if applicable) where incorporated — State — Foreign country

9 Reason for applying (check only one box)
- [X] Started new business (specify type) ►
- [ ] Hired employees (Check the box and see line 12.)
- [ ] Compliance with IRS withholding regulations
- [ ] Other (specify) ►
- [ ] Banking purpose (specify purpose) ►
- [ ] Changed type of organization (specify new type) ►
- [ ] Purchased going business
- [ ] Created a trust (specify type) ►
- [ ] Created a pension plan (specify type) ►

10 Date business started or acquired (month, day, year)
1/01/01

11 Closing month of accounting year
December

12 First date wages or annuities were paid or will be paid (month, day, year). **Note:** *If applicant is a withholding agent, enter date income will first be paid to nonresident alien. (month, day, year)* . . . ► N/A

13 Highest number of employees expected in the next 12 months. **Note:** *If the applicant does not expect to have any employees during the period, enter "-0-."* . . . ►

Agricultural	Household	Other
	0	1

14 Check **one** box that best describes the principal activity of your business.
- [ ] Construction
- [ ] Rental & leasing
- [ ] Transportation & warehousing
- [ ] Health care & social assistance
- [ ] Wholesale–agent/broker
- [ ] Real estate
- [ ] Manufacturing
- [ ] Finance & insurance
- [ ] Accommodation & food service
- [ ] Wholesale–other
- [ ] Retail
- [X] Other (specify) Plumbing

15 Indicate principal line of merchandise sold; specific construction work done; products produced; or services provided.
Plumbing

16a Has the applicant ever applied for an employer identification number for this or any other business? . . . . . [ ] **Yes** [X] **No**
Note: *If "Yes," please complete lines 16b and 16c.*

16b If you checked "Yes" on line 16a, give applicant's legal name and trade name shown on prior application if different from line 1 or 2 above.
Legal name ► Trade name ►

16c Approximate date when, and city and state where, the application was filed. Enter previous employer identification number if known.
Approximate date when filed (mo., day, year) | City and state where filed | Previous EIN

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name — Designee's telephone number (include area code) ( )

Address and ZIP code — Designee's fax number (include area code) ( )

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Name and title (type or print clearly) ► Alpha Bean Cromwell

Applicant's telephone number (include area code) (415) 555-5555

Signature ► *Alpha Bean Cromwell* Date ► 1/1/xx

Applicant's fax number (include area code) (415) 666-6666

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form **SS-4** (Rev. 12-2001)

1. Reporting and Depositing Payroll Taxes

Generally, you must pay each employee's withheld income and FICA taxes to the IRS monthly. You can make federal tax deposits at specified banks. (But if the total owed is $2,500 or less, the deposits are due quarterly.) An IRS federal tax deposit coupon (Form 8109-B) must be submitted with each payroll tax payment.

If your total annual payroll tax obligation exceeds $200,000, you must make electronic deposits. Call the IRS at 800-555-4477 or 800-945-8400 for details, or see IRS Publication 966, *Electronic Federal Tax Payment System*. Alternatively, a private payroll service can set this up for your business.

Form 941, *Employer's Quarterly Federal Return.* Income and FICA tax deposits are reported to the IRS on Form 941, *Employer's Quarterly Federal Tax Return*. This form is due one month after the end of each calendar quarter. Form 941 shows how many employees you had in that quarter, how much you paid them, and the amount of Social Security, Medicare, and federal income tax withheld during the three-month period. (A sample Form 941 follows.)

Alternatively, you can file Form 941 Telefile by using a touch-tone telephone. Call the IRS at 800-829-1040 or visit the IRS's website at www.irs.gov for more information.

Form 940, *Employer's Annual Federal Unemployment Tax Return.* There is also an annual unemployment tax report detailing FUTA taxes due (Form 940 or 940-EZ). This form shows how much federal unemployment tax (FUTA) is owed. Most states also have unemployment tax.

2. Personal Responsibility for Payroll Taxes

Payroll tax obligations are based on a trust fund theory. The employer acts as a tax collector by holding employees' taxes in trust until they are paid to the IRS. Violation of this trust can bring on both civil and criminal punishments to the employer.

Although the IRS seldom throws anyone in jail, it can—and often does—seize a business's assets and force it to close down if it owes back payroll taxes.

The IRS (and most states) can hold people associated with a small business corporation *personally responsible* for payment if the operation fails to meet its payroll tax obligations.

a. Trust Fund Recovery Penalty

Anyone found responsible for not paying payroll taxes has the trust fund portion of unpaid payroll taxes treated as a personal debt.

The trust fund portion is the income tax that should have been withheld from an employee's wages, *plus* one-half of the FICA tax (7.65% of the first $90,000 (in 2005) of wages paid). The other half of the FICA tax (7.65%) and the employer's federal unemployment tax (FUTA) are not trust fund taxes, and so are not personal debts.

To hold you *personally* liable for the trust fund recovery penalty (TFRP), the IRS must find that: (1) you were responsible for making the missed payments, and (2) you acted willfully in not seeing that payroll tax obligations were paid. Business owners are almost always held personally responsible for unpaid payroll taxes.

The IRS has ten years to collect these taxes after they become due. This is true whether the debtor is a business or individual. (IRC § 6502.) The IRS can seize almost anything you own: bank accounts, wages, cars, even your home. You can't wipe out a payroll tax debt even with bankruptcy.

b. How the IRS Determines Responsibility

If an employee or tax pro screws up—or worse, steals the money that should have gone to the government—the owner(s) is still on the hook. Legally, whoever chose the person responsible for tax reporting and paying has the duty of supervising them. (On rare occasions, however, an owner of a business can get off the hook if the IRS finds that someone else acted without the owner's knowledge.)

Form **941 for 20XX: Employer's Quarterly Federal Tax Return** 9901

(Rev. January 2005) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

Employer identification number 00–1234567

Name *(not your trade name)* Rock E. Roader

Trade name *(if any)* Congo Cone Creamery

Address 777 Milky Way

Number Street Suite or room number

Vanilla Bean VA 23001

City State ZIP code

Report for this Quarter ...
(Check one.)

- [X] **1:** January, February, March
- [ ] **2:** April, May, June
- [ ] **3:** July, August, September
- [ ] **4:** October, November, December

Read the separate instructions before you fill out this form. Please type or print within the boxes.

Part 1: Answer these questions for this quarter.

1 Number of employees who received wages, tips, or other compensation for the pay period including: *Mar. 12* (Quarter 1), *June 12* (Quarter 2), *Sept. 12* (Quarter 3), *Dec. 12* (Quarter 4)	1	two
2 Wages, tips, and other compensation	2	19,500.
3 Total income tax withheld from wages, tips, and other compensation	3	3,220.
4 If no wages, tips, and other compensation are subject to social security or Medicare tax		☐ Check and go to line 6.

5 Taxable social security and Medicare wages and tips:

	Column 1		*Column 2*
5a Taxable social security wages	19,500.	× .124 =	2,418.
5b Taxable social security tips	.	× .124 =	.
5c Taxable Medicare wages & tips	19,500.	× .029 =	565.50

5d Total social security and Medicare taxes (*Column 2,* lines 5a + 5b + 5c = line 5d)	5d	2,983.50
6 Total taxes before adjustments (lines 3 + 5d = line 6)	6	6,203.50
7 Tax adjustments (If your answer is a negative number, write it in brackets.):		
7a Current quarter's fractions of cents		.
7b Current quarter's sick pay		.
7c Current quarter's adjustments for tips and group-term life insurance		.
7d Current year's income tax withholding (Attach Form 941c)		.
7e Prior quarters' social security and Medicare taxes (Attach Form 941c)		.
7f Special additions to federal income tax (reserved use)		.
7g Special additions to social security and Medicare (reserved use)		.
7h Total adjustments (Combine all amounts: lines 7a through 7g.)	7h	.
8 Total taxes after adjustments (Combine lines 6 and 7h.)	8	6,203.50
9 Advance earned income credit (EIC) payments made to employees	9	.
10 Total taxes after adjustment for advance EIC (lines 8 – 9 = line 10)	10	6,203.50
11 Total deposits for this quarter, including overpayment applied from a prior quarter	11	6,203.50
12 Balance due (lines 10 – 11 = line 12) Make checks payable to the *United States Treasury*	12	.
13 Overpayment (If line 11 is more than line 10, write the difference here.)	.	Check one ☐ Apply to next return. ☐ Send a refund.

Next ➔

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 1-2005)

9902

Name *(not your trade name)*	Employer identification number

Part 2: Tell us about your deposit schedule for this quarter.

If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see *Pub. 15 (Circular E)*, section 11.

14 [V] [a] **Write the state abbreviation for the state where you made your deposits** OR **write "MU" if you made your deposits in *multiple* states.**

15 Check one: ☐ **Line 10 is less than $2,500.** Go to Part 3.

☐ **You were a monthly schedule depositor for the entire quarter. Fill out your tax liability for each month.** Then go to Part 3.

Tax liability:		
	Month 1	2,067.83
	Month 2	2,067.33
	Month 3	2,067.34
	Total	6,203.50

Total must equal line 10.

☐ **You were a semiweekly schedule depositor for any part of this quarter.** Fill out *Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors*, and attach it to this form.

Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.

16 If your business has closed and you do not have to file returns in the future . . . . ☐ Check here, and

enter the final date you paid wages [/ /].

17 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . ☐ Check here.

Part 4: May we contact your third-party designee?

Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.

☐ Yes. Designee's name

Phone ( ) – Personal Identification Number (PIN)

☐ No.

Part 5: Sign here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

X Sign your name here *Rock E. Roader*

Print name and title Rock E. Roader

Date 04/10/20xx Phone (555) 555 – 5555

Part 6: For paid preparers only *(optional)*

Preparer's signature

Firm's name

Address EIN

ZIP code

Date / / Phone ( ) – SSN/PTIN

☐ Check if you are self-employed.

Form **940-EZ**

Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

► See the separate Instructions for Form 940-EZ for information on completing this form.

OMB No. 1545-1110

20XX

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You must complete this section. ►

Name (as distinguished from trade name): Peter Cone

Calendar year: 20xx

Trade name, if any

Employer identification number (EIN): 1234567

Address (number and street): 362 Main Street

City, state, and ZIP code: Pine, VA 23000

Answer the questions under ***Who May Use Form 940-EZ*** *on page 2. If you cannot use Form 940-EZ, you must use Form 940.*

A Enter the amount of contributions paid to your state unemployment fund (see the separate instructions) . . ► $ 630.00

B (1) Enter the name of the state where you have to pay contributions . . . . ► Virginia

(2) Enter your state reporting number as shown on your state unemployment tax return ► 0-0000000-0

If you will not have to file returns in the future, check here (see **Who Must File** in separate instructions) **and complete and sign the return.** ► ☐

If this is an Amended Return, check here (see **Amended Returns** in the separate instructions) . . . . ► ☐

Part I — Taxable Wages and FUTA Tax

1	Total payments (including payments shown on lines 2 and 3) during the calendar year for services of employees	1	78,000.00
2	Exempt payments. (Explain all exempt payments, attaching additional sheets if necessary.) ►	2	
3	Payments of more than $7,000 for services. Enter only amounts over the first $7,000 paid to each employee **(see the separate instructions)**	3	57,000.00
4	Add lines 2 and 3	4	57,000.00
5	**Total taxable wages** (subtract line 4 from line 1) ►	5	21,000.00
6	**FUTA tax.** Multiply the wages on line 5 by .008 and enter here. **(If the result is over $100, also complete Part II.)**	6	168.00
7	Total FUTA tax deposited for the year, including any overpayment applied from a prior year	7	149.60
8	**Balance due** (subtract line 7 from line 6). Pay to the "United States Treasury." ► If you owe more than $100, see **Depositing FUTA tax** in the separate instructions.	8	18.40
9	**Overpayment** (subtract line 6 from line 7). Check if it is to be: ☐ **Applied to next return** or ☐ **Refunded** ►	9	

Part II — Record of Quarterly Federal Unemployment Tax Liability (Do not include state liability.) **Complete only if line 6 is over $100.**

Quarter	First (Jan. 1 – Mar. 31)	Second (Apr. 1 – June 30)	Third (July 1 – Sept. 30)	Fourth (Oct. 1 – Dec. 31)	Total for year
Liability for quarter	149.60	18.40	0	0	168.00

Third-Party Designee

Do you want to allow another person to discuss this return with the IRS (see the separate instructions)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ► Phone no. ► ( ) Personal identification number (PIN) ►

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and, to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees.

Signature ► Peter Cone Title (Owner, etc.) ► Owner Date ► 1/25/xx

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. ▼ DETACH HERE ▼ Cat. No. 10983G Form **940-EZ** (2004)

Form **940-V(EZ)**

Department of the Treasury
Internal Revenue Service

Payment Voucher

Use this voucher only when making a payment with your return.

OMB No. 1545-1110

20XX

Complete boxes 1, 2, and 3. Do not send cash, and do not staple your payment to this voucher. Make your check or money order payable to the "United States Treasury." Be sure to enter your employer identification number (EIN), "Form 940-EZ," and "2004" on your payment.

1 Enter your employer identification number (EIN).

2 **Enter the amount of your payment.** ► Dollars Cents

3 Enter your business name (individual name for sole proprietors).

Enter your address.

Enter your city, state, and ZIP code.

When it comes to pinning on the personal responsibility tag, the IRS does not always stop with the head people. Nonowner employees, such as a bookkeeper or office manager, can also be held responsible. Even outside accountants and attorneys for the business can be tagged.

Because the IRS is eager to find as many people responsible as possible, its agents are given wide latitude in assigning personal responsibility. The IRS may question anyone to find out who is to blame for the missed payments and filings.

The IRS looks at a number of factors:

- Who made the business's financial decisions?
- Who signed, or had authority to sign, checks? (This is the factor the IRS seems most impressed with.)
- Who had power to direct payment (or nonpayment) of bills?
- Who had the duty of tax reporting?
- Was the nonpayment willful?

Willfulness is mainly what the IRS is searching for. You were willful if you knew payroll taxes were owed and didn't do anything about it—even if you never intended to cheat the IRS.

Protect yourself from co-owners' misdeeds. If you share financial responsibilities with others—that is, you're a partner, LLC member, or corporation shareholder—get a written agreement with the other owners that contains a payroll tax indemnification clause. This obligates your co-owners to reimburse any payroll tax penalty assessed against you personally, plus any costs of fighting the IRS.

A suitable clause looks like this:

"All co-owners (or shareholders) agree to indemnify any of the others that may be held liable for any unpaid payroll tax liabilities of the business that are proposed or assessed against them personally, together with legal costs in contesting the taxes, except amounts in proportion to their ownership (shares) in the business."

Even with this indemnification clause, you are still liable to the IRS for the whole thing if the others don't pay. This clause simply requires them to pay you back some of what the IRS takes out of your hide. It helps as long as the other owners are still solvent (or become so).

c. If You Are Found Personally Liable for Payroll Taxes

If you are found personally liable for payroll taxes, you may appeal. (Maybe you don't believe you are liable, or you just want to delay the collection process.) IRS appeals officers can reverse a TFRP finding. And if you lose the IRS appeal, you may take the IRS to court. (See Chapter 20, Appealing IRS Audits.)

Payroll taxes cannot be legally discharged in bankruptcy. You will either have to pay, or live with a payroll tax debt hanging over your head for ten years (when the statue of limitations for collection runs out).

One way to reduce a payroll tax debt is through a negotiation process called an offer in compromise. The IRS will sometimes accept a compromise offer if it is convinced that you don't have the assets or adequate income to pay in full. (See Chapter 18, When You Can't Pay Your Taxes.)

3. If You Get Behind on Payroll Tax Payments

If your enterprise gets behind in payroll taxes, you need to catch up as fast as possible.

a. Pay Current Taxes First

If you can't pay all past and present payroll taxes, first make payments due for the *current* tax quarter—if you still have employees. Then start paying the delinquent payroll taxes. Paying current quarterly taxes on time stops interest and heavy penalties from accumulating. Perhaps more important, the IRS is much more likely to work with you on past delinquencies if you've made your current quarter's payroll tax deposits.

b. Designate Late Payments

Whenever paying *past due* employment taxes, tell the IRS specifically how you want back payments credited—the type of tax and tax periods. This is called designating the application of your payments. Designating ensures payments don't get misapplied to a different tax period or account. Also, if the payments don't cover the whole tax bill—which is frequently the case—state that you want the trust fund portion of payroll taxes credited first.

Here's how to designate your payments:

Step 1. Write a letter, like the one below, to the IRS office where you file your employment tax returns. If you're in doubt as to where to send it, call the IRS at 800-829-1040 to speak to a taxpayer service representative.

Sample Letter to the IRS

XYZ CORPORATION

September 15, 2007

Dear IRS:

Please apply the enclosed payment of $1,529 to the account of XYZ Corporation, EIN 94-5555555, for payroll tax Form 941 liability, 3rd Quarter of 2006. Apply to trust fund portion only.

Yours truly,

Sandra Shoestein

Sandra Shoestein, President

Encl. Check

Step 2. Enclose your check. Write in the lower left-hand corner: "Apply to trust fund portion only." Under this, write your employer identification number, the tax type, and the period the payment is for, such as: "EIN 94-5555555, for payroll tax Form 941 liability, 3rd quarter 2006."

Step 3. Send the letter and check to the IRS by certified mail.

Inspect your IRS payroll tax records. To find out if the IRS has given you proper credit for all your payroll tax payments, order a printout of your account. Call the IRS at 800-829-1040 and ask for your "BMF," or business master file. Tell them the specific tax periods you want, such as "3rd and 4th quarters of 2006." You should receive this information by mail within two weeks. Compare the IRS records with yours. If the printout is too full of strange codes, call the IRS to ask for an explanation, or show it to a tax pro.

C. Classifying Workers: Employee or Independent Contractor?

Individuals performing services for your business are usually tax code classified as either regular *employees* or *independent contractors* (meaning self-employed for tax purposes).

A small percentage of people are in one of two other categories: statutory employees or statutory nonemployees. We talk about these classifications below.

All of these distinctions are very important to the IRS, and it can be costly if you don't pay attention to them.

1. Reporting Payments to Independent Contractors

Business owners have payroll tax withholding and reporting obligations for all of their employees. Employees' earnings are reported to the IRS on quarterly Form 941s and again on W-2 forms issued at the end of the year to each employee.

On the other hand, with a true independent contractor, business owners don't have to withhold or report payroll taxes. Business owners' only reporting duty to the IRS is to issue a Form 1099 once a year to each worker. There are 11 versions of Form 1099; the 1099-MISC is the one you issue to independent contractors.

Don't report independent contractor payments to the IRS if (1) you pay an independent contractor less than $600 a year, (2) the services were performed for you personally and not for your business, or (3) the independent contractor is incorporated.

See Section E, below, for the filing deadlines and details on reporting workers to the IRS.

Using an independent contractor saves time complying with IRS reporting requirements. It also saves money—you don't have to make the employer's share of the FICA contributions of 7.65% for each worker. You won't have to pay unemployment compensation tax (FUTA), either. But the IRS is *very aware* of the benefits of misclassifying an employee as an independent contractor, and has wide powers to make life miserable for all those it catches doing it. (See Section D, below.)

Are business owners employees? Sole proprietors, limited liability company members, and partners are neither employees nor independent contractors of the business. These owners don't have to fool with payroll tax withholding and paying. Instead, the owners mail quarterly estimated taxes to the IRS. (See Chapter 6, Section D.) However, working shareholders/owners of corporations—C or S corporations—*are* employees and subject to payroll tax rules.

2. Worker Classifications

No other classifications of workers are recognized by the IRS. Many employers mistakenly believe that a short-term worker is not an employee. Maybe, but whether part-time or temporary, called a consultant or subcontractor, a worker must fit into one of the four categories discussed below.

a. Employees

Anyone performing services controlled by an employer (that is, what work will be done and how it will be done) is termed a common law employee, or just plain employee. Even if an employer doesn't actually exercise control, but has the legal *right* to control the method and result of the work done, there's an employer-employee relationship.

Here are more factors that tend to show the IRS a worker is a common law employee:

- The worker follows instructions about when, where, and how to work.
- The worker is trained by the employer to perform services in a particular manner.
- The worker's services are integrated into the business operation, or a continuing relationship exists.
- The worker renders services personally (she can't subcontract work out to someone else).
- Assistants are hired by the business, not the worker.
- The worker has set hours.
- The worker devotes substantial time to the employer.
- Work is done on business premises.
- The worker submits reports regularly.
- The worker is paid by the hour, week, or month, unless these are installments of a lump sum amount agreed to for the job.
- The business pays the worker's business or travel expenses.
- The business furnishes tools, equipment, and materials.
- The business can fire the worker, and the worker has the right to quit, at will.

b. Independent Contractors

Folks in business for themselves who are not subject to control by those who pay them are *independent contractors*, not employees.

When you hire an independent contractor to accomplish a task for your business, you don't have an employer-employee relationship and, therefore, don't have to withhold and pay employment taxes. Independent contractors are responsible for their own tax reporting and are treated as business owners themselves.

The IRS says these factors tend to show a person is an independent contractor:

- The worker hires, supervises, and pays her own assistants.
- The worker is free to work when and for whom she wants.
- The work is done on the worker's premises.
- The worker is paid by the job or on straight commission.
- The worker has the risk of profit or loss.
- The worker does work for several businesses at one time.
- The worker's services are available to the general public.
- The worker can't be terminated early, except for breach of contract.

See IRS Publication 15A, *Employer's Supplemental Tax Guide*, for more help on distinguishing independent contractors from employees.

c. Statutory Employees

Federal law automatically classifies some workers as statutory employees. (IRC § 3121(d)(3).) Statutory employees have taxes withheld by their employers, in *all* cases; they aren't independent contractors. This category includes:

- corporate officers who provide services to the corporation
- delivery drivers of food, laundry, and similar products, even if they are paid strictly on a commission basis
- full-time, business-to-business salespeople, paid on commission—such as manufacturer's representatives and other traveling salespeople who do not sell directly to the public
- full-time life insurance agents working primarily for just one company, and
- home workers who do piecework according to a business's specifications and are provided the materials.

> **EXAMPLE:** Mary is an on-the-road salesperson for RoofCo, a roofing materials manufacturer selling to building contractors. She works out of her car and an office at home, visiting the RoofCo headquarters only twice a month to pick up samples and commission checks. RoofCo has little control over how and where Mary does her work. Although her work meets some requirements of an independent contractor, Mary is a statutory employee.

Employers must issue W-2 forms to statutory employees; however, they are allowed to deduct all business expenses from their statutory employee income, like independent contractors.

A statutory employee reports wages and expenses on Schedule C, the same form used by sole proprietors. (See Chapter 6, Section C.)

d. Statutory Nonemployees

The fourth tax code category for working people is the statutory nonemployee, sometimes also called an exempt employee. (IRC § 3508.) Statutory nonemployees are treated for tax purposes as independent contractors and are not subject to tax withholding of FICA taxes.

This classification covers only two types of salespeople:

- licensed real estate agents working on commission only, and
- direct (to the customer) sellers of consumer products—if the sales take place somewhere other than a retail store or showroom.

Statutory nonemployees report wages and expenses on Schedule C, the same as sole proprietors. (See Chapter 6, Section C.)

A statutory nonemployee's income must be directly related to sales—not to hours worked.

> **EXAMPLE:** Lorenzo operates About Face, a wholesale cosmetics business, and reports that his salespeople are statutory nonemployees. This will stand up to an IRS audit as long as all sales are made off Lorenzo's premises, sales are to consumers of the cosmetics, and the salespeople are paid strictly on commission.

D. Misclassifying Employees as Independent Contractors

Small businesses often run up against IRS auditors by calling their workers independent contractors instead of employees. The interests of the business owners and the IRS are diametrically opposed: The IRS wants to collect employment taxes for as many workers as possible, and the business owner wants to avoid employment taxes.

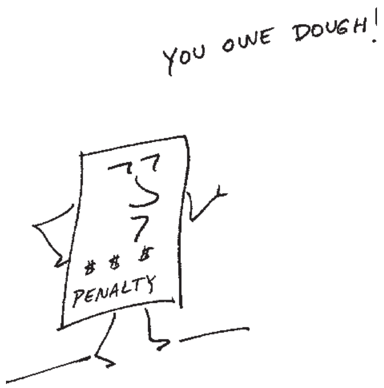
Indeed, a small business can save a bundle by not classifying workers as employees. According to the U.S. Chamber of Commerce, it costs a business 20% to 40% more per worker to treat them as employees.

1. How the IRS Finds Out

If your business is audited for any reason, the IRS looks at payments to independent contractors.

The *Wall Street Journal* reported that in one six-year period, the IRS performed more than 11,000 audits of companies using independent contractors. The results: 483,000 reclassifications of independent contractors to employee status and $751 million in back taxes and penalties. Ouch!

Also, special IRS teams search for misclassified workers under the ETE (employment tax examination) program. Typically, these ETE audits focus on industries where abuses are suspected. Recent targets include temporary employment agencies, nursing registries, and building contractors. Enterprises can also be selected for filing many Form 1099s for independent contractors.



The IRS is very selective in its enforcement of work classification rules. It picks on small businesses, while major corporations often flout the worker classification rules. Two of the largest employers in the San Francisco Bay Area frequently hire independent contractors. These Fortune 500 giants furnish offices, require regular work hours, and treat these so-called independent contractors like their regular employees—except they do not pay employment taxes or give the workers any benefits.

State employment tax agencies can also penalize you. If a worker who was misclassified as an independent contractor is laid off and makes a claim for unemployment benefits, it triggers a state agency inquiry. If the state reclassifies a worker as an employee, the business owner will owe state payroll taxes plus penalties. The state may also turn the employer in to the IRS or vice versa.

2. Penalties for Misclassifying Workers

Here's how a small business owner can get in trouble.

The IRS can order offenders to pay all employment taxes that should have been paid, plus a special penalty ranging from 12% to 35% of the tax bill.

> **EXAMPLE:** Ray, who wholesales American-made bathing suits, faces stiff competition from cheap imports. To survive, he must keep prices low by cutting overhead to the bone. Ray decides to call his secretary, warehouse person, delivery person, and two inside salespersons independent contractors. Here's what he stands to save:
>
> - Administrative work—filing quarterly tax-reporting forms, withholding employees' pay, and making federal tax deposits.
> - Social Security and Medicare taxes. (With independent contractors the employer does not pay 7.65% of their wages as Social Security and Medicare taxes.)
> - Federal and state unemployment tax costs.

- Nontax expenses, like workers' compensation insurance, and employee benefits, such as sick leave and vacation pay.

The problem is that Ray's workers are likely to be employees, not ICs.

EXAMPLE: The IRS audits Ray and reclassifies his secretary, Faye, as an employee. Faye was paid $20,000 per year for the past three years. Ray's audit bill, with interest and penalties, could be as much as $30,000 if the auditor decides that Ray intentionally disregarded the law. If, however, the IRS auditor concludes Ray made an innocent mistake, the tax bill would be about $15,000. Either way, it is still a lot of money.

IRS Classification Settlement Program

The IRS offers an olive branch to small business owners found misclassifying employees. It's called the Classification Settlement Program (CSP). This is a relatively inexpensive way to come clean by making a CSP deal.

To qualify for the CSP, a business owner must:

- have an open case with the IRS, either in an audit or in appeals
- specifically request a CSP deal, and
- be in compliance with § 530 of the 1978 Revenue Act (known as the Safe Harbor Rule). That means an employer must have:
  - filed all tax returns, including Form 1099s showing independent contractor payments
  - treated all similarly situated workers as independent contractors
  - had a reasonable basis for misclassification, such as reliance on court decisions, IRS rulings, or written IRS advice; a past audit that resulted in no employment tax liability for workers in positions substantially similar to the workers in question; or a long-standing practice of a significant segment of your industry.

Qualifying employers will be offered one of three settlement deals:

- Past misclassifications won't be assessed taxes.
- The most recent year of taxes for misclassifications must be paid and the IRS will forget about prior years.
- 25% of the latest audit year deficiency must be paid.

In addition, employers must agree to classify the workers as employees in the future. The IRS will monitor your business for five years to make sure you don't fall back into your old ways.

Which one of the three deals you get depends on the judgment of the auditor or appeals officer—and your ability to convince them you acted reasonably. Excuses that may work: reliance on the advice of an attorney or accountant; industry practice, even if not widespread; or your misinterpretation of the 20 IRS factors used to determine if a worker is an independent contractor.

3. Avoiding Trouble With the IRS

To avoid having the IRS reclassify your independent contractors as employees, they must:

- be paid by the job, not by the hour
- work off your premises
- hold business licenses and workers' compensation insurance coverage (if applicable) and acknowledge they are independent contractors, and
- have a written agreement spelling out the terms of the relationship.

If an IRS auditor attempts to reclassify your worker from independent contractor to employee, a written contract with the contractor may sway the auditor. A written agreement won't help if the worker is obviously an employee, but it can be persuasive in borderline situations.

An independent contractor should acknowledge in writing that he or she is a contractor and should spell out his or her responsibilities. (Pay attention to the IRS list of factors above.) Include a clause stating that all payments to the contractor will be reported to the IRS on Form 1099.

If you plan to regularly hire independent contractors, develop form contracts and require all contractors to sign one before they start working for you. (See "Resources" at the end of this chapter for sources of contracts.)

Always issue a Form 1099 to each independent contractor. Some workers will tell you it isn't necessary to give them a Form 1099. Undoubtedly these folks aren't playing it straight with Uncle Sam. The IRS can penalize you $50 for each Form 1099 not issued when you make payment of more than $600 in the year to an individual. Far worse, you can be assessed all of the income taxes not paid on the earnings from you for each individual not given a Form 1099. There is no penalty for filing a Form 1099 when not required, so if in doubt, file one for each contractor. If you have questions on issuing a Form 1099 (or a W-2 Form) call a special IRS number: 304-263-8700.

Leasing Temporary Employees

Some businesses sidestep employee classification challenges—and save on employee fringe benefits—by leasing temporary workers. The lease company, not you, withholds and does payroll tax reporting. It is all legal as long as you deal with a bona fide employee leasing company.

Weigh whether the cost markup of leasing is worth any fringe benefit or administrative savings for your business. Generally, this idea makes economic sense only for larger businesses with fluctuating needs for workers.

4. Should You Ask the IRS to Classify Your Workers?

If you are in doubt as to how to classify a particular worker, you can ask the IRS to determine the worker's status. You do this by sending to the IRS Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. Be warned, however, that the IRS is very likely to rule them employees no matter.

Additionally, the IRS may not respond for several months, which is too long for most small-time operators to wait.

Think twice before you ask the IRS to classify workers. By submitting Form SS-8, you have put yourself on record. This can work against you if you decide not to follow the IRS's determination and are audited.

5. Appealing a Ruling That You Misclassified Workers

Because the IRS is biased towards finding workers to be employees, business owners often lose on classification audits.

Fortunately, just as with any audit issue, you may appeal. (See Chapter 20 on how to appeal an IRS ruling.) You may even appeal a classification issue before the rest of the audit of your business is complete. (Rev. Proc. 96-9.) And, you may challenge a reclassification of your workers in the U.S. Tax Court. (IRC § 7436.)

There are four good grounds for winning your appeal:

- The IRS didn't properly consider all of the factors.
- The safe harbor rule may apply. Even if the IRS properly classified a worker as an employee, you can claim industry standard relief—which means you classified the worker the same as at least 25% of the other businesses in your industry. (Section 530 of the Revenue Act of 1978.)
- You can raise the previous audit defense if you were audited at any time in the past and no IRS challenge was made to how you classified your workers—assuming you are still in the same line of business with similar workers.
- Offer to treat the disputed workers as employees in all future years, if the IRS will forget the past years. This future compliance offer might be accepted if your workers are in a gray area and the appeals officer believes that you might win in court. (For more on negotiating strategy, see Chapter 20.)

E. IRS Filing and Payment Requirements for Employers

The IRS and states require a lot of form filing by employers. If you fail to file a required form—or file it late—at the very least you'll get annoying inquiries, and, at worst, expensive penalties. Missing a due date will almost certainly cost you extra.

You meet the filing requirement due date if the form is properly addressed, mailed first-class, and postmarked on or before the due date. If any deadline falls on a weekend or legal holiday, use the next business day.

See your tax pro or use a payroll tax service for help with filing requirements. Get IRS Publication 15 and tax forms from your local IRS office, or by mail by calling 800-829-FORM (3676), or online at www.irs.gov. See Chapter 22, Help Beyond the Book, for more information.

Here are the key tax dates:

- **Each payday: Withhold income taxes and employees' share of Social Security and Medicare.** See Section B, Payroll Taxes, above. No separate report needs to be made to the IRS at the time of the withholding. (Make federal tax deposits either quarterly, monthly, or more often, depending on the size of your payroll.)

Late tax deposit penalties are severe. The IRS charges a penalty of 2% for late tax deposits that are one to five days late, and up to 15% for payments not received within ten days of an IRS notice and demand.

- **Annually on January 31: Report W-2 and 1099 payments to workers, file your FUTA return.** January 31 is a key date for businesses with employees or independent contractors. That is the deadline for mailing workers either a Form W-2 to report wages paid for the prior year or Form 1099-MISC for independent contractor payments to individuals ($600 or more only).

  You must send copies of the 1099s and W-2s to the IRS, along with Form W-3, by February 28.

  Also, Form 940 (or 940-EZ), *Employer's Annual Federal Unemployment Tax Return (FUTA),* is due on January 31, along with payment of any balance due.
- **Annually on February 28: Send copies of Forms 1099 (and 8027) to the IRS.** Mail copy "A" of any Form 1099 you issued on January 31, along with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns,* to your IRS Service Center. For service businesses, also file Form 8027, *Employer's Annual Information Return of Tip Income,* if your employees receive tips.

- **Annually on February 28: Send copies of Forms W-2 to the Social Security Administration.** Mail copy "A" of all the Forms W-2 you issued, along with Form W-3, *Transmittal of Wage and Tax Statements,* to the Social Security Administration (address is on the forms). Alternatively, you may file electronically. Go to the Social Security Administration website at www.ssa.gov/employers for more information.

F. Record Keeping for Service Providers

Keep permanent records on workers—whether employees or independent contractors—who provide services to your business. The IRS and state tax agencies can demand to see these records as part of a regular audit or a special employment tax audit. Basic employer records should show:

- names, addresses, Social Security numbers, occupations, and dates of employment for everyone paid for their services
- amounts and dates of wage and pension payments to workers
- fringe benefits and goods or services provided to workers (in addition to cash)
- employee tips reported (if applicable)
- Forms W-2 and 1099 showing payments to workers, including any that were returned by the post office as undeliverable
- income tax withholding certificates completed by each worker (Forms W-4)
- federal and state payroll tax deposit forms with dates and proof of payment (deposit slip, canceled check, or financial institution receipt)
- federal Forms 940 (annual) and 941 (quarterly) and corresponding state payroll tax forms
- your individual or business income tax returns on which payments to workers were claimed, and
- FICA (Social Security and Medicare) and FUTA (unemployment) taxes paid for each worker.

Resources

- IRS Publication 505, *Tax Withholding and Estimated Tax*. This 48-page booklet greatly expands on the information in this chapter.
- IRS Publication 509, *Tax Calendar*.
- Notice 931, *Deposit Requirements for Employment Taxes*.
- IRS Publication 15A, *Employer's Supplemental Tax Guide*. Every employer should be familiar with this publication; it shows how to fill out employment tax forms.
- IRS Publication 15, *Circular E, Employer's Tax Guide*. This is a useful booklet with forms and charts for determining how much to withhold from employees' paychecks if you do not use an accountant or payroll service.
- *Working with Independent Contractors: The Employer's Legal Guide*, by Stephen Fishman (Nolo). Everything you need to know about federal and state laws for working with independent contractors.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book should be helpful in contesting adverse IRS decisions.
- *The Employer's Legal Handbook*, by Fred Steingold (Nolo). This book details all of the legal issues involved with being an employer.
- IRS forms and publications. Call 800-829-3676 to order current and prior year tax forms, instructions, and publications. There's no charge, and you should receive your order in about ten days. Alternatively, download the latest forms from the IRS's website at www.irs.gov.
- SSA wage reporting specialist. If you have a wage reporting problem, call 800-772-1213 for help.
- Social Security Administration website. For SSA-related information, go to www.ssa.gov/employers.

■

CHAPTER

6

Sole Proprietorships

"The most enlightened judicial policy is to let people manage their own business in their own way."

—Oliver Wendell Holmes, Jr., U.S. Supreme Court Justice

A sole proprietor is an individual who owns and operates a business that is not a corporation, partnership, or limited liability company. A business is any enterprise operated with a profit motive.

Sole proprietors can be self-employed freelancers, independent contractors, or consultants who provide services to other businesses. Or they can be retail store owners or service providers.

There are nine million sole proprietorships filing tax returns in the U.S., comprising over 70% of *all* businesses. No wonder—it is the easiest, fastest, and cheapest way to go into business.

For taxes and most legal purposes, a sole proprietor and her business are indistinguishable. Business profits (or losses) are reported on the owner's individual tax return (Form 1040). The owner is personally responsible for business debts, including all taxes.

You can start a sole proprietorship by simply putting up a sign offering your goods or services and getting a local business license, possibly a sales tax permit, and that's about it—you are a sole proprietorship, or a "solo" as we call you.

Taxes and Sole Proprietorships in a Nutshell

1. A sole proprietorship is not a separate entity from its owner, so the business does not file its own tax return. Its income or loss is reported on Schedule C, which is filed with the owner's tax return.
2. Sole proprietors, as self-employed individuals, usually must pay quarterly estimated income taxes, as well as self-employment tax for Social Security and Medicare contributions.
3. Most small businesses begin as sole proprietorships, but some eventually convert to a partnership, limited liability company, or corporation.

A. Business Expenses

You can deduct business expenses under the same rules whether you operate a sole proprietorship or a major corporation. The types of expenses and rules for deducting them are covered in Chapters 1 and 2. For home-based business, also see Chapter 13, Microbusinesses and Home-Based Businesses, for special rules.

B. Profits Left in the Business

The following comes as a shock to most solos: You are taxed on all profits in the year they are earned —whether you take the money out of the business or not. Any profits remaining in a business at the end of the year are taxed as if you had put them in your pocket. Remember, under the tax code, a sole proprietor and her business are one.

For retailers and small manufacturers, this rule means if you put profits into building your inventory —which is often the case—you will be first taxed on those profits. In other words, you must use after-tax dollars to expand your sole proprietorship business.

> **EXAMPLE:** Jose made a net profit of $85,000 in his magic and novelty shop last year. He took $50,000 out of the business bank account for living expenses and spent the remaining $35,000 on inventory. Jose pays income and self-employment tax on the full $85,000. For tax purposes, there is no such thing as a loan from a sole proprietorship to the owner.

By incorporating, you may save tax on profits put into inventory. Owners of C corporations do not report profits left in the business on their personal tax returns, even in one-shareholder corporations. Although profits left in a corporation are taxable to the corporation, initial corporate rates of taxation (15% and 25%) are lower than for many small business folks, producing a tax saving. (See Chapter 7, C Corporations, for the tax advantages and disadvantages of incorporation.) This doesn't apply to S corporations. (See Chapter 8.)

C. How Sole Proprietors Report Taxes

A sole proprietorship and its owner are one and the same for tax purposes. No IRS licensing or even form-filing is required to start off.

The following rules apply to independent contractors, statutory employees, and statutory nonemployees (unless these individuals provide services through a partnership, corporation, or limited liability company).

1. Schedule C (or Schedule F, for Farming)

Business income and expenses are reported on a separate schedule attached to the sole proprietor's annual Form 1040 tax return—either Schedule C or C-EZ, *Profit or Loss From Business (Sole Proprietorship)*, or Schedule F if your business is farming. List your business code number (see instructions for Schedule C) for the type of business you own.

You must file Schedule C if your *net* income (after deducting expenses) from all of your solo ventures exceeds $400. But you should file one even if you make less than $400, or suffered loss. A loss may produce a tax benefit and filing starts the statute of limitations (the period during which the IRS can audit you). The sooner you get this period started, the sooner it will end.

> **EXAMPLE:** In December, Sam and Jeannie Smith open Smith's Computer Sales and Service as a sole proprietorship. The Smiths break even that year. Even though they didn't make or lose money, they should file their Form 1040 income tax return, including a Schedule C or Schedule C-EZ for the business.

A sample Schedule C is shown below. Pay particular attention to lines 8 through 27 for categories of deductible expenses common to most businesses. Refer back to Chapters 1 and 2 for rules on these items. Things that don't seem to fit into a category name can be put on line 48 as other expenses.

2. Schedule C-EZ

A tiny side business may use a simplified form, Schedule C-EZ, if it has:

- gross receipts under $25,000
- less than $2,500 in business expenses
- no inventory
- no employees
- the cash method of accounting
- no Section 179 or depreciation write-offs, and
- no overall loss in operation.

However, most businesses can usually claim much more than $2,500 in business expenses, and Section 179 deductions each year. Since it is only a little more effort to fill out a regular Schedule C form, I recommend it in most cases.

More Than One Sole Proprietorship

If you (and possibly your spouse) operate more than one sole proprietorship, you must file a different Schedule C, or C-EZ, for each business.

> **EXAMPLE:** Jeannie and Sam Smith own Smith's Computer Sales and Service. Besides helping run their business, Jeannie has an Amway distributorship, and Sam buys and sells sports trading cards. The Smiths file one 1040 form with three Schedule Cs. Since the sports card venture incurs more than $2,500 in expenses, they must use a regular Schedule C form, even though the other, smaller ventures might qualify for the C-EZ form.

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business
(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
▶ Attach to Form 1040 or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
20XX
Attachment Sequence No. 09

Name of proprietor: John Stephens
Social security number (SSN): 465 00 0001

A Principal business or profession, including product or service (see page C-2 of the instructions): Tax Preparation
B Enter code from pages C-7, 8, & 9 ▶ 7 6 3 3

C Business name. If no separate business name, leave blank.: Stephens Tax Service
D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶ 821 Union Street
City, town or post office, state, and ZIP code: Hometown, IA 52761

F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶
G Did you "materially participate" in the operation of this business during 2004? If "No," see page C-3 for limit on losses ☒ Yes ☐ No
H If you started or acquired this business during 2004, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐	1	34,280
2	Returns and allowances	2	0
3	Subtract line 2 from line 1	3	34,280
4	Cost of goods sold (from line 42 on page 2)	4	0
5	**Gross profit.** Subtract line 4 from line 3	5	34,280
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	0
7	**Gross income.** Add lines 5 and 6 ▶	7	34,280

Part II Expenses. Enter expenses for business use of your home only on line 30.

8	Advertising	250	19	Pension and profit-sharing plans	
9	Car and truck expenses (see page C-3)	1,266	20	Rent or lease (see page C-5):	
10	Commissions and fees		20a	Vehicles, machinery, and equipment	
11	Contract labor (see page C-4)		20b	Other business property	
12	Depletion		21	Repairs and maintenance	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	3,100	22	Supplies (not included in Part III)	253
14	Employee benefit programs (other than on line 19)		23	Taxes and licenses	
15	Insurance (other than health)	750	24	Travel, meals, and entertainment:	
16	Interest:		24a	Travel	310
16a	Mortgage (paid to banks, etc.)		24b	Meals and entertainment	512
16b	Other	200	24c	Enter nondeductible amount included on line 24b (see page C-5)	256
17	Legal and professional services	350	24d	Subtract line 24c from line 24b	256
18	Office expense	600	25	Utilities	347
			26	Wages (less employment credits)	
			27	Other expenses (from line 48 on page 2)	267

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	7,949
29	Tentative profit (loss). Subtract line 28 from line 7	29	26,331
30	Expenses for business use of your home. Attach **Form 8829**	30	1,462
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go to line 32.	31	24,869

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you **must** attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

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Schedule C (Form 1040) 2004 Page 2

Part III **Cost of Goods Sold** (see page C-6)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ Yes ☐ No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36 Purchases less cost of items withdrawn for personal use	36	
37 Cost of labor. Do not include any amounts paid to yourself	37	
38 Materials and supplies	38	
39 Other costs	39	
40 Add lines 35 through 39	40	
41 Inventory at end of year	41	
42 **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	

Part IV **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ ______/______/______

44 Of the total number of miles you drove your vehicle during 2004, enter the number of miles you used your vehicle for:

a Business ______________ b Commuting ______________ c Other ______________

45 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ Yes ☐ No

46 Was your vehicle available for personal use during off-duty hours? . . . ☐ Yes ☐ No

47a Do you have evidence to support your deduction? . . . ☐ Yes ☐ No

b If "Yes," is the evidence written? . . . ☐ Yes ☐ No

Part V **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

48 **Total other expenses.** Enter here and on page 1, line 27	48	

Schedule C (Form 1040) 2004

3. Income and Self-Employment Taxes

Your bottom line from your sole proprietorship—profit or loss—is shown on Schedule C, line 31. This figure is entered midway down the front page of your Form 1040 tax return. It is added to your income (or losses) from all sources—regular jobs, dividends, capital gains, and so on—to reach the figure at the bottom of the page called adjusted gross income.

After deducting your personal exemptions and itemized or standard personal deductions on Form 1040, the result is taxed at your tax bracket ranging from 10% to 35%.

Solos also pay self-employment taxes (discussed in Chapter 13) of 15.3% of the first $90,000 of their net self-employment income and 2.9% of everything over $90,000 (2005).

> **EXAMPLE:** Wing, a solo, earns $97,700 in 2005. For self-employment taxes, the first $90,000 is taxed at the rate of 15.3% and the next $7,700 at 2.9%. The total self-employment and Medicare tax is $13,993.30.

Paying self-employment taxes produces a tax break on your individual tax return. One-half of your self-employment taxes is deductible. (IRC § 164.) You don't claim this deduction on the business schedule of your tax return. Instead, you claim it on the first page of your Form 1040 tax return as an adjustment to income.

> **EXAMPLE:** Carol quits her teaching job and starts Carol's Catering as a full-time business. During her first year she pays self-employment taxes of $1,102. Carol can deduct one-half of her self-employment taxes, or $551. Since she is in the 27% income tax bracket, this shaves $149 (27% x $1,102 x 50%) off her income tax bill.

A short one-time job may escape self-employment tax. For example, John, a retired mechanic, took a short-term job—less than a month—installing windows in an office building. The tax court held that this did *not* establish John in a trade or business, so he wasn't liable for the self-employment tax. Of course, the income was still subject to income tax. (*John A. Batok*, TC Memo 1992-727.)

4. Claiming Losses

If your sole proprietorship loses money, you can use that loss (called a net operating loss) to offset your other earnings in that year—like wages from a day job.

If you don't have enough other earnings to absorb the loss, you may carry your loss over to the following year's tax return. If the venture makes a profit, you might be able to use the prior years' losses to offset it and reduce your taxes. (See Chapter 4, Business Losses and Failures, for details.)

D. Estimated Tax Payments = Pay as You Go

Solos must make income tax payments, called estimated taxes, four times a year. Estimated tax payments cover self-employment taxes (better known as Social Security and Medicare taxes) as well as plain old income taxes.

If estimated tax payments are too small or aren't made on time, the IRS will assess a penalty. The IRS penalty is a percentage of the tax due each quarter and the rate changes quarterly, by law.

In effect, you must predict how much you will earn ahead of time or risk a penalty. An easy way to avoid the estimated tax penalty is to make payments equal to your tax liability for the previous year.

EXAMPLE: If Brent paid $5,000 in income taxes in 2005 from self-employment, he should make four estimated tax payments of $1,250 each during 2006.

Exception One: You don't have to pay estimated taxes if:

- you expect to owe less than $1,000 in federal taxes (including income taxes and self-employment taxes) for the current tax year, *after subtracting any withheld taxes*, and
- you expect your withheld taxes to be more than the smaller of:
  - ✓ 90% of your total tax obligation for the current year, or
  - ✓ 100% of your total tax owed for the previous year.

What does this formula mean? First, if you are barely breaking even (you expect to make less than $3,000 to $6,000 from your business, depending on your tax bracket), there's a good chance you won't have to make estimated payments.

Exception Two: If you're having income withheld from a paycheck at a regular job, you may not have to make estimated payments. If the taxes that are withheld from your paychecks will cover more than 90% of the total you'll owe in taxes—you don't have to make estimated tax payments for that year. Or, if the taxes withheld from your paychecks will come out to more than your entire tax bill for the previous year, you can skip paying estimated taxes.

If you're still not sure whether you have to make estimated payments, see IRS Form 1040-ES and Publication 505, *Tax Withholding and Estimated Tax*.

To make the quarterly estimated tax payments, use IRS Form 1040-ES. The four equal payments are due on April 15, June 15, September 15, and January 15 (of the following year).

Tax-preparation programs like *TurboTax* print out Form 1040-ES showing how much you should pay each quarter to avoid the penalty. (See IRS Publication 505 for details.)

Estimated tax rules are tougher if you have a higher income. If your income exceeds $150,000 in 2005, you must make estimated payments of at least 90% of your tax bill or 112% of your 2004 tax, whichever is smaller.

Most *states* also require quarterly estimated taxes. Get forms and information from your state's tax agency or a tax pro.

E. Employment Tax Rules

Hiring employees means paying federal and usually state employment taxes and withholding employees' income taxes, as well as more record keeping.

Any business with employees must follow these employment tax rules:

- report federal payroll tax information quarterly (Form 941)
- make federal payroll tax deposits regularly, usually once a month
- report and pay federal unemployment tax (FUTA) annually (Form 940)
- report wages for employees annually (Form W-2), and
- report payments to independent contractors annually (Form 1099-MISC).

All of these rules are explained in Chapter 5, Tax Concerns of Employers.

All businesses with employees must also register with their state's employment department and pay unemployment compensation taxes.

Note that sole proprietors aren't employees of their business, so no payroll taxes are due on their income. Instead, as discussed in Section C, above, sole proprietors make estimated payments quarterly covering self-employment taxes for Social Security and Medicare.

F. Record Keeping

Poor record keeping—such as scribbling cash expenses on scraps of paper, trusting your memory, or mixing up personal and business records—is the downfall of the self-employed. Without accurate records, you will never really know, let alone properly report, your income and expenses.

Basic record keeping is the same for all businesses, including solos. Of course, bookkeeping becomes more complex (and time-consuming) as your operation expands.

A business must keep track of its income and expenses, using a system to accurately record its transactions. The IRS doesn't dictate any particular way to do it—just that records be kept and available for an audit.

Note: If your business sells goods and you maintain stock on hand, you must keep inventory records—meaning you count up the goods on hand at least once every year on the last day of the tax year—December 31st for solos.

Beware of mixing business and pleasure. Segregate business records from your personal ones. Solos tend to run the loosest ships, keeping everything in the same pot. Mixing things up means a mess at tax time. If you haven't set up a real record-keeping system, at least maintain a separate checking account and credit card just for business. If you take money from the business for personal use, write a check from your business to your personal account. Alternatively, use a computer program such as *Quicken* (Intuit) or *MS Money* (Microsoft) to distinguish business from personal items in one or more checking accounts.

For more on keeping business records for tax purposes and computer record-keeping programs, see Chapter 3, Bookkeeping and Accounting.

Start-Up Permits

Although it is easy to start a sole proprietorship, certain businesses and professions (restaurants and attorneys, for example) need state or local permits or licenses before beginning operation.

Here are a few examples of the licenses many sole proprietors have to obtain:

- a local tax registration certificate, a.k.a. a business license
- a seller's permit from your state if you will sell retail goods
- state licenses, such as specialized vocation-related licenses or environmental permits, if necessary
- local permits, if required, such as a conditional use permit or zoning variance.

For more information, see *The Small Business Start-Up Kit*, by Peri Pakroo (Nolo), and *Small-Time Operator*, by Bernard Kamoroff (Bell Springs).

G. Outgrowing a Sole Proprietorship

While most business people start and finish their ventures as solos, others take on partners, incorporate, or form a limited liability company later on down the road. For example, it may make tax sense to incorporate, which can complicate your tax life. For instance, if you shut the corporation down, you will incur extra costs and perhaps taxes that a sole proprietor wouldn't face. (See Chapter 7, C Corporations.)

Tax reasons alone rarely justify changing the ownership structure of your business. More often, entrepreneurs growing out of sole proprietorships do it for nontax reasons, such as the shield from personal liability for business debts that corporations and limited liability companies (LLCs) offer.

Also, partnerships, corporations, and limited liability companies allow you to bring co-owners into the business. And some solos believe the letters "Inc." in a business name may impress customers, investors, and lenders.

Don't forget about new expenses. Don't change the form of your solo enterprise without factoring in the added costs of accounting and legal services. On the other hand, the added fees will be 100% deductible.

H. Ending the Business

Just as a sole proprietorship is the easiest way to go into business, it is also the easiest to end. You simply stop operations. When you file a Schedule C for the final year of business, check the box on top for "Final Return."

However, things aren't so simple when it comes to disposing of your business assets. Typically, you will need to report a gain (or loss) on your tax return. (See Chapter 17, Selling a Sole Proprietorship, for the tax consequences of selling a business or its assets.)

I. Death and Taxes

When you die, your solo assets become part of your estate. There may be estate tax and probate consequences depending on the size of your estate. (See Chapter 12, Family Businesses, for a brief discussion of estate planning for a small business.)

If your heirs (or your spouse) carry on the enterprise after your death, they will report its income and expenses on Schedule C of their own tax returns.

Recommended Reading. For more information about estate planning for sole proprietors, including avoiding probate, see *Plan Your Estate*, by Denis Clifford and Cora Jordan (Nolo).

Resources

- Publication 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*. This is a must-have, especially for those of you doing your own tax return preparation.
- If you are a farmer, see Publication 225, *Farmer's Tax Guide*; if you are a commercial fisherman, see Publication 595, *Tax Highlights for Commercial Fishermen*.
- IRS Publication 505, *Tax Withholding and Estimated Tax*.
- IRS Publication 533, *Self-Employment Tax*.
- IRS Circular E, *Employer's Tax Guide*. This booklet gives a detailed explanation of the payroll tax process and the forms used.

Several good books thoroughly discuss factors to consider when choosing the legal form for your business. Some of the best are:

- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo).
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs).
- *LLC or Corporation? How to Choose the Right Form for Your Business*, by Anthony Mancuso (Nolo).

CHAPTER

7

C Corporations

"You can have a lord, you can have a king, but the man to fear is the tax collector."

—Sumerian Proverb

The word corporation brings to mind IBM, GM, or AT&T—businesses so big and familiar we know them by their initials. Corporations don't have to be huge though; anyone can form one. But should you?

Big business obviously has a great deal of say in Congress, and as a result, our tax code often favors corporate America. But even small incorporated businesses get some tax breaks unavailable to partnerships, LLCs, and sole proprietorships.

Most corporate tax breaks involve fringe benefits. (See Chapters 14 and 15.) This means that only solidly profitable businesses gain a tax advantage by incorporating. Typically, start-up enterprises don't reap tax advantages from incorporating, and the simplicity of a sole proprietorship, limited liability company, or partnership may be preferable. Later, if a business grows, you can always incorporate.

Any tax advantages must be balanced against factors including the more complex tax rules corporations must follow and the legal and accounting costs of a corporation.

A corporation is the most expensive way of doing business. Initial incorporation charges and annual fees to the state are required to maintain a corporation—whether or not it is active or makes a profit. Additional accounting costs can put a significant dent in a new business's cash flow. Also, professional help will be needed to deal with federal and state tax reporting.

C Corporations in a Nutshell

1. A C corporation is a completely separate tax entity from its owners. Owners who work in the business are treated as employees of the corporation for tax purposes.
2. C corporations are subject to corporate income taxes, but most small business C corporations legally avoid paying corporation income taxes by paying profits to the owners in the form of tax deductible salaries, bonuses, and fringe benefits.
3. C corporations are the most formal business entities, and they have greater tax reporting responsibilities than other entities.
4. C corporations allow profits to be kept in the business for expansion or inventory buildup. Retained profits are taxed, but the initial corporation tax rates (up to $75,000 in income) are lower than the tax rates applicable to most individuals.

Tax considerations are only one factor in deciding whether to incorporate. For most folks, the personal liability shield a corporation provides is more important than tax considerations. For example, if your building demolition business carries high risks that can't be adequately covered by insurance, a corporation protects your personal assets from business creditors or a court judgment.

A. Types of Corporations

For federal tax purposes, most business corporations are classified as either C or S corporations. These two letters refer to subchapters of the tax code (in case you were wondering). This chapter discusses tax treatment of C corporations; S corporations are covered in Chapter 8. The professional corporation is covered in Chapter 11, Personal Service Corporations. Nonprofit corporations are beyond the scope of this book.

Most business corporations begin life as C corporations. After incorporating, the shareholders may

How to Set Up a Corporation

Small business corporations are chartered by the 50 states, not the federal government. While there are differences in the details, state incorporation procedures are remarkably similar.

Some states, such as Delaware and Nevada, have very low incorporation fees, seemingly making them more attractive than your home state. These two states, as well as Wyoming, do not tax corporations or tax them at low rates. Sound good?

Be warned: Though another state's incorporation rules and tax structure may seem attractive, there is a big catch. For starters, your home state probably requires out-of-state corporations to register and pay a fee before doing business within its borders.

For instance, California charges the same fee for qualifying as an out-of-state corporation as it does for creating a native California corporation. So if a California resident forms a Nevada corporation, the corporation must pay two annual corporation fees if the company does any business in California. What's more, any income from the Nevada corporation paid to a California resident is subject to California's state income tax. In this case, there is a tax cost, not a savings, for incorporating out of state.

However, there may be nontax advantages (such as the right not to disclose the names of corporate shareholders in Nevada and Wyoming) to incorporating out of state. Check with a knowledgeable business attorney if you're interested in doing this.

Register your out-of-state corporation. If you are tempted to form a corporation out of state and then do business in your home state without registering, you should know the risks. The back taxes, fees, and penalties your home state might assess against you if you get caught are heavy. Further, many states do not permit unregistered foreign (out-of-state) corporations to sue in their state courts until the foreign corporation registers and pays the required fees. That means if your corporation has a grievance with someone and needs to sue, you'd be out of luck.

Incorporating is easy. You can do it yourself using software or a self-help book containing forms and instructions. Or, a private incorporation service (check the Yellow Pages or the Internet) can prepare and file the forms for you. Or you can hire a local business lawyer (the best—but most expensive—way to go).

First, choose your corporate name (after making sure it is available by checking with your state's corporate filing office). Next, prepare a document called the articles of incorporation, often a fill-in-the-blanks form available from your state. In the articles, you state the name of your corporation, its address, its general purpose, and the name of the person to be served with legal papers in case of a lawsuit. (Check your state's secretary of state or corporations department websites for the forms. Visit www.statelocalgov.net for links to these agencies in your state.)

Send this paperwork to your state's corporate filing office, along with the filing fee: typically $50 to $1,000, depending on the state. You will get back a corporate charter and, congratulations, you're incorporated.

Next you must hold a meeting of stockholders and adopt bylaws: rules that govern the corporation's operation. If you're doing it yourself, use fill-in-the-blanks bylaws forms or a software program. Corporate kits with blank stock certificates and form minutes of corporate meetings are widely available on the Internet. After the initial meeting, you must hold annual corporation meetings to maintain your legal status as a corporation.

Keep a corporate records book. Records help prove to the world (including an IRS auditor) that you really are a corporation. Otherwise, you may lose any benefits of corporate status.

choose S corporation status if they want the business owner to be taxed more like a partnership than like a standard C corporation. Read Chapter 8 to fully understand your options. Also, ask your accountant about the built-in gains tax before changing your corporate status.

B. How C Corporations Are Taxed

A corporation is legally termed an artificial person. It may own property, enter into contracts, borrow money, and sue and be sued, just like an individual. For tax purposes, it is an entity distinct from its owners, who are called stockholders or shareholders.

Corporations may have just one stockholder, who can also be a director. This person will likely name himself as the president as well as take on other corporate titles, like secretary and treasurer.

Closely Held Corporations

The corporations discussed in this chapter are referred to in the tax code as closely held corporations. Most small business corporations fall into this category. A closely held corporation is defined as one that:

- sells stock privately and has 75 or fewer shareholders, and
- has shareholders who all work in the business, or are closely related to people who do, or are experienced investors.

If a corporation offers shares to the public or has more than 75 investors, it is not closely held—and more complicated state and federal tax and securities laws come into play. This type of corporation is beyond the scope of this book.

Shareholders who work in the corporation are its employees. A shareholder of a corporation who is active in the business is not self-employed in the eyes of the tax law. Consequently, throughout this chapter, the term employee usually includes owners (the shareholders).

> EXAMPLE: Sam Smith and his wife Jeannie incorporate Smith's Computer Sales & Service. All stock is owned by Sam, Jeannie, and two key employees.
>
> The Smiths and their corporation are now separate taxpayers, and both must file their own tax returns. This is a huge change from when Sam and Jeannie were sole proprietors; then the Smiths and their business were legally one and the same and they filed only one tax return.

1. Double Taxation of Profits

A C corporation follows federal and state corporation income tax rules that are different from those for sole proprietorships, limited liability companies, or partnerships.

Theoretically, before any profits are paid to shareholders, a C corporation must pay income tax on the profits at the corporate rate. (See Section 3, below.) Any profits that are distributed to shareholders via dividends are then subject to the shareholders' individual income tax. This amounts to *double taxation*, with business profits taxed at both the corporate and personal levels—not a good thing. I used the word "theoretically," above because this issue can be easily dealt with.

In the real world, small C corporations can easily avoid income taxes. All or almost all of a small C corporation's earnings typically are paid out to its employees as wages, bonuses, and fringe benefits (which are not taxed to the corporation as profits, since they are deductible business expenses). After everyone is paid for their labor, there is usually no income for the small business corporation to owe tax upon—unless the shareholders want there to be taxable profits left in the corporation. (See Section 4, below, for why this might be desirable.)

EXAMPLE: Ned's corporation, Men's Den, Inc., earns $70,000 one year. But after the corporation pays Ned $50,000 as a salary; provides him with $10,000 in tax-free fringe benefits, including retirement plan contributions; and gives him a year-end bonus of $10,000; the corporation has no taxable net profit. As a result, it owes no federal corporate income tax. Ned, however, pays personal income taxes on $60,000 of earned income. Ned's fringe benefits of $10,000 aren't taxable. (Note that the corporation may still be subject to state income taxes.)

If any corporate income is left in the business, it is usually tied up in inventory or retained to fund future growth. It is taxed, but at corporate tax rates that are, for most small business folks, lower than personal income tax rates.

EXAMPLE: Instead of giving Ned a year-end bonus of $10,000, Men's Den, Inc., retains it all for future expansion. This $10,000 is subject to federal corporate income tax at 15%, resulting in a $1,500 tax bill to Men's Den. Ned pays taxes on $50,000 of earned income at his individual income tax rate.

Although double taxation of C corporations is usually avoidable, it will occur if you pay dividends. For instance, if Sonya and Stella are just investors and don't work for the business, they can't take salaries and fringe benefits. The only way to get profits to them is by paying dividends. The problem is that dividends are not deductible corporate expenses like wages. Dividends are distributed only after corporate income taxes are calculated (taxed once) and then the dividends are taxed (again) to the shareholders who receive them, on their individual tax returns. (See Section F, below, for a discussion of dividends.)

EXAMPLE: Ned's sisters, Shirley and Sally, each invest $100,000 in Men's Den, Inc., in return for 100 shares of stock each. Sally is a salesperson for the business and receives a yearly salary of $50,000; Shirley doesn't work and plays a lot of golf. After paying all wages and operating expenses, Men's Den, Inc., has $30,000 in profits. Its directors decide to pay out $30,000 as dividends to Sally and Shirley. First, the corporation must pay income tax of $4,500 (15% corporation tax rate x $30,000), leaving $25,500 for the dividends. Sally and Shirley are each taxed on $12,750 in dividends on their individual tax returns, most likely 15%.

You can avoid dividend double taxation by paying consulting fees. If you want to compensate shareholders, you could call corporate payments compensation to a consulting shareholder, not dividends. Just make sure she actually does some consulting, otherwise the IRS could recharacterize the payments as dividends. However, the consultant and the corporation both must pay Social Security and Medicare taxes on the compensation. If you are in this situation, have an accountant run the figures to find out the least tax cost.

2. Corporate Losses

Just as C corporation profits belong to the business and not the shareholders, so do losses. Never forget that the corporation is a separate tax entity from its shareholders. Individual shareholders can't claim operating losses of a C corporation business. Instead, losses of a C corporation in one year can be offset against future or past years' corporate profits.

EXAMPLE: Men's Den, Inc., loses $20,000. Ned received no compensation for his year's work, but Ned had a second job. The corporation's loss provides no tax benefit to Ned when he files his individual tax return. The business operating loss can be used to offset any corporate profits in future years, however.

3. Tax Reporting for C Corporations

C corporations must file annual tax returns, either IRS Form 1120, *U.S. Corporation Income Tax Return,* or IRS Form 1120-A (the short form), whether they have any corporate income to report or not. The due date is the 15th day of the third month after the close of the corporation's tax year. So if the corporation uses a calendar year, its tax return is due every March 15. (See Chapter 3, Section H.)

A corporation can get an automatic six-month extension to file its tax return by filing IRS Form 7004. The return will be due September 15, assuming a calendar-year reporting schedule. If any corporate tax is owed, it must be paid along with Form 7004 to avoid penalty and interest charges.

If the corporation expects to owe taxes, during the year it must make periodic estimated tax payments similar to self-employed individuals. (But, as discussed in Section B1, above, small business C corporations usually do not owe income taxes.)

States require annual corporate tax filings as well, on separate state corporate tax return forms. Most states require that a minimum amount of corporate tax (typically a few hundred dollars) be paid each year to maintain the corporate status.

4. Tax on Retained Earnings

Typically, small corporations don't owe taxes because all profits are paid out annually as tax-deductible salaries and fringe benefits. But often an enterprise needs money to expand or build up an inventory. This can be done, but at a tax price.

C corporation profits kept in the business are taxed at an initial tax rate of 15%—usually lower than the individual tax rates of its owners/shareholders. (IRC § 11.)

This ability to retain earnings at a lower tax cost is an advantage that growing small C corporations have over their unincorporated counterparts. (But see Section G2, below, for the limitation on the amount of earnings that a corporation can retain.)

Federal Corporate Tax Rates

Net Income	Total	Tax Rate
First $50,000	$50,000	15%
Next $25,000	$75,000	25%
Next $25,000	$100,000	34%
Next $235,000	$335,000	39%
Everything else	$335,001+	34%–38%

Note: Most states also impose corporate income taxes.

EXAMPLE: Henry's engine-rebuilding corporation, Top Value Motors, Inc., plans to expand. To do so, it retains $100,000 of net profit in the business bank account. Top Value owes corporate income taxes on the profit as follows:

$50,000 x 15%	=	$ 7,500
$25,000 x 25%	=	$ 6,250
$25,000 x 34%	=	$ 8,500
Total tax		$22,250

This is a blended tax rate of 22.25%. By contrast, if Top Value paid Henry this $100,000, depending on his tax bracket, as much as $35,000 could be added to his personal tax bill.

Income Splitting. Disbursing some corporate profits to shareholders and keeping the rest in the business amounts to income splitting. For instance, by keeping up to $75,000 in the corporation and paying the rest of the profits as wages and bonuses, most corporations can save taxes.

Once a corporation reaches the $100,000 profit level (after paying salaries and benefits), retaining earnings makes less tax sense. This is because corporate profits between $100,001 and $335,000 are hit with a 5% tax surcharge, effectively eliminating the benefits of the initial lower corporate tax rates.

Form **1120-A**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Short-Form Income Tax Return

For calendar year 2004 or tax year beginning.............., 2004, ending.............., 20....
▶ See separate instructions to make sure the corporation qualifies to file Form 1120-A.

OMB No. 1545-0890
20XX

A Check this box if the corporation is a personal service corporation (see instructions). ☐

Use IRS label. Otherwise, print or type.
Name
Number, street, and room or suite no. If a P.O. box, see page 9 of instructions.
City or town, state, and ZIP code

B Employer identification number
C Date incorporated 7-1-82
D Total assets (see page 10 of instructions) $ 65,987

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change
F Check accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶

Income

1a	Gross receipts or sales 248,000 b Less returns and allowances 7,500 c Balance ▶	1c	240,500
2	Cost of goods sold (see page 17 of instructions)	2	144,000
3	Gross profit. Subtract line 2 from line 1c	3	96,500
4	Domestic corporation dividends subject to the 70% deduction	4	
5	Interest	5	942
6	Gross rents	6	
7	Gross royalties	7	
8	Capital gain net income (attach Schedule D (Form 1120))	8	
9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)	9	
10	Other income (see page 11 of instructions—attach schedule)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	97,442

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (see page 13 of instructions)	12	23,000
13	Salaries and wages (less employment credits)	13	24,320
14	Repairs and maintenance	14	
15	Bad debts	15	
16	Rents	16	6,000
17	Taxes and licenses	17	3,320
18	Interest	18	1,340
19	Charitable contributions (see page 14 of instructions for 10% limitation)	19	1,820
20	Depreciation (attach Form 4562) 20		
21	Less depreciation claimed elsewhere on return 21a	21b	
22	Other deductions (attach schedule)	22	3,000
23	**Total deductions.** Add lines 12 through 22 ▶	23	62,800
24	Taxable income before net operating loss deduction and special deductions. Subtract line 23 from line 11	24	34,642
25	**Less:** a Net operating loss deduction (see page 16 of instructions) 25a; b Special deductions (see page 16 of instructions) 25b	25c	

Tax and Payments

26	**Taxable income.** Subtract line 25c from line 24	26	34,642
27	**Total tax** (page 2, Part I, line 5)	27	5,196
28	**Payments:**		
a	2003 overpayment credited to 2004 28a		
b	2004 estimated tax payments 28b 6,000		
c	Less 2004 refund applied for on Form 4466 28c ( ) Bal ▶ 28d 6,000		
e	Tax deposited with Form 7004 28e		
f	Credit for tax paid on undistributed capital gains (attach Form 2439) 28f		
g	Credit for Federal tax on fuels (attach Form 4136). See instructions 28g		
h	**Total payments.** Add lines 28d through 28g	28h	6,000
29	Estimated tax penalty (see page 17 of instructions). Check if Form 2220 is attached ▶☐	29	
30	**Tax due.** If line 28h is smaller than the total of lines 27 and 29, enter amount owed	30	
31	**Overpayment.** If line 28h is larger than the total of lines 27 and 29, enter amount overpaid	31	804
32	Enter amount of line 31 you want: **Credited to 2005 estimated tax ▶** 804 **Refunded ▶**	32	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

George Rose — Signature of officer; 2-15-xx — Date; President — Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

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Form 1120-A (2004) Page 2

Part I Tax Computation (see page 20 of instructions)

1	Income tax. If the corporation is a qualified personal service corporation (see page 21), check here ▶ ☐	1	5,196
2	General business credit. Check box(es) and indicate which forms are attached: ☐ Form 3800 ☐ Form(s) (specify) ▶	2	
3	Subtract line 2 from line 1	3	
4	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Other (attach schedule)	4	
5	**Total tax.** Add lines 3 and 4. Enter here and on page 1, line 27	5	5,196

Part II Other Information (see page 23 of instructions)

1 See page 25 of the instructions and enter the:
a Business activity code no. ▶ 5995
b Business activity ▶ Flower Shop
c Product or service ▶ Flowers

2 At the end of the tax year, did any individual, partnership, estate, or trust own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) ☒ Yes ☐ No
If "Yes," attach a schedule showing name and identifying number.

3 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ -0-

4 Enter total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ▶ $ -0-

5a If an amount is entered on page 1, line 2, enter from worksheet on page 17 instr.:
(1) Purchases 134,014
(2) Additional 263A costs (attach schedule)
(3) Other costs (attach schedule) 9,986

b If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☒ No

6 At any time during the 2004 calendar year, did the corporation have an interest in or a signature or other authority over a financial account (such as a bank account, securities account, or other financial account) in a foreign country? ☐ Yes ☒ No
If "Yes," the corporation may have to file Form TD F 90-22.1.
If "Yes," enter the name of the foreign country ▶

7 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000? ☐ Yes ☐ No
If "Yes," the corporation is **not** required to complete Parts III and IV below.

Part III Balance Sheets per Books

			(a) Beginning of tax year	(b) End of tax year
Assets	1	Cash	20,540	18,498
	2a	Trade notes and accounts receivable		
	b	Less allowance for bad debts	( )	( )
	3	Inventories	2,530	2,010
	4	U.S. government obligations	13,807	45,479
	5	Tax-exempt securities (see instructions)		
	6	Other current assets (attach schedule)		
	7	Loans to shareholders		
	8	Mortgage and real estate loans		
	9a	Depreciable, depletable, and intangible assets		
	b	Less accumulated depreciation, depletion, and amortization	( )	( )
	10	Land (net of any amortization)		
	11	Other assets (attach schedule)		
	12	Total assets	36,877	65,987
Liabilities and Shareholders' Equity	13	Accounts payable	6,415	6,079
	14	Other current liabilities (attach schedule)		
	15	Loans from shareholders		
	16	Mortgages, notes, bonds payable		
	17	Other liabilities (attach schedule)		
	18	Capital stock (preferred and common stock)	20,000	20,000
	19	Additional paid-in capital		
	20	Retained earnings	10,462	39,908
	21	Adjustments to shareholders' equity (attach schedule)		
	22	Less cost of treasury stock	( )	( )
	23	Total liabilities and shareholders' equity	36,877	65,987

Part IV Reconciliation of Income (Loss) per Books With Income per Return

1 Net income (loss) per books	29,446	6 Income recorded on books this year not included on this return (itemize):	
2 Federal income tax per books	5,196		
3 Excess of capital losses over capital gains		7 Deductions on this return not charged against book income this year (itemize):	
4 Income subject to tax not recorded on books this year (itemize):			
5 Expenses recorded on books this year not deducted on this return (itemize):		8 Income (page 1, line 24). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	34,642

Form **1120-A** (2004)

EXAMPLE: Top Value Motors, Inc., retains a $200,000 net profit after paying salaries and fringe benefits. The corporation owes $61,250 tax to the IRS ($22,250 on the first $100,000 and $39,000 on the second $100,000). This is an average tax rate of about 31%.

Recommended Reading. For more in-depth information about income splitting, see *Save Taxes With Corporate Income Splitting*, by Anthony Mancuso (Nolo), a downloadable eFormkit available at www.nolo.com.

5. Less Common Taxes

A C corporation faces three other potential federal taxes that other business entities don't have to worry about:

- the accumulated earnings tax
- the personal holding company tax, and
- the corporate alternative minimum tax.

All of these are discussed in Section G, below.

Get help with corporate tax matters. This chapter covers only the basics—not the details—of corporate tax rules. Because the learning curve to master corporate tax intricacies is steep, you should always involve a tax pro.

C. Tax Benefits of C Corporations

C corporations offer the greatest tax planning benefits, but not until the venture is very profitable. Let's look at a few tax opportunities.

1. Income Splitting

A C corporation may engage in income splitting—that is, dividing income between the corporation and the shareholders in a way that lowers overall taxes. This benefits shareholders in the higher tax brackets. (See Section B4, above.)

Another Incorporation Advantage: Fewer Audits

Incorporating a small business lowers your audit odds. Corporations reporting under $100,000 of gross receipts per year are audited at one-third the rate of unincorporated businesses with the same income. Only when a business brings in over $1 million per year do the audit odds turn against corporations.

2. Fringe Benefits

A C corporation enjoys the greatest variety of tax-favored fringe benefits of all business entities. New ventures typically can't afford fringes, so this is not an advantage for many start-ups. But once your business's annual net income exceeds $100,000, consider a C corporation.

A fringe benefit is any tax-advantaged thing of value, like health insurance, allowed a business owner or employee. A fringe benefit is either partially or totally tax-free to the recipient and is usually deductible for the business.

Two big C corporation fringe benefits are retirement and medical reimbursement plans. While any business owner can establish a retirement plan, C corporations offer greater contribution limits and flexibility.

With a medical reimbursement plan, the C corporation reimburses the employee for any medical expenses not covered by insurance and then deducts these amounts as business expenses. The tax savings are usually greater than taking the same medical expense deductions on the shareholders'/employees' individual income tax returns.

Benefits must be offered to all employees. The principal drawback of corporate fringe benefits is that they must be given to most, if not all, employees of the corporation—not just the owner-shareholders. This could be a very expensive proposition for a small business with more than a few employees.

See Chapter 14, Fringe Benefits, and Chapter 15, Retirement Plans, for more details.

3. Operating Losses

While no one enjoys losing money in a venture, it happens. So, let's look for a tax break to cushion the blow. The good news is that there are few restrictions on claiming capital losses or operating losses of a C corporation, which may be carried over to future or past corporate tax years for tax benefits.

By contrast, sole proprietors, partners, and limited liability company owners are subject to restrictive rules for claiming tax benefits from business losses. (See Chapter 4, Business Losses and Failures, for details.)

Limited Liability: A Nontax Reason to Incorporate

Most small business owners who incorporate do so to limit their personal liability for debts of their business—not for tax purposes. The U.S. is the most "sue-happy" place in the world. If you are in business long enough, you will likely be sued, and if you lose, life as you know it could be over.

Incorporating provides a corporate shield that separates your business assets and liabilities from your personal finances. For instance, if a customer is injured on your premises, she can sue only your corporation—not you personally. If she wins, she can collect only from corporate assets—not your house or personal bank account. Ditto if your business fails and can't pay its creditors. Of course, you lose this protection if you personally guarantee corporate obligations to suppliers, who sometimes require this.

So deciding to incorporate (and whether to be a C or S corporation) involves weighing pros and cons. The *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo), discusses the nontax issues involved in choosing a business entity. So, do your homework and then sit down with a tax pro to confirm whether your choice makes good tax sense.

4. Dividends Received From Other Corporations

Another tax break reserved for C corporations is the dividends received exclusion. This helps if your C corporation invests in the stock of another corporation. This rather strange rule says that a C corporation may receive dividends from stock it owns in another unrelated corporation 70% tax-free. In other words, while you as an individual would have to pay taxes on 100% of a $1,000 corporate stock dividend, a C corporation is taxed on only $300.

5. Charitable Contributions

C corporations can directly claim charitable contributions. Sole proprietors, S corporations, LLCs, and partnerships can't. Also, C corporations can get a bonus deduction for certain donations. See IRS Publication 561, *Determining the Value of Donated Property,* for details. Corporations must get a qualified appraisal of property donated when it's more than $15,000 in value.

D. Incorporating Your Business

Forming a C corporation can complicate your life and add an extra bunch of expenses. Don't make this decision lightly.

Remember, a corporation is a separate tax entity from its owners, and normally when two taxpayers transfer assets between themselves there are potential tax issues. However, a going business can incorporate without tax consequences *if* certain rules are followed. (IRC § 351.) We discuss some of these start-up issues below.

1. Putting Cash Into a New Corporation

Typically, the business owners put money into a newly created corporate bank account in return for shares of stock. Accountants call this capitalizing the business.

Whether buying shares of Microsoft or starting your own Minisoft corporation, there are no tax consequences of acquiring stock. You are making an equity investment. The taxes come later, if and when you sell or otherwise dispose of your stock.

> **EXAMPLE:** Marty incorporates her biotech newsletter business and puts $10,000 into its bank account. In return, Marty, Inc., issues Marty 1,000 shares of stock. This is tax-treated as an equity investment by Marty, in Marty, Inc., with no tax consequences. Later, when Marty sells her shares or dissolves Marty, Inc., and receives the money or assets, she will be taxed only if she has a gain—that is, she receives more than her $10,000 tax basis in the stock. Her gain will be taxed at favorable capital gains rates if she has held her stock at least one year.

While there is no minimum investment required for federal tax purposes, there might be under your state's law. Most states require corporations to have sufficient cash or other assets to show that they are not empty shells. In legalese, this is called adequate capitalization.

Always adequately fund your corporation. Make sure there is a reasonable amount of money in your corporation to meet its expenses and pay its debts. Otherwise, the IRS, a court, or a creditor might say the corporation is a sham because it is undercapitalized and hold you personally liable for corporate debts.

2. Lending Money to Your New Corporation

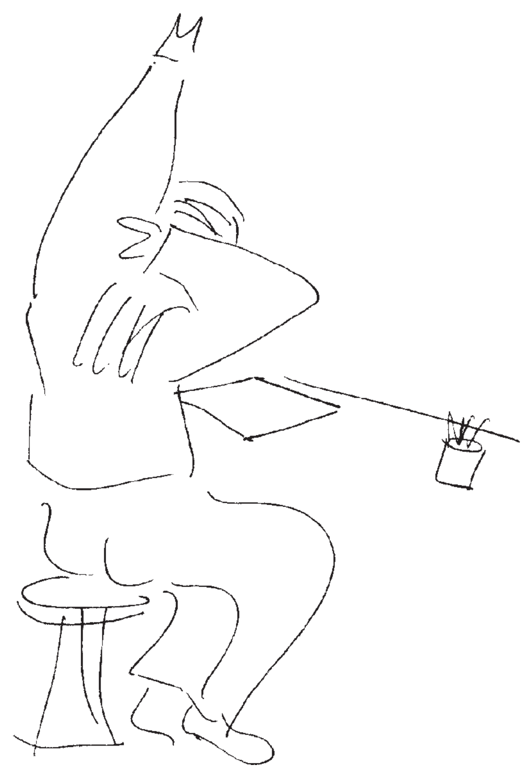
Incorporators are often tempted to lend money to their new corporation rather than purchase stock. This would be advantageous, because then the first money taken out of the business would be a repayment of the shareholder's loan. In effect, the shareholders would receive a tax-free return of their investment.

Sorry—the tax code frowns on shareholder loans (debt) for a corporate start-up. There must be a cash or property investment (equity) for stock. A shareholder cannot take back any corporate IOUs (promissory notes) for his initial contributions to a startup. (IRC § 351.)

Only when a corporation is up and running may a shareholder loan be okay. See "Shareholder Loans to an Established Corporation," below.

3. Putting Assets Into a New Corporation

You may transfer things other than cash—such as a building, vehicle, or patent you own—to a corporation in exchange for its stock. There may be a tax trap, however. Let's look at how to avoid the tax pitfalls.



Shareholder Loans to an Established Corporation

Once a corporation is established and profitable, a shareholder can make loans to it to fund its operations or for expansion. A loan beats making a further capital contribution by the shareholder, because he can take a loan repayment without any tax consequences. Otherwise, money taken out of the corporation by a shareholder is taxable income to him, either as compensation for services or as a dividend.

A shareholder loan must meet legal formalities and be a commercially reasonable transaction to pass potential IRS audit scrutiny. The IRS wants to make sure that the shareholder loan is not really a capital investment in disguise. If the IRS finds that the loan terms are not commercially reasonable (such as a 1% interest rate and no fixed repayment date), the IRS can reclassify the loan repayments as taxable *dividend* payments to the shareholder.

There is a limit to the amount of funds shareholders can lend to their corporation. This limit is determined by the corporation's debt-to-equity ratio. Put simply, this means that a corporation can't have too much debt relative to the investment of the shareholders in the corporation business; otherwise the corporation is termed thin, or undercapitalized. An acceptable debt-to-equity ratio is usually 3:1 or lower. Anything beyond 3:1 could raise the issue of an undercapitalized corporation in the eyes of the IRS.

EXAMPLE: Arturo puts $30,000 in Arturo's Tile Corporation (ATC) to start the business. Later, ATC borrows $90,000 from Arturo to fund a business expansion. ATC's debt ($90,000) to shareholder equity ($30,000) ratio is 3:1, which is usually an acceptable ratio to an IRS auditor, so the loan should be fine as long as its interest and repayment terms are commercially reasonable.

The IRS is more likely to challenge a loan transaction if it is not well documented. There should be promissory notes and corporate resolutions approving the loan recorded in the minutes of a board meeting. The terms of the loan should be met—for example, the interest and principal should be repaid when due according to the promissory note. For promissory notes and resolutions, see *The Corporate Records Handbook* or *Corporate Loans: Create Promissory Notes and Resolutions* (an eFormKit), both by Anthony Mancuso (Nolo).

a. When IRC § 351 Can Help

Transferring an asset with a fair market value greater than your tax basis in it to a corporation for stock is *potentially* taxable. Thankfully, a special elective tax code provision, IRC § 351, lets you postpone any taxes due.

With IRC § 351, there's no tax unless you sell the stock received in exchange for the property at a profit (or the corporation is dissolved and you receive assets worth more than your initial investment).

EXAMPLE: Mario transfers his warehouse (which he has owned for ten years and which has a tax basis of $50,000) to Mario Brothers, Inc,. in exchange for stock. (See Chapter 2, Section D, for an explanation of how the tax basis of property is determined.) At the time of the transfer, the warehouse has a fair market value of $100,000.

Without IRC § 351, the tax code treats this transfer as Mario's selling his warehouse to his corporation. This produces a taxable gain to Mario of $50,000—the difference between his $50,000 basis and the $100,000 market value. Fortunately, Mario can elect *nontaxable* treatment of the transfer by invoking IRC § 351. (But before Mario transfers into the corporation any property that has appreciated, he should check with his accountant.)

b. When Not to Use IRC § 351

Section 351 is not mandatory; it is elective. If property transferred to a corporation has gone *down* in value, IRC § 351 may not be the way to go, because electing IRC § 351 treatment takes away the tax benefit of a loss. A shareholder may not claim a taxable loss when transferring property to his own corporation.

> **EXAMPLE:** In the previous example, suppose Mario bought his warehouse for $50,000 and its value has dropped to $30,000 when he decides to incorporate. In effect, Mario has lost $20,000 on paper. IRC § 351 does not allow a tax loss on a transfer of a shareholder's property to his corporation. So if Mario elected Section 351, he would not get a tax benefit of the $20,000 loss in value if he transfers the warehouse to Mario Brothers, Inc.

c. Selling Assets to Your Corporation

Selling an asset to your corporation and claiming a loss on the sale is a no-no. The related party rules (IRC § 267) prohibit claiming tax losses on transactions between shareholders and their corporation if they own more than 50% of its stock. You and your corporation are related parties.

> **EXAMPLE:** Mario, in the previous example, can claim a $20,000 tax loss resulting from the warehouse's decline in value only by selling the warehouse to an unrelated party—not to his corporation. If Mario Brothers, Inc., needs the warehouse, Mario could lease it back from the new owner after the sale.

d. How to Meet the Conditions of IRC § 351

Generally, when transferring to your corporation property that has appreciated since you acquired it, four conditions must all be met:

1. **The corporation must receive real estate or personal property in exchange for stock.** Real estate and equipment are the most common types of assets, but you can also transfer just about anything of value.
2. **Shareholders must receive only stock in exchange for the property.** Transferors can't take back cash, bonds, corporate promissory notes, or more complicated instruments like stock warrants or stock options, without incurring a tax bill. And each shareholder must receive stock in direct proportion to the fair market value of the property transferred.

EXAMPLE: Joe transfers $20,000 fair market value of equipment and Jill transfers $20,000 worth of real estate to Joe & Jill, Inc. Each must get an equal number of shares of stock in return.

> **If a transferor gets anything else but stock, its value is taxable income to that shareholder.** For instance, if, in addition to stock, Joe receives a $10,000 promissory note from Joe & Jill, Inc., $10,000 of income is taxable to him.

3. **The shareholders who transfer property must be in control of the corporation.** Taken as a group, shareholders who transfer property for stock must own at least 80% of the new corporation's shares after the transfer. Since the stock of most small business corporations is held by only a handful of investors, ordinarily this restriction is not a problem.

EXAMPLE: Paul, Ringo, and John want to incorporate and use IRC § 351. Paul and Ringo transfer $170,000 in biotech research equipment, previously used by their P & R partnership, in return for 75% of the shares of Bio Research, Inc. John, who is retired and does not intend to work in the business, is internationally known in this field; the corporation gives him 25% of the shares outright on condition that it can advertise his name as a shareholder. This transaction *fails* IRC § 351 rules because, after the transfer, Paul and Ringo own less than 80% of the stock.

4. **No stock may be given in exchange for future services.** This condition of IRC § 351 causes the most problems. Any shareholders who got stock for their promise of service will owe income tax on the value of the stock received.

EXAMPLE: Wanda and Perry form Galaxy Inc. to help businesses advertise on the Internet. Perry contributes $100,000. Wanda, who is broke, promises to apply her skill with online networks. They each receive 250 shares of Galaxy Inc. Wanda's stock doesn't qualify under IRC § 351, so she is taxed on $50,000, the value of her half of the corporation's stock. Perry is not taxed, because he is qualified under IRC § 351. Given this result, Wanda may not want to become a stockholder of Galaxy Inc.

e. Value of Stock in an IRC § 351 Transfer

Stock received for assets other than cash has the same tax basis the property had. In tax lingo, this is substituted basis. So, the value of your stock equals the value of the property exchanged for it. For tax purposes, you have the same amount invested in the stock as you did in the asset transferred for it.

EXAMPLE: When he forms Jones, Inc., Jason transfers a building he owns for stock. Jason's tax basis in the building, valued at $110,000, was $75,000, so his basis in his Jones, Inc., stock is $75,000. The actual fair market value of the building ($110,000) is irrelevant to Jason's basis in his stock.

f. IRC § 351 Filing by Corporations and Shareholders

A corporation *and* each shareholder must report all IRC § 351 transfers. A 351 statement listing all property transferred must be attached to the tax returns of the individual shareholders and of the corporation in its first year of operation. There is no IRS preprinted form for this, so get help from a tax pro here. (Reg. 1.351-3.)

Record IRC § 351 transfers from shareholders in the corporate minutes book. Each individual shareholder should also keep records of assets transferred —for as long as they own their shares, and for at least three years after they dispose of them (just in case the IRS comes calling).

Transfers to a corporation may be taxed under state and local laws. IRC § 351 is a federal tax rule. State and local laws may treat transfers of shareholder assets as taxable sales to the corporation. For example, a retail clothier transferring his inventory of men's suits to his new corporation may be hit with his state's sales or inventory tax. There may be other unexpected state tax issues from an IRC § 351 transfer. For instance, real estate transferred may trigger a property tax reassessment. In California, transferring appreciated real estate to a corporation usually means a property tax hike. You might be better off leasing your real estate to your corporation. (See Section F4, below.) So see an accountant or contact state and local tax agencies before making any transfers.

E. The Importance of Issuing Section 1244 Stock

A small business C corporation should always issue Section 1244 stock. (S corporations don't qualify for IRC § 1244—see Chapter 8.) This enables shareholders to get better tax treatment if they lose money on their investment in C corporation stock. (See Chapter 4 for an explanation of how this works.)

There is no downside, and it is easy to qualify for IRC § 1244 treatment. Here are the rules—most of which should not be a problem:

- IRC § 1244 corporate shares may be issued only in return for money or property. You can't exchange stocks or bonds from another corporation, or contribute services, in return for IRC § 1244 stock. And Section 1244 stock can't be issued in return for canceling a prior debt to the shareholder.

- Investors must be individuals—not other business entities, such as partnerships, LLCs, or other corporations.
- No more than 50% of the corporation's gross receipts during the preceding five years (or the life of the corporation) may have been passive income. Passive income includes royalties, dividends, interest, rents, annuities, or gains from securities or stock. IRC § 1244 corporation losses must be from active business operations, not investments.
- The total money or property received by the corporation for IRC § 1244 stock cannot exceed $1 million.
- The corporation must be a domestic (U.S.) company.
- The shareholder must be the original purchaser of the stock.

Authorize more shares than you'll sell. Folks seldom risk putting big bucks into a start-up venture. But an investor can't claim IRC § 1244 treatment for any contributions made *after* the initial shares were issued. You can solve this dilemma by treating any money later contributed as payment for IRC § 1244 stock that was authorized but not issued. The example below shows how to do this.

EXAMPLE: HairCo, a new corporation, authorizes 1,000 shares of IRC § 1244 stock to be issued to Morey, who agrees to buy them at $100 per share. At the time HairCo is formed, Morey pays $40,000 for 400 shares. The next year Morey pays $60,000 for 600 authorized shares, a total of $100,000. All of Morey's stock is IRC § 1244 stock.

1. The Section 1244 Corporate Resolution

Always adopt a written corporate resolution at the time the corporation first issues stock, stating that the shares are IRC § 1244 stock. You might get by an IRS audit without a written resolution if you meet the above conditions, but why take the risk? Even a postdated resolution (made after the stock was issued) will probably pass IRS muster.

Neither the corporation nor shareholders have to file the resolution with the IRS. Just keep it in your corporate records book in case the IRS decides to question the investment loss during an audit. A sample IRC § 1244 resolution is shown below.

Sample IRC § 1244 Resolution

The board considered the advisability of qualifying the stock of this corporation as IRC § 1244 stock as defined in the Internal Revenue Code, and of organizing and managing the corporation so that it is a small business corporation as defined in that section. Upon motion duly made and seconded, it was unanimously

RESOLVED, that the proper officers of the corporation are, subject to the requirements of federal law and the law of this state, authorized to sell and issue shares of stock in return for the receipt of the aggregate amount of money and other property, as a contribution to capital and paid-in surplus, which does not exceed $1,000,000.

RESOLVED FURTHER, the sale and issuance of shares of stock shall be conducted in compliance with IRC § 1244 so that the corporation and its shareholders may obtain the benefits of that section.

RESOLVED FURTHER, that the proper officers of the corporation are directed to maintain such records as are necessary pursuant to IRC § 1244 so that any shareholder who experiences a loss on the transfer of shares of stock of the corporation may determine whether he or she qualifies for ordinary loss deduction treatment on his or her individual income tax return.

________________ ________________________
Date Secretary

2. Claiming a Section 1244 Loss

An IRC § 1244 stock investment loss is claimed on IRS Form 4797. This form is filed with each shareholder's individual income tax return after the year of the loss. The form is in the appendix and on the IRS's website at www.irs.gov. See Chapter 4, Section B, for more information.

F. Taking Money Out of a C Corporation

A C corporation opens up several tax opportunities for shareholders/owners in taking money out of their business. Because a corporation is a separate legal and tax entity from its owners—unlike a sole proprietorship, limited liability company, or partnership—you and your corporation may engage in beneficial financial dealings, such as loans, between each other.

Pay attention to corporate formalities; the IRS does. Always prepare corporate minutes or resolutions (records) of any significant corporate financial transactions—loans, compensation of officers, and so forth. IRS auditors often inspect corporate records. If you haven't kept up your corporate paperwork, an auditor can disregard your business's corporate status. Tax benefits can be disallowed because corporate records books are not up-to-date or state filings for the corporation were not made.

1. Compensation for Services

If you work in your incorporated business, you are *not* self-employed. You are an employee of your corporation, just like the secretary and janitor.

Small corporations may benefit from putting the owner/shareholder's spouse and kids on the payroll. Spreading family business income over lower tax brackets is legal as long as everyone does real work and isn't overpaid. (See Chapter 12, Family Businesses.)

In theory, the tax law (rather vaguely) limits the wages you can receive from your C corporation—salaries and bonuses paid to shareholder-employees must be reasonable. (IRC § 162.) Corporations paying unreasonable compensation for personal services can have this wage expense disallowed or reduced during an IRS audit.

An IRS auditor can also assess a 25% penalty on certain excessive salaries. This penalty applies to officers, directors, and family members of closely held corporations. Also, penalties can be applied if corporate assets are transferred at large discounts instead of cash. (Again, this is not usually a concern for small business corporations.)

Here's one real-life case that allowed a million-dollar annual salary. The principal stockholder was the CEO, who designed products sold by the company. The tax court found that the products he designed were responsible for increased sales, so he, in effect, performed more than one job. The $1 million corporate compensation was not unreasonable under these circumstances. (*PMT Inc. v. CIR,* TC Memo 1996-303.)

Recently, the IRS hasn't pushed this issue in audits.

Prepare for an IRS audit challenge for unreasonable compensation. Assuming you do significant work for your corporation, draw up an employment contract stating your salary and duties. This shows that your pay was a well-thought-out business decision.

Keep your stated salary fairly consistent from year to year—even if the corporation does not always have enough funds to pay it. Otherwise, if your salary is tied to profits, it looks more like a corporate dividend on your investment, and not wages. If the corporation has a down year and can't pay your scheduled salary, get a promissory note from the corporation. Then take funds when they're available in future years as payment on the note. Document shareholder compensation decisions in the minutes of the corporation.

2. Dividends

A C corporation may pay dividends to shareholders if it has enough current and retained earnings to also pay its debts. But, this may not make sense because of the bugaboo of double taxation: Meaning that the corporation is taxed on its profits before the dividend is paid, and the recipient shareholder is taxed again on the same profits. While it seldom makes sense for a small corporation to pay dividends, it may be done for shareholders who don't work in the business and aren't paid salaries.

Lower Tax on Dividends

For individuals, qualified corporate dividends are now taxed at 5% to 15% through 2008, rather than at ordinary income tax rates (which range up to 35%). For details, see Publication 550, *Investment Income and Expenses,* or talk to an accountant.

3. Loans to Shareholders

A profitable C corporation may lend money to its shareholders. A loan from your C corporation isn't taxable income to you and doesn't have tax consequences to the corporation. Interest paid by the borrower on the loan is income to the corporation, of course.

Shareholder loans must be bona fide. This means that the borrowers must promise in writing to repay the loan at a specific date, and the loan should be secured by pledging assets, which will be forfeited to the corporation if the loan is not repaid.

Corporations must charge interest, except on loans to shareholders of less than $10,000—they can be interest-free. Larger loans must carry a commercially reasonable rate of interest—at least the minimum legal interest rate. (See "How to Make Sure a Loan From a Corporation Is Treated as Legitimate by the IRS," below.)

The IRS knows shareholders are tempted to label all withdrawals from their corporation as loans, because loans are not taxable income. So, if a loan doesn't look legitimate, an IRS auditor can rename it and tax it as compensation or a dividend payment to the shareholder.

Checklist: How to Make Sure a Loan From a Corporation Is Treated as Legitimate by the IRS

A loan to a shareholder should look like a bank loan, to withstand an auditor's challenge. Plus, the parties must abide by its terms. The corporation shouldn't give a shareholder any breaks—such as forgiving interest on the loan—that a bank wouldn't give. Here are the specifics:

- The corporate records should reflect all loans.
- The shareholder should sign a promissory note for a specific amount.
- The note should obligate the shareholder to repay the loan unconditionally on a specific date or in regular installments.
- The corporation should charge at least the applicable federal rate (AFR). The Treasury Department sets this rate once a month; call the IRS or check the IRS website at www.irs.gov for the current AFR rate. If a corporation doesn't charge at least this rate, an IRS auditor can attack it as a below market loan (IRC § 7872) and the borrower will be taxed as receiving the value of the undercharged interest.
- The note should be legally transferable by the corporation to a third party.
- The loan should be secured by collateral such as a bank account, real estate, or other shareholder property.
- The note should stand on equal footing with debts of others to the corporation.
- The note should give the corporation the right to sue and take the collateral if the shareholder does not repay the loan on time.
- The shareholder should make all interest and principal payments when due.

For promissory notes and resolutions, see *The Corporate Records Handbook* or *Corporate Loans: Create Promissory Notes and Resolutions* (an eFormKit), both by Anthony Mancuso (Nolo).

4. Leasing Assets to Your Corporation

Leasing your individually owned assets to your corporation is another way to extract profits from the corporation—without paying taxes on dividends or salaries.

Real estate is most often leased to a corporation by its shareholders, but leasing can also work tax-wise for things like equipment or machinery.

Leasing to your corporation can produce a paper loss for you, the shareholder, which you can claim against your other income. Typically, the loss comes from your taking a depreciation deduction on the property. It can also come when cash expenses exceed cash income. Either type of loss can offset, or shelter, other income on your individual tax return.

> EXAMPLE: On January 1, Bart buys a building for $100,000. He immediately leases it to his C corporation, Homer, Inc., at the market rate of $12,000 per year. Since the building is worth $80,000 (the lot is worth $20,000), Bart is allowed to take depreciation deductions of $2,051 per year. (See Chapter 2, Writing Off Business Assets.) Bart incurs annual expenses for real estate taxes, maintenance, and mortgage interest on the building totaling $11,400. After applying the rent payments from Homer, Inc., Bart reports a loss of $1,451 on his tax return ($12,000 income – $11,400 expenses – $2,051 depreciation = $1,451 tax loss). Note: Passive loss rules for real estate may limit Bart's ability to offset rental losses against other income. They are beyond the scope of this book, however, so check with an accountant if this may be an issue.

To pass IRS audit muster, a lease between a shareholder and the corporation must be a realistic deal. The lease payment must be close to fair market value. But because rents for similar properties can vary considerably, you can charge your corporation a bit more (or less) than you might get from others. How much depends on several factors. A 25% discrepancy from fair market value is usually defensible—especially if you can back it up with a written opinion from a real estate professional that the rent paid is within the market range.

> EXAMPLE: Brenda owns a storefront building and rents it to her incorporated bakery business, Tarts to Go, Inc. The building might rent for $500 a month on the open market, but its size, amenities, and location are unique, making precise valuation difficult. Brenda is probably safe renting it to Tarts to Go for $625 a month, but $2,000 is not likely to fly at an IRS audit.

Leasing property limits your liability. A good nontax reason for leasing your property to your corporation (rather than having the business own it) is to protect your assets from corporate liabilities. For instance, suppose your corporation is successfully sued for sexual harassment. The judgment can be collected against the corporation's property, but your leased assets are safe. Even if the corporation declares bankruptcy, leased property is not a corporate asset; it still belongs to you, its owner.

5. Selling Your Corporate Stock

A share of corporate stock—a fractional ownership interest in a business—is an asset. As with any asset, its sale is a taxable event, usually producing a gain or loss to the seller.

a. Capital Gains

A shareholder's gain on sale of stock held longer than one year is taxed at special capital gains rates. (See Chapter 2, Writing Off Business Assets, for an explanation of capital gains rates.)

> EXAMPLE: Robin forms RRR, Inc., and transfers his warehouse to the corporation in exchange for stock. Because of IRC § 351, the transfer is not taxable. (See Section D3, above.) His basis in the warehouse—$75,000—becomes his basis in his stock.

Two years later, Robin sells his stock to Wanda for $175,000. Robin has a taxable gain of $100,000 ($175,000 minus his basis in his stock of $75,000). The capital gains tax on Robin's profit is a maximum of 15% (IRC § 1(h)), making his tax liability $15,000. (Robin's state tax agency will get a cut of the action, too.) Without the capital gains tax rate, Robin's federal tax could have been as high as $35,000.

Lower Capital Gains Tax

The long-term capital gains tax is now a maximum of 15% for gains on sales of corporate stock held more than one year. And folks in the lower 10% or 15% income tax bracket pay only 5% on long-term gains. For details, see Publication 550, *Investment Income and Expenses,* or talk to a tax pro.

b. Capital Losses

Shareholder losses on the sale of stock face more restrictive tax rules than do gains. Unless the corporate stock is qualified under IRC § 1244 (discussed in Section E, above), a shareholder's capital losses can only partly offset his ordinary income ($3,000 in any one year). His capital losses may, however, fully offset any of his capital gains. (See Chapter 4, Section B, for a detailed explanation.)

Tax Breaks for Qualified Small Business Corporation Investors

Investors in qualifying C corporations formed after August 10, 1993 may get a special tax break if they sell their stock at a gain. Fifty percent of any gain on the sale of so-called IRC Section 1202 stock is not taxed if held for more than five years. In effect, the normal capital gains tax rate is cut in half.

Which corporations qualify? The rules are complex. For instance, at least 80% of the corporation's assets must be used in the active conduct of the business. This eliminates corporations with significant income from investments. And corporations that sell services (like health or legal), or a mix of goods and services (like hotels or restaurants) don't qualify. See a tax pro for details.

G. Tax Pitfalls of C Corporations

When you're a C corporation, you are playing with the big boys. Mind-boggling corporate tax complexities occasionally trap small business owners. One worry—double taxation—has been discussed; here are three others.

1. Personal Holding Company Tax

There is a special penalty tax on C corporations the IRS deems incorporated pocketbooks. This targets corporations with 60% or more of their income from investments, such as dividends and royalties. Don't worry about this if you're running an active business.

2. Accumulated Earnings Tax

An advantage of a C corporation over other business entity forms is its ability to accumulate earnings (roughly meaning profits) to fund future growth. These earnings are taxed to the corporation—but at lower rates than if they had been distributed to the shareholders.

If, however, a C corporation keeps too much profit in its coffers, it incurs an accumulated earnings tax of 15%. Smaller C corporations can breathe easy—this tax does not kick in until accumulated earnings exceed $250,000. (IRC § 531.) Again, this is not generally a small business worry.

3. Corporate Alternative Minimum Tax

A corporation using certain tax code provisions to lower its income taxes can be punished. The snag is the corporate alternative minimum tax. (IRC §§ 55–58, Reg. 1.55–1.58.) Because few small business corporations ever have to worry about this, the explanation here is short.

The tax breaks that cause the corporate alternative minimum tax to come into play are called tax preference items. They include out-of-the-ordinary things like income from life insurance or from a corporation spreading its tax liabilities into the future by using the installment method of tax reporting. When the alternative minimum tax is calculated, deductions and credits for these preference items are added back to the corporation's income.

H. Dissolving a C Corporation

How your corporation can go out of business depends on your state's law—just as its formation did. Generally, a corporation can close down if more than 50% of the shareholders vote to quit.

A corporation can also cease to exist involuntarily by operation of law—such as from a deadlock of shareholders or nonpayment of state taxes or fees. Neglecting to keep up with state filings and fees is the most common way small corporations die.

1. Tax Issues Upon Dissolution

The specter of double taxation arises if a dissolving C corporation distributes assets to the shareholders. Or, a sale of the business's assets may mean the corporation owes tax on any gain on the sale and the shareholders owe tax again on the money received.

In addition, if the corporation has ever claimed any tax benefits (such as depreciation) on its assets, the corporation's basis in these assets may be very low or even zero. Depreciation deductions previously taken may be recaptured on dissolution and are now taxable. The result may be unexpected taxable gain even when the corporation disposes of assets for minimal amounts.

Dissolving a corporation is a good time to bring in a tax pro.

Consider switching to S corporation status on your way out. One way around any double-taxation problems on liquidation may be for a dissolving C corporation to elect S corporation status before it liquidates—but don't try this without first consulting a good tax pro.

2. Reporting the Dissolution to the IRS

While it is relatively easy to dissolve a corporation, if you suddenly stop filing corporate income tax returns, expect the IRS or your state taxing agency to send an inquiry letter.

IRS Form 966, *Corporate Dissolution or Liquidation,* should be filed with the IRS whenever a corporation is terminated. For more information, see IRC § 331 and following sections (for shareholders), IRC § 336 and following sections (for corporations), and Reg. 1.331 et seq.

Resources

- IRS Publication 334, *Tax Guide for Small Business*. This is an indispensable publication for any small business, including C corporations.
- IRS Publication 542, *Corporations*. This booklet is especially useful if you are preparing and filing corporate tax forms without professional assistance.
- IRS Form 1120, *U.S. Corporation Income Tax Return and Instructions*.
- *Incorporate Your Business* (National) and *How to Form Your Own California Corporation*, by Anthony Mancuso (Nolo). These books take you through the incorporation process step by step. The forms are available on CD-ROM.
- *The Corporate Records Handbook*, by Anthony Mancuso (Nolo). This book shows you how to write up minutes of corporate meetings and document corporate decisions and transactions, which are often important to withstand IRS scrutiny.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This excellent book deals with all of the ramifications of operating as a C corporation.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinncpas.com.

■

CHAPTER

8

S Corporations

"Corporations cannot commit treason, nor be outlawed, nor excommunicated, for they have no souls."
—Sir Edward Coke

Before tackling this chapter, take a look at the previous one (Chapter 7) on C corporations—all corporations are born as C corporations under the tax code. Becoming an S corporation requires an extra step, called a tax election, with vital tax implications. This chapter explains the tax treatment of S corporations and how to become one.

A. An Overview of S Corporations

C and S corporations (the letters refer to subchapters of the Internal Revenue Code) are distinguished by *how* their income is reported and taxed.

S corporations pass income through to their shareholders, who pay tax on it according to their individual income tax rates. C corporations, as explained in Chapter 7, are separate tax entities that pay corporate income tax on profits.

Electing S corporation status eliminates the possibility of double taxation on business profits. (C corporations may owe income tax at the corporate level, and then the shareholders are taxed again when the corporate profits are put into their hands.) Because S corporations are pass-through entities, their profits are taxed directly to the shareholders, the business's owners. S corporations pay no federal corporate income tax but must file annual tax returns.

Similarly, since losses pass through too, S corporation shareholders take most business operating losses on their individual returns. (There are restrictions on loss-taking by shareholders who aren't active in the business; see Section D, below.) By contrast, C corporation losses remain in the corporation, so their shareholders cannot claim them on their individual tax returns as long as the corporation is in existence.

EXAMPLE: Jeannie Smith works as a loan officer for First Bank, earning $25,000. She and her husband, Sam, also run a small S corporation business selling computers. The Smiths file tax returns jointly. The computer business loses $15,000 that year. By using this $15,000 operating loss to offset Jeannie's $25,000 salary, the Smiths' total taxable income is reduced to $10,000. After taking into account their exemptions and personal deductions, the Smiths probably won't owe any income taxes. If this had been a regular C corporation, Sam's business loss of $15,000 wouldn't have offset Jeannie's $25,000 earnings on the Smiths' personal tax return.

Although an S corporation business is not a tax-paying entity, it is most definitely a tax-reporting entity. An annual corporation tax return, Form 1120S, showing income and expenses and the resulting profits or losses, must be filed.

In addition, an S corporation must file and pay employment taxes on its employees just like a C corporation. (See Chapter 5 for an explanation of employment taxes.) This means that S corporation shareholder-employees don't pay self-employment taxes. The shareholders must make quarterly estimated tax payments if they will owe over $1,000 in federal taxes for the year.

S Corporations in a Nutshell

1. All corporations begin as C corporations but may elect S status with the IRS.
2. S corporations are treated much like partnerships or limited liability companies for tax purposes. S corporations don't pay taxes; instead, shareholders pay taxes on business income at their individual tax rates.
3. Electing S corporation status means forgoing some of the tax benefits available to a C corporation.
4. Because business start-ups typically lose money in their early years, electing S corporation status is advantageous. S corporation shareholders can claim business losses directly on their personal tax returns.

B. Should You Choose S Corporation Status?

Most people incorporate for *non*tax reasons—usually to shield their personal assets from business obligations and lawsuits. Corporate shareholders, unlike partners and sole proprietors, aren't personally liable for business debts.

The S corporation combines this limited liability with pass-through tax treatment—allowing business income and deductions to flow directly to shareholders. This is the same tax result as with a sole proprietorship, partnership, or LLC.

Also, S corporations offer their shareholders tax benefits from operating losses, common in a business's start-up phase. S corporations (unlike C corporations) allow shareholders *active* in the business to take operating losses against their other income. Investors who don't work in the business can't take this benefit.

Start off as an S corporation. New enterprises often elect S corporation status for the early years and, when profitable, convert to a C corporation. Switching to a C corporation produces fringe benefit tax-savings and opens the door for splitting income between the corporation and the shareholders. (See Chapter 7, Section C1, and Chapter 14, Fringe Benefits.)

Consider an alternative to S corporations, the limited liability company. If an S corporation sounds good, consider a limited liability company (LLC). An LLC, like an S corporation, provides a pass through of business income and losses to individual owners. LLCs also offer the personal liability shield of corporations, but are simpler to form and operate than S corporations. (See Chapter 10, Limited Liability Companies.)

1. Small Business Eligibility for S Corporation Status

In all likelihood, you will qualify for S status with the IRS, but check these technical rules to make sure your corporation is eligible:

- It is a U.S. corporation with no more than 100 shareholders. This eliminates public corporations. (A husband and wife are considered one shareholder if they own their stock jointly.)
- All shareholders are individual U.S. citizens or resident aliens, other S corporations, or an electing small business trust.
- The corporation has only one class of stock. There can't be any preferred classes of shares or other types of shares that give special privilege to only some shareholders.
- All shareholders consent in writing to S corporation status by signing Form 2553 filed with the IRS within two months and 15 days of the corporations formation. (See sample Form 2553, below.)

2. S Corporation Disadvantages

S corporations are great for many small business owners, but they are not for everybody. Here are some potential tax disadvantages to consider.

a. Immediate Taxation of Earnings

A successful corporation often wants to squirrel away some profits for future growth. Profits remaining in corporations are called retained earnings.

An S corporation, however, cannot retain earnings without the shareholders' having to pay tax on them. Remember, S corporation profits pass through to the shareholders even if left in the coffers. A C corporation, on the other hand, can keep some profits in the business in return for paying a relatively small amount of tax at low corporate tax rates. (See Chapter 7, C Corporations, for details.)

Form **2553** (Rev. March 2005) Department of the Treasury Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)

▶ See Parts II and III on back and the separate instructions.

▶ The corporation may either send or fax this form to the IRS. See page 2 of the instructions.

OMB No. 1545-0146

Notes: 1. ***Do not*** *file* ***Form 1120S,*** *U.S. Income Tax Return for an S Corporation, for any tax year before the year the election takes effect.*

2. *This election to be an S corporation can be accepted only if all the tests are met under* ***Who May Elect*** *on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed this form; and the exact name and address of the corporation and other required form information are provided.*

Part I Election Information

Please Type or Print	Name (see instructions) XTC Incorporation	**A** Employer identification number 94 : 000 0000
	Number, street, and room or suite no. (If a P.O. box, see instructions.) 123 Main St.	**B** Date incorporated 1/1/05
	City or town, state, and ZIP code Anytown, CA 90210	**C** State of incorporation CA

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its name ☐ or address ☐

E Election is to be effective for tax year beginning (month, day, year) . . . . ▶ / /

F Name and title of officer or legal representative who the IRS may call for more information
Jose Smegola, President

G Telephone number of officer or legal representative
(555) 555-5555

H If this election takes effect for the first tax year the corporation exists, enter month, day, and year of the **earliest** of the following: (1) date the corporation first had shareholders, (2) date the corporation first had assets, or (3) date the corporation began doing business . . . . ▶ 1 / 1 / 05

I Selected tax year: Annual return will be filed for tax year ending (month and day) ▶ 12/31

If the tax year ends on any date other than December 31, except for a 52-53-week tax year ending with reference to the month of December, complete Part II on the back. If the date you enter is the ending date of a 52-53-week tax year, write "52-53-week year" to the right of the date.

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K)	**K** Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		**L** Stock owned or percentage of ownership (see instructions)		**M** Social security number or employer identification number (see instructions)	**N** Share-holder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		
Jose Smegola 123 Main St. Anytown, CA 90210	Joe Smegola	2/10/05	100	1/1/05	123-45-6789	12/31
Francine Schwatzkopf 666 B. St. Anytown, CA 90000	Francine Schwatzkopf	2/15/05	100	1/1/05	987-65-4321	12/31

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer ▶ Francine Schwatzkopf **Title ▶** Secretary **Date ▶** 2/28/05

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 18629R Form **2553** (Rev. 3-2005)

EXAMPLE: Sam and Jeannie Smith's incorporated computer retail store earns a $50,000 profit after paying the Smiths $200,000 in salary. They keep the $50,000 profit in the corporation bank account. If the Smiths were a C corporation, they would pay income tax of $7,500 ($50,000 at a rate of 15%). By contrast, as an S corporation, the $50,000 is taxed at the Smiths' personal income tax rate. The Smiths' rate might be as high as 35%, meaning an additional income tax bill of $17,500.

b. Limited Employee Fringe Benefits

S corporations can't provide the full range of fringe benefits that C corporations can. However, smaller businesses often can't afford fringes anyway, so this is a big deal only for cash-rich, mature corporations. Once a business has substantial earnings, a C corporation offers tax-savings opportunities over an S corporation. That's the time to discuss things with a tax pro.

Chapter 14, Fringe Benefits, and Chapter 15, Retirement Plans, discuss tax-advantaged fringe benefits.

c. Converting a C Corporation

If you convert your existing C corporation to an S corporation, tax bugaboos may pop up. Conversion to an S corporation will produce a tax bill if the C corporation:

- had passive income (from investments, not business operations)
- used the last-in-first-out (LIFO) method to report inventory, or
- had unrealized gains on assets of the C corporation.

Since most of the above tax lingo is probably not in your vocabularly, before converting to an S corporation, *always* see a savvy tax pro.

C. Tax Reporting for S Corporations

An S corporation must file IRS Form 1120S for every year of its existence—*whether or not it has any income*. Typically, the tax year is the calendar year, so the return is due on March 15. Using a different tax year (S corporations are rarely allowed to), the return is due on the 15th day of the third month following the close of its tax year.

A filled-in Form 1120S is shown below to give you an idea of the kinds of things that must be reported to the IRS. This is *not* to suggest that you prepare your corporation tax return yourself. To the contrary, corporate returns are the stuff that tax pros were made for. If you want to try, at least use tax software such as *TurboTax for Business* (Intuit).

Can't get it in on time? Get a six-month extension to file with Form 7004, *Application for Automatic Extension of Time to File Corporation Income Tax Return*. File it before the return's original due date.

S corporations generally must file state tax returns, too, and a separate tax or franchise fee may be imposed.

State S Corporation Tax Rules

Most states recognize S corporation status, but state corporation tax rules may differ from the federal tax law. Check with a local tax pro or your state's corporation office to find out your state's rules. Typically, states impose a minimum annual corporate tax or franchise fee that applies to all corporations operating in their state. Some states also tax S corporation income or gross receipts. California, a particularly tax-hungry state, imposes a 1.5% tax on all S corporation profits—and a minimum annual franchise tax of $800—even if the corporation loses money. The bright side (if you can call it that) is that you can deduct any state and local taxes as business expenses on your federal corporate tax return.

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ **Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation.**
▶ **See separate instructions.**

OMB No. 1545-0130

20XX

For calendar year 2004, or tax year beginning , 2004, and ending , 20

A Effective date of S election: 12-01-99	Use the IRS label. Otherwise, print or type.	Name: StratoTech, Inc.	**C** Employer identification number: 10 4487965
		Number, street, and room or suite no. (If a P.O. box, see page 12 of the instructions.): 482 Winston Street	**D** Date incorporated: 3/1/75
B Business code number (see pages 36–38 of the Insts.): 5008		City or town, state, and ZIP code: Metro City, OH 43705	**E** Total assets (see page 12 of instructions): $771,334

F Check applicable boxes: (1) ☒ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
G Enter number of shareholders in the corporation at end of the tax year ▶ 6

Caution: *Include* ***only*** *trade or business income and expenses on lines 1a through 21. See page 13 of the instructions for more information.*

Income

1a	Gross receipts or sales 1,545,700 **b** Less returns and allowances 21,000 **c** Bal ▶	1c	1,524,700
2	Cost of goods sold (Schedule A, line 8)	2	954,700
3	Gross profit. Subtract line 2 from line 1c	3	570,000
4	Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)*	4	
5	Other income (loss) *(attach schedule)*	5	
6	**Total income (loss).** Add lines 3 through 5 ▶	6	570,000

Deductions (see page 14 of the instructions for limitations)

7	Compensation of officers	7	170,000
8	Salaries and wages (less employment credits)	8	138,000
9	Repairs and maintenance	9	800
10	Bad debts	10	1,600
11	Rents	11	9,200
12	Taxes and licenses	12	15,000
13	Interest	13	14,200
14a	Depreciation *(attach Form 4562)* — 14a: 15,200		
b	Depreciation claimed on Schedule A and elsewhere on return — 14b:		
c	Subtract line 14b from line 14a	14c	15,200
15	Depletion **(Do not deduct oil and gas depletion.)**	15	
16	Advertising	16	8,700
17	Pension, profit-sharing, etc., plans	17	
18	Employee benefit programs	18	
19	Other deductions *(attach schedule)*	19	78,300
20	**Total deductions.** Add the amounts shown in the far right column for lines 7 through 19 ▶	20	451,000
21	Ordinary business income (loss). Subtract line 20 from line 6	21	119,000

Tax and Payments

22	**Tax: a** Excess net passive income tax *(attach schedule)* — 22a:		
b	Tax from Schedule D (Form 1120S) — 22b:		
c	Add lines 22a and 22b (see page 18 of the instructions for additional taxes)	22c	
23	**Payments: a** 2004 estimated tax payments and amount applied from 2003 return — 23a:		
b	Tax deposited with Form 7004 — 23b:		
c	Credit for Federal tax paid on fuels *(attach Form 4136)* — 23c:		
d	Add lines 23a through 23c	23d	
24	Estimated tax penalty (see page 18 of instructions). Check if Form 2220 is attached ▶ ☐	24	
25	**Tax due.** If line 23d is smaller than the total of lines 22c and 24, enter amount owed	25	
26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid	26	
27	Enter amount of line 26 you want: **Credited to 2005 estimated tax** ▶ **Refunded** ▶	27	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

John H. Green — Signature of officer | 3-10-xx — Date | President — Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11510H Form **1120S** (2004)

Form 1120S (2004) Page 2

Schedule A **Cost of Goods Sold** (see page 18 of the instructions)

1	Inventory at beginning of year	1	126,100
2	Purchases	2	1,127,000
3	Cost of labor	3	
4	Additional section 263A costs *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	**Total.** Add lines 1 through 5	6	1,253,100
7	Inventory at end of year	7	298,400
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	954,700

9a Check all methods used for valuing closing inventory: *(i)* ☐ Cost as described in Regulations section 1.471-3
(ii) ☒ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Other (specify method used and attach explanation) ▶
b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶ ☒
c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☒
d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9d
e If property is produced or acquired for resale, do the rules of Section 263A apply to the corporation? ☐ Yes ☐ No
f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B **Other Information** (see page 19 of instructions)

		Yes	No
1	Check method of accounting: **(a)** ☐ Cash **(b)** ☒ Accrual **(c)** ☐ Other (specify) ▶		
2	See pages 36 through 38 of the instructions and enter the: **(a)** Business activity ▶ 5008 Distributor **(b)** Product or service ▶ heavy equipment		
3	At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: **(a)** name, address, and employer identification number and **(b)** percentage owned		X
4	Was the corporation a member of a controlled group subject to the provisions of section 1561?		X
5	Check this box if the corporation has filed or is required to file **Form 8264,** Application for Registration of a Tax Shelter ▶ ☐		
6	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
7	If the corporation: **(a)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation **and (b)** has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years ▶ $ 37,200		
8	Check this box if the corporation had accumulated earnings and profits at the close of the tax year ▶ ☐		
9	Are the corporation's total receipts (see page 19 of the instructions) for the tax year **and** its total assets at the end of the tax year less than $250,000? If "Yes," the corporation is not required to complete Schedules L and M-1.		

Note: *If the corporation had assets or operated a business in a foreign country or U.S. possession, it may be required to attach* **Schedule N (Form 1120),** *Foreign Operations of U.S. Corporations, to this return. See Schedule N for details.*

Schedule K **Shareholders' Shares of Income, Deductions, Credits, etc.**

	Shareholders' Pro Rata Share Items				Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)		1	
	2	Net rental real estate income (loss) *(attach Form 8825)*		2	119,000
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities *(attach schedule)*	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Interest income		4	
	5	Dividends: **a** Ordinary dividends		5a	
		b Qualified dividends	5b		4,000
	6	Royalties		6	16,000
	7	Net short-term capital gain (loss)		7	
	8a	Net long-term capital gain (loss)		8a	
	b	Collectibles (28%) gain (loss)	8b		
	c	Unrecaptured section 1250 gain *(attach schedule)*	8c		
	9	Net section 1231 gain (loss) (attach Form 4797)		9	
	10	Other income (loss) *(attach schedule)*		10	

Form **1120S** (2004)

Part 2 The Structure of Your Business

D. How S Corporation Shareholders Are Taxed on Income

S corporation profits and losses flow though to shareholders, but the tax code adds a twist.

Some items of S corporation income, losses, or deductions are allowed to be separately stated on the shareholder's tax return. For instance, if an S corporation sells an asset at a gain, and it qualifies for long-term capital gains treatment, this is a separately stated item. The shareholder gets capital gains tax treatment (a rate of 10%–15%). And, when the corporation elects IRC § 179 (see Chapter 2, Writing Off Business Assets); the Section 179 deduction flows through to each shareholder as a separately stated item. (IRC § 1366.)

An S corporation reports to the IRS each stockholder's proportionate share of its profit (or loss) on annual IRS K-1 forms. K-1 copies are given to each shareholder who then reports the K-1 figures on her annual individual Form 1040 tax return. As we all know, April 15 is the date for filing your individual income tax return, including this K-1 data, unless you get a filing extension.

S corporations must deposit employment taxes on all employee wages. Sole proprietors, LLC members, and partners pay self-employment taxes individually on their Form 1040 returns on all income. (See Section E, below, for more information.)

1. Profits

Typically, S corporation shareholders take profits either as wages or dividends. Either way—or even if all profits are retained by the S corporation instead of being paid out—the profits are tax-reported by each shareholder. (This means an S corporation business owner is taxed like a sole proprietor, partner, or limited liability company member.)

EXAMPLE: Rusty's S corporation, Rustco, makes a profit of $17,000. It issues a Form K-1 to Rusty, who owns 100% of its stock, reporting $17,000 of income. Rustco, the corporation, owes no income tax. Instead, Rusty enters the $17,000 on his tax return and pays taxes according to his overall income tax bracket.

2. Losses

S corporation operating losses are passed through to individual shareholders. The loss can offset their other income, producing a tax savings.

The operating loss is claimed on the S shareholder's individual tax return.

Fine print: A shareholder may not deduct a loss greater than her tax basis in her stock. Generally, a shareholder's tax basis is the total of money and property and any loans she put into the corporation.

EXAMPLE: Jerrie paid $5,000 for 100% of the stock in her S corporation, JerriCo, when she incorporated. In its first year of operation, JerriCo lost $7,000, which was reported on its Form 1120S corporate income tax form and on Jerrie's Schedule K-1. Jerrie can claim only $5,000 as a loss, because this is the amount of her basis (investment) in her S corporation stock. (We'll assume the other $2,000 is owed to the creditors of JerriCo.)

Lending money to your S corporation can increase your basis. If a small business S corporation needs added capital (fairly common), the shareholder owners can lend money to it. The money loaned increases the shareholder-lender's basis in her stock. This means that, if the operation loses money, the shareholder-lender's tax loss can also increase—up to the amount of the loan. If the corporation makes money, the loan can simply be repaid to the shareholder. All shareholder loans must be properly documented. For more information on S corporation loans, and for promissory notes and corporate resolutions, see *The Corporate Records Handbook* or *Corporate Loans: Create Promissory Notes and Resolutions* (an eFormKit), both by Anthony Mancuso (Nolo).

Material Participation

For an S corporation shareholder to deduct losses against other income, you must materially participate in the business. Merely being an investor in an S corporation doesn't cut it; you must also be *active* in the operation. If challenged by the IRS at an audit to show material participation, you'll be okay if any of the following are true:

- you put in at least 500 hours per year working in the business
- you worked at least 100 hours, if no other shareholder puts in more time, or
- the facts and circumstances show that you worked on a regular, continuous, and substantial basis. (IRC § 469 and Reg. 1.469.)

E. Social Security and Medicare Taxes

Congress wants all small business folks—no matter what the legal structure of their business—to pay the same amount of Social Security and Medicare taxes. For S (and C) corporation owner-employees, these payroll, or employment, taxes are paid by the corporation to the IRS. (See Chapter 5, Tax Concerns of Employers, for details on how these taxes are paid and reported).

In contrast, for noncorporate business owners, these same taxes are called self-employment taxes and are paid as part of quarterly estimated tax deposits. The tax is reported annually on Schedule SE filed with the business owner's individual 1040 income tax return.

Dividends are not subject to Social Security and Medicare taxes. While salaries and bonuses paid by an S corporation to employees are subject to employment taxes, corporate dividends are investment income and are not subject to payroll or employment taxes.

Here's a tax planning opportunity: If you work in your S corporation, you must take some compensation as salary if the business is profitable. However, taking a combination of salary and dividends reduces an owner's overall tax bill, as the example below illustrates.

EXAMPLE: Gordon manages his S corporation, Wham Bam Inc., and pays himself an annual salary of $40,000. The employment tax rate for Gordon is 15.3% ($6,120). Gordon also takes $14,000 from Wham Bam as a dividend on his stock. If the $14,000 dividend were instead labeled as salary or a bonus, Gordon would have had to pay an additional $2,142 in employment taxes (15.3% of $14,000).

IRS auditors may question low S corporation owner salaries. It hasn't escaped the notice of the IRS that S corporation owners minimize their self-employment taxes by taking dividends. If you are audited and the IRS claims your dividends were really wages, you'll have to show your salary was reasonable. One way to show this is to compare compensation paid to managers of similar businesses.

F. Electing S Corporation Status

Before choosing S corporation status, run it by a tax pro first. If you decide to do it, here's how:

- File IRS Form 2553, *Election by Small Business Corporation*. You'll find a filled-in sample in Section B, above. Get the current form by calling 800-829-FORM (1040), or from the IRS's website at www.irs.gov, or by going to an IRS office or your tax pro. (Don't file Form 2553 until your corporation charter has been granted by the state of incorporation.)
- Meet the filing deadlines. File Form 2553 with the IRS no later than the 15th day of the third month after your corporation's taxable year begins—for example, if you begin on January 1, file by March 15. If you miss the deadline, contact the IRS and ask permission to file it

6711

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) **20XX**
Department of the Treasury
Internal Revenue Service

Tax year beginning 2004
and ending 2004

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
123456789

B Corporation's name, address, city, state, and ZIP code
GEEKO TECH GAMES INC.
4340 HOLMES PARKWAY
METRO CITY, OH 43704

C IRS Center where corporation filed return
CINCINATTI

D ☐ Tax shelter registration number, if any

E ☐ Check if Form 8271 is attached

Part II Information About the Shareholder

F Shareholder's identifying number
987654321

G Shareholder's name, address, city, state and ZIP code
GOBI GAMER
666 GALAXY WAY
FAROUT, OH 99999

H Shareholder's percentage of stock ownership for tax year . . . . 100.000 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) 53,300	13	Credits & credit recapture
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction 10,800	16	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1120S. Cat. No. 11520D Schedule K-1 (Form 1120S) 2004 late. If you miss the deadline in one year, you can elect S status in the next year.

- Have Form 2553 signed by whoever is authorized to sign the corporation's tax returns—usually the president.
- Get written consents from all shareholders (or known prospective shareholders). Also have each sign Form 2553 at the appropriate place. Unless every shareholder signs, your S election is invalid. In a newly forming corporation, have every potential shareholder sign. There is no penalty if someone who signs doesn't ever become a shareholder.
- Mail Form 2553 to the IRS address where you file your individual tax returns. The IRS should send you a written acknowledgment that you are an S corporation within 30 days.

Note: You may also have to file a tax election form with your state.

G. Revoking S Corporation Status

Once elected, S corporation status continues until revoked by shareholders holding more than 50% of its shares. The IRS also can revoke your S corporation status for various corporate misdeeds, such as failing to file tax returns or keep corporate records.

There is no IRS form to revoke S status. Instead, send a "Revocation of S Status" letter to the IRS address where you filed your S election form. State the name of the corporation, the tax identification number, and the number of shares outstanding. Have the letter signed by all of the shareholders. A sample letter is shown below.

Letter Revoking S Corporation Status

To: Your IRS Service Center

Dated: 12/20/05

Re: Revocation of S Corporation Status of Bone Corporation
Federal Identification Number #94–0000000

1. Bone Corporation hereby voluntarily revokes its prior election to be treated as an S corporation under IRC § 1362(a).
2. The revocation is to be effective January 1, 2006.
3. At the time of revocation there are 1,000 shares outstanding in the corporation.

Statement of Consent

The following shareholder, who owns all of the shares of the corporation, under penalty of perjury, consents to the revocation of the election of S corporation status:

Hamilton Bone
111 Main St., Juneau, AK
SSN 555-55-5555
1,000 shares acquired 1/1/87

Hamilton Bone
Hamilton Bone
Shareholder

If a corporation revokes S status it cannot be reinstated for five years. Once S corporation status is revoked, the corporation is taxed as a C corporation. (See Chapter 7, C Corporations.)

H. Dissolving an S Corporation

When your S corporation calls it quits, it is liquidated. Shareholders receive whatever money or property the corporation owns. Legally, corporate debts must be satisfied before assets are distributed to shareholders.

Gains and losses on any assets distributed are passed through to shareholders—just as profits and losses from the operating business were. Each shareholder is then taxed on the difference between the fair market value of each asset and the basis of his or her stock. The shares of stock are then returned to the corporation and canceled. Here's how it plays out:

> **EXAMPLE:** Ted, the only shareholder of TYVM, Inc., an S corporation, decides to close up shop and move to Costa Rica. After selling its inventory and paying its bills, TYVM's remaining asset is a patent on an injection molding tool. The patent rights, with a tax basis of $1 million, are sold for $2 million. The $1 million gain is passed through to Ted and is taxed at a 15% capital gains rate, resulting in $150,000 income tax. Ted may owe state income taxes as well.
>
> It would be worse for Ted if TYVM had been a C corporation. Then, there would have been double taxation on the liquidation. First, the gain on the sale of the patent rights would be taxed to TYVM at the corporate rate of 34%, and then again to Ted at his capital gains rate of 15%.

Your final year tax filing. The Form 1120S tax return filed for the final year of operation should be checkmarked as a "Final Return" at the top of the first page. Otherwise, the IRS may keep the corporation in the tax reporting system for future years and send out delinquent return notices.

A tax return checkmarked "final" also increases your corporations's audit odds. See a tax pro whenever dissolving your S corporation, and take special care to file an accurate return.

Resources

- IRS "S" Corporation Income Tax Package (1120S, annually updated). Includes the current year's tax forms and instructions. This package is available at IRS offices, on the IRS website (www.irs.gov), and by telephone at 800-829-3676.
- IRS Publication 542, *Corporations*.
- IRS Form 2553, *Election by a Small Business Corporation and Instructions*.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinncpas.com.

CHAPTER

9

Partnerships

"All taxation is evil."

—Brooks Adams

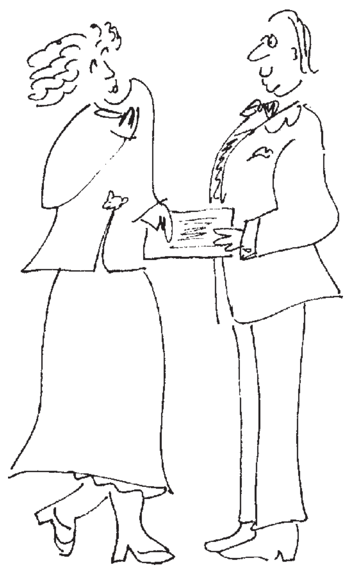
You are probably familiar with the general partnership: two or more people running a business and splitting the profits or losses. Partners contribute money (or property) and their efforts to form a partnership.

Each general partner is *personally* responsible for *all* of the debts and liabilities of the business, not just his or her proportionate share. (An exception to this rule of personal liability is the limited partnership—however, most active small businesses are general, not limited, partnerships. See "Limited Partnerships," below.)

Each state's law governs partnership formation and operation. However, all states have adopted the Revised Uniform Partnership Act, so partnership laws are very similar in each state.

The IRS reports that there are over two million partnerships in the U.S., with over 14 milion partners.

Partnerships happen automatically. Partnership provisions of the tax code apply even when two people go into business on a handshake and never sign a formal partnership agreement. As long as costs and profits of a venture are split, a partnership exists as far as the IRS (and your state's partnership law) is concerned. Be further warned that partnership tax rules are the most complex in the tax code. We only scratch the surface in this chapter.



Limited Partnerships

In a general partnership, each partner can obligate the partnership to any contract, debt, or other transaction.

Limited partnerships (LPs) are primarily used to raise money from passive investors (the limited partners) who will not be active in the business. They are common in real estate investing and private investment firms. LPs have two categories of partners: general partners, who are personally liable for all partnership obligations, and limited partners, who have no liability for partnership debts.

LPs may have to register with the state agency that regulates securities (in most states, the secretary of state or department of corporations) and, in some cases, with the federal Securities and Exchange Commission as well.

LPs are often found in the small business world as family limited partnerships. (See Chapter 12, Family Businesses.)

The following examples illustrate the primary difference between general and limited partnerships.

EXAMPLE 1: Serendipity Partners, a limited partnership, owes $17,000 to various creditors. Raul, the general partner, is personally liable for the whole $17,000 if Serendipity goes under. Chessie, a limited partner who invested $6,200 into the partnership, is not liable for any of the debt. Her liability is limited to the $6,200 she invested.

EXAMPLE 2: If Serendipity was a general partnership, both Raul and Chessie would be each liable for the whole $17,000. Creditors could go after each partner's personal assets to collect the entire debt, not just $8,500 each. Of course, the creditors would not be entitled to collect more than a total of $17,000.

Partnerships in a Nutshell

1. Partnerships do not pay federal taxes; they pass profit and loss through to individual partners. However, partnerships must file annual tax returns.
2. Profits and losses in a partnership may be allocated unequally, which can be beneficial to the partners taxwise.
3. Partnership accounting and tax law is very complex, and seeing a tax pro early prevents headaches later.
4. Contributing services in return for a partnership interest creates a tax problem for the contributor, but there may be a way to get around it.
5. Terminating a partnership may result in tax liability for the individual partners.

A joint investment is not automatically a partnership. A jointly owned investment is not necessarily a partnership; there must be an active business for it to be automatically considered a partnership. For instance, say Conrad and Constance co-own a warehouse that they rent to Big Box, Inc. This is not a partnership for tax purposes unless the co-owners want to file as a partnership or they provide services in addition to renting the warehouse to Big Box, Inc.

A. Partnership Tax Status

Partners are much like self-employed sole proprietors; both report their share of the business's profits or losses on their personal tax return. General partners pay self-employment tax (Social Security and Medicare).

Partnerships also bear a tax resemblance to S corporations and limited liability companies. All three are pass-through entities, which means that the owners—not the entity—pay taxes. Nevertheless, all three entities must file their own annual tax returns, even though no tax may be due.

Spouses who work together in an unincorporated business often report taxes as a sole proprietorship instead of as a partnership. Technically, the couple should file taxes as a partnership. As a practical matter, many couples report just one spouse as the sole owner on their tax return.

If spouses file separate tax returns, though, they must report as a partnership. Check it out with an accountant who knows your complete family tax picture before making this decision. See Chapter 12, Section C.

Get help with partnership accounting. When forming a partnership, you face immediate tax-related decisions, including choosing a method of accounting, the tax year, and the depreciation methods to adopt. While some initial tax decisions may be changed as your partnership goes along, other decisions cannot be, so take care. Consider consulting a tax pro. (See Chapter 3, Bookkeeping and Accounting.)

B. Tax Reporting by Partnerships

An active business partnership is a tax-reporting entity, but it does not pay federal taxes. (IRC §§ 701, 761.) Instead, a partnership's profit or loss passes through to the individual partners. This means each partner reports her share on her individual Form 1040 tax return (or joint return, if filing with her spouse).

A partnership records its income and expenses, obtains its own tax ID number, and files tax returns annually, for as long as it is in operation. States may require separate tax reporting and ID numbers, in addition to federal ones. (See "State Partnership Taxes," below.)

1. Annual Partnership Tax Return

The annual partnership tax return, showing the venture's income and expenses, is IRS Form 1065, *U.S. Partnership Return of Income.*

Part 2 The Structure of Your Business

The annual due date is the 15th day of the fourth month after the end of the partnership tax year—April 15 for most partnerships. A sample Form 1065 is shown below.

Exception: Partnerships that invest in property and don't carry on a business aren't required to file Form 1065. (See IRS Publication 541, *Partnerships*.)

File your Form 1065 on time. Even though Form 1065 is an information-only return, the IRS can penalize you for not filing it on time. The late filing penalty is $50 per month for each partner, to a maximum of $250, and applies to each year the partnership is delinquent. An extension to file is easy to obtain if you can't file by the deadline. Use IRS Form 8736 for the extension.

State Partnership Taxes

Most states treat partnerships like the federal government does—that is, they tax individual partners, not partnerships. A state partnership tax return, similar to Form 1065, is usually required. Partnerships may have to pay an annual tax or fee for the privilege of operating in the state. Check with a tax pro or your state tax department about the forms and fees required.

2. Partner's Profit or Loss Statements (K-1)

Partnerships must issue an IRS Form K-1 to each partner annually (with a copy to the IRS). As discussed in Section C, below, the K-1 shows each partner's share of income or loss, deductions and credits. The K-1 report is entered into IRS computers to cross-check the income of individual partners to make sure it gets reported on the partners' personal tax returns.

3. Partnership Federal Identification Number

A partnership must obtain a federal tax ID number, called a federal employer identification number (EIN), from the IRS. You need an EIN whether or not your partnership has employees. This ID number is required for *all* partnerships and is used on annual partnership tax returns (Form 1065s) and K-1 forms. (Instructions on how to get a tax ID number are in Chapter 5, Section A.)

> EXAMPLE: Brenda and Betty apply to the IRS for a tax ID number. They are assigned 94-1234567 as the employer identification number of the B & B partnership. They must use the number on all partnership tax returns and K-1 form filings. They will most likely be required to use this same EIN for state tax filings, although some states issue separate partnership tax ID numbers.

C. Tax Obligations of Partners

Partners are technically *not* employees of their business. They don't receive wages, and the business does not pay payroll taxes on the partners' income. Instead, partners take out business profits through periodic draws or distributions.

At the end of each tax year, each partner's share of business profits (or losses) is computed and reported on IRS Form K-1. This form shows each partner's distributive share of income or loss, credits, deductions, and various other tax items.

In turn, partners enter the K-1 information on their individual Form 1040 income tax returns. A sample K-1 form is shown below, after the Form 1065 partnership tax return.

Form **1065**
Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2004, or tax year beginning ...., 2004, and ending ...., 20....
▶ See separate instructions.

OMB No. 1545-0099
20XX

A Principal business activity: Retail	Use the IRS label. Otherwise, print or type.	Name of partnership: Able Baker Book Store	D Employer identification number: 10 : 9876543
B Principal product or service: Books		Number, street, and room or suite no. If a P.O. box, see page 14 of the instructions.: 334 West Main Street	E Date business started: 10-1-79
C Business code number: 594		City or town, state, and ZIP code: Orange, MD 20904	F Total assets (see page 14 of the instructions): $ 45,391

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return

H Check accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ 2

Caution: *Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income	1a	Gross receipts or sales	1a	409,465		
	b	Less returns and allowances	1b	3,365	1c	406,100
	2	Cost of goods sold (Schedule A, line 8)			2	267,641
	3	Gross profit. Subtract line 2 from line 1c			3	138,459
	4	Ordinary income (loss) from other partnerships, estates, and trusts *(attach schedule)*			4	
	5	Net farm profit (loss) *(attach Schedule F (Form 1040))*			5	
	6	Net gain (loss) from Form 4797, Part II, line 17			6	
	7	Other income (loss) *(attach statement)*			7	559
	8	**Total income (loss).** Combine lines 3 through 7			8	139,018
Deductions (see page 16 of the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	29,350
	10	Guaranteed payments to partners			10	25,000
	11	Repairs and maintenance			11	1,125
	12	Bad debts			12	250
	13	Rent			13	20,000
	14	Taxes and licenses			14	3,295
	15	Interest			15	1,451
	16a	Depreciation *(if required, attach Form 4562)*	16a	1,174		
	b	Less depreciation reported on Schedule A and elsewhere on return	16b		16c	1,174
	17	Depletion **(Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	
	20	Other deductions *(attach statement)*			20	8,003
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	89,648
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	49,370

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member) is based on all information of which preparer has any knowledge.

Frank W. Able — Signature of general partner or limited liability company member manager

3/12/xx — Date

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ▶ ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN ▶	
		Phone no. ( )	

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11390Z Form **1065** (2004)

Part 2
The Structure of Your Business

Form 1065 (2004) Page 2

Schedule A **Cost of Goods Sold** (see page 19 of the instructions)

1	Inventory at beginning of year	1	18,125
2	Purchases less cost of items withdrawn for personal use	2	268,741
3	Cost of labor	3	-0-
4	Additional section 263A costs *(attach statement)*	4	-0-
5	Other costs *(attach statement)*	5	-0-
6	**Total.** Add lines 1 through 5	6	286,866
7	Inventory at end of year	7	19,225
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	267,641

9a Check all methods used for valuing closing inventory:
- **(i)** ☐ Cost as described in Regulations section 1.471-3
- **(ii)** ☒ Lower of cost or market as described in Regulations section 1.471-4
- **(iii)** ☐ Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)*. ▶ ☐

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? ☐ **Yes** ☒ **No**

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ **Yes** ☒ **No**
If "Yes," attach explanation.

Schedule B **Other Information**

		Yes	No
1	What type of entity is filing this return? Check the applicable box: **a** ☒ Domestic general partnership **b** ☐ Domestic limited partnership **c** ☐ Domestic limited liability company **d** ☐ Domestic limited liability partnership **e** ☐ Foreign partnership **f** ☐ Other ▶		
2	Are any partners in this partnership also partnerships?		X
3	During the partnership's tax year, did the partnership own any interest in another partnership or in any foreign entity that was disregarded as an entity separate from its owner under Regulations sections 301.7701-2 and 301.7701-3? If yes, see instructions for required attachment		X
4	Did the partnership file Form 8893, Election of Partnership Level Tax Treatment, or an election statement under section 6231(a)(1)(B)(ii) for partnership-level tax treatment, that is in effect for this tax year? See Form 8893 for more details		X
5	Does this partnership meet all three of the following requirements? **a** The partnership's total receipts for the tax year were less than $250,000; **b** The partnership's total assets at the end of the tax year were less than $600,000; and **c** Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item N on Schedule K-1.		X
6	Does this partnership have any foreign partners? If "Yes," the partnership may have to file Forms 8804, 8805 and 8813. See page 20 of the instructions		X
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		X
8	Has this partnership filed, or is it required to file, Form 8264, Application for Registration of a Tax Shelter?		X
9	At any time during calendar year 2004, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See page 20 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country. ▶		X
10	During the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520. See page 21 of the instructions		X
11	Was there a distribution of property or a transfer (e.g., by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under *Elections Made By the Partnership* on page 9 of the instructions		X
12	Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return ▶		

Designation of Tax Matters Partner (see page 21 of the instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶ Identifying number of TMP ▶

Address of designated TMP ▶

Form **1065** (2004)

1. Self-Employment Taxes

All general partners are subject to self-employment tax on their share of the partnership profits. Self-employment taxes are reported on Schedule SE, filed annually with the Form 1040 tax return.

Limited partners (investors) don't owe the self-employment tax, so aren't required to file this form.

Note: Partnerships that invest only in property and do not actively carry on a business can elect to not be treated as partnerships for tax purposes and do not have to file annual partnership tax returns. (For details, see IRS Publication 541, *Partnerships*.)

2. Estimated Income Taxes

Partners must make periodic (usually quarterly) estimated income tax payments on their share of the partnership income. These four estimated tax payments are due on April 15, June 15, September 15, and January 15. Partners use Form 1040-ES to report and pay these estimated taxes. (See Chapter 6, Section D, for information on this form.)

If the partnership loses money, no estimated taxes are due, unless the partner has other self-employment income.

Estimated tax payments cover income and self-employment taxes (Social Security and Medicare).

Note: State estimated tax payments are also required if your state has an income tax.

3. Calculating and Reporting a Partner's Income

Calculating a partner's taxable income or loss is not always easy. For instance, the cash a partner takes out isn't necessarily the same as that partner's taxable income from the business. We explain this in more depth below.

a. The Distributive Share

A partner is taxed on the amount she is *deemed* to have received from the partnership under complex tax accounting rules. (IRC § 704.) This is called a partner's distributive share and is reported annually on IRS Form K-1.

A distributive share is normally based on the percentage of the partnership each partner owns—from 1% to 99%. Unless a partnership agreement says otherwise, the tax code presumes all partners are equal. So, if two people are in business together without any written agreement, it's considered a 50-50 partnership.

> **EXAMPLE:** Brenda and Betty's partnership agreement calls for each to get 50% of the profits (or losses) of the B & B partnership. If B & B makes a profit of $70,000, each partner has a distributive share of $35,000 to report on her individual 1040 tax return. In reality, Brenda may have taken $40,000 and Betty may have taken $30,000 out of the partnership. They still must each report 50% of the profits.

b. Special Allocations

All partners are not created equal. If a written partnership agreement authorizes it, *unequal* distributive shares, called special allocations, may be made. A special allocation is a tax code term for any allocation of profits or losses that is *not* proportionate to a partner's ownership percentage.

For instance, giving 65% of profits to Partner A and 35% to Partner B is a special allocation. A partnership agreement could also provide different ratios for splitting losses and profits, such as an 80-20 split for losses and 65-35 split for profits.

Partnership agreements can provide special allocations for any number of reasons. For instance, one partner may work full-time and others only part-time, or one partner may have special skills or generate more income.

6511

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **20XX**

Department of the Treasury
Internal Revenue Service

Tax year beginning 20XX
and ending 20XX

Partner's Share of Income, Deductions, Credits, etc.

► See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
010101010

B Partnership's name, address, city, state, and ZIP code
HAIR RAISERS PARTNERSHIP
10 SCALPER WAY
MT. BALDY, NC 31111

C IRS Center where partnership filed return
ATLANTA

D ☐ Check if this is a publicly traded partnership (PTP)
E ☐ Tax shelter registration number, if any
F ☐ Check if Form 8271 is attached

Part II Information About the Partner

G Partner's identifying number
123006789

H Partner's name, address, city, state, and ZIP code
HARRY HEADUM
444 ELIXIR STREET
FRINGETOP, NC 31111

I ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

J ☐ Domestic partner ☐ Foreign partner

K What type of entity is this partner? PARTNERSHIP

L Partner's share of profit, loss, and capital:

	Beginning	Ending
Profit	50.000 %	50.000 %
Loss	50.000 %	50.000 %
Capital	50.000 %	50.000 %

M Partner's share of liabilities at year end:
Nonrecourse . . . . $
Qualified nonrecourse financing . . $
Recourse . . . . $

N Partner's capital account analysis:

Beginning capital account . . . . $	222,000
Capital contributed during the year . $	
Current year increase (decrease) . . $	88,000
Withdrawals & distributions . . . $	(100,000)
Ending capital account . . . . $	210,000

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) 44,000	15	Credits & credit recapture
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		
		19	Distributions
12	Section 179 deduction		
13	Other deductions	20	Other information
14	Self-employment earnings (loss) 44,000		

*See attached statement for additional information.

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For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1065. Cat. No. 11394R Schedule K-1 (Form 1065) 2004

EXAMPLE: Betty plans to work more hours for B & B partnership than Brenda, who intends to spend part of her time authoring a travel book. The two agree in writing that Betty will receive 60% of the partnership's profits. Betty's distributive share of B & B's $70,000 profit is $42,000, and Brenda's is $28,000. These are the amounts shown on their respective K-1 forms and reported on each of their individual tax returns.

A partner's tax bill depends on her overall tax situation—not just what she gets from the partnership. It's unlikely that two partners will ever pay the same amount of income taxes. Special allocations may be used to sprinkle different tax benefits to partners with different tax situations.

EXAMPLE: Again, Brenda and Betty's partnership makes a profit of $70,000. By the terms of their partnership agreement, Brenda gets a special allocation of a 60% distributive share of the profits, or $42,000. With her other income, exemptions, and deductions, Brenda falls into the 25% tax bracket. So, her federal income tax on the B & B income is $10,500.

Betty, on the other hand, has investment income plus the partnership income. Her share of the partnership profits puts her into the 35% tax bracket, so the tax due on Betty's distributive share of $28,000 is $9,800—almost as much as Brenda's tax on her share.

Without a special allocation there would have been a 50-50 division of partnership profits. Brenda would have paid $8,750 and Betty $12,250 in taxes—$21,000, a total of $700 more in federal taxes, plus any state taxes due.

Special allocation rules are tricky. Your partnership agreement must provide for any special allocations. You'll need to have an attorney write this provision for you. (IRC §§ 703, 704, and Regs. 1.703, 1.704.)

c. Money Left in the Partnership

If a partnership keeps profits in the business at the end of the tax year, the partners are still taxed on that money. It doesn't matter to Uncle Sam that the partners never get their hands on the funds.

If your business needs to retain profits, consider incorporating. Taxwise, forming a C corporation may be the best way to keep profits in your business for future expansion or to build your inventory. Remember that partnerships (as well as S corporations and limited liability companies) are tax pass-through entities. This means that any profits left in the partnership bank account—or as inventory—are taxed straight to the partners. C corporations can offer some relief from this tax bite through income splitting. (See Chapter 7, C Corporations, to see how this works.)

D. Partnership Losses

Partnership *losses* are treated similarly to profits—they pass through to each partner in proportion to her ownership share. This is true unless a different scheme is written into the partnership agreement.

A partner can deduct her share of a partnership loss on her individual tax return. This can lower her tax bill by offsetting her other income, and may even produce a tax refund. (See Chapter 4, Business Losses and Failures, for an explanation of the rules of loss carryovers.)

EXAMPLE: Betty and Brenda formed the B & B Partnership. The operation lost $40,000 the first year, largely because their bed and breakfast inn was not yet listed in travel guides. Brenda gets a distributive share of 60% of the loss ($24,000) under their partnership agreement. Brenda may be able to use her $24,000 B & B loss to offset her other income that year. (See Chapter 4.)

Passive Partners

If Evie is a silent or money partner—that is, she invested in a general partnership but is not involved in its day-to-day operations—the tax code treats Evie as a passive investor. Tax rules limit Evie's claiming partnership losses of more than $25,000 per year if the losses are from rental real estate activities. (IRC § 469, Reg. 1.469.) If Evie's partnership investment losses are greater, the balance may be able to be carried forward to claim on her future years' tax returns. Evie should discuss this with her tax pro, as the rules are tricky.

E. Partnership Contributions

When folks form a partnership, they typically throw a combination of money, assets, and services into the pot. These contributions may have unexpected tax consequences, however, to the individual partners.

Tax and accounting rules for partnerships are not simple. If your situation strays beyond the ones covered here, head for the resources listed at the end of this chapter or see a tax pro.

1. Keeping Track of Partners' Contributions: Capital Accounts

Each partner's contribution to the partnership is recorded in that partner's capital account. This means tracking the contributions and withdrawals of each partner, including her annual distributive share of income or losses from the partnership. Think of each partner's capital account as his financial history, starting at the beginning and continuing through the life of the partnership.

A partnership interest is an *asset* of the partner—an investment in the business. You must establish and track the investment you have in your partnership interest for as long as the partnership is in operation or holds any assets.

Keep meticulous records of all partnership contributions and distributions. This is vital for determining the tax consequences of taking money or property out of the partnership.

Your capital account balance is generally equal to your tax basis in your partnership interest. Your tax basis changes annually according to your distributive share of income and losses.

The following example illustrates this point and one made earlier (in Section C): that *cash* you take out of a partnership is not necessarily the same as your taxable *income* from the business.

EXAMPLE: In exchange for partnership interest, Moe contributes $14,000 and six seltzer bottles (which cost Moe $200) to the Stooges Partnership. So, $14,200 is the amount of Moe's capital account balance and his initial tax basis in his partnership interest.

In the first year, Stooges Partnership makes $30,000 and Moe is taxed on $10,000 (his ⅓ interest). The partnership distributes $9,000 cash to Moe. His capital account is $16,200 ($14,200 + $10,000 - $9,000).

a. Cash Contributions

When everyone contributes just cash for their partnership interests, then things are simple, tax-wise. Each partner's capital account equals the cash contributed.

EXAMPLE: Curly puts $11,000 cash (nothing else) into the Stooges partnership. His initial capital account balance is $11,000.

b. Asset Contributions

If you transfer anything other than money—such as real estate, vehicles, or copyrights—to the partnership, more complicated tax rules come into play. Your existing tax basis in the asset transferred to the partnership becomes your tax basis in your partnership interest.

> **EXAMPLE:** Ken transfers an office condominium he owns to VideoPro, a partnership that he and Barbara are setting up to sell video conferencing equipment. In exchange for the office condo, Ken receives a 50% share of the VideoPro partnership. At the time of its transfer, Ken's tax basis in the condo (what he paid, minus depreciation, plus the cost of his improvements) was $50,000. Ken's initial tax basis in his partnership share is $50,000.

Real life is often more complex than this example. For instance, if real estate owned and contributed by a partner has changed in value between the date acquired and date contributed (very likely), the tax result changes as well. There could be built-in gain taxes on any increase in value of the asset prior to the date of contribution. However, there wouldn't be an immediate tax bite. Instead, taxes would be delayed until the property is either disposed of by the partnership or the partnership is dissolved.

> **EXAMPLE:** Suppose Ken's office condo is worth $100,000 when he contributes it to VideoPro partnership, instead of $50,000 (Ken's basis). Two years later, VideoPro has outgrown the office and sells it for $140,000. There are two tax results. First, Ken is taxed on $50,000 of the initial gain (the difference between his basis and the condo's value at time of contribution). Second, Ken is taxed on $20,000 of the $40,000 increase in value after the contribution. (Barbara is taxed on the remaining $20,000 gain.)

c. Contributions of Services to the Partnership

Often one partner has cash, while another has only the expertise to make the business go. This may create a tax problem because services are not considered property when contributed to a partnership.

There's a tax cost if you take ownership in a partnership in return for a promise to work in the business. You are liable for income tax in that year on the value of your ownership interest—it is treated as income to you.

> **EXAMPLE:** Brenda and Betty form the B & B partnership to operate a bed & breakfast inn. Betty has $100,000 in cash but no business experience. Brenda has 20 years in the hospitality field but no money. If they are both 50% partners, Brenda is taxed on the fair market value of her share in the partnership. Since Betty contributed $100,000, and Brenda (whom the IRS views as contributing nothing) received a 50% interest, Brenda owes tax on $50,000 income.

Becoming a profits-only partner can get around this problem. Putting a profits-only partner clause in your partnership agreement can reward someone who wants to work but can't make a financial contribution. This clause states that the individual contributing services has no ownership, but gets a share of partnership profits—if any—in exchange for his work. (This doesn't prevent that partner from buying into the partnership later and obtaining a capital interest as a general partner.)

> **EXAMPLE:** Brenda and Betty draw up their partnership agreement stating Brenda is entitled only to 50% of the profits. Brenda is now a profits partner, and there is no tax to pay because she doesn't own a capital interest in the partnership.

Two additional tax code rules restrict the rights of profits partners:

- A profits partner can't sell her profits interest in the partnership within two years of receiving it.
- A profits partner can't be promised any fixed amount of money; she must bear a genuine risk of getting nothing if the partnership doesn't make a profit. (IRS Rev. Proc. 93-27.)

A tax disadvantage to being a profits partner is that if the partnership suffers a *loss*, a profits partner

—who may have put blood, sweat, and tears into the business—can't deduct any of the loss on her tax return. Partnership tax losses can pass through only to the real partners (the owners), not the profits partners.

2. Adjustments to Partners' Capital Accounts

Once a partnership begins, continual accounting adjustments must be made to each partner's capital account. These adjustments are necessary for annual tax reporting of each partner.

Numerous circumstances require adjustments to each partner's capital account. Here are a few of the common ones:

- A partner contributes additional cash or property to the partnership. Contributions increase a partner's basis in his capital account.

EXAMPLE: In June of the first year of business, the Sylvester & Son partnership needs operating capital. Sylvester puts in another $10,000 (beyond his $50,000 initial investment). The partnership breaks even in year one. Starting in year two, Sylvester's tax basis in his capital account is $60,000 (his $50,000 initial contribution plus $10,000 additional investment).

- A partner gets a distributive share of partnership profits or losses. (These amounts are passed through to the individual partners and then reported on their personal tax returns.) A profit increases a partner's tax basis; a loss decreases his basis.

EXAMPLE: Sylvester & Son partnership earns a small profit of $2,000 in its second year. Sylvester is a 50% partner. Thus, his $60,000 capital account is increased by $1,000 to $61,000, by including 50% of the partnership's profit.

3. Partnership Liabilities

Not all financial transactions of the partnership change a partner's basis. For instance, a partner's capital account is not usually affected by his share of partnership liabilities.

EXAMPLE: Sylvester & Sons partnership borrows $15,000 from Bus Bank to buy factory equipment. In the partnership books an asset of $15,000 is added, but it is offset by a $15,000 liability. Because of this wash, Sylvester's capital account is unaffected.

F. Getting Money Out of a Partnership

Since you went into business to put cash in your pocket, let's look at the tax effect of taking money from your partnership. Again, the tax bogeyman makes this more than a bit complicated.

1. Taxation of Withdrawals

Let's recap. Each partner has a capital account—maybe it's $100 or $10 million. This figure represents her investment in the partnership business for federal tax purposes.

The tax basis in the capital account for each partner is continually adjusted through the life of the partnership from different financial transactions. For instance, withdrawals by the partner decrease her tax basis; contributions by the partner increase it.

Withdrawals of money or assets from a partnership are first treated as a (nontaxable) return of your investment. Only after you have recovered your entire investment (meaning that your basis in your partnership interest has been reduced to zero) are withdrawals taxable to you.

EXAMPLE: Sylvester puts $50,000 into Sylvester & Sons partnership. Business is good and Sylvester is entitled to a distributive share of $10,000 of profits at the end of the year.

Sylvester withdraws $60,000. He will owe income tax on only $10,000, the amount he received in excess of his basis ($50,000). In effect, Sylvester would get back all of his contributions to Sylvester & Sons, plus his share of profits. His basis in his partnership interest (Sylvester's capital account) is reduced to zero at the beginning of the following year.

2. Loans to Partners

Partnerships can lend money to their partners. So, you can get money out of your partnership—at least for the short term—without its being taxed. (Loans aren't income if there is a legal obligation to repay them.) Moreover, borrowing from your partnership doesn't affect your tax basis in your partnership interest.

A loan must meet tax code requirements. You must sign a written, legally enforceable obligation to repay the partnership on a determinable date and at a reasonable rate of interest. (See Chapter 7, Section F3, for all of the legal requisites of a corporate loan, which apply to partnerships, too.)

G. Partnership Expenses

Tax rules for deducting expenses of a partnership are the same as for other businesses: an expenditure related to the trade or business is usually deductible. (See IRC § 162 and Chapter 1, Deductible Expenses.) Expenses are deductible on the partnership's tax returns (Form 1065), not on the individual partners' returns.

H. Selling or Transferring a Partnership Interest

Eventually a partner may dispose of her partnership interest. Naturally, there are tax ramifications.

1. Selling Your Interest in a Partnership

Selling your partnership interest to another partner—or to anyone else—has no tax impact on the partnership. It's like a shareholder selling stock in a corporation—it doesn't affect the corporation one way or the other.

For the selling partner, there is likely a taxable gain or loss. Your basis in your partnership interest determines the amount of taxable gain or loss.

The gain or loss is computed by subtracting your tax basis in your partnership interest from money (and/or property) you receive. If you have owned your partnership interest for over 12 months, your gain qualifies for long-term capital gains tax rates—a top tax rate of 15% on your profit. (See "Lower Capital Gains Tax Rate," below.)

EXAMPLE: Ken sells his VideoPro partnership interest to Jackie for $75,000. Ken had initially put $40,000 into VideoPro and contributed another $15,000 when the business needed cash for expansion. Ken also took $50,000 out of the partnership over several years, which represented his distributive share of earnings on which he paid tax. All told, Ken's basis in his partnership interest was $55,000 when he sold to Jackie.

	$40,000	Ken's original basis
+	$15,000	additional investment
+	$50,000	distributive share of earnings on which Ken paid tax
–	$50,000	withdrawals
=	$55,000	Ken's adjusted basis

So Ken has a taxable gain of $20,000 when he sells to Jackie ($75,000 sales price less his $55,000 basis).

Reporting sales to the IRS. When a partnership interest is sold or exchanged, the partnership reports it to the IRS on Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*. This form is filed with the annual partnership tax return (Form 1065).

2. When the Partnership Buys Out a Partner

If the partnership itself buys out your interest, the tax result is usually the same as selling to anyone else. The tax code calls this a retirement of a partner.

If you are the partner being retired, payments you receive from the partnership are treated first as a payback of your partnership capital account. In other words, you first get back your investment—with no tax consequences. Anything else you receive is a taxable gain to you. If you receive less than what's in your capital account, you have a taxable loss. A retirement has no tax effect on the remaining partners.

> **EXAMPLE:** Starsky retires from the Starsky & Hutch partnership in return for $60,000. Starsky's tax basis in his partnership interest is $80,000. The $60,000 Starsky gets from the partnership is a nontaxable return on his investment. The balance of his capital account, $20,000, is deductible as a loss on his investment. (See Chapter 4, Business Losses and Failure, to see how Starsky can get a tax benefit from this loss.)

Lower Capital Gains Tax Rate

The long-term capital gains tax is now a maximum of 15% for qualifying gains. (If you're in the 10% or 15% tax bracket, you'll now pay only 5% on long-term gains.)

One more tricky tax rule comes into play when you transfer a partnership interest.

3. Relief of Debt—Phantom Income

The amount of income you are taxed on when you sell your partnership interest includes—in addition to cash and any property you receive—your share of any partnership liability you are leaving behind.

For instance, if Luke's three-person partnership owes $150,000 to its creditors when Luke retires, he is treated as receiving $50,000 in income because he no longer owes that portion of partnership debt. This relief of debt income is not obvious to most of us. But it can produce an unexpected tax shock.

> **EXAMPLE:** Brenda, a 50% partner in the B & B partnership, retires. Brenda takes partnership assets—a car worth $10,000 and $25,000 cash—in return for her share. Brenda is also relieved of $20,000—half of the $40,000 owed by B & B to its creditors. The tax code says Brenda got a total of $55,000 ($10,000 + $25,000 + $20,000) for her partnership interest.

4. Date-of-Sale Adjustment

When selling, your basis in your interest is adjusted for any partnership gains or losses for the year to date. Only if you sell at the last day of the partnership's tax year is this not an issue.

Any operating partnership profit for that year to date must be reported on your individual tax return as ordinary income—not capital gain on the sale. Conversely, if it's a year-to-date loss, it is deducted from your basis and reduces your gain or increases your loss on the sale.

> **EXAMPLE:** On July 1, Betty sells her 50% partnership interest for $100,000. Her basis is $50,000. The B & B partnership has a profit of $40,000 so far during the year. Betty must report $20,000, half of the profit, as her distributive share for that year. She also must report any gain or loss on the sale of her partnership interest. She owes regular income tax on the partnership profits ($20,000) at a rate as high as 35%. Betty's gain of $50,000 on her partnership share, however, is taxed at her capital gains tax rate which is likely to be 15%.

I. Ending a Partnership

Unless a written agreement provides otherwise, a partnership automatically terminates upon the death or withdrawal of a partner.

All partnership assets—equipment, inventory, and any other property—are considered sold to the individual partners. (IRC § 708(b).) The value of the property is reported by each recipient in the year distributed.

If there is gain, tax is due on the difference between the partner's tax basis and the property's fair market value. This is true whether the partner sells or retains the asset.

If there is a loss instead of a gain, the loss may be claimed on the partner's individual tax return to offset other gains he may have.

The value of a deceased partner's share goes into her estate, where it may be subject to tax, depending on the size of the estate. (See Chapter 12, Family Businesses, for an explanation of estate tax.)

> **EXAMPLE:** Ken dies, and his VideoPro partnership with Barbara terminates. Barbara takes the business equipment (a value of $120,000) to use in a new business. Ken's estate takes the partnership bank account of $120,000. At the date the partnership ends, Barbara's basis in her partnership interest is $50,000. Barbara has a taxable gain of $70,000 ($120,000 value of equipment less her basis of $50,000). Whether or not Ken's estate will have to pay taxes depends on the value of his estate.

You may need cash to pay your tax liability if you receive property when a partnership ends. Implicit in the above example is the danger of a tax liability without receiving the cash to pay it. If you take noncash assets—like real estate, that is hard to liquidate, or that you want to keep—make sure you have enough cash to pay the tax man.

Partnerships and IRS Audits

Partnerships are audited only about one-third as often as sole proprietorships. The IRS apparently reasons that since partnerships don't pay taxes (partners do, remember), auditing them won't directly result in more revenue. Of course, if a business partner's tax return is audited, chances are the IRS will look at the partnership's tax return, too. And if problems are found—such as an improper tax deduction taken on the partnership tax return—it can lead to the audit of all of the other partners' income tax returns as well.

Resources

- IRS Publication 541, *Partnerships*.
- IRS Form 1065, *U.S. Partnership Return of Income*, and instructions.
- IRS Schedule K-1, *Partner's Share of Income*.
- *The Partnership Book*, by Denis Clifford and Ralph Warner (Nolo). Contains a wealth of details about setting up and running a partnership business.
- IRS Publication 505, *Tax Withholding and Estimated Tax*.
- IRS Publication 533, *Self-Employment Tax*.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinncpas.com.

CHAPTER

10

Limited Liability Companies

"I stay within the law only because the law is maneuverable, it can be manipulated."

— William M. Kunstler

An increasingly popular way to organize a small business is the limited liability company (LLC for short).

An LLC offers nontax advantages over a partnership or a corporation. Unlike a general partnership, an LLC protects its owners' personal assets from business creditors. LLC owners' liability for business debts is limited to their ownership interest in the business—hence the name limited liability. Plus, all LLC members can take an active role in the operation of the business without exposing themselves to personal liability—unlike limited partners.

Limited Liability Companies in a Nutshell

1. The limited liability company offers a personal liability shield to its owners, much like a corporation does.
2. State law regulates the formation and operation of LLCs.
3. LLCs are taxed by the IRS like general partnerships; the LLC does not pay taxes, but instead passes its profits and losses through to its individual owners.

A. Taxes

The LLC, like a partnership or S corporation, is a pass-through tax entity. Owners (called members) report and pay taxes on LLC income on their individual tax returns and are responsible for filing estimated taxes like sole proprietors and partners. (See Chapter 9, Section C1.)

1. Federal Tax Reporting

Because LLCs, like partnerships and S corporations, do not pay federal income taxes, LLC income is taxed at a single level—to the members. While an LLC could elect to be taxed as a corporation, it is rarely done.

LLCs with more than one member are taxed as partnerships, and LLCs with one member are taxed as sole proprietors.

Members owe self-employment tax on earnings (Social Security and Medicare) if they are working in the LLC, but not if they are just passive investors.

a. Multimember LLCs

Multimember LLCs must file Form 1065, *U.S. Partnership Return of Income*. LLCs must also annually issue each member IRS Schedule K-1, showing each member's annual share of the business's profit or loss.

b. Single-Member LLCs

Single-member LLCs file Schedule C. They are treated like sole proprietorships for tax purposes. (See Chapter 6, Section C1.)

2. State Taxes on LLCs

Your state may tax LLCs, even though the IRS doesn't. For example, in California, LLCs are subject to annual fees and taxes that range from $800 to as much as $12,000. Most states require annual tax reporting on their own state forms.

3. Allocations of Profit and Loss

LLC profits and losses pass through the LLC and are allocated and taxed annually to the LLC members. Or, put another way, the LLC owners, not the LLC itself, are responsible for paying income taxes on business profits.

In a co-owned LLC, the percentage of income or loss allocated to each LLC member is stated in the LLC's operating agreement. In a one-member LLC, of course, all income and loss will pass through to the sole owner.

Unlike an S corporation, an LLC may make distributions of profits (or losses) disproportionately to its members—if authorized in the LLC agreement. These are called special allocations. (See Chapter 9 for details.)

Like a partnership, however, an LLC can distribute profits unequally only if it meets some technical tax code rules. This entails including some special language in your LLC operating agreement that will satisfy the IRS rules. This is tax pro stuff—not for do-it-yourselfers.

B. Comparing LLCs With Other Entities

LLCs are attractive because they combine the pass-through taxation of a partnership with the limited liability of a corporation. So, if the business is sued or incurs obligations it can't meet, a creditor can only go after the assets of the business—not assets belonging to the members.

One exception: The IRS (and probably your state tax authority, too) can collect delinquent LLC payroll taxes directly from members. (See Chapter 5, Tax Concerns of Employers.)

This limited liability feature is the reason most folks choose an LLC. Here's a summary of how LLCs stack up against other entities:

- **Sole proprietorship.** An LLC can be a one-man band, but the owner will not be personally responsible for business debts, as a sole proprietor is.
- **General partnership.** A multimember LLC usually elects to be taxed like a partnership. But LLC owners aren't personally liable for nontax business debts as are general partners.
- **Limited partnership.** There is no tax difference between limited partnerships and LLCs. While limited partners, like LLC members, are shielded from personal liability for business debts, they can lose this protection if they participate in the management of the business; limited liability company members have no restrictions on participation. Plus, each limited partnership must have at least one general partner with full personal liability for business debts.
- **S corporation.** LLCs and S corporations are both tax pass-through entities, so profits and losses flow through the business to its owners. LLCs are less formal and so are cheaper to operate than S or C corporations. LLCs can allocate income and expenses to their members disproportionately, but S corporations must allocate income and expenses according to the shareholders' percentages of ownership. There's no limit on the number or types of owners (members) an LLC can have. By contrast, an S corporation may have no more than 75 shareholders, including individuals and estates. And S corporation shareholders can't be nonresident aliens—which rules out any foreign shareholders. Because LLCs aren't under the ownership restrictions of S corporations, it may be easier for them to bring in more owners to raise capital.
- **C corporation.** As separate entities from their owners, C corporations offer shareholders protection from business creditors. However, C corporations—unlike LLCs—are taxpaying entities, which could mean double taxation of profits. Also, the liquidation of C corporations may trigger corporate and shareholder taxes, but LLC liquidations will usually only have tax consequences to the members. In addition, an LLC can be run less formally than a corporation.

An LLC and its owners don't face the prospect of double taxation that C corporations do. But there's a downside. A C corporation can keep some of its earnings in inventory or in cash for future growth.

LLC members, on the other hand, can't leave profits in the business without first paying taxes on these profits at their individual tax rates, which might be as high as 35%.

Professional Limited Liability Partnerships and LLCs

Many states allow certain professionals to form professional LLCs, but a few states call them limited liability partnerships (LLPs). Only certain state-licensed occupations—such as doctors, lawyers, and accountants—may form these professional LLCs or LLPs. (For example, in California only accountants, lawyers, or architects may form LLPs.)

The designation LLP (or RLLP, Registered Limited Liability Partnership) becomes part of a firm's name and must be used in all legal transactions and advertising to the public. Once registered, the partners of the LLP do not have liability for the malpractice of the other partners, but remain liable for their own acts. This limited liability feature—not taxes—is the primary reason why professionals form LLPs.

If you provide professional services, check with your state or your attorney for LLC and LLP restrictions and requirements.

C. Forming and Operating a Limited Liability Company (LLC)

As with most business entities, LLCs are regulated by individual state laws. While state laws are similar, there is not yet a Uniform Limited Liability Company Act, so LLC laws, procedures, paperwork, and expenses vary from state to state. What follows is generally true for all states, but yours may be an exception.

1. Formalities

To form an LLC, you'll need to prepare written articles of organization (some states call this a certificate of formation or certificate of organization) and send them to your state's filing office, often the secretary of state. The articles may be just a simple one-page form, similar to articles of incorporation.

Fees. The filing fee depends on your state and ranges from $50 on up. (Tax-hungry California charges $70 plus an $800 annual tax.) Most states provide a blank articles form on their secretary of state or department of corporations website.

Extra steps. Some states require a few extra steps before your LLC can start business. In New York, for instance, you must publish notice of your LLC formation in a newspaper. Also, you may need a local business license before you start doing business.

Operating agreement. A written agreement (called an operating agreement) may also be required by your state. The operating agreement sets out the internal rules for governing the LLC: voting rights, check-signing authority, and other vital matters. They are similar to partnership agreements or bylaws that govern a corporation.

Even if a written LLC operating agreement is not required by your state, it is certainly a good idea. It should help avoid or settle disputes about the management of the LLC business later down the road. See Nolo's *LLCMaker* or *Form Your Own Limited Liability Company*, by Anthony Mancuso, for help creating an operating agreement.

Recording decisions. Most states' LLC laws don't require corporate formalities such as keeping minutes, passing resolutions, and holding annual meetings. However, it's wise to document the LLC's major actions, such as entering into an expensive executive employment agreement.

LLCs can elect corporate-style taxation. LLCs (as well as partnerships) can choose either pass-through taxation or to be taxed like a corporation. (It would be unusual for an LLC to want to be taxed like a corporation, however.) If you're interested, talk to your tax pro and see IRS Form 8832, *Entity Classification Election.*

Tax ID Number. To satisfy the IRS, the only step you must take after forming an LLC is to get a federal identification number (EIN) (whether or not your LLC will have employees). See Chapter 5, Section A, for details on how to get an EIN.

Where to Get Help

Check with your secretary of state's office for LLC fee and filing rules. Most states provide sample LLC articles or fill-in articles forms.

See the "Resources" box at the end of this chapter for recommendations on legal self-help references. Business lawyers can help you form an LLC, and tax pros can do the IRS and state tax reporting. Attorneys' fees are about the same as for forming a partnership or corporation—ranging from $500 to $2,500.

If you are forming a one-person LLC, you should be able to do it without a lawyer, but you may need help if others will be involved. Again, see the "Resources" box at the end of this chapter.

2. Converting a Corporation to a Limited Liability Company

Before converting an existing corporation to an LLC, consider the tax consequences and professional fees.

A corporation must be formally liquidated before its assets may be put into an LLC. Corporate liquidations of successful, active companies are complex—liquidating a C corporation with significant assets might mean taxes for the corporation, because this is treated as a sale of the corporation's assets. Then the funds from the sale of assets are deemed to have been distributed to the shareholders, who may be taxed again. (See Chapter 7, C Corporations.) Whatever is left after taxes goes into the LLC.

If you convert an S corporation to an LLC, you'll fare better, because any taxes on liquidation are placed only on the shareholders. There is no double taxation, as with C corporations.

A relatively new corporation, one that has not been successful or that has minimal assets, may be able to convert to an LLC without a tax cost.

Get tax advice before switching. Bottom line: If you are tempted to convert your business to an LLC, see a tax pro first.

3. Restrictions on Members' Rights

LLC members don't have to be involved in managing the business if the LLC operating agreement states this. This kind of member is likely just an investor in the LLC. This is similar to a limited partner or the holder of nonvoting corporate stock. However, there are some rights an LLC member must hold (such as the right to vote to dissolve the LLC). Check your state's LLC statute or with your legal adviser.

4. Transferring Ownership—Sale or Death

Unless restricted in the LLC operating agreement, transferring an LLC ownership interest is relatively easy—the member simply signs over his membership interest, and the buyer or transferee gets all the rights (and obligations) of the departing member.

The tax consequences to the transferring member are the same as with a partnership—the gain or loss is determined by the member's tax basis in his share. (See Chapter 9, Section H.)

However, most small business owners don't want a co-owner forced on them. An LLC operating agreement should contain restrictions on transfers of LLC interests (called buy-sell provisions). Typically, an agreement may state that a retiring or departing member of an LLC must first offer his share to the remaining members before selling to anyone else. Usually, a predetermined price for a share or a formula for valuing it is set out in the operating agreement. These buy-sell provisions bind all members and should be part of the LLC formation process.

The IRS becomes interested when a member dies. That's because an LLC membership interest is an asset in the estate of the dearly departed member, so, if the estate is big enough, there may be an estate tax return to file.

The good news is that the IRS usually respects the terms of a well-drafted buy-sell agreement (or an LLC operating agreement with buy-sell provisions) for fixing a fair price of a member's share. See *Buy-Sell Agreement Handbook: Plan Ahead for Changes in the Ownership of Your Business*, by Anthony Mancuso and Bethany Laurence (Nolo), for more information on setting a fair price for LLC membership interests.

Tread carefully when assigning a value to your business. Valuation of business interests is a number one concern to an IRS estate tax auditor. Many estate executors end up in IRS battles over just what a small business interest is worth. (See *Stand Up to the IRS*, by Frederick W. Daily (Nolo), for more information about estate tax audits and business valuations.)

D. Terminating a Limited Liability Company

Generally, the rules for terminating or dissolving an LLC are similar to closing up a partnership.

Income tax treatment of the members is the same as if they were general partners. (See Chapter 9, Section I.)

Resources

- *A Guide to Limited Liability Companies* (Commerce Clearing House) and *The Limited Liability Company*, by James Bagley (James Publishing). These are technical books written for CPAs and attorneys.
- *Limited Liability Companies*, by Robert W. Wood (John Wiley & Sons). This book discusses in depth the implications and mechanics of converting existing small businesses to LLCs.
- *Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo). This book provides step-by-step forms and instructions for setting up an LLC without costly legal fees.
- *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo). This book provides ongoing help on running your LLC, as well as numerous minutes and resolution forms.
- *LLCMaker* software, by Anthony Mancuso (Nolo). This interactive computer program takes you, step by step, through the LLC formation process and helps you create articles of organization that meet the requirements for your state, as well as a comprehensive operating agreement.
- IRS Form 8832, *Entity Classification Election and Instructions.*
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinncpas.com.

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CHAPTER

11

Personal Service Corporations

"There is no magic in parchment or in wax."
—William Henry Ashhurst

Many professionals—physicians, lawyers, accountants, and others—operate as sole proprietorships or partnerships, and go by the same tax rules as these entities. However, certain professionals who offer services may form a special entity called a professional corporation. Moreover, state laws require specified categories of professionals to incorporate only as professional corporations. A professional corporation's shareholders perform services for the corporation as employees.

Each state regulates various professions and determines who may—or may not—form a professional corporation. For example, a group of attorneys and paralegals may not form a single professional corporation if under their state's law a nonlawyer can't hold stock in a professional legal services corporation.

Most professional corporations are classified by the federal tax code as personal service corporations (PSCs) and are taxed similarly to C corporations, with a few twists. To be taxed like a corporation, a professional corporation must qualify as a PSC.

Limited liability partnerships (LLPs) are now allowed in many states. LLPs, a relatively new form of business, provide an alternative to the PSC for professionals in states that allow LLPs, like California.

Personal Service Corporations in a Nutshell

1. In most states, certain specified professionals who want to incorporate must form professional corporations.
2. The IRS recognizes specified professional corporations as separate tax entities called personal service corporations (PSCs).
3. For a successful professional, incorporating offers a few tax advantages, including a greater range of fringe benefits.

Nontax Benefits of Professional Corporations

Professionals find that incorporating is beneficial for non-tax-related reasons. For instance, like any corporation, a professional corporation has perpetual existence. So if one shareholder dies or withdraws, the business can carry on with minimal legal disruption.

Professional corporations also offer shareholders limited personal liability. (The extent of this protection depends on state law.) However, an incorporated professional can't legally escape personal liability for her own negligent acts—for this you need professional liability insurance. But a shareholder practicing with other professionals can usually avoid personal liability for *other* shareholders' malpractice or misdeeds.

> **EXAMPLE:** Allison and Bill, both psychiatrists, form a professional corporation, sharing a receptionist and other common expenses. If Dr. Bill loses a malpractice lawsuit, both the corporation's assets and Dr. Bill's personal assets are in jeopardy. However, Dr. Allison will not be personally liable—meaning her house and savings cannot be grabbed to pay the judgment. If, on the other hand, they operated as a general partnership, Dr. Allison would be personally liable for Dr. Bill's acts in their practice of medicine.

A. Personal Service Corporations

A personal service corporation is one in which substantially all of the activities involve services in the fields of health, law, engineering, accounting, architecture, veterinarians, actuarial science, performing arts, or consulting.

IRS regulations elaborate on the allowed occupations. For example, health care professionals include physicians, nurses, dentists, and others, but not folks who operate health or exercise clubs. Consulting covers someone who sells advice, but not a salesperson or any kind of broker. Performing arts covers actors, entertainers, and musicians but not their promoters or managers. Interestingly enough, professional athletes are not allowed to form PSCs. (Reg. 1.448-1T(e)(4).)

A professional corporation isn't always treated as a PSC. (IRC § 448.) If a professional corporation doesn't qualify as a PSC, it is taxed as a general partnership. (See Chapter 9, Partnerships.)

The IRS imposes two tests a corporation must meet to qualify as a personal service corporation. These tests focus on what the corporation does (the function test) and how it's owned (the ownership test).

1. Function Test

Substantially all of the activities of the PSC must involve rendering personal services. IRS regulations say that "substantially all" means 95% or more of work time expended by employees. (Reg. 1.448-IT(e).)

> **EXAMPLE:** Jack and Jill are fresh out of law school, but they cannot find full-time work as attorneys. To keep bread on the table, they form an S corporation, Sweetstuff, Inc., to operate a frozen yogurt store. In addition, they do free-lance legal work for about ten hours a week. Can they convert their S corporation into a PSC? No, because as Sweetstuff, Inc., employees, Jack and Jill don't devote 95% of their time to providing legal services.

2. Ownership Test

Substantially all stock (95% or more) in a PSC must be held directly or indirectly (through one or more partnerships, S corporations, or other qualified PSCs) by:

- employees performing professional services for the corporation
- retired employees who performed services in the past
- the estates of such individuals, or
- someone who inherited stock from any such persons.

> **EXAMPLE:** Ralph and Connie are physical therapists who are approached by Gino, the owner of Costa La Health Spa, to offer services at the spa. If Ralph and Connie will incorporate as a professional corporation with him, Gino will invest $20,000 in return for some stock. They incorporate as Spa Time Inc., with Ralph and Connie owning 75% of the stock and Gino 25%. Spa Time Inc. may qualify as a professional corporation, but it isn't a personal service corporation under the 95% ownership rule, because Gino, who is not a health professional, owns more than 5% of the stock.

B. Taxes

A PSC is annually taxed at a flat rate of 35% of any net income left in the corporation. In practice, as with most small corporations, the shareholders take out all profits as tax deductible (to the corporation) salaries, bonuses, and fringe benefits. So, typically the shareholders pay income taxes on their individual tax returns and the PSC, with no net income, pays nothing. States usually tax PSCs as well.

1. Tax Year Election

A PSC can keep its records on either a calendar year or fiscal year basis. (See Chapter 3, Bookkeeping and Accounting.)

A PSC must get IRS permission to use a fiscal year by showing a business purpose for it. (Rev. Procs. 87-32 and 87-57 have details and examples.) To apply for permission from the IRS to use a fiscal year, file IRS Form 1128. However, it's better to have a tax pro do this for you.

2. Accounting Method Elections

A PSC may choose either the cash or accrual method. (See Chapter 3, Section G.)

3. Section 1244 Stock

A PSC may adopt IRC § 1244 status when it is formed (as long as it has not elected to be an S corporation). This allows advantageous tax treatment to shareholders if they ever sell their stock in the PSC for a loss. (See Chapter 4, Business Losses and Failures.)

C. Fringe Benefits

A PSC may offer many of the fringe benefits available to a C corporation. (See Chapter 14, Fringe Benefits, and Chapter 15, Retirement Plans, for a discussion of corporate fringe benefits.)

Technically, a PSC may elect to be an S corporation, but if it does, it won't qualify for the corporate fringe benefits discussed below. (See Chapter 8, S Corporations.) Moreover, the tax code does not provide PCS shareholders the same flow-through tax treatment as S corporation shareholders get, so PSCs seldom elect S status.

1. Tax-Advantaged Retirement Plans

A PSC may establish corporate retirement plans and a 401(k) plan for owners and employees. (See Chapter 15, Retirement Plans.)

2. Health and Life Insurance Benefits

A PSC with three or more shareholders may establish a Voluntary Employees' Beneficiary Association (VEBA). This allows the PSC to deduct the cost of and provide health and life insurance coverage to all PSC employees and shareholders as a tax-free benefit. VEBAs are usually administered by banks or insurance companies. (See IRC § 501(c)(9) for details, or consult a tax or pension professional.)

3. Other Fringe Benefits

Generally, PSCs can offer tax-advantaged life and disability insurance, death benefits, dependent care, and other fringes, without establishing a VEBA. (See Chapter 14, Fringe Benefits.)

Alternatives to the Professional Corporation

Some states recognize professional limited liability companies (LLCs) as an alternative to the professional corporation. Other states (such as California, Delaware, Louisiana, and Texas) allow professionals to form a similar business entity called a limited liability partnership (LLP). See Chapter 10, Limited Liability Companies, for more information about the pros and cons of forming an LLC or LLP.

D. Potential Tax Problems

A few tax problems may creep up on an unsuspecting PSC shareholder. They are rarely encountered, but I'll mention them briefly.

1. Passive Loss Limitations for Nonactive Shareholders

Passive loss limitations prohibit nonactive PSC shareholders from deducting corporation losses. This rule means the majority of PSC shareholders must actively perform services for the corporation—they can't be part-timers or shareholders who have retired. (IRC § 469.) In reality, most PSCs are composed of active owners, and few lose money.

2. Income Splitting Doesn't Work

Unlike with C corporations, splitting income between PSCs and their shareholders does not save shareholders taxes. (See Chapter 7, Section C1.)

One reason is because a flat 35% PSC tax applies to any profits left in the corporation at the end of the year, which is just as high as or higher than as the individual shareholders' tax rates. A tax-savvy PSC doesn't have any net earnings at year end, however.

E. Transferring Shares

State laws typically prohibit transferring PSC stock to a nonprofessional. This also would violate the IRS requirement that substantially all stock be held by those who are actively performing services.

PSCs typically have written agreements, binding on both the shareholders and their estates, requiring the purchase of deceased shareholders' stock by the PSC. Often, this type of agreement is funded by a life insurance policy. The PSC takes out life insurance policies on its members and uses the payoff to buy the deceased owner's share from his or her estate.

F. Dissolving a Personal Service Corporation

A PSC may be ended voluntarily, by a majority vote of the shareholders. A PSC may also be dissolved involuntarily by the state or as a result of legal action against it.

The tax results from dissolving a PSC are roughly the same as for a C corporation. (See Chapter 7, Section H.) The important thing to know is that a taxable gain (or loss) for each shareholder results when a PSC folds. See a tax pro for guidance through this process.

Resources

- IRS Publication 542, *Corporations*.
- *How to Form a California Professional Corporation*, by Anthony Mancuso (Nolo). While this book is geared for California, much of it applies to other states, too, and it contains many valuable professional corporation forms.

CHAPTER

12

Family Businesses

"Don't tax you, don't tax me; tax the fellow behind the tree."

—Senator Russell B. Long

Many small businesses get the whole family involved. Parents bring children into a business for help and to teach the kids money-making skills. When the children grow up, they may take over the family business and then pass it on to their offspring.

While the tax rules discussed in previous chapters also apply to family businesses, there are additional tax pitfalls and opportunities unique to family businesses.

Family Businesses in a Nutshell

1. Family businesses allow income splitting between parents and children to reduce the family's overall tax bill.
2. It is okay to hire your spouse and kids and take tax deductions for their paychecks, as long as they do real work and their pay is reasonable.
3. A corporation or a family limited partnership allows a transfer of a valuable family business to a younger generation over time, while reducing or eliminating estate tax.

A. The Legal Structure of a Family Business

Either spouse can own a sole proprietorship, but if other family members share ownership, too, the operation must be organized as a partnership, limited liability company, or corporation.

These more complex forms of doing business offer families both tax and nontax advantages. Partnerships, limited liability companies, and corporations allow more tax and estate planning flexibility than sole proprietorships. For instance, incorporating allows family members to receive ownership benefits (such as stock dividends) even if they don't work for the enterprise. (See Section B, below.) Or, forming a family limited partnership or LLC makes it easier to transfer business ownership to family members gradually over time and save both income and estate taxes.

Families can even combine several different types of business structures to best distribute tax benefits. For instance, a partnership with several siblings can own and rent a building to a corporation owned by their parents. Whether or not multiple entities make sense depends on the tax situations of *all* the family members.

Generally, whether the complications of forming several entities are worth it hinges on the income splitting ideas discussed below.

If this sounds intriguing, check it out with a top tax pro, preferably a CPA or tax attorney.

B. Income Splitting to Lower Taxes

Family members often pool their efforts and resources to run small businesses. For many, this provides not only a good living, but also a sense of security and closeness. As a bonus, family ventures can also bring tax savings for the family unit.

A tax saving technique known as income splitting shifts income from higher bracket taxpayers—usually parents—to lower ones—usually children or retired grandparents. Obviously, these strategies depend on cooperation and trust between family members.

1. Legality of Hiring Your Kids

It's perfectly legal to hire family members to do some work in the business for a salary. Court decisions have supported parents hiring their minor children as long as they give them real work to do. Employing kids or other relatives is okay—as long as the pay isn't outrageous. Following are the basic tax code rules on hiring your children or parents.

2. Tax Benefits of Hiring Your Kids

Putting your children to work in your business can reduce your family's tax bill. Paying your kids reduces the business profits that would otherwise be taxed at your tax rate (which is always higher than your kids' rates).

A minor child can earn up to $4,700 without owing taxes to the IRS. Then, the tax rate starts at 10%. As long as the income is earned by a child

Paying Your Children Legitimately

Courts have okayed kids as young as seven getting paid for simple chores like taking phone messages or cleaning the office windows. (I don't know about your kids, but I shudder at the thought of a seven-year-old answering my business phone.) Children can be paid a reasonable sum for their work; reasonable pay depends on the facts and circumstances of each case. My advice: Don't try to pay and deduct more than $3,000 per year to any of your children under age 12.

> **EXAMPLE:** Dr. Moriarty (his real name—not Sherlock Holmes's nemesis) hired his four teenagers to do clerical work for his medical practice. An IRS auditor said this was a mere subterfuge to deduct the kids' allowances as a business expense. The tax court overruled the IRS, saying it was all legal as long as the kids did real work and were paid reasonable wages. (*James Moriarty*, TC Memo 1984-249.)

Type of work. The kind of work done by the child—such as washing the company car, filing, or going to the mailbox—doesn't matter, as long as it's a task a business customarily would pay someone to do. Duties should reflect the age and training of the children. While it is fine to pay a 14-year-old to do computer inputting, it wouldn't wash for an eight-year-old. But it's okay to hire your precocious 13-year-old to do filing even if you might not hire someone else's 13-year-old for the job.

Rate of pay. Generally, don't pay your child more than you would a stranger, although there is some wiggle room. If you pay little Susie $7 per hour, and you could realistically find someone else to do it for $5.50, an auditor will likely let it pass. But you are pushing the envelope if you pay Susie $20 per hour.

Schedule of pay. The payments to your kids should match up to a work schedule. This can be tied to school vacations, after-school time, or holidays. If you make only one or two lump sum payments in a year, an auditor might think that you are trying to fudge on your taxes instead of legitimately paying Junior for work.

who works in the family business, the kiddie tax (tax on a child's *investment* income, discussed in Section 3, below) doesn't apply.

Besides Junior's lower tax bracket, no FICA (Social Security and Medicare) taxes are due when he works for Mom or Dad's business. Ditto for FUTA (federal and state unemployment) taxes when Junior is under 21. In other words, no payroll taxes are incurred for putting Junior on the payroll. (IRC § 3121(b)(3)(A), IRC § 3306(c)(5).) Assuming Junior saves up or uses the money for things the parents would be buying anyway, this is money in the family piggy bank.

> **EXAMPLE:** Laura, a single mother and the sole proprietor of PhotoLand, earns $300,000 per year, putting her in the top tax bracket (35%). Her 17-year-old daughter, Louisa, helps out after school, on weekends, and all summer. Louisa is paid $20,000 over the year, putting her in the 15% tax bracket.
>
> Louisa files a Form 1040 tax return, taking her personal exemption and claiming the standard deduction. She owes $2,650 (10% on her first $7,000 of taxable income and 15% on the remainder) in income taxes and no FICA tax.
>
> If Laura hadn't hired Louisa, and instead took the $20,000 in income herself, she'd pay taxes of $7,580 ($7,000 in income taxes plus an additional $580 in self-employment taxes—2.9% for Medicare).
>
> Total family federal tax savings: about $5,000. The tax deal can be even better if Louisa opens an IRA. (See just below.)

Save even more with an IRA for your child. An individual retirement account can be established for any working child who earns wages. Up to $3,000 can be put aside each year tax-deferred—meaning that Junior may earn $7,300 ($4,300 plus $3,000) before incurring any income tax liability. Income earned over that is taxed starting at the lowest income tax rate, 10%.

Putting money into an IRA makes tax sense even if the child takes it out long before retirement, say for college. (See Chapter 15, Retirement Plans, for details on new IRA contribution limit rules.)

3. Making Your Kids Co-Owners

You can also shift business income from higher-bracket family members to lower ones by giving your children stock in your corporation. Children don't have to work in the family business with this income-splitting technique.

Stock ownership is treated as an investment in the business by the family member, even if that person didn't pay for the stock. The primary drawback to giving your children stock is that you must *irrevocably* transfer the stock to them. You have no legal right to take it back later.

Children then receive dividends on their shares of an incorporated family business. Dividends are classed as investment income and are taxed according to how old the kids are. Here are the rules:

- **Under 14 rule.** An under-14-year-old child's net unearned income—such as stock dividends from a family-owned corporation—is taxed at the parent's tax rate. This is the so-called kiddie tax, which applies to young children who don't work in the business. However, the first $1,500 of the child's dividend income is exempt from the kiddie tax, although it will be taxed at the child's rate.
- **Over 14 rule.** If your child is 14 or over and gets dividends from the family corporation, the child is taxed on all dividend income at *her* tax bracket rate. (Don't ask me why 14 is the magic age.) The family unit wins because the child is in a lower tax bracket than the parents, thereby lowering the family tax bill.

Run the numbers. Watch out for double taxation. A family C corporation paying dividends may have already incurred corporate income tax on this money, so overall tax savings may vanish in the process. Have a tax pro run the numbers to see whether paying dividends makes sense for your family. (See Chapter 7, Section B1, for a discussion of the taxation of corporations.)

If you are the cautious type, give your kids only shares of nonvoting stock. Otherwise, they will have a vote in the management of the business—including whether they will get any dividends each year.

EXAMPLE: Wally and Wanda own House of Shoes, Inc., and give their three children each $20,000 worth of stock every year ($10,000 from each parent). The gift is not subject to federal gift tax. The children's stock is nonvoting, so Wally and Wanda maintain control of the management of the House of Shoes, Inc. See the discussion in Section D, below, about estate and gift tax basics and transferring shares to your kids.

4. Putting Older Parents on the Payroll

Income splitting also works between older parents and their grown children. For example, a builder who might otherwise help his retired father financially could hire his dad part-time for light work. Not only does the business benefit from the expense deduction, but the father's pay is likely to be taxed in a lower bracket. Of course, shifting income to parents makes sense *only* if they are in a lower tax bracket and need the income.

Before hiring Mom, see what effect earnings will have on her Social Security benefits. If she's under age 65, her Social Security benefits may be reduced (see "How Working Affects Social Security Benefits," below).

Compensation received by a person on Social Security is still taxable and subject to FICA (Social Security and Medicare) tax.

How Working Affects Social Security Benefits

People who collect Social Security before the year in which they reach full retirement age will lose one dollar of those benefits for every two dollars they earn over a set yearly limit.

Age	Annual Earnings Limit	Reduction in Benefits
62 through 65½	$12,000	$1 for every $2 earned

(These amounts are for 2005, and are subject to an annual adjustment in subsequent years.)

EXAMPLE: Marina started drawing Social Security benefits at age 62. She went to work for her son, Manny, at his Motel Five as a part-time desk clerk. In 2005, Marina earned $13,200. She will lose $660 in Social Security benefits under the tax code rules ($13,200 – $12,000, divided by 2 = $660).

If Marina continues to work after age 65½, she won't lose any Social Security benefits, no matter how much she makes. Social Security benefits are reduced only as a result of earned income from working. Other income—investments, annuities, private pensions, unemployment, gifts, and rents—don't count toward the $12,000. However, Marina's wages will continue to be subject to Social Security and Medicare taxes.

Don't enlarge a parent's large estate. Think twice before paying your parent if she has an estate that is large enough to be subject to federal estate tax at her death. The federal estate tax threshold is $2 million (2006), increasing to $3.5 million by 2009.

C. A Spouse in the Business

When spouses work together, taxes can be saved by keeping one working spouse off the payroll. The reason is that *all* employees—except owners' children under 18—are subject to payroll taxes.

Social Security and Medicare taxes add 15.3% to the cost of wages, up to $90,000 in 2005, and 2.9% on all wages over that. Spouses aren't subject to federal unemployment taxes, however. But, other expenses are also incurred when a spouse is on the payroll, such as state unemployment and disability taxes and workers' compensation insurance.

There are two ways to get around the added expenses of a spouse on the payroll:

- let your spouse volunteer, or
- report taxes as a sole proprietorship in community property states.

Let's take a closer look at both options.

1. Letting Your Spouse Volunteer

There's no payroll tax or employee expenses if your spouse doesn't get a paycheck. I have never seen any government agency, including the IRS, try to force a working—but unpaid—spouse onto the payroll.

> **EXAMPLE:** Susie Sanders earns $100,000 from her SS Personnel Services business. Susie hires Jocko, her hubby, as a consultant and pays him $20,000 a year. Putting Jocko on the payroll increases the Sanders' joint tax bill by $3,060 (Social Security and Medicare tax of 15.3% x $20,000). By contrast, if Jocko had not been paid for his work (thereby increasing Susie's income by $20,000), the family would have come out ahead about $2,500 ($3,060 minus $580, the amount of Medicare tax that Susie would have had to pay on the extra $20,000 income). This example assumes Susie and Jocko file a joint tax return, which most spouses do.

Watch out for Social Security issues. An unpaid spouse won't get Social Security account credit. This is not a problem if the spouse has already qualified for coverage from a former job by working ten years or more.

2. Reporting as a Sole Proprietorship

In community property states only (Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, and Wisconsin), a husband or wife can run a family business as a sole proprietorship and have both spouses list their names on Schedule C of their joint tax return. In this case, the IRS should consider them both owners, not employees.

One spouse is legally an employee and must pay self-employment taxes (Social Security and Medicare).

In the other 41 states, the two spouses are legally a partnership. This doesn't normally change the overall income tax consequences for either partner, but both are liable for self-employment taxes, and, in a few instances, it may allow income splitting and estate tax savings. (See Section D, below, and Chapter 9, Partnerships.)

Co-owning spouses can write off business travel. Spouses co-owning an enterprise may get a tax break for out-of-town travel. If both travel together—to conventions or on other business—the expenses of both are tax deductible. By contrast, if one is not an owner, but an off-the-books volunteer, her or his travel costs aren't deductible. (See Chapter 14, Fringe Benefits.) Solution: Paying the spouse a small salary might be worth the tax trade-off if you do a lot of business travel with social overtones (if you have other employees).

D. Preserving a Family Business After Death

This book deals with the day-to-day tax issues. We can only touch on estate planning—how to pass on a business, at death, to minimize or avoid probate fees and taxes. For details on estate planning, see the "Resources" list at the end of this chapter.

Anyone with a business may be concerned about:

- keeping the operation going after the owner dies, and
- preventing estate taxes from taking a huge share of the business's assets or forcing its liquidation.

Choosing an Estate Tax Strategy

Lawyers and financial planners can often find loopholes to avoid or greatly reduce estate taxes for small businesses. This may be accomplished through marital bypass trusts (AB trusts), charitable trusts, and other types of trusts called by acronyms such as GRITS, GRATS, and QTIPS. This area is fraught with tax peril; the best strategy for you depends on your personal and financial situation. Have a tax pro or lawyer guide you. Below, we discuss some of the other, less sophisticated ways to keep businesses in the family after death.

1. Death and Taxes

A successful small family enterprise often becomes so valuable over time that significant federal estate taxes may be due after the death of the owners. The federal estate tax begins on all estates with a value in excess of $1.5 million in 2005, and $2 million in 2006 through 2008. (Roughly speaking, your taxable estate is everything you own at your death.)

> **EXAMPLE:** Stella, a single woman, dies in 2005. Her estate has a net value, after debts, of $1,725,000. In 2005, $1.5 million can be passed tax-free, so Stella's estate is taxed on the balance ($225,000). Her estate will owe a federal tax bill of almost $90,000, and may also owe estate taxes to her state.

Estate taxes can be more than 50% when combining federal and state tax rates. To pay them, family members may be forced to sell the business or its assets.

Don't overlook state death taxes. Most states also impose death taxes. However, since there is a federal estate tax credit for any state death taxes paid, combined federal and state death taxes usually don't exceed the federal tax alone. A few states impose estate taxes higher than the federal credit—which can be significant in multi-million-dollar estates. If this worries you, check with an estate planning professional. You may want to change your state of residence if your state's death taxes are particularly onerous.

2. Installment Plans for Estate Taxes

Here's a tax break that lets families avoid business liquidations on the owner's death: a long-term estate tax payment plan. The interest rate charged by the IRS on tax for the first $1 million taxable due is 2%, and 4% on any balance. An estate with a small business worth at least 35% of the estate's total value can pay estate taxes over 14 years. And for the first five years, the estate is allowed to pay interest only. (IRC § 6166.)

> **EXAMPLE:** Jorge suddenly dies, having a will but no other estate planning. Jorge's Plumbing Supplies, his sole proprietorship, is worth several million dollars. Jorge's will leaves the business to his two sons, but there isn't enough money for the estate taxes. Choosing the installment payment option, Jorge's sons can keep the business. They can pay the estate tax out of future profits over 14 years at a favorable interest rate of 4%.

Although the installment plan helps business owners' families, through estate planning, Jorge might have been able to eliminate estate taxes altogether. We'll discuss some ways to do this next.

Joint ownership doesn't avoid estate taxes. There is a widespread misconception that joint ownership of property avoids estate and gift taxes. Sorry, it doesn't. Adding a child's name to a deed or stock certificate as a joint tenant may avoid state probate expenses, legal fees, and delay, but it doesn't remove an asset from the reach of the federal estate tax. The only possible exception would be if the joint owner contributed funds to purchase the property. Married couples may be joint owners with the survivor taking the property tax-free. See "Estate and Gift Tax Basics," below.

3. Transferring a Business Before Death

Strategies for keeping a family business after the death of an owner include forming a corporation, family limited partnership, or LLC. Each requires preplanning; deathbed transfers won't pass IRS muster. Several types of trusts are mentioned above, but any in-depth discussion is beyond the scope of this book.

a. A Family Business Corporation

Incorporating a business makes it easier to pass it on and continue operation after the owner's death. And incorporating also provides a way to minimize estate and death taxes that is not available to sole proprietors.

With a corporation, a parent can give his kids the business stock in a series of annual gifts. As long as the value of the stock given to each recipient each year is no more than $11,000, the transfer is not taxable to anyone. This is true whether the business is an S or C corporation. For a valuable business, this is obviously a long-term planning device, because of the annual $11,000 limitation. Married co-owners can combine their $11,000 annual gift limits for a total of $22,000 per recipient, which helps a little.

Giving corporate stock, however, is more complicated than giving cash. Each time a business owner gives away corporate stock, she must determine its fair market value. Valuing a private company's stock requires the help of a CPA or business appraiser. If the IRS ever audits, it is doubtful it will just take your word for the stock's value—the auditor will probably want to see a professional opinion.

Giving away small business corporation stock doesn't mean relinquishing control of the business. An owner may transfer stock but keep the voting rights of the shares. A parent-owner could put children's stock in a trust and reserve the right to vote the shares.

This advice bears repeating: Whenever transferring a business to family members, get an accountant or business appraisal expert to make a written valuation. Keep these documents handy in case you are ever audited by the IRS.

b. Family Limited Partnerships (FLPs) or Limited Liability Companies (LLCs)

Instead of incorporating your family business, you may form a family limited partnership (FLP) or LLC. An FLP is taxed like a limited partnership. (See Chapter 9, Partnerships, for a discussion of limited partnerships and Chapter 10 for a discussion of LLCs.)

Typically, parents form an FLP or LLC and transfer their assets, such as an existing business, to this entity. A venture can, however, be formed as an FLP or LLC right from the start.

FLPs and LLCs can minimize or avoid estate taxes *and* can help business owners shift current business income to (lower bracket) family members. (Section B, above, discusses splitting income to lower taxes for the family group.)

In a family limited partnership, the parents are usually the general partners. Children are limited partners, with an ownership interest in—but no

Estate and Gift Tax Basics

Estates

Federal estate taxes are due if you leave an estate valued at over $2 million in 2006 through 2008. In future years, these exemption amounts will change:

Year	Personal Estate Tax Exemption
2004–2005	$1.5 million
2006–2008	$2 million
2009	$3.5 million
2010	estate tax repealed
2011	$1 million unless Congress extends repeal

Estate taxes, like income taxes, are graduated—the bigger the estate, the higher the tax rate. The bite begins at 37% and quickly ascends to 48% (although this top rate is scheduled to decrease gradually to 45% in 2007).

There is no federal inheritance tax; beneficiaries of an estate do not owe tax on anything they inherit. Instead, the estate pays any federal estate tax due before the property is distributed. Only if the estate tax isn't paid can the IRS come after the beneficiaries.

Marriage

One break for married couples is that when the first spouse dies, all property can be left to the surviving spouse (if a U.S. citizen) free of estate tax. This is called the unlimited marital deduction. Of course, when the surviving spouse dies, the estate is fully taxed if it's over the threshold amount.

Gifts

Gifts made while living are considered part of your estate at the time of your death, with one major exception. Under the annual exclusion rule, you may give $11,000 (in property or cash) to as many folks as you like, each year, without any tax or reporting requirements. Recipients of gifts are never taxed. The $11,000 annual exclusion is subject to annual cost of living adjustments, so will likely rise in future years.

If you give away more than $11,000 in cash or property to an individual in a calendar year, the excess is subtracted from your lifetime estate tax exclusion ($2 million in 2006-2008). The giver must file a federal gift tax return for that year, but no tax is due until you have given away more than your lifetime exclusion amount. Nontaxable gifts (such as the $11,000 gifts) do not count toward the exclusion amount.

> **EXAMPLE:** John & Julie Johansen have an estate of $5 million. They want to transfer as much as possible to their kids and other relatives. They gift money annually to their two kids, two nephews, one grandchild, and one old friend. The Johansens can give away $132,000 tax-free each year to these folks (6 x $11,000 for John and 6 x $11,000 for Julie) under the annual exclusion rule. These annual gifts don't count against John or Julie's estate tax exclusion. If they live long enough, the Johansens may be able to reduce their estate so that no estate taxes will be due.

A few other kinds of gifts are tax-free as well, regardless of the amount:

- gifts to your spouse (limited to $110,000 if the recipient is not a U.S. citizen)
- gifts to tax-exempt charities, and
- gifts for tuition or medical expenses.

right to manage—the operation. In an LLC, the children receive nonvoting membership interests.

As with corporation stock, each child can receive an ownership interest worth $22,000 per year (from a set of two parents) as a gift, without tax consequences to anyone. (See "Estate and Gift Tax Basics," above, about the annual exclusion rule for gift taxes.)

With an FLP or LLC (as with a corporation), business owners can gift ownership of a business to others (usually children) over a period of years. This can lower the estate tax bite, especially if the business is appreciating in value. Given enough time, as much as 99% of the parents' business can be transferred to the children tax-free, leaving little or nothing subject to estate tax. Mom and Pop can maintain their income and remain in full control, deciding how annual profits are to be split among their kids. An FLP or LLC can be a win-win tax deal for the family business.

> **EXAMPLE:** Wally and his wife Wanda, who are in the highest income tax bracket (35%), form an FLP to own and operate North Oxon Pottery. They give each of their three children—who are all in the lowest income tax bracket—limited partnership interests in the business over a number of years. (As long as the interest given by the parents to each child is worth under $22,000 each year, there is no gift tax liability.) The children, as limited partners, have no say in the day-to-day affairs of the business.
>
> Over 25 years, Wally and Wanda give most of North Oxon Pottery FLP ownership to their kids, while controlling the business until they are ready to step down. If planned right, when Wally and Wanda have both died, their remaining partnership interest is minimal, and their estates won't owe estate tax on the entire value of the business.

You can't use an FLP or LLC solely to beat estate tax. An FLP or LLC must have a business purpose. It must be an active business venture with reasonable prospects of profitability, not merely holding a family investment. For example, an FLP or LLC formed to own a family-used vacation home isn't considered an active business. Likewise, an FLP or LLC that holds an investment portfolio of marketable securities, is not considered an active business.

FLPs and LLCs also protect the personal assets of the business owners from any business creditors. The owners can lose only the value of their business interests to creditors—not their personal bank accounts, homes, and so on.

See a tax pro. If you are considering forming an FLP or LLC for tax advantages, see a tax or estate planning attorney. But unless your business is worth at least $1 million, an FLP or LLC may not justify the legal and accounting fees and state-imposed costs.

c. Employee Stock Ownership Plans (ESOPs)

Another tax-wise option for passing a small business corporation to the next generation is an Employee Stock Ownership Plan (ESOP for short). ESOPs are typically offered as a fringe benefit to employees by big corporations, but they also can work for small-timers, too.

ESOP rules under IRC § 404 are very complex; we can only skim the surface here.

Small business ESOPs typically work like this: The corporation makes annual contributions of its stock (or cash) to an ESOP trust. The trust is set up under tax code rules similar to corporate retirement plans, discussed in Chapter 15. Over time, stock ownership passes to the beneficiaries of the trust, the company employees. Employees have account balances in the ESOP in proportion to their salaries.

> **EXAMPLE:** Blowhard Corporation stock has a total value of $1 million. It pays out $500,000 in salaries to employees in 2005, the year the company establishes an ESOP. The tax code allows Blowhard to make an annual contribution of up to 25% of all employees' salaries to the ESOP, or $125,000, to purchase corporate stock. This represents 12.5% of the stock of the company.

Tax-Discounting the Value of a Family Business

The tax law—as interpreted by various federal courts—allows you to discount the value of small business interests when transferred by gift or on death. Reduced valuations can produce tremendous gift and estate tax savings, or eliminate these taxes altogether. This is particularly true when ownership is passed from one generation to the other. The reduction is called a marketability or minority discount. It applies to family corporation stock, family limited partnership shares, or limited liability company shares.

Small enterprises are inherently difficult to value. As a practical matter, outsiders are not eager to get part ownership of any small business; they want control. But because anything will sell if the price is right, a 20% to 40% discount might entice someone to settle for a piece of the action. The IRS routinely allows discounts of 15%–20%, but discounts as high as 50% have been upheld in court cases where the interest is minority, or the corporate stock lacks voting rights or if it is a limited partnership interest.

The size of a discount is determined by as many as ten factors; one or more might apply to your situation. A 1995 tax court case (*Bernard Mendelbaum v. Commissioner*, TC Memo 1995-255), involving a family-owned S corporation, discussed the factors. My comments (in parentheses) follow each point as to its importance in justifying a large discount:

1. Whether or not the stock has been traded publicly (insignificant; hardly ever the case in a small business).
2. Financial statement analysis (fairly important; best done by an experienced tax pro, mainly to see how profitable the business is; if only average or marginal, a larger discount can be taken).
3. Dividend policy of the business (usually insignificant; most small corporations don't pay dividends).
4. Nature, history, and industry position of the business (not too significant; how the business is positioned for competition and like factors).
5. Strength of company management (important; successful businesses depend heavily on personalities).
6. Degree of control in the transferred shares (very important; if the transferor maintains control after the transfer—typical with small businesses—large discounts can be justified).
7. Stock transfer restrictions (very important; for example, first refusal clauses, which require offering shares to family members on favorable terms, make it very difficult to sell partial ownership).
8. Required holding period of stock (important; a stock transfer restriction; see comments on #7 above).
9. Stock redemption policy of the company (important; if the business has not historically redeemed stock of shareholders, this factor allows larger minority discounts).
10. Public offering costs (insignificant; few businesses worth less than $10 million ever consider a public offering).

EXAMPLE: Juan, a widower, owns 70% of the stock of Star-Tar, Inc., which manufactures Spanish guitars. Juan's five children, all active in the business, own the other 30%. A business valuation expert values Juan's corporation at $2.3 million. If Juan starts on an estate plan to give each of the children $11,000 worth of stock every year, after 12 years he will have probably given away a majority interest in the corporation. Because of the discount allowance for family corporate stock, the value of Juan's new minority stock interest could be discounted. Depending on the value of his other assets, Juan's estate may not owe any estate taxes. (The same analysis holds true if Juan forms a family limited partnership or LLC instead of a corporation.)

Joe Blowhard, Jr., received a $120,000 salary, so he has 3% of Blowhard stock allocated to his ESOP account at the end of the year ($120,000/ $500,000 x 12.5%).

Blowhard, Inc., gets a tax deduction for the value of the stock contributed, and it is not income to the beneficiaries of the ESOP. If the company had simply given the stock to the employees, without using an ESOP, the stock would have been taxable income to the recipients.

The main drawback of an ESOP is that it must be offered to all employees—it cannot keep out long-term employees who aren't family members.

ESOPs are not do-it-yourself plans. First, only a C corporation can set up an ESOP. Hire a sharp CPA or a tax attorney to do it (their fees will be deductible to the company). Also, figure in the costs of annual appraisals of the value of the company while an ESOP is in place. Generally, owners should be approaching retirement, say in five to ten years, for an ESOP to make the most sense, and only in a business worth $1 million or more.

Resources

- IRS Publication 554, *Older Americans Tax Guide*.
- IRS Publication 950, *Introduction to Estate and Gift Taxes*.
- IRS Publication 929, *Tax Relief for Children and Dependents*.
- *Plan Your Estate*, by Denis Clifford and Cora Jordan (Nolo). This is a thorough overview of estate planning options and strategies, including federal and state estate taxes.
- *Make Your Own Living Trust*, by Denis Clifford (Nolo). This book contains forms and instructions for creating two kinds of trusts: simple living trusts that avoid probate and a more complicated AB trust to reduce estate taxes.
- *Quicken WillMaker Plus* software (Nolo). This program lets you make probate-avoidance living trusts as well as an AB trust to reduce estate taxes.
- *Social Security, Medicare & Government Pensions*, by Joseph L. Matthews with Dorothy Matthews-Berman (Nolo). This book explains, among other things, the rules that govern taxation of Social Security benefits.
- Smartmoney.com. This site has a tax calculator to answer the question, "Will I owe estate taxes?" It's a good starting point, but if your estate is sizable, you'll want to run the answers by a tax pro.

CHAPTER

13

Microbusinesses and Home-Based Businesses

"Of course there's a different law for the rich and the poor; otherwise who would go into business?"

—E. Ralph Stewart

Millions of Americans already operate very small businesses, many of them home-based. Quite a few of these ventures supplement a regular job or another business.

Most tax rules are the same whether your business has 500 employees or it's just you, working alone from home. Nevertheless, a few tax code restrictions are aimed at home-based and other small enterprises that look more like hobbies than profit-seeking ventures.

This chapter focuses on sole proprietorships, which make up 75% of all businesses, but most of these principles apply to any type of unincorporated business. If your business is incorporated, also see Chapter 7, C Corporations, and Chapter 8, S Corporations.

Microbusinesses and Home-Based Businesses in a Nutshell

1. Business expenses are deductible, no matter where they are incurred. But to deduct part of your rent or claim depreciation for a home office, you must meet strict tax law requirements.
2. Losses from home-based and sideline businesses can be claimed against your other income to reduce your overall individual tax bill.
3. If you claim losses from your small business, an IRS auditor may challenge you, saying your business was really a (nondeductible) hobby. Defend your business loss by showing a profit motive.
4. You must make estimated tax payments and pay self-employment taxes if your enterprise is profitable.

A. Business Expenses Incurred at Home

Business expenses are tax deductible, no matter where they are incurred—at home, on the road, or in a traditional office or shop.

Home office expenses include office supplies, materials, professional and trade memberships and dues, travel, business use of your auto, meal and entertainment expenses, insurance premiums for business assets, local and long-distance telephone calls on the home phone (but not the cost of the basic monthly service), maintenance and repair of office computers and other equipment, depreciation (or IRC § 179 write-off) of furniture and other business assets, interest on business debts, employee wages and benefits, publications and software, and advertising. (See IRC § 162, Reg. 1.162, and Chapter 1, Deductible Expenses, for details and examples of other expenses.)

You can claim business expenses incurred in the home without a real home-based office. You may deduct all of the above kinds of home-based business expenses whether or not you qualify for the home office deduction discussed in Section B, just below.

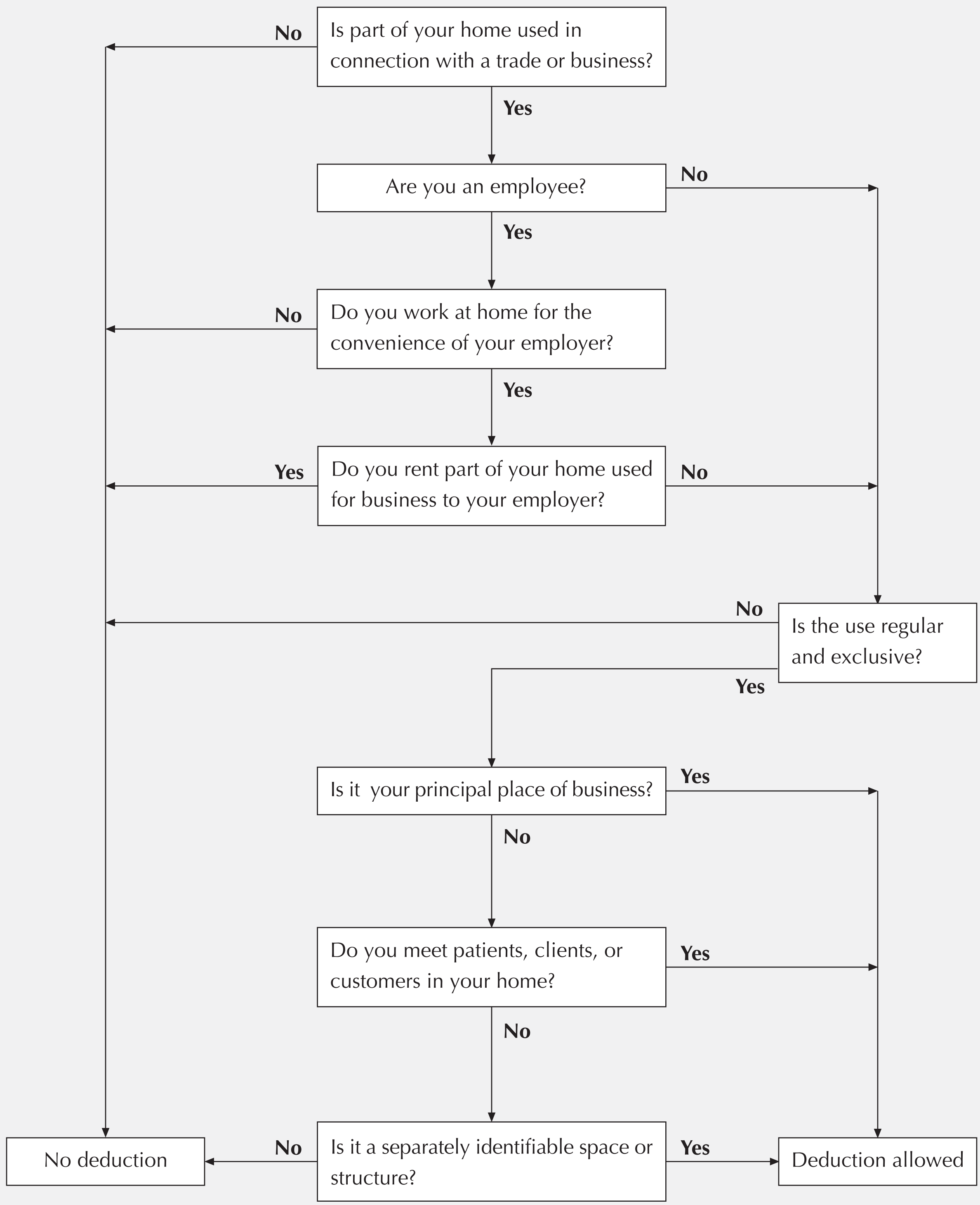
B. Deducting Part of the Cost of Your Home

With a home-based business, you may be able to deduct part of your rent or take a depreciation deduction. This tax break is commonly called the home office deduction.

About two million folks claim a home office deduction, according to the IRS. Undoubtedly, more people could legally claim the deduction, but don't know how or are scared they will be audited if they do.

A house, apartment, condominium, mobile home, motor home, boat, or just about anywhere else with

Can You Deduct Expenses for Business Use of the Home?



sleeping and cooking facilities can qualify for the home office deduction.

To claim a home office deduction (meaning you can deduct rent or depreciation), your home office must be:

- the principal place of your business, and
- a separately identifiable space in your home, and
- regularly and exclusively used for business.

All three of the rules must be satisfied, and are discussed in detail next. (IRC § 280A.) Calculating the amount of rent or depreciation you can deduct is discussed in Section C, below.

Rule 1. Principal Place of Business

Determining whether or not your home is the principal place of your business is not as simple as it sounds.

If your *only* jobsite is at home, it is your principal place of business. But if you conduct business at a site outside your home and just bring work home sometimes, the home may or may not qualify as the principal place of business.

Your home can also qualify as your principal place of business if both of the following are true:

- you conduct the administrative or management activities of your business there, and
- you have no other fixed location where you conduct those activities.

EXAMPLE: Jake, a plumber, works out of his home garage. Jake works at his home shop ten hours a week and in the field 40 hours. He gets a deduction for rent (or depreciation) and can deduct all other ordinary business expenses, such as the salary of his employee, as long as he meets Rules 2 and 3, below.

In other words, your home doesn't have to be the place where you generate most of your business income. It's enough that you regularly use it to do such things as keeping your books, scheduling appointments, doing research, and ordering supplies. As long as you have no other fixed location where you do such things—for example, an outside office—you should claim the deduction.

EXAMPLE: Ellen, a wallpaper installer, performs services for clients in their homes and offices. She also has a home office that she uses regularly and exclusively to keep her books, arrange appointments, and store supplies. Ellen is entitled to the home office deduction.

Service providers and salespersons who spend most of their time at job sites but whose offices are at home should get the home office deduction.

Two other ways satisfy the principal place of business requirement—if you meet patients, clients, or customers at home *or* you use a separate structure on your property exclusively for business purposes.

a. Meeting Clients or Customers at Home

If your home isn't your principal place of business, you may still be entitled to deduct expenses for business use of your home if you *regularly* use part of your home to meet there with clients, customers, or patients. Doing so even one or two days a week is probably sufficient.

You can use the business space for other business purposes as well—doing bookkeeping, for example, or other business paperwork—but you'll lose the deduction if you use the space for personal purposes, such as watching videos.

> **EXAMPLE:** Julie, an accountant, works three days a week in her downtown office and two days a week in her suburban home office, which she uses only for business. She meets clients at her home office at least once a week. Because Julie regularly meets clients at her home office, she can take a home office deduction. This is so even though her downtown office is her principal place of business.

Keep a log of the clients or customers you meet at home. Maintain an appointment book to record the name of the client or customer and the date and time of each meeting at your home. Save these books for at least three years to prove business usage if you're ever audited.

b. Using a Separate Building for Your Business

If your home isn't your principal place of business and you don't meet clients or customers at home, you may be able to deduct expenses for a separate, freestanding structure that you use regularly and exclusively for your business. This might be a studio or a converted garage or barn.

> **EXAMPLE:** Norm is a self-employed landscape architect. He has his main office in a professional center near a shopping mall, but he grows perennial seedlings in a greenhouse in his backyard. Because Norm uses the greenhouse regularly and exclusively for his landscape architect work, it qualifies for the home office deduction.

Use the structure only for your business. Don't store garden supplies there or even use it for the monthly meeting of your garden club.

Rule 2. Separately Identifiable Space

Assuming your home is the principal place of your business, let's move on to the second rule. The space in which you work must be separate from the rest of your home to qualify for the home office deduction.

A completely separate structure works best as proof of a legitimate home office to the IRS—for example, a detached garage converted to an office. But it's not necessary.

Many folks just convert a spare bedroom to a home office by removing the bed and personal items. Or, if your home office is not physically divided by walls, some kind of demarcation should be evident between the business and personal space. For instance, a desk and file cabinet set off in the corner of your living room will pass audit muster.

Rule 3. Regular and Exclusive Use

If you passed tests one and two, then let's go to the last test: regular business use. If you meet business customers or do paperwork at your home office, it should satisfy the regular use test. Keep a diary of use or appointments, in case you're ever questioned by an IRS auditor.

Exclusive use means you can't use the space for any other reason than business. This eliminates the kitchen table or the den where you watch TV with the kids. This rule is akin to Rule 2, separately identifiable space, above. An office should look like a pure work space if the IRS ever audits you.

Storing Inventory or Product Samples at Home

If you sell retail or wholesale products and you regularly store inventory or samples at home, you can deduct expenses for the business use of your home. There are two limitations, however. First, you won't qualify for the deduction if you have an office or other business location away from your home. Second, you have to store the products in a particular place—your garage, for example, or a closet or bedroom. It's okay to use the storage space for other purposes as well, as long as you regularly use it for inventory or samples.

> EXAMPLE: Jim sells heating and air conditioning filters to small businesses. His home is the only fixed location of his business. Jim regularly stores his inventory of filters in half of his basement. He sometimes uses the same area for working on his racing bikes. Jim can deduct the expenses for the storage space even though he doesn't use that part of his basement exclusively for business.

Don't be afraid to claim a legitimate home office deduction. Claiming a home office depreciation or rent expense does increase your audit risk. A home office deduction is reported separately on IRS Form 8829, attached to your tax return, so it is easy for the IRS to spot.

However, even if taking the deduction doubled your chances of audit, statistically, there's less than a one in 50 chance of an IRS confrontation. And, you would lose the home office deduction only if you failed to follow the rules. Before the audit, you will have plenty of time to make sure your home office appears office-like. Rarely will the auditor make a personal visit. Take some photographs of the home office to show the auditor.

C. Calculating Your Home Office Deduction

If you qualify for the home office deduction, calculate your deduction on IRS Form 8829, *Expenses for Business Use of Your Home.* You file this form with your Form 1040 income tax return. (See sample below.) Tax software like *TurboTax* (Intuit) greatly simplifies taking this deduction and can prepare the form if you don't use a tax preparer.

Deduct only as much as your business's net income. The overall home office deduction cannot be greater than the profit generated by your home-based business. For instance, if your business made a profit (after expenses) of only $2,700 before taking into account a home office deduction, the deduction can't be larger than $2,700.

When calculating your home office deduction, first divide the number of square feet used for your home business by your home's total square footage. The resulting percentage of business use (for instance, 27%) determines how much of your rent or depreciation is deductible each year. Other home-related expenses are deductible too, as discussed in Section 3, below.

Prorate for partial years. If your business use of the home is for less than 12 months, you must prorate deductions to the nearest month. For instance, three months' business use means 3/12 of the home office is deductible.

1. Renters

For renters, too, the home office deduction is simple. Take the percentage of the space occupied for business and multiply it by your rent payments for the year or tax period you are in operation.

> EXAMPLE: Lois, who makes and sells ceramic frogs at home, rents a 900-square-foot apartment. The room that contains a kiln and working

Form **8829**

Department of the Treasury
Internal Revenue Service (99)

Expenses for Business Use of Your Home

► File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

► See separate instructions.

OMB No. 1545-1266

20XX

Attachment Sequence No. 66

Name(s) of proprietor(s)	Your social security number
John Stephens	465 00 0001

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for day care, or for storage of inventory or product samples (see instructions)			1	200
2	Total area of home			2	2,000
3	Divide line 1 by line 2. Enter the result as a percentage			3	10 %
	• **For day-care facilities not used exclusively for business, also complete lines 4–6.**				
	• **All others, skip lines 4–6 and enter the amount from line 3 on line 7.**				
4	Multiply days used for day care during year by hours used per day	4	hr.		
5	Total hours available for use during the year (366 days × 24 hours) (see instructions)	5	8,784 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.		
7	Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ►			7	10 %

Part II Figure Your Allowable Deduction

			(a) Direct expenses	(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions				8	26,331
	See instructions for columns (a) and (b) before completing lines 9–20.					
9	Casualty losses (see instructions)	9				
10	Deductible mortgage interest (see instructions)	10		4,500		
11	Real estate taxes (see instructions)	11		1,000		
12	Add lines 9, 10, and 11	12		5,500		
13	Multiply line 12, column (b) by line 7	13		550		
14	Add line 12, column (a) and line 13				14	550
15	Subtract line 14 from line 8. If zero or less, enter -0-				15	25,781
16	Excess mortgage interest (see instructions)	16				
17	Insurance	17		400		
18	Repairs and maintenance	18	300	1,400		
19	Utilities	19		1,800		
20	Other expenses (see instructions)	20				
21	Add lines 16 through 20	21	300	3,600		
22	Multiply line 21, column (b) by line 7	22		360		
23	Carryover of operating expenses from 2003 Form 8829, line 41	23		-0-		
24	Add line 21 in column (a), line 22, and line 23				24	660
25	Allowable operating expenses. Enter the **smaller** of line 15 or line 24				25	660
26	Limit on excess casualty losses and depreciation. Subtract line 25 from line 15				26	25,121
27	Excess casualty losses (see instructions)	27				
28	Depreciation of your home from Part III below	28		252		
29	Carryover of excess casualty losses and depreciation from 2003 Form 8829, line 42	29				
30	Add lines 27 through 29				30	252
31	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 26 or line 30				31	252
32	Add lines 14, 25, and 31				32	1,462
33	Casualty loss portion, if any, from lines 14 and 31. Carry amount to **Form 4684,** Section B				33	
34	Allowable expenses for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ►				34	1,462

Part III Depreciation of Your Home

35	Enter the **smaller** of your home's adjusted basis or its fair market value (see instructions)	35	75,000
36	Value of land included on line 35	36	15,000
37	Basis of building. Subtract line 36 from line 35	37	60,000
38	Business basis of building. Multiply line 37 by line 7	38	6,000
39	Depreciation percentage (see instructions)	39	4.2 %
40	Depreciation allowable (see instructions). Multiply line 38 by line 39. Enter here and on line 28 above	40	252

Part IV Carryover of Unallowed Expenses to 2005

41	Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0-	41	
42	Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0-	42	

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 13232M Form **8829** (2004) tables is 200 square feet. She pays $8,000 rent per year. Lois is entitled to deduct 22% (200/900) of her yearly rent—$1,778—as a home office expense (assuming 12 months of business use). In addition, 22% of her utility and renter's insurance expenses are also deductible business expenses. Lois must file Form 8829 with her tax return each year showing this allocation of expenses to her home business.

2. Owners

Homeowners must figure the percentage of their home's square footage used for business and then take another step: separate the value of the building from the value of the land it rests upon. This is necessary because you cannot deduct the cost of the land. (Land never depreciates in the eyes of the tax code.)

Either use your local property tax assessor's breakdown, or you are probably safe allocating up to 80% of your property's value to structure and 20% to land. (See Example 1, below.)

Find the tax code depreciation rules in effect in the year you bought your home. For instance, after 1987, you must use straight-line depreciation. And from 1987 to 1994, the period for taking the depreciation deduction was 31.5 years. Since 1995, the period has been 39 years. This means you can deduct $\frac{1}{39}$ of the tax basis of the home every year, multiplied by the business use percentage. (See Chapter 2, Writing Off Business Assets, for an explanation of depreciation rules and methods.)

EXAMPLE 1: Katie uses 22% (400 feet) of her home's 1,800 square feet for Katie's Krafts. Katie bought her home for $100,000 in 1996 and started her business in 2004. The local property tax assessor says the lot her home is on is worth $20,000 and the structure $80,000. (The $20,000 land portion can't be taken as a depreciation deduction.)

Katie calculates her depreciation deduction on her home by first dividing $80,000 by 39 years. This gives Katie a potential deduction of $2,051 per year. This number ($2,051) is then multiplied by the business usage percentage, 22%, which equals $451. That's the amount of the home office depreciation deduction Katie can take each year she is in business.

EXAMPLE 2: Since she bought her home, Katie has made improvements costing $20,000, so her basis for home office depreciation is increased from $80,000 to $100,000. (How to figure the basis of business property is discussed in Chapter 2, Writing Off Business Assets.) This increases her home office depreciation deduction to $564 per year ($100,000 divided by 39 years multiplied by 22%).

3. Other Home-Related Deductible Expenses

Form 8829 requires separating all of your home-related business expenses into two categories: direct and indirect. Costs for the part of your home that is used exclusively for an office are a *direct* expense. Costs related to the entire home, such as your home's utility bill, are *indirect* home office expenses.

Direct expenses. Take a 100% tax deduction for anything spent just for the home office. Examples: costs of insuring equipment; decorating, modifying, or furnishing; or hiring maid service for your office.

Indirect expenses. Deduct a pro rata share of the utilities, repairs, taxes, and insurance expenses for all of your home as indirect home office expenses. Single-line telephone service to your home is not deductible, but a second phone line for business qualifies, as do any business long-distance charges. (IRC § 262(b).)

These indirect expense deductions are based on the same business use percentage of your home that you calculated earlier.

EXAMPLE: Katie, from the previous example, spent a total of $2,110 for gas, electricity, and homeowner's insurance in one year. She also doled out $820 to modify and repaint the office space. Tax result: Katie can write off 22% of the

$2,110 ($464) for the indirect overall home expenses and all of the $820 in direct home office expenses. With Katie's depreciation deduction of $451 (see Section 2, above), her total home office deduction is $464 + $820 + $451 = $1,735. The only limitation on this deduction is that Katie's home-based business must have made a profit of at least $1,735 to claim the deduction in full.

D. Tax After Selling Your Home

When selling a residence on which you have taken any depreciation deductions for a home office, there is a depreciation recapture tax. So, all of the past depreciation deductions you have taken for business use of your home since May 6, 1997 are taxed (recaptured in tax lingo) in the year of the sale. (The fact that the law entitles homeowners to exclude $250,000 (single) or $500,000 (married) from the gain of the sale of their house doesn't help homeowners avoid the recapture tax.)

EXAMPLE: James took $20,000 in home office depreciation deductions after May 6, 1997 and then sold his residence. The $20,000 in previous deductions are now taxed to James in the year of the sale. James's tax bracket is 25%, so his recapture tax would be $5,000 ($20,000 x 25%), plus any state taxes, depending on where he resides.

Renters with home offices don't have this depreciation recapture problem.

E. A Microbusiness as a Tax Shelter

Hopefully, your home business will be a moneymaker. But even if it doesn't pan out, it may provide a tax shelter. This tantalizing term doesn't refer just to gold mining schemes, ostrich farms, or oil wells. A venture becomes a tax shelter simply by applying its net operating losses to offset your taxable income from other sources, such as a regular job. There is no minimum amount of time or money you must invest in the business to qualify for this tax benefit, as long as you had a profit motive at the outset.

IRS Audits of Net Business Losses

Historically, the odds against a small business being audited are about 50-to-1 in any year. However, tax returns with business losses—home-based or not—are audited most. The more years of losses, the more likely you'll be audited. The size of the loss is probably the biggest factor; a $50,000 loss is more likely to blip on IRS radar than a $5,000 one. (See Chapter 19, Audits.)

1. Business Losses

A tax loss is *not* necessarily a cash loss. For instance, depreciation deductions for real estate are not out-of-pocket expenses, but are often referred to as paper losses.

EXAMPLE: Carol, a clothing store manager who enjoys cooking, forms Carol's Catering as a sideline. Carol's big catering client declares bankruptcy, and Carol ends the year with a loss. Carol throws in the towel, having spent $18,500 for food, supplies, and equipment against revenues of $16,000.

On her tax return, Carol claims a cash operating loss of $2,500 plus $2,200 for automobile expenses, giving her a total business loss of $4,700. This loss offsets wages from her regular job, trimming about $1,500 off her income taxes. Carol's $2,500 out-of-pocket operating loss becomes a $1,000 out-of-pocket loss after tax savings are taken into account ($2,500 – $1,500).

2. Hobby or Business?

To deduct business losses from your other income, your business must look legitimate to the IRS. The tax law says a true business is "any activity engaged in to make a profit."

To discourage folks from claiming business losses from fun things like speedboat racing or stamp collecting, the tax code prohibits claiming losses for "activities not engaged in for profit." (IRC § 183.)

Expenses of enterprises without a realistic profit motive can be deducted *only* up to the amount of income produced from these activities. In other words, losses from a nonbusiness can't reduce your income from a real job. (This is called the hobby loss provision, but a truer description would be the no hobby loss rule.)

> **EXAMPLE:** Carol, of Carol's Catering, is audited. The IRS auditor finds she was only indulging her cooking hobby, not running a business with a profit motive. Consequently, Carol's $4,700 cash and paper losses in excess of revenues are disallowed—they can't offset her income from her regular job. (Carol can appeal this decision; see Chapter 20.)
>
> Whether Carol ultimately wins or loses depends on whether or not she can prove her business motive—that her goal was to make a profit.

3. The Profit Motive Requirement

You don't actually have to make a profit to be considered a business—you must just make an honest effort to do so. This so-called loophole invites imaginative people to claim tax losses for hobbies and other pleasurable, but money-losing, activities. The IRS looks at several factors to see if you have a profit motive.

a. The "3 of 5" Test

One way the IRS determines whether a profit motive exists is by applying a mechanical tax code test. If a venture makes money in three out of five consecutive years, it is legally presumed to have a profit motive. (IRC § 183(d).) The IRS relies heavily on this test when auditing small businesses that lose money.

Even if you flunk the 3 of 5 test, you can still claim business losses. It may just be a little harder. Courts have held that even an activity that never makes a profit can still be a business. The tax court upheld one long-suffering taxpayer who claimed small business losses for 12 straight years! (*Lawrence Appley*, TC Memo 1979-433.) So don't give up taking losses on your tax return just because your enterprise doesn't pass the 3 of 5 test. As you'll see in Subsection b, below, there are other things you can do to show your profit motive—no matter what an IRS auditor may tell you.

> **EXAMPLE:** Let's return to Carol and her struggling catering operation. This time, assume she keeps her business going, but at the end of her second year, she is still losing money. Carol has several tax options:
>
> 1. She can throw in the towel, close her business, take tax losses in both years, and hope she isn't audited.
> 2. She can continue to run her business and take any future losses on her return. If Carol does this, the likelihood of an audit goes up with every year that she reports a loss.
> 3. She can close her catering business and go into a new sideline venture, which starts the 3 of 5 rule period over again.
> 4. If the prospect of an audit keeps her awake at night, Carol can continue her catering business but stop claiming losses on future tax returns.
>
>   Filing Form 5213, *Election to Postpone Determination That Activity Is for Profit*, gives you an extra year to show a profit under the 3 of 5 test. For instance, say

you lost money in the first three years of operation, but believe you'll turn the corner soon. Filing this form gives you a sixth year to overcome the presumption that your business is a hobby.

Don't draw IRS attention. Few people ever file Form 5213, and for good reason. It draws the IRS's attention and may invite an audit.

Appeals on the profit motive issue are frequently successful. If you really tried to make a profit—but can't convince an auditor—you can usually appeal or go to tax court. There is a good chance you'll get at least part of your claimed loss restored. Courts have allowed gentlemen farmers, stamp collectors, bowlers, garage-based inventors, and many other unsuccessful venturers to claim business loss deductions over IRS objections. (See Chapter 20, Appealing IRS Audits.)

EXAMPLE: Gloria, an amateur artist, painted at home in her spare time and tried, mostly in vain, to sell her paintings. She lost money every year for many years, and was audited. Her business losses from painting were disallowed by the IRS for lack of a profit motive. The tax court heard Gloria's story and, finding that she had made a serious effort to sell her art, overruled the IRS. (Gloria Churchman, 68 TC 696.)

The 3 of 5 test is not the final word, even for perpetual money-losers. The IRS also must look at other factors to see if you have a profit motive, like how you conduct business, whether you have substantial income from other sources, and how pleasurable your business activity is.

b. Other Ways to Show Profit Motive

Another way to show a profit motive—and withstand an audit—is by demonstrating that you ran your venture in a businesslike manner. So be prepared to show an auditor:

- **Business records.** Bank statements, canceled checks, and receipts backing up your expenses.
- **Advertising.** Flyers, business cards, stationery, ads, listings on the Internet, and anything promoting your business.
- **Your business diary or calendar.** Entries showing the names of people contacted for business and any business use of your car or home. An entry might look like this: "3/1/06 12:30 p.m. Met Don Skinner, buyer for Bargain Basements, at Fabio's Restaurant, Kalamazoo. Discussed sale of 10,000 Tonya Harding T-shirts. Lunch: $27.42 with tip. Cab fare: $12 round trip." (See Chapter 3, Bookkeeping and Accounting.)
- **Licenses and permits.** State and local licenses, a fictitious business name registration, an occupational license, and a sales tax permit if required.

EXAMPLE: Carol printed flyers for her catering service that she mailed to 2,000 local businesses, friends, and contacts, and she passed out business cards at social events. She kept track of her marketing efforts and business expenses in a spiral notebook. She also kept most receipts for her expenses, but never got around to getting a business license. Even though Carol did not do everything perfectly, this should be sufficient to establish a profit motive to an auditor.

Try to look like a business. Be sure that an activity you enjoy—woodworking, bird breeding, or sewing, for example—appears businesslike. Inexpensive indicia of profit efforts, such as business cards, stationery, and classified ads in local shoppers, can help persuade auditors that you're not just indulging in a hobby. As they say, "Walk the walk and talk the talk."

Resources

- IRS Publication 505, *Withholding and Estimated Taxes*.
- IRS Publication 587, *Business Use of Your Home*.
- IRS Publication 946, *How to Depreciate Property*.
- *Being Self-Employed*, by Holmes Crouch (Allyear Tax Guides). This little book contains some practical tips from a self-educated small businessman.
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs). This CPA-authored book contains a wealth of information for very small businesses.
- *The Home Business Bible*, by David R. Eyler (John Wiley & Sons). This book has answers to common tax—and nontax—questions, and also comes with a disk with small business accounting software.

■

CHAPTER

14

Fringe Benefits

"When I hear artists and authors making fun of businessmen I think of a regiment in which the band makes fun of the cooks."

—H. L. Mencken

Everyone has heard of fringe benefits, fringes, or perks, but exactly what are they? The term fringe benefit is mentioned—but not actually defined—in the tax code. Generally, fringes are things of value a business provides owners and employees over and above their wages and bonuses.

A fringe benefit usually isn't taxable to the recipient, or is tax-deferred, partially taxable, or taxable at an advantageous rate. From the business owner's point of view, fringe benefit expenses are usually tax deductible expenses. (See Chapter 1, Deductible Expenses.) However, Congress is a spoilsport—it doesn't let businesses run amok with fringes.

If you have questions on fringe benefits, see a tax pro. This chapter is only a summary of the rules on some, but not all, fringe benefits. And, the rules are more complex than space permits in this book.

Fringe Benefits in a Nutshell

1. A business can offer its owners and workers a variety of fringe benefits, which may be wholly or partially tax-free or tax-deferred.
2. The widest selection of fringe benefits can be offered by a regular C corporation business, but fringes alone are seldom a reason to incorporate.
3. Retirement plan benefits offer the greatest short- and long-term potential tax savings of any fringe benefit.

A. How Fringe Benefits Save Taxes

A fringe benefit may be any of the following:

- **Totally tax-free to the recipient.** For example, if an employer provides medical insurance, employees pay no tax on the value of the coverage.
- **Partly tax-free to the recipient.** For example, if an employee uses a company-provided car partially for personal purposes, some of the value of the car may be includable in the employee's income, while the value of the car attributed to business use is not.
- **Tax-deferred—that is, not taxed until a later date.** For example, if an employee receives an option to buy company stock at a below-market price, no tax may be due until the stock is sold.
- **Fully taxable to the recipient in the year provided.** For example, the value of a group disability insurance policy may be taxable to the recipient, but such benefits may nevertheless be desirable if an owner or employee can get something cheaper than if they had to buy it on their own.

A fringe benefit is tax-free or advantageous taxwise only if Congress grants a specific exemption somewhere in the IRC. Most of the specific exclusions from income covering fringes are found in IRC §§ 101 to 137, and are noted below. (See IRS Publication 15B.)

Follow the rules on benefit plans or risk the consequences. The IRS can audit fringe benefit plans separately or as part of a regular examination. If plans are not in compliance with all aspects of the tax law, then previous tax deductions or contributions to the plans can be disallowed. The business loses the deductions, and the benefit recipients will have to pay taxes on the benefits—an all-around disaster.

Tax-Free Benefit Requirements

For a fringe benefit to be totally tax-free, all of the following requirements must be met:

- **The tax code must specifically exclude it.** Unless a fringe benefit is excluded from income by the tax code, its value is taxable income to the recipient.
- **It may have to be in writing.** Certain types of fringes—such as 401(k) plans—must be set out in a document that conforms with tax law rules, called an employee benefit plan. An unwritten policy probably won't satisfy the tax law.
- **It must have an indefinite life.** A benefit plan can't expire next year, or when an employee reaches a certain age, or for most any other reason.

The reason tax-free fringe benefits are popular is simple. Unlike cash profits or wages from your business, you don't add to your taxable income when you take a fringe benefit. A fringe benefit, such as medical insurance, gives you something of value and you don't have to pay any tax on it.

A few fringes are available only to C corporations. When folks first hear this, they naturally think about incorporating. However, the decision to incorporate should rarely be made based on the availability of fringe benefits alone. In reality, very few businesses are profitable enough to afford the full range of corporate-type fringe benefits.

This chapter discusses the most popular benefits for small businesses, including retirement plans and health benefits; business vehicles, meals, and travel; and education and day care benefits.

B. Retirement Benefits

Dollarwise, the most valuable tax deductible fringe benefit is—by far—a retirement plan. Business owners and employees alike can deduct and put away money in retirement funds to accumulate tax-free for many years. Until withdrawn, the funds are invested, and any income produced is not taxed. Retirement plans are available to all types of business owners and employees. Chapter 15 is devoted entirely to the fringe benefit of retirement plans.

C. Motor Vehicles

Car ownership is the average American's third-largest expenditure, after housing and food. Happily, the tax code helps share the cost of business vehicles. Auto costs are a fringe benefit if, like most small business owners, you use the same vehicle for both business and personal transportation.

There are several tax-approved methods of providing autos as fringe benefits. Rules for deducting auto expenses on cars used for business are in Chapter 1, Deductible Expenses, and Chapter 2, Writing Off Business Assets.

D. Meals

If a business pays for meals of owners and employees, the cost is usually partly tax deductible to the business and tax-free to the employee if the meals serve a business purpose and are provided in the course of employment. (IRC § 119.) (Note that meals taken while traveling are treated differently; see Section E, below.)

Here are the basics:

- **Meals provided on site.** Meals are 100% deductible to the business and tax-free to the employee if given for the convenience of the employer. This rule covers employees working late or attending company meetings through the meal hour.

  EXAMPLE: Reggie, the owner of a wholesale drapery business, occasionally orders pizza or sandwiches for employees working late. This expense is for the convenience of the employer and is deductible to the business and tax-free to the employees, including Reggie.

  Provided meals are also tax-deductible if there are no suitable places to buy food nearby or if meal periods are too short for employees to leave work.

- **Meals provided at cost.** Inexpensive meals—but not free food—can be provided to employees on a regular basis from a company cafeteria or dining room. Prices employees pay must cover the company's direct costs. These subsidized meals are tax-free to the employees, and the cost is tax deductible to the business.
- **Meals provided off the premises.** Off-the-premises meals and drinks for employees are deductible to the business and nontaxable to the employee *only* if business is discussed and such events are occasional rather than every day. (See Chapter 1, Deductible Expenses.)

  EXAMPLE: Reggie takes her sales manager and a top salesperson out to dinner once a month. They discuss plans for future promotions. Reggie spends about $100 on drinks, dinner, and the tip. There should be no problem with Reggie's claiming this as a business expense.

Meal money given to an employee is tax-free to them only if given to them occasionally and for a business reason.

E. Travel and Lodging

Most of us like to go out of town occasionally, even if it's for work. If it's deductible and we can sightsee or visit friends along the way, all the better.

When you travel for business, your enterprise can deduct *all* of your lodging costs if you go far enough away from home to require rest.

But your business can deduct only *half* of your meal costs. It's not 100%, because you would have presumably had some meal costs if you had stayed home (and home-cooked dinners aren't deductible). (IRC § 132.)

1. Mixing Business and Pleasure Travel

If your business pays for an out-and-out vacation—not a business trip—it should add the cost to your income reported to the IRS. The company can then deduct the cost of the vacation from its income as additional compensation for your services. That said, let's see how a business can pay for—and deduct—at least some of your vacation expenses *without* having the cost added to your income.

Have you noticed that more trade shows are held in resorts and destinations like San Francisco than in cities like Des Moines? Convention planners, aware of this fringe benefit opportunity, know they can build attendance with meetings in fun places.

To be tax deductible and not count as income to the traveler, the trip's *primary* purpose must be business. Travel for political, investment, or social conventions cannot be tax deducted as a business expense. Commerce, however, doesn't have to be the *sole* purpose—if you have some fun on the side, it's okay with those junketeers in Congress who write the tax laws.

How do you prove your trip had a clear business purpose? Obvious cases—say you are a car dealer and go to Detroit to meet with factory representatives, or you own a bookstore and travel to a booksellers' trade show—shouldn't be questioned by an IRS auditor.

On the other hand, if you're a plumber and you go to Hawaii to see how they insulate pipes, or if you own a water-ski shop in Florida and you travel to Aspen to check out whether snow skis might be adaptable to your business, expect to be quizzed if you are audited.

There are few hard-and-fast rules: If you use your common sense and don't push too far, your mixed-purpose travel will pass tax muster.

Here are some special tax code rules for business meetings, trade shows, and conventions:

- **In the United States.** If you travel to a trade show within the U.S., your expenses are deductible to the business. There's no problem as long as you go straight there and come back as soon as the show is over.
- **In the rest of North America.** If you go to a trade show in Canada, Mexico, Puerto Rico, or most of the Caribbean Islands, travel is tax-free to the recipient; expenses may be business deductions *only* if you stay away no longer than a week and spend at least 75% of your time on business. If not, you must allocate the expenses between business and pleasure. Keep a log of how your time is spent in case an auditor comes calling.
- **Outside North America.** Travel outside North America is deductible only if you can show a valid business necessity for the trip—it was something you could not accomplish in the U.S. Researching tropical fruit processing in Paraguay for your frozen food operation sounds okay, but studying high technology there doesn't.
- **On cruise ships.** Once I attended a tax seminar on a Hawaiian cruise ship and got a nice business deduction. The whole cruise is tax-free and deductible in full as long as all of the following are true:
  - There is a bona fide program on board related to your business.
  - The majority of the days are spent in program attendance.
  - The ship is registered in the U.S.
  - The ship stops only at U.S. ports (or U.S. possessions).
  - The trip costs less than $2,000.

  However, because of federal laws and union rules, few cruise ships are registered in the U.S. Generally, only companies operating in Hawaii and on the Mississippi River qualify.

Weekend stayovers are deductible if you fly. Most airlines require a Saturday night stayover for the lowest fare. So, if the total costs of air, weekend hotel, and meals on a business trip are less than the cost of air without a Saturday night, you can come back home on Sunday or Monday and the whole shebang is deductible. Note for your records both the excursion and regular airfares in case you're audited.

Temporary Assignment Relocations

Business may take you away from home for up to one year with company-paid (or reimbursed) travel and living expenses. While there is no limit on how much your business can pay and deduct, it must be reasonable under the circumstances. A multi-million-dollar business can put you up at the Ritz-Carlton for six months, but if you are a struggling consultant, the Motel 6 would be easier to pass by an IRS auditor. After the first year, living expenses paid by your company are income to you—but are still tax deductible, as compensation, by the business. (IRC § 162, Rev. Rule. 93-86.)

2. Family Travel for Business

Family travel brings more tax rules into play. If you take the spouse and kids on a business trip, you can't deduct greater business expenses than if you were traveling alone.

Happily, your entire car expense for a business trip can be deducted even if relations ride along (even though the additional weight probably cuts your gas mileage per gallon). The same with hotels; if your family stays in one standard room with you, the entire cost is tax deductible. Look for two-for-one or "bring along the family" hotel and airline fare discounts—you don't need to pass the cost break along to the IRS.

> **EXAMPLE 1:** Sam, a computer retailer, his wife Jeannie, Sam Jr., and daughter Sandra fly to Anaheim, California, so Sam can attend the Worldwide Computer Show. He finds out about the latest technology while Jeannie and the kids go to Disneyland. Expenses for Sam (only) are fully deductible.

> **EXAMPLE 2:** Sam and his family drive to Anaheim instead of flying. The entire car expense is deductible, even if the back seat is wall-to-wall kids. Once in California, Sam squeezes everyone into a regular room at the Holiday Inn, so the hotel cost is also deductible. The business can't, however, deduct the expense of family meals or tickets for Disneyland. And if everyone lingers for more sightseeing, none of the after-convention expenses are deductible, even for Sam.

The law formerly allowed a spouse's travel expenses to be deducted if his or her presence served a business purpose. Now, only a spouse who is a bona fide employee or co-owner of the business can have his or her expenses paid and deducted.

Make a paper trail. Keep a copy of programs and workbooks from trade shows along with all receipts for your expenses in case the IRS audits. (See Chapter 3, Bookkeeping and Accounting, for the kinds of records to keep.)

What About Frequent Flyer Miles?

If you are like me, you love free trips from frequent flyer miles. The IRS has long threatened to tax the receipt of these freebies if the awards resulted from deductible business travel and business credit card charges. Luckily for us, it appears that the IRS has abandoned its efforts to tax frequent flyer miles, as long as they aren't converted to cash.

3. Lodging at Your Workplace

Owners and employees of businesses such as motels and funeral homes, where someone must be on-call 24 hours a day, can live there tax-free. The business can deduct all the housing costs and the resident owner or employee doesn't incur any taxable income from the arrangement.

The business can also deduct costs of the resident owners' or employees' meals if they are eaten on the premises. To qualify, three conditions must be met:

1. Living on the premises must be an express condition of employment.
2. It must be primarily for the convenience of the employer.
3. There must be a legitimate need for someone to be at the business around the clock. (IRC § 119.)

F. Clubs and Athletic Facilities

You can deduct the cost of entertaining at private clubs or athletic facilities, as long as it serves a *business purpose*. However, membership fees for these facilities are no longer deductible. (IRC §§ 132, 274; Reg. 1.132, 1.274.)

- **Civic associations.** Dues for civic associations—chambers of commerce, real estate boards, business leagues, and public service clubs like Rotary and Lions—are deductible.
- **Social clubs.** Dues for purely social clubs are not deductible or tax-free benefits—even if the club is used primarily for business. (Reg. 1.274-2.) But while the cost of country clubs and the like are not deductible, 50% of business entertainment expenses incurred there —such as greens fees and 19th hole libations —are deductible and tax-free fringes.
- **On-premises athletic facilities.** The cost of off-premises athletic clubs is not deductible. But owners can provide athletic facilities on the business's premises and deduct the cost (as long as they are open to all employees). This can be anything from a NordicTrack in an unused storeroom to a full company gym with a swimming pool.

G. Association Dues and Subscriptions

Business owners and employees can get tax-free trade association memberships and subscriptions to business publications. These are deductible if the organization is not primarily social in nature. (IRC § 162; Reg. 1.162-6, 1.162-15.)

> **EXAMPLE:** Jessica, owner of Wheelies, a motorcycle parts store, pays $200 per year for membership for her and her employee, Joy, in the Motorcycle Parts Retailers Association. They both go to its annual dinner. This is a deductible business expense for Wheelies and is a tax-free benefit, no matter how much champagne Jessica and Joy drink at the affair.

H. Health Benefits

Medical plans are a hot fringe benefit. Tax rules depend upon whether or not your business is incorporated. C corporations get a better shake, as explained below.

1. Unincorporated Businesses and S Corporations

Tax rules for business-paid health benefits are different for owners than for their employees—unless it is a C corporation.

a. Owners

Sole proprietors, partners, limited liability company members, and S corporation shareholders active in a business can deduct 100% of the health insurance premiums paid by them—not the business—for themselves and their families. (IRC § 162(*l*).) However, these folks can deduct medical expenses (other than health insurance premiums) as itemized deductions only to the extent they exceed 7.5% of their adjusted gross income. This rule effectively eliminates medical deductions for many higher-income individuals if they are insured.

The insurance deduction is claimed as "medical insurance premiums" on the front page of your Form 1040 tax return.

No insurance premium deduction is allowed if you're eligible to participate in a health plan at another job or through your spouse's work.

> **EXAMPLE:** Jack, a sole proprietor, pays $3,200 for a family health insurance policy. Jack deducts $3,200 on his individual tax return, Form 1040. Depending on what Jack's tax bracket is, his tax savings ranges from about $320 to $1,200.

Archer Medical Savings Accounts

Business owners and their employees can set up an Archer Medical Savings Account (MSA). You make tax deductible contributions to the MSA, which is set up at a financial institution, and any earnings on the MSA build up tax-free. When you incur medical expenses not covered by your health plan, you can pay for them out of your MSA.

To qualify for an MSA, you or your business (up to 50 employees) must first purchase a medical insurance plan. The insurance must have an annual deductible of at least $1,700 (for an individual) or $3,450 (for a family). MSA contributions produce an immediate tax deduction—up to 65% of the insurance plan's deductible portion for individuals or 75% for families. The MSA deduction is claimed as a personal—not business—deduction. You take the deduction on the first page of your Form 1040 tax return, close to where IRA contributions are claimed.

Alternatively, employers can put money into their employees' MSAs, and the contributions are not included in the income of the employees. MSA investments must be managed by an insurance company or financial institution.

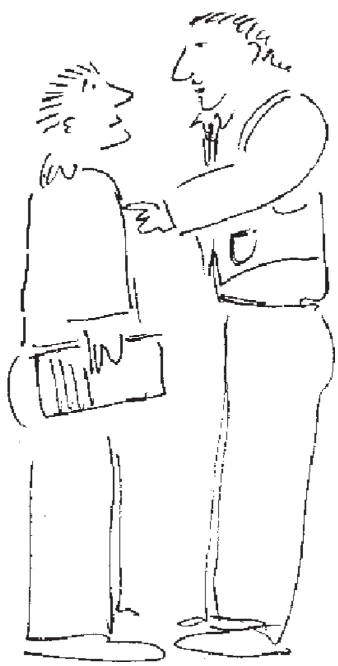
See IRS Publication 969 for details. The above is only a summary of the rules of this fairly complex tax provision.

b. Nonowner Employee Health Benefits

In a sole proprietorship, limited liability company, partnership, and S corporation, health benefits for *nonowner employees* are 100% tax-free to the employees and deductible as a business expense for the business.

2. C Corporations

For C corporation businesses, a health plan has even better tax advantages. Medical costs, including insurance premiums paid by owners and employees, are entirely tax deductible to the corporation and tax-free to the recipient. This is better taxwise than claiming deductions for medical expenses on an individual tax return. (Unincorporated business owners can deduct medical expenses (other than health insurance premiums) only to the extent that they exceed 7.5% of their adjusted gross income. This rule effectively eliminates medical deductions for many higher-income individuals.)



EXAMPLE: Lois's Pets 'R Us, Inc., is a C corporation. The whole amount of Lois's annual health insurance premium ($3,000) is tax deductible to the business and tax-free to Lois—even if she is the only person eligible for the plan. Depending on Lois's tax bracket, this could produce a federal tax saving of as much as $1,200. Whether or not this will offset the added expense of being incorporated is another question.

Health benefits don't have to come from a group plan. Instead, an owner/employee of a C corporation can pay for an individual health policy and be reimbursed tax-free by the corporation. (See IRS Publication 15B, *Employer's Tax Guide to Fringe Benefits*.)

Alternatively, C corporations can establish a medical reimbursement plan, which pays for—and deducts—medical costs not covered by insurance for employees, their spouses, and dependents. A reimbursement plan must cover 70% or more of the employees (excluding employees under age 25, part-time or seasonal, or those on the job for less than three years). (IRC § 105(h).)

EXAMPLE: Fred and Ethel's incorporated business, Sitcom Writers, Inc., adopts a medical reimbursement plan. Ethel has an operation that costs $25,000; their individual medical insurance policy covers $20,000. If the corporation pays the additional $5,000, it can deduct it—whether paid directly to the medical provider or to Ethel. The payment is tax-free to Ethel either way.

Even if your corporation doesn't have a health plan, the cost of physical checkups by an employee's doctor can be paid and deducted by the business. To qualify, there should be a written employment contract between the corporation and employee stating that annual checkups are a condition of employment. (IRC § 162.)

I. Day Care Benefit

Any business can deduct the cost of a dependent or day care assistance plan for its employees' children under age 13.

Payments for day care of up to $5,000 per worker annually are tax-free to the parent. (If the employee is married but files taxes separately, the maximum is $2,500.) However, the business can still deduct all payments to workers, even if they are more than $5,000. (IRC § 129.)

This benefit must be given to every parent on the payroll, except that the corporation may exclude:

- employees under age 21
- those with less than one year of service
- leased employees, or
- employees covered by a collective bargaining agreement. (IRC § 129.)

Some businesses without a dependent care plan (perhaps because it would be too expensive to cover all employees) may still qualify for the dependent care income tax credit. This tax break for working parents is rather complex. For details, see IRC § 21.

In addition, a general business tax credit of 25% of the costs of providing a child care facility can be claimed each year, up to $150,000. See IRC § 45F for details. Also see Chapter 1, Section C25, for an explanation of the general business credit.

J. Education Benefits

There's a great tax break for businesses helping employees and owners with educational expenses, as long as they follow the tax code rules.

1. Directly Related Education

Any business can pay—and deduct—an owner's or employee's education expenses if they are *directly related* to her job. Deductible costs include tuition, fees, books, course supplies, lodging, and similar education expenses. There is no upper limit to the education benefit, but the expenses must be reasonable, taking into account the financial circumstances of the business. For instance, sending Rachel, who works at your snack bar, to a local cooking course is okay. But it wouldn't pass muster to send her to Paris for two years to attend a culinary academy.

2. Educational Assistance Plan

A business can pay and deduct up to $5,250 per year for each employee's education expenses, even if the costs are not directly related to the job. However, this must be traditional education—hobby-type courses don't qualify. In other words, English literature, yes; astrology, no. (See IRC § 127, Reg. 1.127, for details.)

The business must adopt a written Educational Assistance Plan (EAP). An EAP can cover tuition, books, and supplies. Direct payments to an institution or reimbursements are tax-free to the employee. The EAP is entirely tax-free; it is not included as wages on the employee's W-2 form.

K. Gifts, Rewards, Discounts, and Free Services for Employees

Goods and services can be deducted and given to employees tax-free if they fit into one of six categories.

1. Small Gifts to Employees

Gifts to employees totaling under $25 per year per recipient are nontaxable. (IRC § 132, Reg. 1.132.) So, the proverbial Thanksgiving turkey gift for employees is tax-free to them and deductible to you. This $25 limit applies to all business entities, and it isn't subject to an annual inflation adjustment.

2. Achievement Awards for Employees

With a qualified award plan, a business can give and deduct achievement awards valued up to $1,600 each year tax-free to employees—gift certificates, watches, TVs, and the like.

These awards must be for special achievement, length of service, or safety efforts. Awards can't be:

- in cash
- given to more than 10% of all employees, or

- given to highly compensated employees (over $95,000 wages) only.

(See IRC §§ 74 and 274 for more details.)

If your business doesn't have a qualified award plan, you still may give employees deductible "good habit" rewards of goods or services, up to a value of $400 per employee per year. Again, no cash payments qualify; cash is taxable income to the employee. See IRS Publication 535, *Business Expenses,* for details.

3. Employee Freebies

Certain businesses—such as hotels, airlines, and cruise lines—can provide their services or facilities tax-free to employees, retired employees, and their families.

This applies only to "excess capacity" services—something that would likely remain unused if not given away. This applies to empty airplane seats and hotel rooms, but not much else. For other types of employee services, employees can exclude from their income only 20% of the value of the services. (IRC § 132, Reg. 1.132.)

4. Employee Discounts

Discounts on your business's goods or services may be given to employees and families tax-free. You can provide anything your business makes or sells at a reduced price, but never below cost.

> **EXAMPLE:** Harrison Hot Tubs sells a hot tub valued at $3,000, to Jennie, the business office manager, for $2,000, its cost. There are no tax consequences for Jennie. But if she had paid only $1,500, she would have had to report $500 as income for the deal.

Services may be provided at a discount of up to 20%.

Discounts must be given across the board to employees and families (or even retired employees), not just to higher-paid people.

There are a few items specifically prohibited from being discounted without being taxed to employees—primarily, real estate and investment property. (IRC § 132, Reg. 1.132.)

5. Employee Parking or Cash

Any business can either provide free parking for employees or reimburse parking expenses. The costs are deductible to the business and tax-free to the employee.

Alternatively, a business can give an employee cash up to $200 per month (2005). The monthly stipend is indexed for inflation annually. However, if cash is chosen, it is taxable to the employee, but deductible to the business. (IRC § 132.)

6. Miscellaneous Minor Benefits

Some fringe benefits are so small that even the IRS doesn't require a business to keep track of them. Things that fly below IRS radar include use of the company copy machine, having a personal letter typed by a secretary, coffee and donuts, local telephone calls, or an occasional theater ticket. However, petty cash can't be given tax-free, unless it's used for meals for employees working late or local transportation expenses (under $1.50).

Look out for taxable fringes. More valuable perks—season tickets to sporting events, the use of an employer-owned vacation facility, or a company car used for commuting—are taxable income to the recipient. The fair market value of these benefits must be shown on an employee's W-2 form along with wages. The expense is still deductible to the business, however.

L. Adoption Assistance

A business can pay directly, or reimburse an employee for, qualified adoption expenses up to

$10,390 per child under an adoption assistance plan. (Qualified expenses are those that are necessary for the adoption itself, such as attorney's fees, court fees, and adoption agency fees.)

A business can also pay or reimburse an employee up to $10,390 for the adoption of a child with special needs, regardless of whether the employee's expenses are qualified. The determination that an adopted child has special needs must be made by the employee's state. See IRS Publication 9688, *Tax Benefits for Adoption,* for details. However, adoption expense payments are not entirely tax-free, because they are still subject to Social Security, Medicare, and federal unemployment (FUTA) taxes.

However, this benefit is not available to highly compensated employees (for a definition of highly compensated, see IRS Publication 9688, *Tax Benefits for Adoption*).

M. Special Benefits for C Corporation Employees Only

Most of the tax rules for fringe benefits discussed so far apply to all business structures. But C corporations get a few more tax breaks for providing certain fringe benefits. Keep in mind that owners/shareholders of C corporations who work in the business can get these perks, too.

1. Financial and Tax Planning

A C corporation can provide tax-free financial and tax planning help to employees. Such benefits must be part of a written employee benefit plan and available to all employees, not just the owners. (See IRC § 127, Reg. 1.127-2, for details on qualifying.)

If your corporation doesn't adopt a plan, there's another way to provide this fringe benefit: The corporation may add the cost of financial or tax counseling (say $500) to an employee's taxable pay. Then the employee claims $500 on his or her individual tax return on Schedule A as a miscellaneous deduction. (Rev. Rul. 73-13.) The downside is that the employee's tax break is not as good as with a written plan deduction. The employee can take a deduction only under the more limited itemized deduction rules.

2. Disability Insurance and Payments

C corporations can deduct insurance premiums paid for disability (wage continuation, sickness, and accident policies) for employees, including owners.

However, disability payments are reportable as income to employees, except in the case of permanent or total disability. (IRC § 104, Reg. 1.104, and IRC § 105, Reg. 1.105.)

3. Group Life Insurance

Generally, C corporations can provide employees or former employees with $50,000 in tax-free life insurance and deduct the premium costs. (IRC § 79.) The rules are in IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*. Here is a summary of how this fringe benefit works.

Only group term life insurance qualifies. Individual policies, or those that accumulate cash reserves—called whole life or universal life—do not qualify.

Death proceeds for group life beneficiaries over $50,000 are okay but are taxable to the employee or retired employee (though the cost is still deductible to the corporation). IRS tables show the taxable portion of excess coverage, depending on the recipient's age and amount of insurance. The IRS income table inclusions are relatively small, so even if some of the premium is taxable, there is a savings. The portion that is taxable is shown on the annual W-2 form.

A corporation must cover all full-time workers and can't require physical exams. The business doesn't, however, have to give the same coverage to everyone. The death payoff can be greater for owners, subject to the $50,000 limit per person.

4. Loans to Shareholders

A shareholder can borrow up to $10,000 from his or her C corporation, *interest-free*. For loans over $10,000, he must either pay interest to the corporation or pay tax on the minimum amount of interest he should have paid. The interest rate is determined by IRS tables. (IRC § 7872.)

Tax-free loans are *not* available to sole proprietors, partners, limited liability company members, or S corporation shareholders.

Observe loan formalities. Chapter 7, Section F3, covers loan rules. For example, your corporate records must show the loan was authorized, and there must be a written promissory note to the corporation. Otherwise, an IRS auditor may rule that the shareholder loan is really a disguised dividend, wages, or bonus, making it taxable income to the borrower.

5. Entertainment Facilities

Businesses can't deduct the cost of acquiring and maintaining facilities used purely for the entertainment of owners and employees: ski cabins, yachts, hunting lodges, and so forth. (IRC § 274(a).) Facility operating costs are deductible for the periods solely used for business, however.

The value of vacation stays in business-owned properties is taxable income to owners and employees (unless there is a business purpose). A business can provide bargain rental rates to owners and employees, though.

A shareholder may rent property to his corporation to use for business. This is okay as long as the rent is reasonable and the facility is available for rental to the public. The corporation may even lend the shareholder funds to acquire a facility. The shareholder is entitled to tax write-offs for interest, depreciation, and other expenses of ownership of the facility. If you are intrigued, have a tax pro run the numbers for you. There may be no tax savings if all you are doing is taking money from one pocket and putting it in the other.

6. Job Placement Assistance

Helping departing or former employees find new jobs is a tax-free benefit and deductible for C corporations. Assistance must be provided to all employees, and the former employees can't be offered the choice of job placement services or cash. (IRC § 132(d), Rev. Rul. 92-69.)

Consider a cafeteria plan. A business may offer employees an option of taking cash instead of fringe benefits through a cafeteria, or flexible benefit, plan. Qualifying nontaxable benefits under a cafeteria plan include group term life insurance; health, accident, and disability insurance; dependent care assistance; and certain 401(k) plans. However, if an employee chooses to take cash instead of applying it to a qualifying fringe benefit, the cash is taxable income to the employee.

Resources

- IRS Publication 560, *Retirement Plans for the Self-Employed*.
- IRS Publication 502, *Medical and Dental Expenses*.
- IRS Publication 503, *Child and Dependent Care Credit*.
- IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.
- IRS Publication 535, *Business Expenses*.
- IRS Publication 970, *Tax Benefits for Education*.
- IRS Publication 968, *Tax Benefits for Adoption*.

Final thought: *"Money is a sixth sense, without which it is impossible to enjoy the other five."*

—W. Somerset Maugham

CHAPTER

15

Retirement Plans

"No man who knows what the law is today can guess what it will be tomorrow."

—Alexander Hamilton

Only the most wide-eyed optimist believes that Social Security will provide enough money for our golden years. Indeed, as the ratio of workers to retirees shrinks, Uncle Sam effectively reduces benefits by taxing recipients on outside income. The answer: Create your own retirement plan for your small business.

Congress helps business owners and their employees save for retirement. Any kind of business—corporation, partnership, sole proprietorship, or limited liability company—can set up one or more tax-advantaged retirement plans. If you don't have a retirement plan, you are missing one of the greatest tax benefits of self-employment!

Tax rules on retirement plans are very complicated. This helps explain why only a third of small businesses have retirement plans, compared to five-sixths of major companies.

This chapter outlines retirement plan options. First, get familiar with retirement plan basics, and then select a retirement plan that fits your needs.

Many financial institutions and professionals are available to help you implement these options. Stock brokerages, banks, and insurance companies offer retirement plan advice, mostly to sell their investment products. Also, independent pension consultants, CPAs, and tax attorneys and planners will help, for a fee. See Section D, below, for more information

Expect continuing changes in the law. Rarely does a session of Congress go by without significant changes being made to retirement plan rules. If the book in your hand is more than a year old, beware!

Retirement Plans in a Nutshell

1. One of the best tax reasons for being in business is to have a retirement plan.
2. Plans allow businesses to deduct contributions to accounts that accumulate tax-deferred until they are finally distributed to the retiree.
3. Businesses with full-time employees usually must include all employees in their retirement plans, which can be expensive.
4. All small businesses can take advantage of retirement plans.
5. All distributions from retirement plans are taxable—except from a Roth IRA or an educational savings plan.
6. Federal law heavily regulates retirement plans, and professional guidance for setting up and maintaining plans is advisable.

A. Advantages of Retirement Plans

Retirement plans share these tax attributes:

- Your contributions as an owner or employee are tax deductible from your current income, thus reducing your present income taxes.

  A contribution to a tax-advantaged retirement plan must come from earned income, meaning compensation for active work (or net income after expenses). An investor in a business who isn't active in it can't deduct contributions to its retirement plan. Neither can a landlord contribute to a plan based on his rental income.
- Income generated by investments in your retirement plan accumulates tax-free until it is withdrawn, usually after you retire.
- There are penalties for taking money out of a plan before age 59½, but some early withdrawals are allowed.
- When you retire, withdrawals from your plan are usually taxed at a lower rate than when you were working, as your overall income will probably be diminished.

New tax credit for some retirement contributions. There's a tax credit of up to $1,000 for contributions to some types of plans such as IRAs and 401(k)s. The catch: Your adjusted gross income must be $50,000 or less. Tax preparation software such as *TurboTax* will automatically determine your eligibility and the amount of your credit.

Clearly, retirement plans are a deal that is hard to refuse. Not only can you put aside money before it's taxed, but as long as you keep your hands off it, it will grow tax-free if invested wisely.

Plan participants contributing $5,000 to $8,000 a year can build up $150,000 to $400,000 over a ten- to 20-year period, depending on how plan investments perform. If you contribute for 20 or more years and make maximum contributions, you might easily accumulate several million dollars.

The keys to retirement plan success are to start early, make the largest contributions you can, and take full advantage of all that the law allows.

What if you don't have the funds to make a contribution? Many folks find themselves without the bucks to put aside for annual retirement contributions, and lose the opportunity once the year passes.

If it comes time to make your annual contribution to a retirement plan, and you come up short, get creative. Borrow money from wherever you can, because the long-term tax savings will outweigh your short-term borrowing costs. Or liquidate any nonretirement investments and use the funds for the plan contribution. Again, even if there is tax from selling an investment, the retirement plan benefits will likely outweigh it.

Also, you don't need to contribute by December 31. A retirement plan contribution is the only way I know to do any tax reduction planning *after* the year has passed. (You can make contributions between January 1 and April 15 of the next year, or up to October 15 if you are granted an extension to file by the IRS.)

B. Overview of Retirement Plan Types

Rules, rules, and more rules govern who can get into which kinds of plans and how much money can be contributed each year.

This can get confusing fast. When you're finished reading this chapter, if you want more punishment, see IRS Publication 560, *Retirement Plans for the Self-Employed*.

Here are the different types of retirement plans—starting with the simplest and increasing in order of complexity. Note that the differences between plans are largely a matter of the limits on the annual contributions. Why Congress has created this crazy quilt of retirement plan rules is beyond all comprehension.

- **Individual Retirement Accounts (IRAs).** Set up by individuals, not by the business itself. Annual contribution limit of $4,000 (in 2005). The law allows an additional $500 for individuals who are age 50 or older.
- **Simplified Employee Pensions Plans (SEPs).** Annual contribution limit of the smaller of 25% of compensation (or net business income) or $42,000 (in 2005).
- **"SIMPLE" IRAs.** Annual contribution limit of $10,000 (in 2005), plus an extra $2,000 for individuals who are age 50 or older. Plus, the business can match a worker's contribution up to 3% of the employee's compensation (or net business income) or, if employee's contributions are not matched, can make a flat contribution to the plan of up to 2% of the employee's compensation. The total contribution—from the worker and the business—can be as high as $21,000, or $24,000 for participants age 50 or older (in 2005).
- **Profit Sharing Plans (PSPs).** Same annual contribution limits as SEPs (see above), except the 25% limit is applied differently. Also, PSPs have differing rules on eligibility and the rate of contribution between employees and business owners.

- **401(k) Plans.** Annual contribution limits of $14,000 per owner or employee, plus another $4,000 for individuals who are age 50 or older (in 2005). Business owners and employees can elect each year to contribute to the company's 401(k) plan. Employer may match a portion of the amount contributed by the employee.
- **Money Purchase Plans (MPPs).** Same annual contribution limits as PSPs (see above). Recent changes in the law have rendered them obsolete. As a result, MPPs are discussed only in passing in this chapter.
- **Defined Benefit Plans (DBPs).** The annual contribution limit is based on complex actuarial formulas, allowing up to $170,000 for individuals aged 52 or older.
- **"SIMPLE" 401(k)s.** These plans are so overly complicated and expensive that they are rarely ever used. They require a pooled trust to be formally administered and time-consuming paperwork. We don't recommend them, and they won't be discussed further.

Choose the retirement plan that best serves your needs at the time. This usually means the one that allows you to make as large a contribution as you can afford. Then, as your business matures and you advance toward retirement, annually review your plan. Chances are your needs will change, and Congress will have altered the rules. You may want to add plans so you can make larger tax deductible contributions each year.

C. Details About Each Type of Retirement Plan

Let's look more closely at the contribution and participation rules for each of the plans discussed in Section B, above. In Section F, below, we'll talk about withdrawing money from these retirement plans.

Contribute to retirement plans as early in the year as you can. No matter what type of tax-advantaged plan you choose, don't hold off in making annual contributions. Typically, folks contribute just before they file their tax returns. This means you could miss a full year of tax-free compounding!

1. Individual Retirement Accounts (IRAs): Traditional and Roth IRA Plans

Anyone with earned income can contribute to an individual retirement account, called an IRA. Earned income simply means money from work, as opposed to collecting dividends or interest.

Like all retirement plans, investments in IRAs compound tax-deferred until withdrawn. IRAs can be invested in a number of things—typically, stocks, bonds, and mutual funds.

It's okay to have an IRA even with other retirement plans in place (see below). And, a business owner can have his or her IRA without contributing to her employees' retirement plans.

An IRA is a fine starter plan, but may not be enough when your golden years arrive. The annual contribution limits are too small to provide for most folks' needs.

Take advantage of the multiple uses of IRAs. IRAs aren't just for retirement; they can also be used for savings accounts to fund your children's education, medical expenses, and first-time home ownership. (See below for details.)

a. Traditional IRAs

First we'll discuss the rules for traditional IRAs, and then we'll look at the Roth IRA. In both IRAs, the investment accounts build up tax-deferred until withdrawn.

Contribution limits. The IRA contribution limit is $4,000 per year (in 2005), plus another $500 per year for individuals age 50 and older. You can contribute less annually to an IRA; this is just the maximum you can put in.

Key Self-Employment Retirement Plan Rules		
Type of Plan	**Last Date for Contribution**	**Maximum Contribution**
Traditional and Roth IRA	Due date of individual income tax return (NOT including extensions)	Smaller of $4,000 or taxable compensation ($4,500 for those age 50 or older)
COMMENT: Good for sideline businesses and those with limited funds.		
SIMPLE IRA	Due date of individual income tax return (plus extensions)	Up to $20,000 (2005), depending on whether employer makes matching contributions*
* Additional contribution of $4,000 may be made for individuals 50 and older, including the matching contribution by the business.		
SEP IRA	Due date of employer's return (plus extensions)	**Employer** Smaller of $42,000 or 25% of participant's taxable compensation **Self-Employed Individual** Smaller of $42,000 or 20% of taxable compensation
401(k)	Due date of employer's return (plus extensions)	Smaller of $14,000 (2005) or 100% of participant's taxable compensation*
* Additional contribution of $4,000 may be made for individuals 50 and older.		
Profit Sharing Plan	Due date of employer's return (plus extensions) (To make contributions to a new plan in a given year, the plan must be set up by the last day of the employer's tax year.)	**Employer** Smaller of $42,000 or 25% of employee's taxable compensation **Self-Employed Individual** Smaller of $42,000 or 20% of self-employed participant's taxable compensation
Defined-Benefit Plan	Due date of employer's return (plus extensions) (To make contributions to a new plan in a given year, the plan must be set up by the last day of the employer's tax year.)	Up to $170,000 or the amount needed to provide an annual retirement benefit no larger than 100% of the participant's average taxable compensation for his or her highest three consecutive years

Spousal IRAs. There's an added break for married couples. Stay-at-home husbands or wives can contribute up to $4,000 per year to a spousal IRA, plus an additional $500 for those who are age 50 or older. The working spouse must earn at least as much as the IRA contribution made for the nonemployed spouse. Spouses *can't* share the same account—each must have a separate IRA.

Relationship to other retirement plans you have. If you participate in a qualified retirement plan (see Section 4, below), you can still have an IRA. However, your IRA tax deduction is reduced once you earn more than $50,000 (single) or $70,000 (married). The deduction is phased out entirely once you earn more than $60,000 (single) or $80,000 (married). (These phase-out limits are for 2005. The dollar amounts are scheduled to increase in future years.) Note: These phase-outs apply only to taxpayers covered by a retirement plan at work.

You can contribute even if you're over the income limit. While you don't get an IRA tax deduction that year if your income is above these limits, you can still contribute to a traditional or Roth IRA. This is to take advantage of the IRA's long-term tax-deferred earning benefit.

Other tax rules. You can make contributions to an IRA *only* if you have earnings from work. This eliminates folks who live on unearned income like interest, dividends, or income from rental property.

Deadlines. You have until April 15 to establish and contribute to an IRA for the preceding year (or if you file an extension, until August 15 or October 15).

Withdrawal rules. There is an early withdrawal penalty of 10% if you make an IRA withdrawal before age 59½—with two big exceptions:

- **First-time home buyers** or their close family members may withdraw up to $10,000 within four months of the purchase of the home.
- **Higher education expenses** of an IRA account owner or her immediate family may be withdrawn. (Also see Coverdell education accounts, below, covering both primary and secondary school expenses.)

Note: Traditional IRA withdrawals are taxed in the year they are taken, along with all the rest of your income at your tax rate.

IRA contribution limits are slated to increase as follows:

IRA Contribution Limit Projected Increases

Year	Under Age 50	Over Age 50 Bonus
2005	$4,000	$500
2006	$4,000	$1,000
2007	$4,000	$1,000
2008	$5,000	$1,000
2009	indexed for inflation	$1,000
2010	indexed for inflation	$1,000

All figures shown are subject to changes in the law.

b. Roth IRAs

The Roth IRA is an alternative to a traditional IRA. The most important difference between the two IRA plans is that Roth IRA contributions are *never tax deductible*.

The reason you might choose a Roth IRA over a traditional IRA is that *withdrawals* from Roth IRAs are *not* taxed—unlike all other retirement accounts. Earnings on your Roth IRA investments are tax-free as long as you don't withdraw them before age 59½.

Contribution limits. Roth contribution limits are the same as with a traditional IRA (see above). You can have both types of IRAs, but the overall contribution limit applies. No double dipping.

Relationships to other retirement plans you have. You can make Roth IRA contributions even if you have other qualified retirement plans. However, your overall adjusted gross income must be less than $95,000 (single) or $150,000 (married). The Roth IRA offers much higher earnings limits than with traditional IRA contributions (see above).

No age limit on contributions. Unlike a traditional IRA, a Roth IRA can be established *after* you turn 70½ years old.

Withdrawals. You may withdraw your Roth contributions, but not your earnings, from your Roth account at any time without penalty. With other retirement plans, you usually can't make *any* withdrawals before 59½ years old without penalty.

Traditional IRA or Roth IRA?

"Should I take a tax break now with the traditional IRA or later with a Roth IRA?" For most middle-earners under age 40, the long term benefits of tax-free compounding likely will outweigh the loss of the immediate tax deduction—so younger folks may want to go for the Roth. But, for individuals closer to retirement age, and in higher income tax brackets, the immediate deduction of the traditional IRA makes more tax sense. Ask a tax pro to run the numbers both ways, plugging in your age and tax bracket, to see how the two might compare over the long run. Or, check out www.fundadvice.com for a free Roth IRA comparison calculator.

c. Coverdell Education Savings Accounts (ESAs)

Similar to a Roth IRA is the Coverdell education savings account (ESA), formerly called the Education IRA. Contributions to an ESA may be made by anyone who earns at least $2,000. The contribution can be up to $2,000 to be used for educational expenses of named qualified family beneficiaries. Withdrawals from an ESA are tax-free, including any increases in value on investments in the ESA. There is no limit to the number of Coverdell ESAs that can be established for a beneficiary over a number of years.

Coverage. A qualified beneficiary must be under age 18, or older if he or she has special needs (physical or mental disabilities). If funds in an ESA aren't used for the designated beneficiary, the account may be rolled over to another qualified person in the same family.

Withdrawals. Withdrawals from an ESA must be used for educational expenses such as tuition, fees, books, supplies, computers, and Internet access. The money must be used for primary and secondary school expenses and college expenses and all distributions must be made no later than 30 days after the beneficiary turns age 30.

Limitations. ESA contributions may be made only by individuals whose adjusted gross income is less than $110,000 (single) or $220,000 (married).

> **EXAMPLE:** Dr. Estarch and her husband have an adjusted gross income of $250,000. Her office manager, Leslie, earns $55,000. Dr. Estarch can't contribute to an ESA, but Leslie can set up two ESAs for her two minor kids and contribute $2,000 to each ESA every year.

Other plans. You can set up an ESA even if you maintain and contribute to any other retirement plans. Most tax rules are the same for ESAs as they are for IRAs. See IRS Publication 970, *Tax Benefits for Education,* for details.

2. SIMPLE IRAs

The SIMPLE plan (Savings Incentive Match For Employees) is hardly true to its acronym, as you'll see below. There are two choices, the SIMPLE IRA and SIMPLE 401(k). As mentioned above, the SIMPLE 401(k) is too complicated, so we're only going to cover the SIMPLE IRA.

The two distinguishing features for the SIMPLE IRA compared to traditional and Roth IRAs is that it is designed to cover businesses with employees, and it allows larger annual contributions and deductions.

Contributions for employees may be required. The employer must make an annual SIMPLE contribution for each employee (see below). This rule could make this type of plan too costly for many small business owners with several employees or more.

As with traditional IRAs, earnings in SIMPLE IRAs are not taxed until the funds are withdrawn.

Contribution limits. Business owners and employees may contribute up to $10,000 (in 2005) of their earnings to a SIMPLE IRA. *In addition*, the business owner must either match each employee's entire contribution (up to 3% of the employee's wages) or contribute 2% of the employee's wages. The boss can also match her own contribution (and the business can deduct it). But, the employer's matching contribution can't be more than the employee's contribution—which is limited to $10,000, for a total of $20,000. Plus, participants age 50 or older can make an additional contribution of $2,000 per year, making their total contribution limit $24,000 if the catch-up contribution is matched (2005).

> **EXAMPLE:** Winnie, age 52, owner of Winnie's Windsurfing World, earns $270,000. Winnie's maximum SIMPLE IRA contribution is $10,000, plus an additional $2,000 because of her age, plus an $8,100 match from her business, for a total of $20,100.

Anyone age 50 or older can make additional contributions of $2,000 in 2005 and $2,500 in 2006 and beyond.

Tax deduction rules. Employer-made SIMPLE contributions are tax deductible to the business owner as compensation paid to employees. Contributions are not taxed to the employee until the SIMPLE account funds are withdrawn, along with any earnings on investments within the accounts (the same as with a regular IRA).

> **EXAMPLE:** Scone, owner of Scone Land, pays Leotis, his business's manager, $25,000 in wages. Leotis chooses to contribute 2% of his wages, or $500, to a SIMPLE plan. Scone Land must match the entire $500 contribution, as it is less than 3% of Leotis's wages. The total contribution for Leotis is $1,000, all of which is tax deductible for Scone Land. Leotis is not taxed on the $1,000 contribution until he withdraws it from the plan.

Eligibility and participation rules. Business owners must contribute funds to the plans of all long-term employees who earned at least $5,000 that year and who also earned at least that much from the business in up to three prior years.

Withdrawal rules. Withdrawal rules and penalties are the same as for traditional IRAs; see Section 1a, above.

Setting Up and Maintaining an IRA-Type Plan

Traditional IRAs, Roth IRAs, Coverdell ESAs, and SIMPLE IRAs can be established by most mutual fund companies, banks, and stock brokerages. The cost may be nominal, or even free, to set up and maintain the account every year. IRA accounts are self-directed, meaning you make the investment decisions among stocks, bonds, funds, or bullion.

3. Simplified Employee Pensions (SEPs)

The simplified employee pension (SEP) is also called a SEP IRA; it follows the rules for IRAs, but has higher annual contribution limits. SEPs can cover both self-employed folks and their full- or part-time employees.

SEPs are too costly for many businesses with employees. Since SEPs force businesses to contribute for employees, many owners today choose SIMPLE IRAs over SEPs, which have less stringent coverage requirements. (See Section 2, above.)

Subject to the overall contribution limits discussed below, an owner or employee may contribute and maintain other retirement plans as well as a SEP.

Business owners can decide every year whether or not to contribute to a SEP, but can't play catch-up for any past years.

Congress's misuse of the word "simplified" indicates a rather strange sense of humor on Capitol Hill.

A business owner can contribute to separate SEP accounts for herself and for each eligible employee and deduct the contributions. SEPs are called noncontributory plans, because only the boss makes a contribution for everyone—employees can't make contributions to SEPs. Contributing businesses can be sole proprietorships, partners, or managing members of a limited liability company.

Contribution limits and rules. The maximum annual contribution to a SEP plan is the *lesser* of:

- $42,000 (in 2005), or
- 25% of an *employee's* compensation, or 20% of the net business income of an *owner* (the formula is complicated, but it works out to 20%).

Only earned income from the business qualifies for a SEP contribution. This means that a business owner's income from interest, dividends, and the sale of items producing capital gains can't be used to figure his or her SEP contribution.

> **EXAMPLE:** Manfred's Grand Prix Scooter shop operation loses money one year, but Manfred made a gain of $32,000 from the sale of real estate and inherited $61,000 that year. Manfred can't make any SEP contribution.

There is a 6% penalty tax on excess contributions made to your SEP account, which can be waived by the IRS if you withdraw the excess right away. This typically happens to business owners who make SEP contributions throughout the year, before knowing their business's net income, on which the SEP contribution is based.

If a business owner wants to contribute to her own SEP, she must also contribute to all eligible employees' SEPs as well. Contributions must be made to each employee in the same proportion as to the owner. If you're confused, here's an example.

> **EXAMPLE:** Bella's Tango Studio earns $70,000 (after deducting all expenses and one-half of Bella's self-employment tax). She can choose to contribute up to 20% of the business's $70,000 net income ($14,000) to a SEP account for herself. Bella pays Danielle, one of her long-time instructors, $20,000 in wages. Bella must also contribute the maximum—25%, or $5,000—to Danielle's separate SEP plan. Bella's business gets the tax deduction for both contributions, a total of $19,000.

Who must be covered. Business owners must contribute to a SEP for all employees, full- and part-time, who:

- are older than 21 years
- have been employed there at least one day in three of the five prior years, and
- earn at least $450 in the current year.

Deductibility rules. SEP contributions are not deductible from income or wages for purposes of Social Security and Medicare taxes. In other words, owners and employees must pay Social Security and Medicare taxes on money that they put into a SEP account. Kind of a bummer, but that's the law.

Deadlines. You have up to the date of filing your tax return to contribute to a SEP, including requested extensions to August 15 or October 15.

Establishing and maintaining a SEP. Professional fees for paperwork and annual tax reporting are tax deductible to the business. The costs are nominal, or even free, with some financial services companies. SEPs are set up and maintained by the same financial companies that are in the IRA business. Shop around with banks, brokers, or mutual fund families.

You may freely change investments within a SEP account as you see fit.

You may maintain one or an unlimited number of SEP accounts. Of course, you can't contribute more than the annual limit. My wife and I have accumulated six different SEP, 401(k), and IRA accounts with different mutual fund families and brokers.

4. Qualified Retirement Plans

The most complicated type of retirement plans are qualified, or ERISA, plans. They require much more paperwork and annual tax reporting than IRAs, SIMPLE IRAs, and SEPs.

Any type of business entity, whether a sole proprietorship, a partnership, a limited liability company, or an S or a C corporation, can establish a qualified plan.

The main reason a small business owner would adopt a qualified plan is to make larger retirement contributions than other plans allow.

The biggest drawback to qualified plans is that owners must contribute funds for most of their employees who work at least 1,000 hours in the year. Generally, there is no reason to consider a qualified plan unless your needs are not met by IRAs, SIMPLE IRAs, and SEP plans.

A pension pro or higher-level financial services institution must set up and annually review and maintain a qualified plan, and make the proper tax reporting.

Tax credit for set-up costs. An employer can take a business tax credit of up to $500 per year for up to three years ($1,500) for the business's expenses in setting up a qualified retirement plan. This tax benefit is available to all businesses with fewer than 101 employees and at least one employee in the plan other than the owner and the owner's spouse.

5. Profit Sharing Plans (PSPs)

The next tax-advantaged retirement plan is technically called the defined contribution plan (DCP). This was originally a Keogh plan, and you may still see this terminology.

The DCP has two subdivisions: the profit sharing plan (PSP) and the money purchase plan (MPP). For our purposes, we're going to refer to this type of retirement plan simply as a profit sharing plan, or PSP for short. (MPPs are discussed in the next section.)

Contribution limits. As the name profit sharing plan implies, annual contributions to a PSP are based on a business's profits. The owner, not the employees, makes the contribution.

A PSP doesn't require *any* annual contribution by the business, even if it turned a profit; contributions are entirely voluntary each year. But, if any PSP contributions are made, everyone covered by the plan must share in the contribution. That is, the owner can't contribute funds for herself without doing the same for her employees.

A business owner may contribute the *lesser* of:

- $42,000 (in 2005)
- 100% of the net business income of the owner or the compensation of the employee, or
- 25% of the aggregate compensation of all PSP participants, reduced by contributions made for the owner's account.

Use tax preparation software or a pension specialist to figure out your contribution. Congress has made so many rules that it is difficult to figure out the correct contribution limits for retirement plans. Luckily, tax preparation software like *TurboTax* or a tax professional can make the computations for you.

Eligibility and participation rules. All full-time employees age 21 or older and with the business at least one year must be covered by the PSP.

6. Money Purchase Plan (MPP)

The second type of defined contribution plan, the money purchase plan (MPP), now has the same contribution limits as the PSP. Before this change in the law, the contribution limits were higher for MPPs, so they made sense. Today no one chooses an MPP, because contributions are *mandatory* each year—whether the business makes a profit or not. It's safe to say the MPP is now obsolete.

7. 401(k) Deferred Compensation Plans

Any business entity can establish a 401(k) plan. Participants may contribute part of their wages to the plan tax-deferred. An employer may also contribute to the plan on behalf of the employee. The employer's contribution is a dedictible expense..

Contribution limits. Each business owner or eligible employee may contribute up to $14,000 (in 2005) to a 401(k). The contribution can't be more than the employee's earned income for each year. An additional $4,000 is allowed if the individual is at least 50 years old.

These maximums increase to $15,000 for 2006 and beyond. And, for folks over 50 years of age, the additionally allowed amount is increased to $5,000 in 2006 and beyond.

Add a 401(k) and a profit sharing plan for a greater tax deduction. Under rather complex rules, you can contribute to both a profit sharing plan (see Section 5, above) and to a 401(k) plan.

> EXAMPLE: Monte the Magician, age 51, earns $100,000 working the showrooms of Las Vegas. Monte can contribute up to $18,000 to a 401(k) plan (the $14,000 limit plus $4,000 for being over age 50). Monte can also contribute $20,000 to a profit sharing plan, making his total retirement plan contributions $38,000 for the year.

Participation rules. A business's 401(k) plan must be open to any full-time employee, 21 years of age or older, who has worked for the business at least one year.

A qualified employee doesn't have to contribute to the 401(k) but should be encouraged to. Lower-rung employees are required to contribute similar proportions of their wages as do the top brass. If the rank-and-file don't join the plan, the higher-paid guys either can't contribute or can't make the maximum contribution, because this violates tax code rules against top-heavy 401(k) plans. Because you can't force employees to participate in a 401(k) plan, some businesses offer a matching incentive. Typically businesses match half of the employee's contributions up to 6% of wages. Or a business can contribute a set amount, such as $1,000, as long as the employee also contributes.

Social Security and Medicare taxes. Money contributed to a 401(k) plan is still subject to a tax for Social Security and Medicare purposes. For some folks, this extra cost causes too much shrinkage in their paycheck, so they skip making a contribution—not smart.

> EXAMPLE: Dennis, owner of DenCo, a management consulting firm, sets up a 401(k) plan. Dennis is in the 35% income tax bracket. DenCo contributes $9,000 into Dennis's 401(k) plan and deducts the full amount as a business expense. The contribution is not income to Dennis, but he will owe somewhere between 2.9% ($261) to 15.3% ($1,377) of the $9,000 contribution. (The exact tax amount will depend on his total earnings for that year.) This is still not bad, considering the contribution saved Dennis $3,150 (35% x $9,000) in income taxes. Also, there was probably a state income tax savings, depending on where Dennis resides.

Establishing and maintaining a 401(k). 401(k) plans can be set up by a pension pro or by some financial service companies offering IRAs and SEPs. There is more paperwork and higher initial fees and annual maintenance costs involved with 401(k)s than with IRAs and SEPs.

Businesses with 401(k)s must do a separate annual tax reporting (Form 5500) each year. This means a tax pro or financial services firm, although these paperwork expenses are tax deductible. Before setting up a 401(k), check out the costs of establishing it and the annual charges. Compare the benefits offered to the other plans discussed in this section.

Most 401(k) plans restrict the participants' investment choices offered by the financial institution handling the plan. A few 401(k)s permit participants to freely play the stock market, but whether this is a wise move in a 401(k) account is another question.

8. Defined Benefit Plans (DBPs)

The defined benefit plan (DBP) is the most complicated (and expensive) retirement plan of all to set up and maintain. It is also the plan that allows the largest annual contributions, so it offers the greatest potential tax benefits.

A DBP is designed to provide either a specific monthly payment (such as $1,500) or a lump sum (such as $200,000) upon retirement. The actuarially determined amount is usually tied to a percentage, such as 40% of the average annual compensation for the highest three years of self-employment. The amount the owner must contribute every year is based on this target monthly or lump-sum benefit.

Eligibility and participation. All qualified employees must be included in the DBP. How much must be contributed each year for each participant depends on his or her age, length of service, and annual compensation. Age is the most critical factor. Typically, DBPs provide for the biggest contributions for those over age 45—folks with shorter life expectancies.

Annual tax deductions of up to $170,000 are possible for each participant—far greater than for any other retirement plan. The formula to determine the exact amount is complex and is subject to revision every year (see below).

Pension pro and actuary required. A DBP requires not only the services of a sharp pension planning professional, but a licensed actuary as well. The actuary does all of the complicated contribution computations based on your life expectancy, the amount of benefit the plan is expected to provide, and how well or how poorly your plan investments perform every year.

In turn, this means the preparation and annual filing of a set of forms (primarily IRS Form 5500). Expect $2,500 or more in professional fees to establish a DBP and a similar amount every year thereafter. These fees are fully tax deductible to the owner of the DBP.

DBPs allow late bloomers to catch up. A DBP is a life-saver for highly compensated business owners and professionals who weren't able to build up retirement accounts earlier in their careers. At age 50, I started a DBP and am overjoyed at the large tax savings it gives me every year—sometimes as much as 100% of my earnings from writing and practicing tax law can be contributed and deducted. This is by far *the* largest single tax deduction on my return.

D. Where to Go for a Retirement Plan

Find a financial services institution, a private financial planner, or a pension consultant to help you set up your retirement plan. Ask your banker, accountant, or attorney for recommendations. An older business associate or trusted friend probably has had some experience in this area. Talk to a number of outfits to find out what they have to offer. Don't rush into anything; retirement planning might be the most important financial move of your life.

For most folks, especially for those with businesses with no employees other than the owner(s), a ready-made plan is fine. Fidelity Investments and Charles Schwab are two low-cost financial institutions I've worked with that set up and maintain a multitude of plans. With off-the-rack plans, a financial institution such as Fidelity or Schwab will automatically take care of the annual IRS reporting required by most tax-advantaged retirement plans. (For custom plans, such as defined benefit plans, this paperwork should be tackled by an accountant, plan administrator, or pension pro.)

As your business grows and you near age 50, talk to a pension plan professional.

Choosing a pension pro. Find someone who is truly independent—meaning he or she is compensated by you on an hourly or flat-fee basis and not from commissions on investments they sell. Expect to pay $100–$250 an hour (tax deductible, of course) for a pension professional.

A business owner with at least one nonowner employee can take an additional tax credit of up to $500 for three years for fees paid in setting up a plan. This means Uncle Sam is reimbursing you for $1,500 of your costs in setting up a plan—an offer you can't (or shouldn't) refuse.

Managing Your Retirement Plan Investments

You can make your own plan investment decisions or let others do it for you.

At the least, you should keep an eye on your retirement plan's performance. Most financial institutions issue monthly or quarterly reports. It's easy to change the investment portfolio or the institutions handling your plan if you're not happy.

The bulk of my retirement account funds are in the hands of a professional money manager. These folks typically charge an annual fee of around 1% of the value of the account. If you go this route, shop around first to compare track records.

E. Potential Tax Problems With Retirement Plans

Retirement plan rules are so complex and ever-changing that plans sometimes fail to meet the tax rules, even when financial institutions are handling them. When problems arise, they are usually found in IRS audits of the business or its owners.

Retirement plan audits are prompted by reviews of annual Form 5500 filings (required for most types of plans, *except* IRAs and SEPs). The IRS uses agents who are specially trained in retirement plans to ferret out technical violations.

IRS Publication 4224, *Retirement Plan Correction Programs,* explains how to fix defective retirement plans. There is also a CD-ROM version of this publication available at www.irs.gov.

Here are some common technical violations.

1. Excess Contributions

The most common problem found is that contributions made to a plan exceed the yearly limit. As discussed, each type of retirement plan has strict annual maximums.

It's easy for an owner to overcontribute, particularly if payments are made to a retirement plan throughout the year, but the business's net income isn't known until the year ends.

Excess contributions may be returned to the contributors and become taxable income to them. Otherwise, if the IRS catches the mistake, a 10% tax penalty can be imposed on the plan.

2. Overfunded Plans (Defined Benefit Plans Only)

A defined benefit plan balance can become "too fat" under complex IRS formulas. For instance, this could happen if plan investments were projected to return 4% annually and they actually returned 8%. In this case, no further contributions can be made to the plan until projections even out. With a DBP, you should be working with a pension pro to see that overfunding doesn't occur.

3. Affiliated Service Groups and Controlled Groups

A rare problem—not meeting minimum coverage requirements—may arise if spouses own businesses and both have retirement plans (other than SEPs and IRAs), and they reside in a community property state. This is an instance where there is cross-ownership of businesses, which are (in tax lingo) affiliated services groups or controlled groups.

If this sounds like it might apply to you, consult a pension pro.

Which Is Best for Me: IRA, SEP, SIMPLE, or Qualified Plan?

By now you're probably thoroughly confused. Sorry, I'm only the messenger—blame the Alice-in-Wonderland rules on Washington. Some rough comparisons may help you decide what plan or plans work best.

IRAs and SEPs are the easiest retirement plans to set up and maintain. A SEP may be all you ever need, especially if your business has no employees. It allows you to contribute up to $42,000 a year to a retirement plan, assuming you meet the net income requirements to contribute the max.

A 401(k) plan should be considered if your income isn't high enough to qualify you for the full $42,000 SEP contribution, but you want to make a larger tax deductible contribution.

If your business has employees for whom the law requires you to make contributions in order to contribute for yourself, SIMPLE IRAs and profit sharing plans are better.

Defined benefit plans are the Rolls Royces of the bunch, allowing tax deductible contributions as high as $160,000 per year. The downside is that large contributions may be required for employees of the business, and these plans are expensive to set up and maintain (although the costs are tax deductible).

F. Withdrawing Money From Retirement Plans

The part we all wait for is the retirement plan payday. The only downside—other than getting old—is that the income tax bill is finally due (except for Roth IRA and Coverdell education savings accounts, from which withdrawals are tax-free).

Here is how it works. You'll owe tax on both the original contributions and on any plan earnings that have accumulated tax-deferred over the years.

How much tax is due depends on how much is withdrawn per year and on your income tax bracket. Typically, your bracket will be lower in retirement than when working, which is yet another advantage of retirement plans. This could mean a drop from years in which your federal and state tax rate was 40% to a low of 10%.

See the Introduction, Section D, for the income tax brackets for 2005 and beyond.

Until it's all gone, money in your retirement account continues to accumulate tax-deferred.

Retiring to a low- or no income-tax state. If you live in a tax-hungry state like California, New York, Hawaii, Maine, Wisconsin, or Vermont (to name the worst offenders), consider relocating when you retire (or even before). Seven states have no state income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Two others, New Hampshire and Tennessee, tax only dividend and interest income, but not retirement plan income. Several years ago, I moved my family three miles across the California state line to Nevada. Our state income tax savings were close to $20,000 in the first year alone! But even the no-income-tax states can get into your pockets in other ways, like through high property taxes and sales taxes. Check the state's tax laws out carefully with a tax pro before you move.

1. Withdrawal Eligibility

Here are the rules on withdrawal penalties for most retirement plans (except for SEPs and IRAs, which are discussed in Sections C1 and C3, above). To take money from a retirement plan *without a tax penalty,* you must fulfill at least one of the following requirements:

- you are at least 59½ years old and retired from the business that provided the plan
- you have left the business and are at least 55 years old
- you are permanently disabled
- you have medical expenses, have school tuition, or are buying a home

- you have died (and since you can't "take it with you," this means your heirs or named beneficiary gets it), or
- you are subject to a qualified domestic relations order. This usually means you're getting divorced and the judge orders you to distribute part of your retirement to your ex- or soon-to-be-ex-spouse.

2. Tax Withholding

There is a 20% IRS withholding tax for withdrawals (except for IRAs and SEPs). This doesn't mean you owe 20% or any tax at all on the withdrawal—you won't know until you file your tax return. You may get a refund or owe more, depending on your total taxable income for the year. Keep filing tax returns to report plan withdrawals after you retire—especially if you're due a refund.

3. Mixed Contribution Plans

In a few cases, withdrawals from retirement plans may consist of both taxable and nontaxable distributions. You may have made contributions to an IRA that weren't deductible. Make sure to report this properly so that you don't pay tax on the nondeductible portion. IRS Publication 575, *Pension and Annuity Income,* shows how to do this, or, pay the IRS to do the calculation for you. See IRS Publication 939, *General Rule for Pensions and Annuities*.

Early withdrawal penalties. If you don't follow the retirement plan withdrawal rules, you can be hit with a 10% tax penalty, plus tax due on the withdrawal.

EXAMPLE: Jocko withdraws $10,000 from his retirement account to buy a car he needs to get to his new job. Jocko must pay a 10% penalty tax of $1,000 plus $2,500 in federal income tax (assuming his tax bracket is 25%). And, if Jocko lives in state with a personal income tax, he'll owe state taxes and possibly penalties, too.

4. Loans From Retirement Plans

You may borrow from your retirement plan *(except for IRAs and SEPs)* if the plan documents allow it.

The borrowing limit is $50,000 and you must provide collateral. (Generally, pledging the other half of your retirement account balance does this.) You must repay the loan with interest, at commercial loan rates, within five years. Exception: For home purchases, you get up to 30 years to repay.

5. Lump-Sum Withdrawals

If you were born in 1935 or earlier, you can take all of your retirement balance out at once and spread the texes out over a period of up to ten years. This averaging break doesn't apply to SEPs and IRAs. See a tax pro for the rules before trying this.

6. Mandatory Withdrawals

Except for Roth IRAs, you must start withdrawals from your retirement plan by age 70½ or risk a 50% penalty tax. IRS tables show the minimum annual withdrawals required, based on your life expectancy. The intent of the law is that your retirement account is zeroed out on the day you die. See Publication 950, *Individual Retirement Arrangements,* for how to determine your required minimum distributions. Also, you can use a free minimum distribution calculator at www.fundadvice.com.

7. What Happens at Death

At death, the balances in your retirement funds become part of your taxable estate. (See Chapter 12.) Your retirement plans automatically terminate *unless* your spouse is the named beneficiary of the plans, in which case he or she can take the money or roll over the funds into an IRA.

For SEPs and IRAs only, the widow or widower can transfer the accounts into a new SEP or IRA and name younger family members as beneficiaries. This stretches the tax deferral benefits even farther.

Don't try this without running it by a tax pro first, though.

G. Closing Your Business

If working for yourself is not cutting it—or you start up a new business—this won't affect any existing retirement plans you own.

If you abandon self-employment to work for someone else, and don't make any further contributions to your old plan(s), the plan investments will continue to accumulate tax-deferred until withdrawn.

If you leave an employer, generally you may transfer your retirement plan funds with you without any penalty tax. You do this by rolling over your share of the plan's money into either an IRA account or a new employer's retirement plan. If you go the IRA route, you can self-manage your investments.

Final thought: *"The trouble with retirement is that you never get a day off."*

—Jack Patterson

Resources

- IRS Publication 590, *Individual Retirement Arrangements* (SEPs and IRAs).
- IRS Publication 560, *Retirement Plans for the Self-Employed*.
- *IRAs, 401(k)s & Other Retirement Plans: Taking Your Money Out*, by Twila Slesnick and John C. Suttle (Nolo). A comprehensive guide to various retirement plans that helps you make sense of the rules governing distributions and contains detailed information on avoiding or minimizing the taxes and penalties that can crop up when you start taking distributions.
- *Social Security, Medicare & Government Pensions*, by Joseph L. Matthews with Dorothy Matthews-Berman (Nolo). As the title indicates, this book covers the whole realm of retirement income, not just retirement plans, from a recipient's point of view.
- *How to Pay Zero Taxes*, by Jeff Schnepper (Addison-Wesley). Although the title overpromises, the book includes some innovative tax twists on using retirement plans.
- *Retirement Savings Plans*, by David A. Littell (John Wiley & Sons). This is a fairly technical book written for tax professionals. It contains a number of forms, examples, and sample plans.
- Craig Schiller, of Schiller's Pension Consulting (Burlingame, California), is very knowledgeable in all pension plan matters and helped in the writing of this chapter.

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CHAPTER

16

Buying a Business

"The rule of my life is to make business a pleasure, and pleasure my business."

— Aaron Burr

Instead of starting from scratch, you can usually find someone with a business for sale. Buying an established enterprise may be more costly—but less risky—than starting a new one. There's a lot to be said for taking over a proven business with a customer base and established location.

This chapter covers the tax concerns of buying a business. The flip side, selling a business, is covered in Chapter 17. Take a look at both chapters, no matter which side of the fence you are on, to get a well-rounded tax picture.

Whether you want to acquire a service, retail, wholesale, or manufacturing business, the tax issues are remarkably similar. Once you are aware of them, you must ferret out any tax land mines.

Buyers do have tax worries not faced by those who start from the ground up, such as:

- outstanding tax and other potential liabilities that come with the business, and
- potential tax audits of the business for prior years.

Buyers beware—get professional advice. An existing business may come with undisclosed taxes and debts, overstated earnings, employee problems, overvalued inventory, and pending or potential lawsuits. Hidden liabilities can lurk in all areas—from land contaminated with toxic chemicals to accounts receivable that prove to be uncollectible to inventory that's defective or dated.

A business-savvy attorney should be on your team for all but the smallest of business acquisitions. A lawyer can represent you through the whole process or just answer a few questions. She can act as an escrow agent or recommend a company to handle the exchange of money. Many attorneys don't know the tax aspects of business transfers, so run the deal by a tax pro, too. (See Chapter 22, Help Beyond the Book.) All professional fees here are tax deductible, and if a professional adviser screws up, he may be liable for any losses you suffer from the bad advice.

If the deal is big enough, say over $100,000, consult a business appraiser, too. Find someone with expertise in valuing businesses in the same industry. This can help not only in coming up with a fair purchase price but in establishing an IRS-proof tax basis for the business assets.

Buying a Business in a Nutshell

1. A buyer and seller must assign a value to all business assets (including any agreement not to compete) and report it to the IRS on their respective tax returns.
2. A buyer must write off the business's goodwill and other intangible business assets purchased over 15 years.
3. Buyers should be wary of outstanding tax liabilities. Always check for tax liens, and require the seller to agree to indemnify you for any tax debts that may attach to transferred assets.
4. There is no federal tax on the purchase of a business, but states and localities may impose transfer taxes.

A. Buying the Assets of a Business

A business is simply a collection of assets. Someone offering a business for sale is trying to sell all of these assets together.

A buyer may not want everything, however. For instance, say Dayna wants to buy Sal's Pizza Parlor because of its prime location and open a futon shop. She doesn't want Sal's business name or the old pizza ovens. If Dayna makes Sal a good enough offer, he may sell just the building to her and sell the rest of the items to other folks.

How the business is legally structured—sole proprietorship, partnership, limited liability company, or corporation—has important tax consequences to both the buyer and seller, as we'll see.

1. Unincorporated Businesses

If you buy a partnership, limited liability company, or sole proprietorship, you are purchasing its *assets*—a store lease, inventory, customer list, and so on.

Liabilities. Normally, buyers don't agree to take over business-related *liabilities*. Purchase contracts typically require the seller to pay all debts before closing, or out of escrow funds. Unpaid bills usually remain the seller's personal responsibility after the transfer.

Debts that attach to specific assets—such as manufacturing equipment—are usually assumed by the new owner.

Tax debts. The IRS never releases the seller from unpaid taxes when a business is transferred. Buyers normally don't have to worry about the seller's tax debts, however, unless the IRS (or state taxing agency) has filed a tax lien prior to the business transfer. Tax liens normally appear on the public record in the name of the business or the owner. (See Section B1, below, for how to find out whether a tax lien has been filed.)

> EXAMPLE: Angelo, a sole proprietor, sells his profitable business, Korner Mart, to Luigi. Angelo has not filed or paid income taxes for the past three years. The IRS hasn't caught on to Angelo—yet. Luigi takes the business assets free of any tax liability (there are no tax liens yet). Angelo, of course, remains personally liable for taxes he should have paid on the business income before he sold the business.

Legal notice. You are not required to notify the IRS before purchasing or selling a business. However, you may need to notify state and local agencies and publish a notice to creditors under your state's Bulk Sales Act (ask your attorney or local newspaper for their form and about the procedure).

2. Small Business Corporations

The tax rules are different when you buy someone's incorporated business. Whether you buy corporate shares or just the corporation's assets is a crucial choice, because:

- If you buy only a corporation's *assets*, you don't automatically assume the corporation's liabilities, including taxes.
- If you buy a corporation's *stock*, you take both its assets and liabilities—including known and unknown taxes. An example of an unknown tax debt would be one from an IRS audit of the corporation that has not yet begun. Legally, an individual seller of corporate shares is released from all corporate debts unless he agrees in writing to be liable for them after the stock is transferred. A good buy-sell agreement would cover this situation.

Why, then, would anyone consider buying a small business corporation's stock, given the potential for legal trouble? Because some owners will sell only if a buyer takes the stock. There are several valid reasons a seller might insist on this arrangement. One is to rid himself of any potential tax liabilities (as discussed in Section B, below). More likely is that the seller has a tax savings motive for selling corporate stock instead of its assets.

B. Buying Shares of Stock

Buyers of the stock of a small business corporation take over any tax debts of the business—disclosed or not—along with its assets. For instance, a potentially devastating audit tax bill can be inherited from a corporation that misclassified its employees as independent contractors.

> EXAMPLE: Renate buys all of the stock of XTC corporation from Kendra. Unbeknownst to Renate, XTC's employment tax returns were not filed or taxes paid two years ago. When Renate buys the stock, no tax liens had been filed. When the IRS catches on, the corporation (now owned by Renate) will be held liable for the old payroll taxes—whether Renate knew about them or not. Renate may have a claim against Kendra, but the IRS doesn't care about that. Kendra is also personally liable to the IRS for the payroll taxes.

Your purchase contract should include a guarantee from the sellers that the corporation doesn't owe taxes and that the sellers are liable to the buyer if this turns out not to be true. (In legal lingo, the sellers agree to indemnify the buyer.)

Before buying corporate shares in a small business, see a tax pro. Ask about the potential for undisclosed tax liabilities, and do some investigating (discussed just below). But know that even with the best investigation of a corporation and its owners, it's impossible to predict some future tax problems. No one knows whether the IRS (or any state taxing agency) will audit tax returns the corporation filed before you bought its shares.

Take the following steps to minimize future problems.

1. Investigation

You'll need to gather all sorts of documentation from and about the seller. This is called doing due diligence.

Tax returns. Ask the seller for copies of all business income tax returns and employment tax returns for the last three years. Demand proof that taxes have been paid. Copies of filed tax forms, along with canceled checks, should be provided once you have signed a purchase contract with the seller. (Your agreement should provide for an inspection of the business books, and the right to back out if irregularities are found.)

Consider hiring a business attorney or tax pro to help check the seller out. Your expert should look for signs of unreported income, unfiled tax returns, and unpaid taxes. Is there anything that doesn't jibe with what corporation records should show? If a red (or even a pink) flag is raised, probe further.

Exactly what to look for depends on the type of business you are buying. For instance, if independent contractors are used in the business, check whether Form 1099s have been filed and other IRS reporting rules were met. (See Chapter 5, Tax Concerns of Employers.)

If a corporation's tax returns look strange to your tax pro, ask why. If items catch his attention, they might interest an IRS auditor as well.

Personal credit reports. You should also require selling shareholder(s) to furnish personal credit reports; be suspicious if they won't. Tax liens against the individual shareholders may show up on their personal credit reports; tax liens against their corporation, however, will not.

Put a disclosure requirements clause in the purchase contract. Use a clause something like this one: "Seller agrees to furnish copies of all business income and employment tax returns for the past three years within ten days of acceptance of this offer. Seller will give full access to all business records to buyer or his representative, for the purposes of verifying that there are no present or potential tax liabilities. Seller will provide a copy of a current credit report on all shareholders of the corporation."

Information from the IRS. Sellers often lie about business income and expenses. I've even seen them dummy up tax returns. Without confirmation from the IRS, you won't know whether or not the returns shown to you are the real thing. The solution: Require in your purchase agreement that the seller give you a signed *Tax Information Authorization* (Form 8821) for the individual shareholders as well as the business. This form, available on the IRS website or in the appendix of this book, allows you, or your attorney or tax pro, to access the seller's IRS tax records. Allow several weeks for the IRS to send computer printouts showing a business owner's (or corporation's) tax filing and payment history, and if any taxes are owing. Pay particular attention to whether employment tax returns were filed. Compare the tax disclosures the seller provided against the IRS records.

IRS printouts are free, but are in IRS code and difficult to decipher. Ask a tax pro to analyze them, or call the IRS and ask for an explanation.

Public records. Your county records office has books or computer files showing recorded federal and state tax liens against a business or its owners. If taxes are owed, the IRS may have recorded a Notice of Federal Tax Lien. Liens bear the tax ID number (either the Social Security or employer identification number) of the business or its owners.

Look up the names of the owners and the business's name in your county recorder's office or land registry office. Search records by computer, microfiche readers, or handwritten record books, depending on your locality. Ask a clerk for help, or hire a credit bureau, title company, or attorney to search the records for you.

> **EXAMPLE:** Harold wants to know if Alco Motors, Inc., or Al Coors, its principal shareholder, has ouststanding tax bills. He goes to the county records office and searches the name index for "Alco Motors, Inc." and for "Al Coors." Harold looks back ten years, because this is how long a tax lien is normally valid. No liens appear. This is a positive sign, but not a guarantee that Alco Motors or Al Coors doesn't owe taxes—it just means that no liens appear on the records.

Checking public records is not foolproof. The IRS doesn't always file lien notices on tax debtors.

UCC and state records. Check for state liens with your state's secretary of state or department of corporations (official titles vary from state to state). As with searching local records, you can do it yourself or hire an expert.

Get state lien information by sending a Form UCC-3 to your secretary of state's office with a small fee. ("UCC" means Uniform Commercial Code, a set of laws that has been adopted in most states.) UCC forms are available from the Internet and your secretary of state's office (many state agencies have websites from which you can download forms) or from stationery stores, reference libraries, business attorneys, or accountants.

The agency sends back a UCC filing report showing state tax liens, judgment liens, and financing liens on business equipment. UCC reports, however, are often incomplete or not up-to-date.

2. Indemnification

Your buy-sell contract should provide that the seller of stock of a small business corporation promises to pay any taxes and other liabilities discovered after the closing. While this indemnification clause obligates the seller to pay any hidden tax liabilities, if he disappears or can't pay, the pledge will be worthless. Your corporation will be stuck with the old tax liabilities.

3. Holdbacks and Offsets

What is your best protection from unknown tax liabilities when buying stock? Require part of the purchase price (perhaps 5% to 30%) to be kept in an account with an escrow company, attorney, or bank after closing.

This holdback money is earmarked to pay any corporate liabilities, including taxes discovered after the sale. The longer money is held back for contingencies, the better. Understandably, most sellers won't agree to holdbacks for longer than a few months. However, many sellers will agree to a longer period if the holdback account pays interest to them.

Alternatively, if you aren't paying for the stock in full (if you're paying some cash up front with an installment promissory note for the balance), you should always include an offset clause in your agreement. This lets you reduce promissory note payments by the amount of any undisclosed taxes or debts discovered after closing.

Remember to notify creditors. All states require that sellers of a business (or a major portion of its assets) notify all creditors of the business before the sale is completed. This is called a bulk sale notice, which is published in a local newspaper. Check with your legal adviser to make sure you are in compliance. If a bulk sales notice is not published, the buyer can be held liable for many debts of the seller.

C. Assigning a Price to Business Assets

As you negotiate the purchase of a business, you'll be evaluating each of its major assets. The tax code requires buyers and sellers to jointly agree on the amount of the purchase price allocated to each business asset or group of assets. (Amounts allocated must be at the fair market value and reported to the IRS.)

You will use these same values to calculate your tax depreciation deduction for each asset, and to figure the taxable gain or loss when you later sell or dispose of the asset or the whole business.

The overall price paid for a business or its assets usually reflects how eager the parties are to make a deal, not how much each item is really worth. Asset value allocations have great tax significance to a buyer.

Back up major asset valuations with appraisals. Professional appraisals are recommended, especially for deals over $100,000. If either side is ever audited, the IRS may question the asset valuations and allocations, and you'll need some backup. If the numbers are not in line with fair market values, the IRS can refigure them. This usually results in longer depreciation periods for the assets, which decreases a buyer's annual tax deductions—and produces an audit bill for the IRS's efforts. (See "Resources" at the end of this chapter for help finding an appraiser.)

EXAMPLE: Tony buys Ace Tool & Die from Jim for $95,000. After hiring an appraiser to determine the fair market value of each asset, Jim and Tony agree to allocate the purchase price as follows: $65,000 for machinery, $10,000 for goodwill, and $20,000 for a patent right. If either Tony or Jim is audited, they can produce a report from the appraiser backing up their allocations.

1. Classifying Assets for the IRS

Allocation of the business purchase price is reported on Form 8594, *Asset Acquisition Statement*. Both the buyer and the seller file this form along with their individual income tax returns in the year after the transaction.

The IRS allocation reporting process has two steps: First, you must classify the assets into the classes discussed below. Second, you must assign dollar values to each class according to tax code rules.

Get help with Form 8594. Classifying assets is complicated, and the IRS rules in this area are in a state of flux. Consult a tax pro before filing Form 8594. Also, see Regulations 1.1060-1 and 1.338-6.

2. Allocation to Seven IRS Classes

Here's how the asset allocation process works:

Business buyers and sellers must break down the transferred business assets into seven classes. (IRC § 1060(a).) Each class has different tax consequences, especially to a buyer. Naturally, most buyers want to classify assets in a way that gives them the fastest tax write-offs. (Types of assets and how fast they can be deducted are covered in Chapter 2, Writing Off Business Assets.)

Here are the seven asset classes:

Class one. Cash, demand deposits, and similar accounts in banks, savings and loan associations, and other depository institutions. Typically, the only cash transferred is minimal amounts in petty cash or in business checking accounts. Sellers usually clean out any savings or money market accounts.

Class two. Assets that can be easily converted to cash, including certificates of deposit (CDs), U.S. government securities, foreign currency, publicly traded stocks, and securities.

Class three. For all but a handful of businesses, the only asset in class three that is likely to apply is the accounts receivable of a business being transferred. But most buyers don't want the responsibility of collecting the former owner's accounts, so often these accounts receivable are not part of a business purchase and sale anyway.

Class four. Inventory offered for sale to customers is the main asset in this category. When a buyer agrees to purchase the existing inventory of a business, some of the goods are often unsaleable for one reason or another. In this case, a buyer should heavily discount the value of the inventory for allocation purposes.

Class five. A catchall for assets that don't fall into the other classes, including furniture and fixtures, land and buildings, and equipment. Some items in class five that deserve special attention are:

- **Land, buildings, and leases.** These items provide some of the biggest tax deductions the buyer is going to get out of the deal, so it pays to get a friendly, tax-savvy real estate expert to come up with written valuations.
- **Machinery and equipment, furniture, and fixtures.** These tangible items typically produce the fastest tax write-offs for buyers, so hopefully the buyer can allocate a significant portion of the purchase price to these assets. If a significant amount of business equipment is being transferred, get a written valuation from a dealer. For run-of-the-mill desks, chairs, and water coolers, you can get by with rough estimates of the used value.

Class six. Intangible assets, *except* for goodwill and going concern value. In general, an intangible asset is usually a legal *right*, rather than a thing that can be touched or physically possessed. Examples include books and records, patents, copyrights, designs, formulas, licenses, government-granted rights, covenants not to compete, trademarks, customer lists, and customer- or supplier-based intangibles (such as long-term contracts).

Generally, intangible assets have longer write-off periods than tangible assets—usually 15 years. Plus, accelerated depreciation methods are not allowed for intangible assets; deductions must be taken in equal annual amounts—which means $^1/_{15}$ of the cost per year for 15 years. This means it will take a buyer a long time to write off the cost of intangible assets.

Intangible assets are difficult to value. For valuable items, get valuations from a CPA or business valuation specialist.

Class seven. The only assets in this class are goodwill, or going concern, value.

Goodwill comprises the reputation and customer relationships of an existing business. If the price paid for a going concern exceeds the fair market value of all the rest of the assets, the IRS considers that the excess was paid for goodwill.

EXAMPLE: Sam pays $100,000 for Honest John's Network Communications Emporium. The cash and tangible assets of the business add up to $69,000: $1,000 in the cash drawer, $15,000 in inventory on hand, $3,000 worth of machinery, and a building worth $50,000. Why is Sam willing to pay $31,000 more than the value of all of the company's identifiable assets? Because Honest John's has a good location and a solid customer base. Sam thinks that a lot of John's customers will stick around, so he pays this premium for the business's goodwill.

3. Assigning Dollar Values to the Classes

After the buyer and seller divide the assets into seven classes, they must agree on dollar values for each class. They do this by allocating a part of the purchase price to each class.

EXAMPLE: Gunter, a sole proprietor, owns Geowhiz, a geothermal energy consulting firm. Kinte agrees to buy Geowhiz for $100,000. They make the following asset allocations:

- Class one: $1,000 in the business's bank account at the time of the transfer
- Class two: zero
- Class three: zero
- Class four: zero
- Class five: $14,500, the fair market value of office equipment included in the deal
- Class six: $42,000 assigned to Gunter's patent on a small geothermal measurement instrument (professionally appraised)
- Class seven: $42,500, the remaining sum, necessarily goes to goodwill by default.

The allocation will determine how quickly Kinte, the buyer, can write off the cost of the various assets and also Kinte's gain or loss when he later disposes of these assets.

A tax pro can help you make the best allocation analysis. The buyer and seller should agree on the allocation of asset costs as part of negotiating for the business. Because there is almost always flexibility in valuing assets, the buyer should propose the allocation of the purchase price in a way that provides the most tax benefit.

Typically, buyers want to allocate as much of the purchase price as possible to assets with the fastest tax write-offs—that is, those with the shortest depreciation periods. If it's realistic, attribute the lion's share to tangible assets, like equipment and fixtures which can be depreciated over as little as three years.

The amount allocated to an asset shouldn't exceed the fair market value of the asset. If an IRS auditor finds the allocation unreasonable, she can reallocate your stated purchase price. That's why it's a good idea to back up your allocations with an expert opinion.

Conversely, smaller values should be assigned to intangible assets, because they have 15-year write-off periods. Keep in mind that commercial real estate, with a depreciation period of 39 years, requires the longest time to write off your costs.

D. State and Local Transfer Taxes

The state, county, or city where the business or its assets are located may impose a transfer tax on either the buyer or the seller. This is common whenever real estate changes owners.

If the transfer tax is on the seller, then your agreement should provide that it be paid out of escrow at closing. Be aware that if the seller doesn't pay a transfer tax, the taxing agency can usually come after the buyer or the business assets.

Make sure state and local taxes are paid off. Some states or localities impose taxes, such as annual personal property taxes, on business fixtures and equipment or on inventory. Ask for proof that these types of taxes are not delinquent, or are paid at the time of closing—or else you may inherit them.

Resources

- IRS Form 8594, *Asset Acquisition Statement,* and instructions. The instructions provide more details on allocating business assets. A copy of the form is in the appendix.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This self-help book has a lot of nontax pointers on buying a business.
- *Quicken Legal Business Pro*. This software includes purchase agreements with comprehensive instructions.
- To locate an appraiser of business assets, check the Yellow Pages under "Appraisers" or go to www.appraisers.org, www.go-iba.org, or www.nacva.com.

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CHAPTER

17

Selling a Sole Proprietorship

"The business of America is business."

— Calvin Coolidge

This chapter focuses on the tax consequences of selling a sole proprietorship. The flip side, buying a business, is covered in Chapter 16. To get a well-rounded tax picture, take a look at that chapter, too.

If you are not a sole proprietor, go to these other chapters:

- Transferring a partnership (or limited liability company interest) is covered in Chapter 9, Partnerships.
- Selling a corporation's shares is covered in Chapter 8, S Corporations, and Chapter 7, C Corporations.

Congress, realizing that there are opportunities for people to play tax games on business transfers, has enacted laws to ensure that Uncle Sam gets his cut. To pass IRS muster, the sale of a business must be bona fide—that is, the price and terms must be realistic in the business world.

If you sell to a stranger, chances are the deal is fair, and the IRS won't bother you as long as you report it and pay any taxes due. But if you deal with a relative or close friend, an IRS auditor may find that the sale terms weren't realistic and will hit you with a tax bill.

Selling a Business in a Nutshell

1. Selling a business or its assets is a taxable event, meaning that it usually produces a gain or loss to the seller.
2. Tax rules for sales of a business interest may depend on whether the business is a sole proprietorship, partnership, limited liability company, or S or C corporation.
3. A business is a collection of assets. The IRS requires the buyer and seller to allocate the purchase price to specific classes of assets.
4. Transfers of businesses between related parties look suspicious to IRS auditors.

A. Selling Assets of a Sole Proprietorship

A business is just a collection of assets—typically, equipment, inventory, and goodwill. The tax code requires that sellers and buyers assign a specific value to each asset or groups of similar assets. (The process and rules for allocating the purchase price of a business to specific assets are covered in Chapter 16, Section C.)

EXAMPLE: Harry sells his business, Bagel World, to Sally for $45,000. They agree that the kitchen equipment and ovens are worth $30,000; the furniture, $2,000; computers and cash registers, $3,000; the store lease, $9,000; and the goodwill of the business, $1,000. Harry's taxable gain or loss must be figured on each of these items, as discussed below.

Report the sale of your business to the IRS by attaching Form 8594, *Asset Acquisition Statement,* to that year's income tax return.

Whenever you sell a business asset, you might have a taxable gain, and Uncle Sam wants his share of it. On the other hand, if you have a loss from the sale, there may be a tax savings opportunity.

Report any gain or loss on your sale of business assets on Form 4797, *Sales of Business Property,* to be attached to that same tax return. (Both the IRS forms are in the appendix to this book.)

1. Figuring Gain or Loss

Whenever a sole proprietorship is sold, each asset transferred must be analyzed separately for tax consequences. Your gain or loss is determined by subtracting your tax basis (see Chapter 2, Section D) from the sales price for the asset. Typically, you will have taken depreciation deductions for the assets in the years of ownership prior to the sale. If you have a gain, you must repay the deprecation deductions you've taken. This is called depreciation recapture.

EXAMPLE 1: Don, who owns Don's Trucking, sells a diesel engine rebuilding machine to Bruce for $15,000. Don paid $30,000 for it and had taken depreciation deductions totaling $20,000 in past years. These deductions reduced Don's tax basis in the machinery to $10,000. Don sells the machine for $15,000, $5,000 more than his tax basis. He has a taxable gain of $5,000—even though he sold it for less than he originally paid for it. In a sense, Don is repaying the government for a prior tax deduction.

EXAMPLE 2: Now assume Don's machinery is in bad shape and he gets only $8,000 from Bruce—$2,000 less than his tax basis. Don has a loss of $2,000 for tax purposes (a $2,000 tax deduction).

EXAMPLE 3: Don's machinery became worthless due to technological advances and the unavailability of parts. Don's tax basis is $10,000 when he sells the machinery to Giuseppe, a scrap metal dealer, for $10. Don has a tax loss of $9,990. Don could junk the equipment himself and take a $10,000 tax write-off. However, a documented sale to a third party looks better in case the IRS ever audits.

2. How Gain or Loss Is Taxed

Special tax rules apply when the assets of a sole proprietorship are sold. Business assets (such as equipment, vehicles, and buildings) held for at least one year are called Section 1231 assets. As such, they may or may not qualify for favorable capital gains tax rate treatment when sold. I'll summarize the rules.

If a Section 1231 asset is sold at a gain (meaning it's sold for more than your tax basis in the asset), the gain is taxed as ordinary income to the extent that it represents the recapture of deprecation deductions taken in prior periods. Any gain over the depreciation recapture is taxed at a more favorable capital gains tax rate. Let's look at some examples.

EXAMPLE 1: Don sells his diesel engine rebuilding machine for $15,000—$5,000 over the machine's basis of $10,000. That $5,000 of gain is owed to his depreciation deductions, so Don owes tax on $5,000 at his ordinary income tax rate. Assuming Don is in the highest federal tax bracket (35%), he will pay $1,750 in taxes.

EXAMPLE 2: Let's change the facts a little. Don sells the machine for $35,000, before taking any deprecation deductions. Don has a taxable gain of $5,000, as in the original example, but it is now a Section 1231 gain. Don's $5,000 gain is taxed at his capital gains rate of 20%, meaning a tax of $1,000.

The rules are trickier than these examples let on, particularly for real estate. Luckily, tax preparation software makes all the calculations for you. Filling in the mind-boggling IRS Form 4797, *Sales of Business Property,* is what tax pros and computers were made for. (For all the gory details, see IRS Publication 544, *Sales and Other Dispositions of Assets.*)

Spread out taxes by using an installment sale. Sellers facing a large taxable gain on the sale of their business might consider selling on the installment plan.

For example, a sale with 20% down and the balance paid over five years (with interest, of course), will spread the tax on the gain over five years. This is a way to, in effect, income average. Sellers will likely be in a lower tax bracket for each year by not getting paid all at once. Of course, there is always the risk that the buyer may not make the payments. See IRC § 453 for other rules on installment sales, or ask a tax pro whether or not an installment sale would be tax savvy for you.

B. The Importance of an Arms-Length Deal

If a business or its assets change hands for an artificially low price, the IRS usually loses out. But often the true sales price is not clear because business transfers may involve exchanges, promissory notes, or unusual terms dreamt up by attorneys and accountants.

Sweetheart deals. Even when the sale price looks fair, the terms may not be commercially reasonable in the IRS's eyes. For instance, a business sold for no money down and paid off over 50 years at an interest rate of 3%, is not a deal any seller would make without an ulterior motive—most likely, tax avoidance. Such deals often mean a son, daughter, or other relative is the buyer. Sweetheart deals look more like gifts than business transactions.

The IRS auditor can look past the stated terms of the deal and rewrite it to reflect its true economic substance.

If you sell your business to a family member—directly or indirectly—be careful. While the IRS doesn't routinely monitor sales of businesses, if an auditor raises the issue, you must prove this was a bona fide business transaction. The IRS can disregard your figures and terms and present you with an audit bill.

> EXAMPLE: Bill, a sole proprietor nearing 70 and in poor health, sells his coffee shop chain, Moonbucks, to his son Junior for $100,000. This price equals Bill's tax basis in the business assets of Moonbucks. It doesn't include any value for the tremendous amount of goodwill the business has built up. Any other buyer would be glad to pay $1 million for Moonbucks. So by selling to Junior at the bargain price, Bill is avoiding income taxes and estate taxes as well (see below). If Bill were audited, the IRS would hit him with taxes on an additional $900,000 of income, because this was not an arms-length deal.

Unrelated parties. On the other hand, if you make an arms-length deal with an unrelated party, the IRS normally won't question it.

The Estate Tax Angle

Income taxes aren't the IRS's only concern when family members are involved. The IRS is also looking ahead to collecting federal estate taxes someday. As discussed in Chapter 12, Family Businesses, everyone may leave $1.5 million in 2005 free of estate tax. Over the next few years, the estate tax exemption will gradually increase to $3.5 million by 2009.

Until repeal of the estate tax, anything over the exempt amount is taxed starting at 37% and going as high as 49% (although this top rate will gradually decrease to 45%). To avoid estate tax, older business owners have a strong incentive to sell to relatives for bargain prices, or on special terms.

> EXAMPLE: After Bill (from the preceding example) sells Moonbucks (worth $1 million) to his son for $100,000, Bill's total estate is valued at $1.5 million—below the amount that can be passed at his death tax-free. However, if Bill owned Moonbucks at his death, his estate would be $2.4 million, producing a hefty federal estate tax. So, besides beating the income tax law by selling Moonbucks to Junior for $100,000, his estate escapes estate tax as well. (See Chapter 12, Family Businesses, for some advantageous but legal ways to minimize estate taxes when transferring businesses to family members.)

C. How to Protect Yourself From IRS Challenges

There is no way to IRS-proof yourself when selling your business, but you can do several things to reduce the odds of an IRS attack.

1. Set a Reasonable Price and Terms

Except in very small deals, have your business assets evaluated by an expert. Valuation specialists include accountants and business brokers. Or, a seller of similar equipment or a dealer in the same type of merchandise can appraise or make offers. Keep the written opinion or offer of these experts in case the IRS auditor comes calling.

If you are making a special deal for family or friends, there are some legitimate steps to save taxes. Transferring your business incrementally over several years instead of all at once may be a tax planning opportunity (or loophole, if you like). This is because the tax law recognizes a minority interest discount. It works likes this:

Whenever you sell less than all of your business—for instance, a one-third interest—you are allowed to discount the value of this minority interest for tax reporting. The larger the discount, the less taxable gain to you from the sale. Reductions of 40% off the value of a minority interest in a business have been upheld in the courts against IRS attacks. (See Chapter 12, Family Businesses, and run this by a tax pro before claiming a minority interest discount.)

2. Observe the Formalities

Selling an enterprise doesn't require a formal contract, for tax purposes. The deal can be written on the back of a napkin, for all the IRS cares. The IRS's only interest is whether it is losing any taxes that should have been paid on the transaction.

The more "legal" a deal appears, the less likely the IRS is to challenge its tax implications at an audit. That doesn't mean you can make anything fly with a lot of legal boilerplate and neat typing, but you are ahead of the game if you followed normal business formalities. IRS auditors are fairly unsophisticated about business practices, but some can smell a rat.

Hire a business attorney. Using an attorney and producing a raft of supporting documents lends an air of legitimacy to the deal. For all but the smallest deals, have a business attorney by your side. A tax pro should be consulted as well if the size of the deal justifies the expense. Professional fees are deductible—which makes them easier to swallow.

3. Allocate Asset Values Fairly

When a business—or substantially all of its assets—is sold, both the buyer and seller must agree upon the value of the assets. Usually the IRS accepts the valuations, but an auditor may question whether the overall price is fair if the parties are related (as discussed above).

The seller and buyer must attach an identical Form 8594, *Asset Acquisition Statement,* to their tax returns. If the forms aren't identical, an IRS computer cross-check might discover the discrepancy and audit the buyer or the seller or both.

See Chapter 16, Section C, for details on Form 8594 and for tips on allocating values to business assets.

Remember to notify creditors. All states require that sellers of a business (or a major portion of its assets) notify all creditors of the business before the sale is completed. This is called a bulk sale notice, which is published in a local newspaper. Check with your legal adviser to make sure you are in compliance. If a bulk sales notice is not published, the buyer can be held liable for many debts of the seller.

4. Keep Your Records After the Sale

Good records help sell a business, but don't turn original records over to the buyer. The reason is that you remain responsible for an IRS audit after the business is sold. You have three tax years after the transfer to worry about an audit; to be on the safe side, keep records six years. (See Chapter 19, Audits.)

Resources

- IRS Publication 537, *Installment Sales*.
- IRS Publication 544, *Sales & Other Dispositions of Assets*.
- IRS Form 4797, *Sales of Business Property*.
- IRS Form 8594, *Asset Acquisition Statement* and Instructions for Form 8594. The instructions provide more details than are given here. (A copy of the form is in the appendix.)
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This self-help book has a lot of nontax pointers for sellers of a business.
- To locate an appraiser of business assets, check the Yellow Pages under "Appraisers" or go to www.appraisers.org, www.go-iba.org, or www.nacva.com.

■

CHAPTER

18

When You Can't Pay Your Taxes

"Creditors have better memories than debtors."
— Benjamin Franklin

The IRS has enormous legal powers to collect past due taxes—it is tougher than any other bill collector you're ever likely to face, with the possible exception of the Mafia. The IRS can seize just about anything that you own, including your bank account, home, and wages.

The IRS doesn't need a court order or judgment before closing your business and grabbing your assets. In most cases, the IRS only has to send you a demand letter before it acts—and in some circumstances, it isn't compelled to give you any warning at all. The IRS can even close your business down by seizing your assets or padlocking your doors.

However, the awesome IRS collection machine won't crush you if you know how it works and you know your legal options. For instance, you can bargain for more time to pay or maybe for a reduction of the amount owed. If your financial situation is truly dire, you can request to be put on hold while the IRS bothers other poor souls.

One crucial thing to remember, if you're behind on taxes and want to stay in business, is to keep in touch with the IRS. The worst thing you can do when you get behind in your taxes is to bury your head in the sand. A business is a sitting target; it can't run. The IRS might leave you alone for a while, but usually not for long. Unless you are out of business, flat broke, unemployed and likely to remain that way, IRS tax collectors will be hovering.

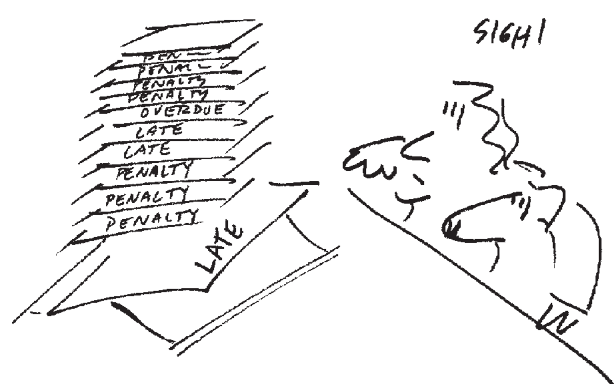
On the plus side, the IRS collection machine is slow to start and react, which gives you time to plan your next move. You'll get a raft of computerized tax bills and maybe IRS telephone calls, too. But it might be months or even several years before you have to confront the IRS face to face. With limited personnel, the IRS tries everything before assigning a real person to your case.

Don't get too comfortable, though, just because no one knocks on your door. Every year the computerized IRS collection system gets bigger, faster, and meaner. Computer-generated tax liens and levies can make your life every bit as miserable as human collectors can.

And keep this in mind: Father Time is especially cruel to tax debts—they grow larger every day with mounting interest and penalties.

IRS Collections in a Nutshell

1. The IRS has legal powers that no other debt collector has; it can seize bank accounts and just about anything else that you own—sometimes without warning.
2. You don't have to disclose financial information to an IRS collector unless you are formally served with a summons.
3. The IRS can, but rarely does, shut businesses down—usually for unpaid payroll taxes.
4. Tax debtors may pay off old tax bills in monthly installments, but interest—and usually penalties, too—is always accumulating.
5. Some folks can make a deal with the IRS to settle a tax bill for pennies on the dollar through the offer in compromise process.
6. If you file for bankruptcy, you may be able to hold off the IRS and wipe out some tax debts—but you can never wipe out most payroll tax debts.



Recommended Reading. The strategies discussed in this chapter are covered at length in *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

A. If You Owe Less Than $25,000

If you owe less than $25,000, chances are your account is a fairly low IRS priority. It may be a lot of money to you, but it's small potatoes to the IRS. Often, the IRS won't assign a case to a collector if the balance due is less than $25,000—but it will hound you by mail and telephone.

If you owe payroll taxes, there is no minimum threshold for vigorous collection efforts. Chapter 5, Section B, explains how the IRS pursues business owners who fall behind on payroll taxes.

B. Getting More Time to Pay

Generally, if you can't pay a tax bill you have received, the first thing to do is call or write to the IRS at the number or address on the bill and request more time. A request for a 30- to 60-day delay is usually honored if you haven't called more than once or twice before. If asked, explain why you need the extra time—for example, because you are applying for a loan or waiting for a customer to pay up.

Request more time to pay even if you won't be able to meet the new deadline. The IRS rarely gives you an extension longer than a few months, so you may have to agree to a deadline you can't keep. It is easier to get several short extensions—a month or two—rather than one long one. This is the way the IRS operates, presumably to keep the pressure on you.

If you are granted a reprieve by phone, you may not get anything in writing from the IRS to confirm your deal. A new due date will be entered into the computer, but don't expect a reminder from the IRS when the time is up. Note the new deadline on your calendar; then contact the IRS before it is up if you still need more time. You may have to make a partial payment to get more time.

C. Paying in Installments

If you need more than a few months, ask the IRS for an installment payment agreement. A monthly payment plan relieves you of the worry that the IRS will seize your wages or assets—as long as you make payments.

You have no legal right to pay overdue taxes in installments, but the IRS usually agrees to monthly payments. *Your Rights as a Taxpayer* (IRS Publication 1) says that you have the right to propose an installment agreement, and that the IRS must fairly consider it. The hitch is that you must show you can't pay your bill in full from your present resources.

To request to pay in installments, call or write to the IRS. If writing, send a copy of the tax bill or, even better, file IRS Form 9465, *Request for Installment Payments*. If you have already been in contact with a specific person at the IRS, direct your request directly to that person. If the IRS agrees, you'll get written confirmation and monthly payment vouchers. For more information, see *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

If your request is granted, you pay the IRS monthly, like a credit card balance. And, as with your Visa or MasterCard, an interest charge is added (discussed further just below). The IRS also imposes a $43 user fee for setting up an installment plan. As mentioned above, the IRS is tough on payroll tax delinquencies, and may not allow you a long-term payment plan for this type of tax debt.

Time Limit on IRS to Collect Tax Debts

There is some justice, even in the tax world. The law limits the IRS to ten years from the date a tax is assessed to collect it. (IRC § 6402(a).) After that, you are home free! However, taking certain actions—filing for bankruptcy, making an offer in compromise, or signing an IRS extension form—can lengthen the time limit beyond ten years. Nevertheless, since a business failure or other catastrophe can put you into a very deep tax hole, it is comforting to know that there is some light at the end of the tunnel.

1. Interest and Penalties

There is no free lunch with the IRS. A major downside to paying the IRS on an installment plan is that interest and late-payment penalties keep adding up. Recently, interest and penalties have run at a combined rate of 6% to 10% per year. If your installment payments are low and the unpaid balance sufficiently large, you may find the balance you owe the IRS is increasing every month.

> EXAMPLE: Carson owes the IRS $40,000 for back payroll taxes from her failed graphic design studio. The IRS determines Carson can pay $300 per month. She is also charged 12% interest and penalties, adding $4,800 per year to her bill. One year later, after paying $300 per month, Carson owes $41,200, which is $1,200 more than her original bill! (Carson has some other alternatives in dealing with the IRS, discussed below.)

2. Under $25,000 Payment Plans

If you owe less than $25,000, you qualify for an automatic installment payment plan. Make your proposal on Form 9465.

The catch is that your proposed payments must be sufficient to pay the bill in full within 36 months. Monthly payments must be equal. Interest, around 6% annually, and late payment penalties of ¼% per month, will be added.

You can always make larger payments than called for in the plan, but if you send less, the plan may be canceled. If you can't make a full payment, call the IRS to ask for permission to send less.

The IRS is tougher on payroll taxes. If you owe back payroll taxes—in any amount—the IRS may require detailed financial information and faster payoffs.

3. Over $25,000 Payment Plans

If you owe over $25,000, your monthly payment amount is whatever the IRS perceives as your maximum ability to pay. This is determined by the IRS's evaluation of the financial information it has gotten from you and recorded on its collection information statements. (These forms are discussed in Section D, below.)

The IRS rarely accepts less than $50 per month, and payment plans can be as high as $5,000 per month—it all depends on your financial circumstances. The IRS welcomes any payments over the agreed-upon amount. Prepaying cuts down the interest and penalty charges that always continue to accrue during the installment plan.

If the IRS asks for more in monthly payments than you can afford—as is frequently the case—you can attempt to negotiate. How successful you are may depend on your powers of persuasion.

Make sure your requests get to the right IRS department. When writing about a bill, always send the IRS a copy of the notice, using the bar-coded IRS return envelope that came with it. This ensures that your request for more time or an installment agreement gets to the right department.

4. If You Fall Behind on Your Payments

If you get an installment plan, make the payments faithfully each month. If you don't, the IRS can void the agreement and start seizing your bank accounts and other assets.

If you can't make a payment, call the IRS and explain your circumstances. Ask that the agreement not be defaulted. Promise to catch up in the next month or request that the monthly amount be lowered because of an unexpected reversal of fortune. The IRS may be sympathetic and go along if you stay in touch.

If the plan is reinstated, you may be charged an additional fee of $24 for this privilege.

D. What to Expect When the IRS Gets Serious

If you get behind on taxes, a raft of threatening past due notices and many months or even years may pass before the IRS gets serious. But if you owe more than $25,000 in income taxes, or payroll taxes in any amount, you may eventually be visited by an IRS revenue officer—the elite collectors of the IRS. These folks are to be both feared and respected for their powers.

1. The Sneak Attack

Revenue officers usually show up at your business or home unannounced, often before 9 or after 5. The collector will start grilling you right then and there—if you let him.

Keep calm and resist the urge to curse your luck or the IRS. Instead of giving off-the-cuff answers, say that you need time to get financial information together. Emphasize that you want to deal with your tax problems and will meet the collector at the IRS office within a week or two. Avoid making any financial commitments at this time unless you are absolutely certain you can follow through.

2. Meeting With the Collector

Collectors ask for information about both your business and personal finances. This data is entered on IRS Collection Form 433-A for your personal finances and self-employment income and Form 433-B for a separate business entity's assets, liabilities, income, and expenses. After these forms are completed, you will be asked to read, verify, and sign them.

Know what information the IRS wants before the meeting with the revenue officer. Obtain Forms 433-A and 433-B from IRS offices, at www.irs.gov or by calling 800-829-1040. These forms are discussed in detail in *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

Don't be rushed into signing a Form 433. Data on these forms is the key to further IRS collection efforts. A misstatement or wrong figure—intentional or not—is not easy to correct.

Resist pressure from a collector to complete and sign the financial forms at the first interview. Ask for time to review them. Explain that you want to be sure everything is correct and that your memory is not good enough to do it right then and there; you need to check your records first.

Beware of the "necessary living expenses" trap. When filling out IRS Form 433-A, pay strict attention to the "necessary living expenses" questions. This is the crucial area in the IRS determination of how big your payments must be (or what kind of offer in compromise it will accept, as discussed in Section E, below). The IRS expects you to keep a minimal lifestyle until the tax debt is paid off. Expenses for private schools, trips to Hawaii, or champagne-and-caviar grocery bills aren't tolerated.

Don't underestimate your family's living expenses—list where every penny goes every month. Write in the comments section on the Form 433-A if your expenses will increase in the near future (a baby is on the way, your car needs a new transmission, and so on). If your income is likely to decrease, your spouse is about to be laid off, or one of your major customers has declared bankruptcy, mention that as well. Paint it black.

Are Your Personal Assets at Risk?

Whether or not the IRS can come after your personal assets for business-related taxes—or after your business assets when you owe personal taxes—depends on the form of your business entity and the type of taxes owed.

If you operate as a *sole proprietorship*, there is no legal distinction between your business and you. Accordingly, the IRS can grab just about anything you own for any kind of tax debt.

If you are in a *partnership* or *limited liability company*, the IRS can go after your share of property owned by the company. The IRS can also tag the personal assets of any general partner for 100% of a tax debt of the partnership.

If your business is *incorporated*, your personal assets may or may not be shielded from corporate tax bills. If a small business corporation owes payroll taxes, the IRS can go directly after personal assets of all responsible shareholders and officers (as discussed in Chapter 5, Tax Concerns of Employers).

Conversely, because a corporation is a separate tax entity from its owners, the IRS can't seize corporation assets for bills owed by its shareholders. However, if shareholders are using the corporation just to keep assets away from the IRS, the IRS may be able to reach the corporate assets. (That's why it's critical to observe corporate formalities.)

While the IRS can't usually take corporate assets to satisfy your personal tax debts, it can seize your shares of stock in a corporation. But since stock of a small business corporation is difficult to sell, the IRS rarely bothers to take it.

3. Actions the Tax Collector Can Take

Entrepreneurs are natural-born optimists. Typically, when small business owners get behind on their bills—including taxes—they believe that things will turn around any day and they'll pay back everyone.

IRS collectors, however, are born pessimists. They want their money now, not pie in the sky. If you don't pay, the IRS will ask for a list of everyone who owes you money (your business's accounts receivable) and the name of your bank. This gives the IRS a road map for places to go to seize assets—which can force you out of business real fast.

After analyzing your finances, a revenue officer can proceed in one (or more) of the following ways:

- Demand immediate payment of the full amount if she believes you can pay without much difficulty.
- Ask you to apply for a loan from at least two financial institutions.
- Ask you to sell any assets not currently used in your business, or personal items she considers extravagant—for example, a second home or a pleasure boat.
- Propose an IRS installment agreement allowing monthly payments. (See Section C, above.)
- Suggest you submit an offer in compromise (see Section E, below) to settle the tax bill for less than the balance due.
- Begin enforced collection against your business—and maybe personal—assets. This means seizing bank accounts, accounts receivable, equipment, and other things you own. (See Section F, below.)
- Report your file as currently not collectible, if she can't locate enough assets or income for even a nominal payment. Even the IRS has heard about getting blood from turnips. In IRS lingo, this is called "53-ing" a case—a collector can submit IRS Form 53 to her superiors. If approved, IRS collection efforts are suspended, but interest and penalties continue to mount.

  Suspension doesn't last forever—every six to 18 months, the IRS computer may bring up your account. You may be contacted and asked to update your financial situation. If you rejoin the ranks of the employed while on 53 status, the IRS expects you to notify them—but they won't find out automatically.

Regardless of which course the IRS collector pursues, she will demand that—if your business is still operating—you stay current on all required tax filings. These include personal income tax returns and business payroll tax returns (if you have employees). If you have income from your sole proprietorship, limited liability company, or partnership, you must make quarterly estimated tax payments as well. Furnish evidence that these filings are current to the IRS.

If you don't pay payroll taxes, your business is in jeopardy. The IRS will shut down a business with employees if it's not making current payroll tax deposits. You may be allowed to keep your doors open if you owe past-due payroll taxes, but only if you keep current on new taxes (and if you agree to a payment plan for old ones).

Will the IRS Close Down Your Business?

Revenue officers will pressure you into coming up with money to pay your back taxes. But their bark is often worse than their bite. In fact, at the IRS, padlocking the doors of a delinquent taxpayer's business is considered an admission of failure, not a badge of honor. It doesn't usually result in revenue for the government, because auction sales of business equipment typically don't bring much in—often not enough to cover the costs of seizing, storing, advertising, and selling the items. Realistically, a shutdown is unlikely because it is simply too much trouble and paperwork—except when you owe payroll taxes for the current quarter.

4. Cooperating With the Collector

IRS collectors typically ask where you bank and for a list of the business's accounts receivable. The IRS can use this information to start seizing income.

While lying to any IRS employee is a crime, not answering questions is legal. If you don't provide financial data, the IRS won't beat you with rubber hoses.

The worst that can happen is that an IRS collector may issue a summons—a legally enforceable order requiring you to appear and provide information under oath. If a collector issues a summons, it usually means she suspects you of hiding assets. However, the IRS doesn't issue summonses very often.

Never ignore an IRS summons. This could get you hauled in front of a federal judge and jailed. If you have few assets, you probably have little to lose by cooperating. If you have a lot to lose, talk to a tax attorney before answering a summons.

E. Dealing With a Monster Tax Bill

Sad to say, lots of people have huge tax bills and little hope of ever being able to pay.

EXAMPLE: The Smiths' computer store is faced with a new deep-discounting competitor across the street. Trying to keep their business afloat, the Smiths run up $800,000 in debts—including $300,000 to the IRS for payroll taxes—before calling it quits. Sam Smith goes to work as a salesperson, earning $25,000 per year, and Jeannie Smith now earns $15,000 a year as a part-time bank teller. The Smiths' combined earnings are less than the annual IRS interest and penalties on their $300,000 tax bill. Even if they cut expenses to the bone, they will probably never be able to pay off their tax bill. What should the Smiths do? Hint: The answer is not move to Brazil.

Take heart—there are ways to reduce or even eliminate gargantuan tax bills. One way is the offer in compromise. For some folks, another solution is bankruptcy. Let's look at both possibilities.

1. The Offer in Compromise

Under its offer in compromise program, the IRS sometimes accepts a few cents on the dollar and calls things square. (IRM §§ 57(10)1, IRC 7122.) For example, in 1994, after hounding country singer Willie Nelson since 1980, the IRS accepted a final compromise settlement of $9 million on a $32 million tax bill. The IRS accepts many offers in compromise that are properly submitted and not too outlandish.

Don't think that the IRS takes the forgiving of any tax debt lightly. It will accept less only if it is doubtful more will be collected later. To get the IRS to accept an offer in compromise, you must demonstrate to the IRS that it's in its—not your—best interests.

An offer in compromise *must* be made on IRS Form 656. It must be accompanied by a completed IRS Form 433-A (individual) and, if you have a separate business entity, Form 433-B (business). (These are the forms used in all IRS collection situations, discussed in Section D, above.)

You'll be asked to provide verification—such as bank statements for the past three to 12 months, living expense receipts, vehicle titles, mortgage notes, rental and lease agreements, and a list of outstanding debts.

EXAMPLE: The Smiths, whose failed computer business left them with $300,000 in tax debts, make an offer in compromise. They give a Form 433-A and documentation to verify their poor financial state. After losing most of their assets to creditors, the Smiths' financial form is relatively simple. Form 433-B is not necessary, because the Smiths are no longer in business and now have jobs earning minimum wage. They offer the IRS $25,000, to be provided by Jeannie's mother. Will the IRS accept this? I think the Smiths have a good shot.

Recommended Reading. For details on how to present an offer to the IRS, see Chapter 6 of *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

2. Bankruptcy

Bankruptcy laws have changed! Congress has drastically revised the bankruptcy code. Bankruptcy is now much less attractive—and more onerous—for bankruptcy filers. Go to Nolo's Bankruptcy area at www.nolo.com for the latest information.

Bankruptcy still offers another way out to some small business owners who have impossibly large bills. Despite IRS misinformation to the contrary, it is possible to reduce or even wipe out certain business and personal federal tax debts—but not all kinds of taxes—through the federal bankruptcy courts. Although the details of bankruptcy are beyond the scope of this book, let's briefly review the tax effects of a filing a petition under the U.S. Bankruptcy Code.

The Automatic Stay

One of the most alluring features of filing for bankruptcy is the automatic stay. It works like this: The moment you file a bankruptcy petition, all creditors—including the IRS—are stopped cold. No further seizures, or even threats, can be made by the IRS for as long as your case is pending. Some folks file bankruptcy just to buy time, without ever intending to follow through—simply to stop the IRS from seizing property or otherwise putting them out of business. (This is not strictly legal.)

A variety of bankruptcy code options are available to small business people. These are usually referred to by the number given to their location in the federal bankruptcy code: Chapter 7, Chapter 11, Chapter 12, and Chapter 13. As you will see, each chapter allows you to get a different kind of relief from your tax problems.

a. Chapter 7

Straight liquidation bankruptcy, called Chapter 7, allows some individuals to wipe out most of their unsecured debts—including older income taxes.

The rules get complicated fast, but bankruptcy may be the answer to your prayers if you qualify.

Income taxes due more than three years ago might be wiped out in a Chapter 7 bankruptcy if both of the following are true:

- Tax returns for these debts were filed at least two years ago.
- The tax bill has been on the IRS's books (assessed) for at least 240 days.

However, most payroll taxes and Trust Fund Recovery Penalty taxes can't be wiped out in bankruptcy.

EXAMPLE: As a result of the failure of their business in 2000, Tom and Barbara Keene owe $500,000 to unsecured creditors and $300,000 in trust fund payroll taxes to the IRS. They owe another $20,000 for their jointly filed individual income taxes for 2000, which they weren't able to pay when the return was filed on April 15, 2001. This is added to the $70,000 they owe the IRS from an audit of a late-filed 1995 tax return, completed January 15, 2004.

The Keenes file a Chapter 7 bankruptcy in May 2004. The general creditor bills of $500,000 can be wiped out. The $300,000 in payroll taxes are not dischargeable. The $20,000 of 2000 individual taxes are dischargeable after April 15, 2004 (three years after the tax return was due). The added $70,000 audit debt from 1995 tax returrn does not qualify for discharge because the bankruptcy wasn't filed more than 240 days after January 15, 2004, when the taxes were assessed.

Obviously, bankruptcy is not for everyone. See *Bankruptcy: Is It the Right Solution to Your Debt Problems?*, by Robin Leonard (Nolo), for more information.

b. Chapter 13

Partial debt repayment plans for wage earners and self-employed folks are known as Chapter 13 plans. This provision permits any debtor (except a corporation) to repay debts monthly, including any kind of taxes. There are some restrictions on who can use Chapter 13. (Chapter 12 gives farmers a repayment option similar to Chapter 13.)

When filing for Chapter 13, you propose a plan based on formulas established by the IRS for reasonable living expenses. This figure deducted from your income determines the amount you will have to pay your creditors monthly through a Chapter 13 plan. Repayment plans typically run five years, but the bankruptcy judge may order repayment plans of only three years. A plan must provide for full payment of some types of debts, but other debts can be reduced or even wiped out at the discretion of the court.

Tax bills arising within three years of filing for Chapter 13 must be paid in full through the plan—but interest and penalties stop accruing once the petition is filed. Generally, if an income tax bill is over three years old, it may be reduced by the judge in a Chapter 13 plan.

> **EXAMPLE:** Jim and Jackie Jones owe creditors a total of $90,000, including $40,000 in income taxes that are more than three years old. The Joneses file for Chapter 13 bankruptcy, qualifying for a debt repayment plan of $500 per month. If the bankruptcy judge approves the plan, Jim and Jackie will be ordered to make monthly payments to a bankruptcy trustee for a period of up to 60 months.
>
> After that time, if all payments are made, the balance of the debts, including taxes, is discharged by the court.

c. Chapter 11

Chapter 11, called a bankruptcy reorganization, requires at least partial repayment of debts. Chapter 11 works for those with debts in excess of Chapter 13 limits. Chapter 11 is too complicated and expensive for most small businesses. A fast-track Chapter 11 procedure, for small businesses with debts up to $2 million, simplifies the procedures somewhat, but requires an experienced bankruptcy attorney.

F. When the IRS Can Take Your Assets

If you and the IRS don't agree on repayment of back taxes and you don't file for bankruptcy, you face what the IRS calls enforced collection. This usually means a tax *lien* and *levy*.

1. Federal Tax Liens

If you owe a tax bill, the IRS may record a notice of federal tax lien in the public records in your county. (IRC § 6323(f).)

A recorded lien shows the world, or at least anyone who bothers to look, that you have a federal tax debt and the original amount you owe. Lien notices are often picked up and reported in local newspapers and business publications. Credit bureaus collect tax lien information and sell it.

The IRS may record a tax lien if you owe more than $10,000 and you don't agree to pay it off within a year. The IRS doesn't always file a tax lien; it is hit or miss. Whenever you are dealing with a collector, request the IRS not to file a lien. Once recorded, it is very difficult to get a tax lien released without making full payment to the IRS.

A tax lien becomes a legal charge against all of your assets, much like a mortgage or deed of trust on real estate. A tax lien is the kiss of death to a credit rating.

Congress grants the IRS the right to take just about anything you own to satisfy a tax lien. Lenders will shun you, and others may fear that the IRS might grab their money or goods in your possession.

2. Federal Tax Levies: Seizing Assets

A tax lien doesn't take any of your property—a tax levy does. A levy occurs when the IRS physically seizes your assets to satisfy a tax debt. The IRS may grab something directly (such as your office equipment), or it may make a written demand to someone holding your property (your bank, for example). A levy may follow closely behind a tax lien notice, or happen without a tax lien being filed, or it may never happen at all.

Seizures are most likely when you refuse to deal with the tax problem or you can't be located. When you hear about the IRS padlocking a business, you can bet it didn't come out of the blue. The IRS first warns the individual or business owner of its intent in writing.

Once the IRS has your property, it is not easy to get it back. You'll need to show it's in the IRS's best interest to release it. For instance, you might get back an essential business asset if losing it means you will have to close your doors, and thus be deprived of any means to pay your tax debt.

> **EXAMPLE:** Harry, owner of Pavco, a road contracting business, owes $75,000 in back payroll taxes. The IRS seizes his paving trucks, effectively putting Harry out of business. Harry offers to pay $10,000 per month for the next five months if the IRS will release the trucks. With his trucks back, Harry can stay in business. The IRS may go for this deal. Otherwise, an IRS collector will auction off Harry's trucks to pay Pavco's tax debts.

a. What the IRS Can Take

The IRS usually seizes bank accounts first, because it just takes the push of a button. A computer-generated levy form is sent to any financial institution that the IRS even suspects holds your money.

The next most popular IRS target is your wages—even if due from your own corporation. And if you are self-employed and have received payments in past years (reported on Form 1099), the IRS can send levy notices to the payors.

The IRS can also intercept any money owed you for goods or services. And tax refunds from the IRS or states are taken automatically. In addition, if a tax collector can find it, an officer can grab money or property held for you by relatives or friends.

Most anything you own is subject to IRS levy, including your residence—no matter what your state homestead laws provide—as well as your pension plans. Thankfully, the IRS does not aggressively go after homes and retirement plans because of the political heat and bad publicity generated. The IRS wants to be perceived as tough, but not heartless. The IRS won't usually levy until it has tried, and failed, to get you to agree to make a payment plan, sell your assets, or take other positive steps to deal with your tax debt.

It can make sense to stonewall an IRS request for information, at least in the short term. Never lie to an IRS collector about anything, but you may want to by tight-lipped. Say something like, "I intend to pay the money I owe as soon as possible. I take my debt seriously and am sincerely trying to get the necessary funds. I'm sorry, but for my own peace of mind, I can't divulge private information about my bank accounts or other assets." The collector won't be overjoyed, but she won't throw you in chains, either. Use the time to plan on how to deal with your tax problem. The IRS isn't going to go away.

b. What the IRS Cannot Take

Some of your assets are exempt from IRS seizure by law. The IRS won't take the shirt off your back or the clothes in your closet. Unfortunately, the assets that are exempt from IRS levy have fairly low dollar values.

Generally, the IRS can't touch your family's wardrobe, personal effects, tools of your trade, or a portion of your wages as determined by IRS tables. (IRC § 6334(a).)

> **EXAMPLE:** Brian and Wynona, a married couple with two small children, had a retail seafood business that failed. They are now working for Wal-Mart. If they don't negotiate a deal with the IRS to pay back taxes—such as a payment plan—and the IRS levies their wages, they'll be allowed to keep only about $250 per week, total. The balance goes to the IRS. But unless the couple owns valuable assets (a race car, vacation home, boats, or the like), the IRS is highly unlikely to seize any of their personal property.

Before seizing assets from your business premises, the IRS will ask for your permission. If you refuse, the IRS can legally remove things only from the public areas of the business, such as the cash drawer, furniture, and equipment. However, the IRS must get a court order to seize anything in nonpublic areas, like the back office and storeroom.

The IRS cannot come into your home to seize assets, unless you agree or the officer has a court order. The IRS rarely seeks court orders.

EXAMPLE: The IRS levies on Ling Wo's Chinese restaurant's assets. It can empty out the cash register, but can't remove the woks from the kitchen—unless Ling Wo agrees or the IRS has a court order.

3. Getting Liens and Levies Released

To release a recorded tax lien, the IRS wants something in return. A typical scenario for small business folks is when they find a buyer for their business assets. Typically the IRS won't approve the transfer free of the tax lien unless it receives virtually all of the proceeds of the sale. The collector must also be convinced that the assets are being sold for their fair market value.

EXAMPLE: Valjean, who runs a motorcycle repair shop as a sole proprietorship, owes a $40,000 tax audit bill. The IRS collector threatens to shut his operation down and auction off the contents of the shop. Booger, Valjean's mechanic, offers to buy the shop's tools and equipment for $20,000. To get the IRS to go along with the sale and release the tax lien, Valjean must convince the IRS collector that $20,000 is the fair market value of the assets. Valjean won't get any money from the sale, but will get a $20,000 reduction of his tax bill.

Resources

- IRS Publication 594, *Understanding the Collection Process*. This is a short, relatively clearly written pamphlet.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book discusses solving IRS collection problems in greater detail than is given in this chapter. It also contains many useful forms for dealing with the IRS.
- *Bankruptcy: Is It the Right Solution to Your Debt Problems?*, by Robin Leonard (Nolo). This book explains bankruptcy alternatives and how to handle your own Chapter 7 bankruptcy case.
- *Chapter 13 Bankruptcy: Repay Your Debts*, by Robin Leonard (Nolo). This book explains how to use Chapter 13 of the bankruptcy code to pay off your tax debts.
- Bobby Covic (E.A.), one of the most knowledgeable tax pros I know in this area of practice, is available for telephone consultations on tax collection matters. He can be reached at 775-831-7694 or P.O. Box 6206, Incline Village, NV 89450.

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CHAPTER

19

Audits

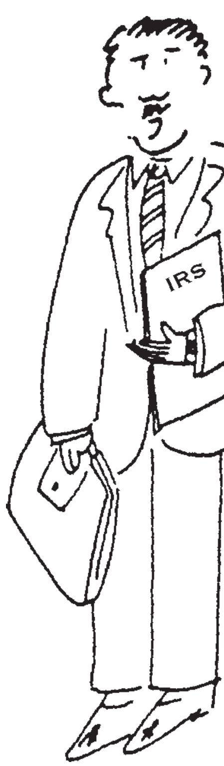
"It is not the thief who is hanged, but one who was caught stealing."

— H. L. Mencken

An audit is an IRS examination of you and your business as well as of your tax return. The IRS's goal is to verify that your tax return accurately reflects your income and tax deductible expenses. Besides looking at your records, auditors make subjective decisions about your honesty.

As a small business owner, you are four times more likely to be audited than wage earners. Odds are, if you stay in business very long, you'll be audited at least once. And if irregularities are ever found, audit lightning is likely to strike again. Indeed, a few small-time operators are audited every year or two.

Recommended Reading. How to prepare for, avoid, and defend yourself in an audit is covered in detail in *Stand Up to the IRS*, by Frederick W. Daily (Nolo). The fraud and criminal chapters there may be of interest as well. If you're facing an audit, it is an invaluable resource.



Audits in a Nutshell

1. In a small business audit, you must convince the IRS that your business reported all of its income and was entitled to any deductions the IRS questions.
2. Prolonging an audit usually works to your advantage; the IRS is under pressure to finish its cases.
3. It's advisable to keep the IRS from holding an audit at your place of business.
4. If you hire a tax pro to handle an audit, you don't have to meet the IRS auditor face to face.
5. Don't expect to come out of an audit without owing something—the odds are against you.
6. Talk to the auditor's manager if you are being treated unfairly.
7. If you lost receipts or records, try to reconstruct them by other means.
8. If you are worried about tax fraud, bring in a tax pro to handle the audit.

A. Who Gets Audited?

Audit victims are seldom selected randomly out of the 130 million tax returns filed annually. Small businesses and their owners are pulled from the IRS audit hopper in several very deliberate ways, discussed next.

1. Computer Picks

Computer scoring is the most likely way a small business becomes an audit candidate. An IRS computer program, known as the DIF scoring process, scans every Form 1040 and assigns it a numerical grade. The highest scores, roughly 10% of all individual tax returns, are human-reviewed for audit potential.

Sole proprietors' returns are audited the most. At least 80% of small businesses are sole proprietorships whose owners report their business income on Schedule C of their Form 1040 individual tax returns.

Business partnerships, LLCs, and small business corporations all file returns, too. However, the audit rate of these entities is about half that of sole proprietorships.

How the DIF program works is a highly guarded IRS secret, but here is what former IRS employees have told me. The most important scoring factor is the *ratios* of a business's income to various types of its expenses. For instance, if the IRS computer data shows restaurants in your area average food costs as 32% of gross sales, and yours claims 55%, you will get a higher DIF score. However, it usually takes more than just one item to get you audited.

2. Market Segment Specialization Programs

Every year the IRS targets certain businesses, professions, and industries for audit. These campaigns are called industry specialization or market segment specialization programs. Recent victims range from funeral home operators, car dealers, and attorneys, to airline pilots and plastic surgeons.

The IRS zeroes in on certain businesses when experience has shown a high degree of noncompliance with the tax laws. For instance, an IRS study of attorneys found that criminal and immigration lawyers were less likely to report all of their income than other attorneys. Another study found that airline pilots were prone to investing in questionable tax shelters. And, the IRS reasons that lawyers, pilots, and other high earners are the ones most likely to be able to pay audit bills.

3. Informants' Tips

Tips to the IRS—from disgruntled former business associates, employees, or ex-spouses—can trigger an audit. But don't be overly concerned about your enemies' list. The IRS knows that many tips result from spite and may not be accurate, so only 2% of all audits come from tip-offs. Anonymous tips are usually ignored altogether.

However, if other people know things—you're keeping two sets of books, paying your house painter with a business check, or skimming cash from the till—be at least a little worried. Today's bookkeeper can become tomorrow's tax squeal, particularly if he can document your tax cheating to the IRS.

4. Follow-Up Audits

Audits of other individuals or businesses can bring the IRS to your door. For instance, if one of your business partners gets audited, you may be next.

If you have your finger in many pies, you may be hit with a package audit of all your enterprises: corporations, investment groups, and trusts. The IRS looks askance at folks who operate in myriad business forms, suspecting income may be shifted or hidden among the entities.

5. Prior Audits

If you were audited once and flunked, your odds of a return visit go up greatly. Folks caught claiming phony tax deductions or not reporting income are likely to try it again, the IRS reasons.

On the other hand, some folks lose audits badly, yet never hear from the IRS again. The IRS audit machine operates in hit-or-miss fashion.

6. Criminal Investigations

Law enforcement and IRS criminal investigations can lead to an audit. For instance, when a police agency makes an arrest and finds a lot of cash in someone's possession, it may contact the IRS. Similarly, folks charged with embezzlement or drug dealing may be brought to the IRS's attention. However, the information flow between law enforcement agencies and the IRS is very spotty.

7. Amended Returns and Refund Claims

What about filing amended tax returns—for example, if you later discover an overlooked deduction? Generally, you have 36 months after the original due date of the return to amend it to lower your tax liability. (Use Form 1040X.) While the IRS may reject any amended tax return, it usually accepts them.

Many people file amended returns to get a refund. And, as you most surely know, the IRS is not in business to give money back. So, not surprisingly, the audit likelihood for amended returns is higher. If an amended return is audited, the original tax return—not just the items amended—is opened up for inspection.

Computer-Generated IRS Bills and Adjustments

The IRS often sends computerized notices when it finds a suspected problem with your individual or business tax return. The notice may appear to be a bill. For instance, the IRS may claim you forgot to report $400 in interest from your savings account. The notice further states how much additional tax you owe—on the assumption that the IRS is correct, and you're wrong.

This letter is an IRS "automated adjustment notice," usually designated as a CP-2000 letter. If the IRS is right—you did forget the $400 interest—then consider it a bill.

But if the IRS computer is wrong—you really did report the $400 on your return, but listed it under dividends instead of interest—call and mail a letter with documentation to the IRS. Make sure to send a copy of the notice you received.

B. How Long Do You Have to Worry About an Audit?

Generally, a tax return can't be audited after 36 months from the date it was filed. Note that this time limit (called a statute of limitations) starts to run *only* when you actually file a tax return. Years in which you never file a tax return are open to IRS scrutiny forever.

Most audit notices are sent out between 12 to 18 months after you file your tax return. Typically, if you haven't heard from the IRS within 18 months, you won't be audited.

Exceptions to the three-year rule. Some circumstances give the IRS more time to audit:

- If you understate your income by at least 25% on a tax return, the audit deadline is extended to six years.
- If you file a fraudulent tax return, there is no time limit. Tax fraud, as explained below, is more than just a little fudging. The IRS rarely tries to audit anyone after six years, even if fraud is suspected.

Deadlines. Once an audit is started, the Internal Revenue Manual directs it to be wrapped up within 28 months—beginning on the date you filed your tax return. The 28-month cutoff is an internal rule to give the IRS time for potential appeals processing after an audit and still end it within the 36-month time limit. (See Chapter 20, Appealing IRS Audits.)

Bottom line. These statutory and internal IRS time limits mean the auditor is under pressure to close out your audit file. So, the older an audit case gets, the more anxious the IRS is to bring it to a conclusion. The auditor can close a case more easily if you agree and sign the audit report; her job performance is partially judged on getting your agreement. Knowing this opens up the possibility of negotiating, as explained in Section K, below.

C. How the IRS Audits Small Businesses

The IRS audits small businesses and their owners by office audits and field audits. The difference is not only where the audit is held, but the intensity of the process.

1. Office Audits

If your sole proprietorship takes in less than $100,000 per year, the IRS is likely to request you to come on in. Usually, only one year's tax return is selected for an office audit. Just as it sounds, you go to the IRS offices with your records (see below for what you must bring) and meet with a tax examiner for a few hours.

A typical business taxpayer emerges owing additional taxes of about $4,000, but it can be much more (or less).

2. Field Audits

With a partnership, corporation, or sole proprietorship with gross annual receipts over $100,000, the audit is usually held outside the IRS office. Called a field audit, this process is much more intensive than an office audit.

Field auditors are called revenue agents, and are much better trained in accounting than IRS office tax auditors.

The average adjustments for a field audit—meaning additional tax, penalty, and interest assessed—total over $17,000. The IRS may devote as much as 40 hours (including time to write a report) to a field audit of a small business.

Conduct your audit away from your premises. You have the right to keep an IRS field auditor away from your business premises if her presence would interfere with your operation. You can demand that the audit be held elsewhere—at the IRS office or, if you have a tax pro represent you, at her office.

My advice is to hold the audit elsewhere, even if it is not an inconvenience. Otherwise, the auditor can observe your operation and form an opinion as to whether it is more successful than your tax return indicates. Or, the auditor might question your employees and get the wrong ideas.

> **EXAMPLE:** An IRS auditor sees a picture of a beach house on the desk of Benny, owner of Benny's Burgers. Since he reported only $15,000 to $20,000 in income for the past six years, the auditor asks how he can afford this luxury item. If Benny can't explain (like an inheritance from a rich uncle), the auditor will look hard for evidence of unreported income.

Another reason to hold the audit off your premises is that you have better control of the situation. If the auditor asks to see additional records, they may be back at the business. Since digging up documents slows things down, the auditor may drop the request. And even if she insists on seeing the documents later, the delay gives you a chance to edit out material the auditor is not entitled to see—like data from years that are not under audit.

Auditors look for personal expenses disguised as business deductions. With small businesses, the IRS auditor is ever on the lookout for people who bury personal expenses in their business. Cars, travel, and entertainment are often targets. In these areas, particularly, it pays to keep good records.

Your Audit Rights—The Taxpayer Bill of Rights

To stem IRS abuses, Congress passed a Taxpayer Bills of Rights. This law is explained in IRS Publication 1, *Your Rights as a Taxpayer* (available by calling 800-829-1040 or at www.irs.gov). It summarizes your rights during any (noncriminal) IRS proceeding, including audits, appeals, and collections, including your right to:

- have a say in the time and place of the audit
- hire a representative to meet with the auditor instead of going yourself
- audio-record IRS meetings, and
- speak with an IRS employee's manager if you are being treated unfairly.

D. The Auditor's Powers

Forget about being innocent until proven guilty. The tax law specifically places the burden of proof on *you* to back up what is in your tax return. Proving the correctness to an auditor may not be all that easy. The IRS wins over 80% of all audits, often because people can't verify data on their returns. Poor record keeping—not outright cheating—is the downfall of most audit victims.

Never forget that it's your job to prove to the IRS auditor the accuracy of your tax return, what lawyers call the burden of proof. It is not up to the IRS to disprove anything. Typically, this means verifying expense deductions claimed on your tax return. For instance, can you produce an invoice showing that you incurred the expense? Can you prove that you paid it with a cash receipt, check, or credit card statement? Can you show it was business-related?

EXAMPLE: An auditor challenges a $300 deduction that Ethan, owner of Ethan's Travel Service, took as a business entertainment expense. Ethan first proves he incurred the expense—he didn't just make it up. He shows a Visa receipt, his monthly Visa statement, and his canceled check to Visa. Next, Ethan shows notations written on the charge slip and in his business diary that the expense was for taking Harry, a longtime customer, out to dinner at the Ritz-Carlton. They discussed a worldwide cruise for Harry's honeymoon. This satisfies the auditor that Ethan was entitled to claim this expense as a business deduction.

Congress gives the IRS broad, but not unlimited, powers in auditing. The IRS, in the course of an audit, may do any of the following:

- inspect your business premises
- view your home office
- scrutinize your records, or
- summon records held by others.

Let's look more closely at each of these.

1. Inspecting Business Premises

Even though you can insist the audit be held outside your business (see above), the IRS may enter your premises if they're open to the public.

However, the auditor cannot go into your business's private area, such as a storeroom or office, unless invited. But, just because you can keep the IRS out of these areas doesn't necessarily mean that you should. If you have nothing to hide, then don't just be obstinate—it may arouse their imaginations. Give agents a guided tour rather than let them wander around on their own.

2. Viewing Home Offices

Legally, you don't have to let an auditor into your home unless she has a court order. If you claimed a home office deduction on your tax return, photographs and diagrams of the business space will satisfy most auditors.

Occasionally, though, auditors request to see home offices. If you don't show her, she will probably disallow your home office depreciation or rental expense because you haven't sufficiently verified your deduction. Remember, the burden of proving deductions taken on a tax return is always on you.

3. Scrutinizing Your Records

Whether the audit is at the IRS office, your place of business, or your tax pro's, the auditor will expect to see records. If they are on a computer, she will ask for a printout, plus check registers, bank statements, canceled checks, receipts, and invoices. If you keep a formal set of books, you must show those as well.

If you don't produce something, the auditor may give you a formal document request with a date to comply. If she still isn't satisfied, the auditor can issue a summons to you (just like the third-party summons discussed in Section 4, below).

In the end, if you never come up with acceptable records, the auditor can create her own figures—meaning that deductions will be disallowed and/or unreported income may be added.

Do your records contain a smoking gun? If something incriminating is hiding in your records, you may withhold them by claiming your constitutional right against self-incrimination. This is a judgment call that should be discussed with an attorney, not with your accountant.

4. Summoning Records Held by Others

An auditor can get records from your tax preparer, banks, suppliers, customers, and others by using a third-party summons. An auditor won't issue a summons without first attempting to get this information directly from you. For example, she'll first ask you for bank statements and canceled checks or invoices. Usually, you should be cooperative, as these are things an auditor can get with a third-party summons anyway. If in doubt, see a tax pro.

E. Should You Get Audit Help?

If you have good reason to fear an upcoming audit, such as tax fraud, consult a tax attorney well before meeting the auditor.

Tax Fraud and How to Avoid It

Careless mistakes, or even overstating a deduction on a tax return, is not tax fraud. Fraud is roughly defined as a deliberate attempt to evade taxes. To put your mind at rest, tax fraud is charged in less than 5% of all audits. Nevertheless, a fraud penalty of 75% can be tacked on to any tax found owing. And, where the fraud covers three or more years (found in less than 1% of all audits), the IRS may call in its Criminal Investigation Division.

If you have major skeletons in your tax closet—income you didn't report or phony business deductions—see a tax attorney before the audit starts.

For the typical audit, hiring a tax pro may be a waste of money. It is okay to go it alone if yours is an office audit and you have nothing to hide.

For a field audit, consider bringing in a tax pro from the get-go, because:

- Field audits produce much larger tax bills (on average four times greater) than do office audits. So it's a lot easier to justify the expense of a tax pro. Her fees are tax deductible.

- The IRS field auditors are better trained than office auditors. So it's more likely that you will be outmatched if questions come up about documents or tax law.
- If you hire a representative, the field audit can be conducted at her office—not yours.

If you are worried about tax fraud, always bring in a tax attorney. An authorized representative must be an attorney, a Certified Public Accountant (CPA), an Enrolled Agent (EA), or the preparer of the tax return in question, and must have your written power of attorney (IRS Form 2848). (For more information, see Chapter 22, Help Beyond the Book.)

Tax attorneys and CPAs are the most expensive (expect to pay $125 to $400 per hour for their time). Enrolled agents charge about $50 to $150 per hour. Professional time for a small business field audit ranges from ten to 50 hours. You do the math.

By law, you may take anyone with you to an audit that you like. Your tax preparer or bookkeeper can explain the business receipts and records. Or you can bring along a friend to lend moral support.

You do not have to personally attend an audit, in most cases. There is no legal requirement that you ever have to meet the auditor—*unless* they issue a summons to you. Keeping out of the picture means that there is no possibility of your giving damaging answers to the auditor's questions.

Bookkeepers, managers, or any other employee with knowledge of the business's tax affairs can go to the audit instead of the owner. But if you don't want to show your face, it's best to have your attorney, CPA, or EA show up for you.

These tax pros speak the same language as the auditor and may even have dealt with her before and have an idea of what makes her tick. Also, if tough questions are raised, a tax pro can say, "I don't know, let me check with my client." This may cause the auditor to adjourn the audit so you and the pro can talk things over.

Perhaps most important of all, a seasoned tax pro can spot problem areas—for example, expenses on which you didn't keep good records, or ones that look more like personal, than business, deductions.

F. Preparing for Your Audit

Before meeting the auditor, thoroughly review the tax returns being audited. Be ready to explain how you—or a tax return preparer—came up with the figures. If you can't, ask your tax preparer or another tax pro.

Pinpoint problems backing up income sources or expense deductions. Research tax law, if necessary. You'll need to legally show your right to take tax deductions or other tax benefits claimed on your return.

Find all records that substantiate your tax return. The IRS has a right to look at any records you used to prepare your tax return. Organize your records for the auditor in a logical fashion.

Preaudit organization of receipts, checks, and other items refreshes your recollection for the audit meeting.

Neatness counts. Forget about dumping a pile of receipts before an auditor and telling her to go at it. Messy records mean more digging, and the more gold the IRS expects to mine. Auditors reward good record keepers by giving these folks the benefit of the doubt if any problems arise. Neatness builds your credibility even if you are not really all that honest. (Order appeals to an accountant's mentality.)

G. What to Bring to an Audit

Audit success means documenting your expenses. Be prepared to show that your tax return is based on good business records. Proof should be in writing, though auditors are authorized to accept oral explanations. A list of items the auditor wants to see accompanies your audit notice.

At a minimum, the IRS will expect you to produce the following documents:

- **Bank statements, canceled checks, and receipts.** The auditor will want to see bank records—both personal and business—from *all* of your accounts. As a rule, don't discard any business-related canceled checks or invoices or sales slips. If you paid some expenses with cash, keep the paperwork (handwritten notes, receipts, or petty cash vouchers) showing the payments.

- **Your books and records.** The auditor will ask to see your books. As explained in Chapter 3, Bookkeeping and Accounting, small businesses don't have to keep a formal set of books; don't let an auditor tell you otherwise. Records can be just a bank statement, checkbook, or cash register tapes. If you maintain more formal records—such as ledgers and journals—the auditor is entitled to see them. If your data is on computer, the auditor will want to see a printout.
- **Electronic records.** Many banks don't return canceled checks anymore, and many business expenses are charged on credit or debit cards. Bank and charge card (Visa, MasterCard, American Express) statements are accepted by the IRS as proof of payment. They must show the name, date, amount, and address of the payee.

  But, because charges, slips, and monthly statements don't show the business nature of the expense, you can't rely on them as your only records.

Don't make the IRS guess. If you don't produce adequate records, the auditor is legally permitted to estimate your income and/or expenses—plus impose a separate penalty for your failure to keep records. Don't expect the auditor to be a generous estimator.

- **Appointment books, logs, and diaries.** Businesses that offer services typically track activities and expenses using calendars, diaries, appointment books, or logs. An entry in a business diary helps justify an expense to an auditor—as long as it appears credible.

  You must keep special records for certain equipment, called listed property, if used for both business and pleasure. (IRC § 280F.) (See Chapter 3, Bookkeeping and Accounting.)

  Computers kept at home (but used for business), cellular phones, and vehicles used for both business and pleasure are tax-termed as listed property. Purely business equipment is not listed property—for example, mechanic's tools, a lathe, or a carpet loom—so no records of usage are required.

  When assets are susceptible to both business and personal use, the auditor can demand records of usage.

EXAMPLE: Tina uses her computer for business email and to shop on eBay. She should track of the business portion of her use. One way is with a note pad next to the computer. To a great extent, Tina is on the honor system.

If she hasn't kept usage records, she can reconstruct them by memory or notes.

- **Auto records.** A vehicle you use for business is listed property if used for personal purposes. This dual purpose use requires records showing the work portion. A log is the best way to keep track but is not strictly required by the tax code. (See Chapter 1, Section D for a sample log.)

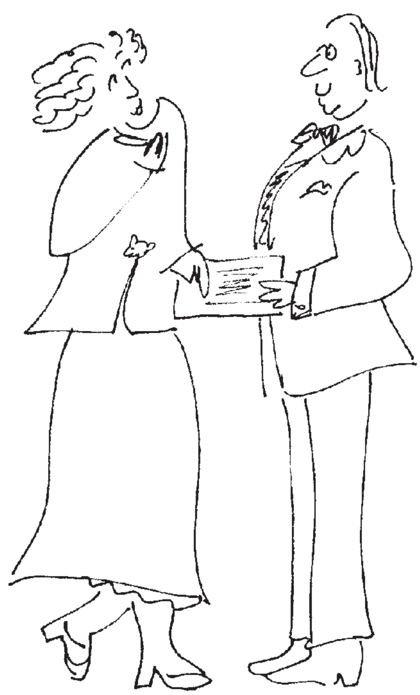
  Alternatively, keep all gas and repair receipts with notations of trips showing when the car was used for business. Or, add up the gas bills and divide by the number of miles per gallon that your car averages. Show the auditor your auto trip receipts and explain how they link up to your business diary. A day-timer or calendar notations help back up your deduction.
- **Travel and entertainment records.** By law, out-of-town business travel and entertainment expenses (T & E, in auditor lingo) require greater record keeping than most other expenses.

  You *must* have a written record of the specific business purpose of each travel or entertainment expense, as well as a receipt for it. (IRC § 267.)

Carry an appointment book or diary. A good way to document T & E expenses is with a day-timer, calendar, or appointment book, noting each time you incur a business expense, and the reason.

Most folks aren't disciplined enough to write down every expense as it is incurred. It is okay to reconstruct records after you have received an audit notice. But be up front about it—don't insult the auditor's intelligence by trying to pass off wet-inked paper as an old record. Remember, it's key to develop and maintain credibility with the auditor.

EXAMPLE 1: Bianca, a self-employed interior designer, reconstructs a calendar book with a notation for June 18, 2005, as follows, "Round-trip cab fare to office of John Johnson, prospective client—$14 (no receipt). Lunch at Circle Restaurant. Discuss proposal to decorate new offices at 333 Pine St.—$32 (Visa charge) plus cash tip of $6 (no receipt)." The auditor will probably be satisfied, or she may ask Bianca a few questions.



EXAMPLE 2: Sam (the owner of the computer store) went to an out-of-town computer retailers' convention. He spent $1,800 and claimed it as business travel expenses on his tax return. On audit, Sam produces charge card statements to prove the $1,800 was spent for hotels, meals, and convention registration. The auditor asks Sam to justify the business purpose of this trip. Sam produces a program for the convention. If it looks legitimate, and Sam's explanation of why it was important for him to be there is convincing, the auditor should allow the deduction in full.

- **Expenses for renting or buying property.** Prove rental expenses with a copy of the lease, or if you didn't have a lease, with canceled checks or signed receipts. If you bought the property or equipment, bring in the purchase contract or receipts, or proof of purchase. These documents establish grounds for claiming these expenses as well as a beginning tax basis of the property for depreciation deductions.

What You Need to Prove Certain Business Expenses

	Expense			
	Travel	**Entertainment**	**Gift**	**Transportation (Car)**
Amount	Amount of each separate expense for travel, lodging, and meals. Incidental, smaller expenses may be totaled in categories such as taxis, daily meals, long distance calls, and so on.	Amount of each separate expense. *Note:* The IRS is strict about records of entertainment expenses.	Cost of gift.	Amount of each separate expense, including: • cost of the car • mileage for each business use of the car, and • total miles for the tax year.
Date	Date you left and returned for each trip, and number of days for business.	Date of entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the discussion.	Date of gift.	Date of the car expense or use.
Place	Name of city or other destination.	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if entertainment is directly before or after a business discussion.	N/A	Name of city or other destination if applicable.
Description	N/A	N/A	Description of gift.	N/A
Business Purpose	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
Business Relationship	N/A	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee was present if entertainment was a business meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	N/A

What to Do About Missing Documents

Myth: Every deduction must be proven, or it won't be allowed.
Fact: Courts say that taxpayers can't be expected to keep perfect records. If your tax documentation is incomplete (which is often the case with small business owners), don't despair. You are required to demonstrate to the IRS only that you are in substantial compliance with the tax laws.

The substantial compliance rule means you can try any of the following when you don't have original documentation:

- offer oral explanations to auditors in place of missing records
- reconstruct records, or
- approximate expenses.

> EXAMPLE: Elijah produced a small music festival and rented tents from a traveling carnival company, which insisted on payment in cash. Elijah lost the receipt for the payment of $800, and the carnies moved on to parts unknown. Elijah can reconstruct this receipt with his oral explanation, a picture of the tents from the local paper, and a letter from a ticket taker who saw him make the $800 cash payment.
>
> The auditor also asked to see Elijah's office utility bills for the year under audit. Elijah could come up with only nine months of bills, and the utility company could not provide duplicates because its computer broke down. Elijah can approximate the missing expense data by averaging out the other nine months of bills.

Even if you can't figure out a way to document an expense, recreate your own paperwork and tell the auditor this is what you have done. For instance, write a repair receipt with the name and address of the person who did the work, the date, and amount paid.

For missing items, you may invoke the Cohan rule for expenses other than travel and entertainment. A court case (*Cohan v. Commissioner of the Internal Revenue*, 39 F.2d 540, 2nd Cir. 1930) allowed George M. ("Give my regards to Broadway") Cohan to approximate his business expenses in an IRS audit. The case stands for the proposition that estimations of business expenses are acceptable—as long as it is reasonable to believe that some amount was spent, and there is a good reason why records are not available. Typical excuses are that records were lost or destroyed, or the transactions were not the type that receipts are normally given for, such as cab fares or tips.

If less than $75, a business-related travel or entertainment expense doesn't require substantiation, as long as it is believable to the auditor and not excessive under the circumstances. (Regulation 1.274-5T.)

H. Don't Rush a Field Audit

Most people want to get an audit over with as quickly as possible. I don't blame them. With an office audit this may not be a bad idea, but with a *field* audit, faster isn't always better.

Slowing down an audit often works to your advantage. Extra time to get records together or delaying for any other plausible reason is both permissible and wise.

The older an audit file gets, the more anxious the IRS is to close it out, for several reasons. Auditors are facing the statute of limitations, discussed above, which gives the IRS only three years to audit you. Also, the IRS has internal rules requiring an audit to be completed within 28 months after a return is filed. After an auditor is finished, her report must be processed, reviewed, and formally approved, all of which eats up time. So, an auditor is under time pressure to close your case.

Making the auditor watch the calendar isn't the only reason to delay. Since you never can be too well prepared for an audit, it often makes sense to ask for extensions of time. Most folks need time to dig out papers from the recesses of their garage and put them in order. Or to contact their bank to get missing copies of checks or statements. After getting it all together, you may need to run it by a tax pro. Assuming you work for a living, this project takes a lot of your spare time to do right.

Also, events like your annual family reunion may be set at the time the audit is scheduled, or you may become ill, are in your business's Christmas season, or have some other excuse for a delay. If you need a postponement, call the auditor. In most cases, the appointment will be reset for a month or two later.

I. What Auditors Look for When Examining a Business

First and foremost, the IRS training manual tells its auditors that they are examining *you*, not just your tax return.

The auditor wants to see how you match up with the income reported on your return—economic reality in IRS-speak. If your business is audited, the IRS will likely want to know:

- **Did you report all of your business sales or receipts?** If you know that you "forgot" to report significant business income—$10,000 or more—strongly consider hiring a tax attorney to handle the audit. Remove yourself from the process altogether. If the auditor finds this kind of unreported income, and it looks intentional, he may call in the IRS criminal investigation team. However, if there is a plausible explanation ("someone must have forgotten to record September's sales"), then don't worry about the IRS cops. The auditor will probably just assess the additional tax you should have paid in the first place, plus interest and a 20% penalty for your error.
- **Did you write off personal living costs as business expenses?** The IRS knows that every small-time operator has likely claimed a personal expense as a business one. For little things—a few personal long distance calls on the business telephone line—the IRS won't get too excited. But if you deducted $2,000 in repairs on your motor home during a trip to Yellowstone, an auditor may figure this out by looking at your credit card statements—and disallow it, with a penalty added.
- **Does your lifestyle square with your reported income?** An auditor sizes you up for dress style, jewelry, car, and furnishings in your home or office, if given a chance to make these observations. Someone who looks like a Vegas high roller, with a tax return of a missionary, will cause any auditor to dig deeper.
- **Did you take cash—or otherwise divert income into your own pocket—without declaring it?** Auditors naturally suspect skimming if your business handles a lot of cash. (See "Cash Transactions Catch the IRS's Attention," below.)
- **Did you write off personal vehicle expenses as business expense?** Personal use of your

business set of wheels is so common that auditors expect to find it. That doesn't mean they will accept it, however. Auditors don't believe you use your one-and-only vehicle 100% for business and never to run to the grocery store or the dentist. If you drive for both business and pleasure and claim a high percentage of business usage, keep good records—preferably a mileage log.

- **Did you claim personal entertainment, meals, or vacation costs as business expenses?** Travel and entertainment business expenses are another area where the IRS knows it can strike gold. Document all travel and entertainment deductions. Taking buddies to the ball game and calling it business won't fly if you can't show a business relationship.
- **If you have employees, are you filing payroll tax returns and making tax deposits?** Employment taxes are a routine part of every audit of a small enterprise. See "Employment Classification: A Hot Issue," below, and Chapter 5, Tax Concerns of Employers.
- **If you hire people you call independent contractors, are they really employees?** Again, see "Employment Classification: A Hot Issue," below, and Chapter 5.

This list is by no means complete—these are just the most likely things an IRS auditor looks for.

Employment Classification: A Hot Issue

Auditors are on the lookout for employees misclassified as independent contractors. Once the IRS raises this issue, it's up to you to prove that the workers were truly independent contractors. The IRS auditor may talk to the people in question if they can be found.

So far, we know that unreported income, poor business record keeping, and mixing business and personal use of property are obvious IRS audit concerns. Let's next focus on areas in which your tax returns are most vulnerable.

Cash Transactions Catch the IRS's Attention

The IRS is suspicious of all businesses that are inherently cash intensive. Bars, game arcades, restaurants, minimarts, pawnshops, and laundromats are frequent audit targets. So are waiters, car dealers, cab drivers, gambling industry workers, bellhops, and immigration lawyers.

If yours is a predominantly cash operation, an IRS auditor will be particularly interested in your lifestyle. Sports cars, rental property, vacation homes, boats, and low reported income could mean an intense audit or, worse, an IRS criminal investigation.

All businesses—including financial institutions—must report transactions of cash over $10,000. Not just greenbacks, but also cash equivalents—traveler's checks, money orders, and bank drafts—must be reported to the IRS on Form 8300. Personal checks of any amount are not within the cash reporting requirement. While aimed at money launderers and drug dealers, this law applies to legitimate businesspersons, too.

Structuring a transaction to avoid this law—say, making three cash deposits of $4,000 on three different days—is also required to be reported on Form 8300. Penalties for not following cash reporting rules range from fines to audits and even jail. (See IRS Publication 1544, *Reporting Cash Payments of Over $10,000,* for details and a copy of Form 8300.)

This law doesn't apply to nonbusiness cash transactions. So, for instance, a parent giving a child more than $11,000 in cash doesn't have to file Form 8300. (But there is a federal gift tax filing requirement.)

1. The Income Probe

The number one issue auditors are trained to sniff out in business audits is *unreported income*—especially if your operation is cash-intensive (see "Cash Transactions Catch the IRS's Attention," above). Expect an auditor to start with the income probe. Anticipate questions like, "Did you report all of your income?" Another favorite is, "Do you keep a lot of cash around?" Don't conclude that big brother IRS has secret knowledge here. Auditors ask everyone these questions. This puts you on the defensive early in the game.

2. Bank Deposit Analysis

This brings us to bank deposit analysis. Office auditors seldom do this, but field auditors routinely add up all your bank deposits to see if the total is more than your reported income. Auditors also ask to see *all* of your personal bank account records to check that the deposits are consistent with your business receipts.

If you don't produce bank records voluntarily, the auditor will likely get them from your bank. If you cover up bank accounts, or otherwise lie to the auditor, you risk being investigated for tax evasion.

Audit your bank accounts in advance. Do your own bank deposit analysis before the audit. If deposits exceed the income reported, be ready with explanations. Don't invent sources; many deposits aren't taxable income. Loans, sales of assets (only the gain, if any, is taxed), transfers from other accounts, inheritances, and money held for relatives are among many explanations.

3. Is It a Legitimate Business Expense?

Next, the auditors move on to verifying *business expenses*. Remember, *you* prove that deductions were for profit-making purposes; it's not up to the IRS to disprove them. Any expense may be questioned, but certain ones are IRS favorites. The auditor is searching for any of the following deductions which were nondeductible personal expenses in whole or part:

- travel and entertainment (see Chapter 1 and discussion above)
- home office (see Chapter 13)
- asset purchases (see Chapter 2)
- auto expenses (see Chapter 1).

Review these chapters for the rules on deductibility to see if you are on firm ground before the audit begins.

J. How to Behave at an Audit

The Internal Revenue Manual says the first taxpayer interview is the most important phase of an audit. Whether you handle this interview or have a tax pro go for you, remember that both you and your business are under the microscope. Take a tip from Shakespeare and be true to thine own self. If you lay bricks for a living, don't try to act or look like a lawyer, and vice versa. Here are some other words to live by.

1. Keep Chit-Chat to a Minimum

Talking with the auditor about the weather or football is okay, but avoid rattling on about your business and personal affairs. Because audits are so stressful, many of us cover our nervousness by talking. IRS auditors rely on this natural tendency and listen for clues or admissions. For instance, don't fill in a silence by remarking how jet lagged you are from a trip to Bora Bora, or the auditor may wonder how you can afford it. After all, she may earn about the same as you say you do, but can't swing the bus fare to Omaha. Don't be surprised if she asks point blank how you manage money so well. It doesn't hurt to ask the auditor about herself—to take the focus off you.

Without your telling them, auditors know very little about you before the meeting. Your auditor will have the tax return under audit and a printout of all W-2s and 1099s if you're required to report wages and certain financial transactions. The auditor's file may also include a listing of real estate and vehicles registered in your name. But that's it. She won't even have your other years' tax returns, although she may have some computer data for two more years.

Don't lie about what you do. The IRS knows how you make a living because it's on your tax return. (Occupations must be stated both in plain English and by listing a four-digit code on 1040 forms.) It is a crime to misstate the nature of your business on a tax return—a prostitute was once convicted of tax fraud for telling the IRS she was in public relations.

2. Answer Questions Concisely

When the auditor asks a direct question, the preferred comeback is "Yes" or "No." Resist the temptation to overexplain, ramble on, or answer questions that weren't asked.

If you are in doubt, say, "I don't know," or "I'll get back to you on that," or "I'll have to check my records," or "I'll ask my accountant." The auditor may let it go. If she doesn't, at least you slowed the process down, usually to your advantage.

> **EXAMPLE:** The auditor asks Sue what percentage of sales in her Clothes Horse boutique were for cash. Sue doesn't keep separate figures for cash sales apart from credit card and check sales. Sue might make a fairly accurate guess, or she could go into a long explanation of how most customers pay for clothes with credit cards or checks. But, why should Sue risk giving an answer that may be wrong or misinterpreted by an auditor? Sue should simply say, "I have no idea because I don't keep those kinds of records." Or, "If you give me time, I can review my records and get back to you."

It's Okay to Ask for Time Out

You may recess an audit for any good reason—a bathroom or lunch break, maybe for the day if you feel ill or need to confer with a tax attorney or your CPA. IRS Publication 1, *Your Rights as a Taxpayer,* states your right to get tax advice or bring in a representative at any time. If you are in over your head, are confused, or can't answer a question, firmly tell the auditor that you need a recess. Auditors are tightly scheduled and may not have time to meet again soon. Use the delay to consider your next step.

3. Don't Be Hostile or Phony

What about trying to charm the auditor with your wonderful personality or good looks? Up to a point, this is fine. All rumors to the contrary notwithstanding, auditors are human. The IRS also gives its auditors wide latitude; a lot of judgment calls are made. If you are pleasant and run an honest looking business, you may get the benefit of the doubt if the auditor uncovers problems. Conversely, if you come in radiating hostility, you are daring the auditor to reciprocate. Nevertheless, don't try too hard to ingratiate yourself. Auditors abhor folks who think sucking up is a way to get ahead.

4. Complain If the Auditor Is Abusive

Most auditors are straightforward and professional, but a few delight in giving taxpayers a hard time. You may run into an auditor who is impolite, hostile, or downright nasty. Perhaps you upset her or she is just having a bad day.

The Taxpayer Bill of Rights entitles you to courtesy from the IRS. Remind the auditor of this and ask her politely to lighten up. If she persists, tell her you are too upset and want to call off the audit for the day. Or say that you want to consult a tax pro before going farther, another privilege in the Taxpayer Bill of Rights. Threatening this can reform an auditor's attitude, because she is under time pressure. Or demand to speak with her manager. If all else fails, simply walk out. Send a tax pro to the next appointment in your place, or appeal the audit result. (See Chapter 20, Appealing IRS Audits.)

Never offer favors to an auditor. If the audit is at your place, it's fine to give an agent a Coke or cup of coffee. Don't go beyond that, whether it is lunch or a small discount at your store. All perceived bribery attempts (or threats, for that matter) are reported and can result in an especially thorough audit, if not a criminal investigation.

K. How to Negotiate With an Auditor

Despite IRS claims that auditors can't negotiate, give-and-take is common. An auditor's job performance is judged largely based on how many cases she closes marked "agreed." She wants you to consent to her findings and not appeal or go to tax court. So the auditor is told to get your consent. This gives you negotiating power. It doesn't mean an auditor wants your signature so badly she will allow bogus business expenses or overlook unreported income. But it does give the auditor incentive to negotiate. Here are some negotiating strategies.

1. Don't Just Sit There

Keep asking the auditor about disallowances she is considering as the audit progresses. Otherwise, she won't tell you what's on her mind, so you will be in the dark until you get her examination report. Don't let an auditor take the easy way out—make her face you and justify her decisions. In turn, you can argue your position right then and there. Or if she plans to make an adjustment because you didn't produce records, you can ask for time to find or reconstruct the documents.

> **EXAMPLE 1:** The auditor tells Sue, owner of the Clothes Horse boutique, that she is disallowing a $400 expense paid to Helena, a fashion consultant. Sue produces a canceled check but hasn't produced anything else showing the nature of Helena's services. Sue could ask for time to get a statement from Helena describing the work, and bring or mail it to the auditor.

> **EXAMPLE 2:** The auditor isn't convinced that it was necessary for Paul to buy a $40,000 airplane for his plumbing subcontracting business. Paul could get a letter from Morgan, the general contractor who hired him, saying that he hired Paul to work a project in a remote area inaccessible by car.

> **EXAMPLE 3:** The auditor tells Barbara, a direct mail consultant, that she is disallowing her deduction for the theft of a computer. Her reason is that there is no documentation of the loss. Barbara could get a copy of the police report for the auditor.

2. Talk Percentages, Not Dollars

Auditors don't talk about the dollars you will owe from an audit, but they will discuss percentage adjustments. For instance, your auditor wants to disallow a $500 deduction. Don't reply, "Would you take $300?"

Instead, talk in terms of percentages, based on whether the adjustment should be made in the first place. Although this amounts to the same thing, adjustment percentages, not dollars, are the language of IRS auditors.

Keep in mind the difference between arguing and negotiating. When you argue, you are usually disputing an auditor's conclusion ("It was really a deductible business trip"). By contrast, negotiating is the art of meeting in the middle. ("The trip was for both business and pleasure, so how about agreeing that 70% of expenses were deductible for business and 30% nondeductible for nonbusiness?")

Or let's say you lost all paperwork for an $820 office supply deduction. The auditor proposes to disallow 100% of the deduction. You could counter along these lines: "Since I made a decent profit and maintained an office, I must have bought office supplies. I lost the receipts, but my reconstruction of expenses is reasonable. I should be allowed at least 50%."

> **EXAMPLE:** Bertha is a part-time wedding consultant with a small downtown office. At an audit, Bertha was asked to produce paperwork showing she paid $932 in cash for parking at a nearby garage. Bertha didn't bother to keep parking receipts. The auditor says, "No deduction." Bertha could counter by saying, "You know that I live 12 miles away and there is no public transportation to my office, so I must have driven, and there is no street parking. However, I will agree to your disallowing 25% of parking expenses just to get it over with."

3. Arguing Issues

Most audit issues fall into two broad categories: *verification* and *justification*. So far we have focused on verification problems, such as lost paperwork. In the previous example, the auditor didn't question Bertha's right to claim a parking expense, but whether it was verifiable.

A justification issue, on the other hand, arises if the auditor questions whether Bertha's wedding consulting really was a profit-seeking business—or if it was a social pastime. If primarily for pleasure, Bertha wasn't entitled to claim *any* parking expense. (See Chapter 13, Section E2, for a discussion of why a hobby is not a business for tax purposes.)

Unlike verification issues, justification or legal issues (such as whether or not your corporation is valid) may require a tax pro. If a legal issue comes up, ask the auditor for time to do some research or confer with a tax pro.

4. Adjustments in Your Favor—Taking the Offensive

An audit is not a one-way street. The Internal Revenue Manual says auditors *must* make adjustments in your favor whenever found. Even the most hard nosed auditor knows that folks occasionally make mistakes in the IRS's favor or overlook claiming tax benefits on their returns.

This is another good reason to go over your return and records with a fine-toothed comb before the audit. If you find any missed deductions or if you were too conservative—for instance, you didn't take a deduction for entertainment because you were afraid of raising an audit flag—then bring it up at the end of the audit. You no longer have anything to lose.

Bring up items in your favor after the auditor has completed her review. Psychologically, it's better not to raise anything in your favor until after the auditor has decided on all adjustments against you. If you bring them up earlier, the auditor may look harder for offsetting items. But if you wait until after she is locked in, she has no choice but to consider your positive change items.

5. Don't Try to Negotiate Based on Inability to Pay

The worst way to negotiate is by telling an auditor you can't afford the bill, simply throwing yourself on the auditor's mercy. *Whether you ever pay the tax bill from the audit is not the auditor's concern. His job is to audit you.* After the audit is finished, his job is done and your case goes to the IRS Collection Division, a completely separate department.

Take heart—there are ways to reduce audit bills. It may be possible to lower an audit bill that is beyond your ability to pay by using the IRS offer in compromise procedure. Alternatively, if things are really bad, your debt may qualify for reduction or discharge in the bankruptcy law. Or, you can usually get an installment payment plan. (See Chapter 18, When You Can't Pay Your Taxes, for details on all of these options.)

L. Your Options After Getting an Audit Report

After the auditor is finished, you will be handed or mailed an IRS examination report. The IRS considers the audit completed, but the report may still be modified if you act quickly enough.

You have three choices after getting the report.

1. Agree

You may throw in the towel by signing the report. Then it's all over, and generally speaking you can't change your mind. If tax is due, you will get a bill with interest and penalty (if any) included. The audit report is not officially a tax bill. The final bill is issued by the IRS Service Center a month or two after the IRS audit file is closed.

Check your bill. Sometimes, statements from the IRS Service Centers differ from those given by auditors. Don't ask me why; it just happens. If the bill is for more than the auditor's report, complain to the Service Center. If less, then you may have lucked out.

Getting an Audit Payment Plan

The audit is over and you (reluctantly) agree with the IRS that you owe some money. Naturally, your thoughts turn to how you are going to pay. The auditor may ask if you can pay on the spot. If you can't, she will offer to help you set up a payment plan.

You don't have to discuss payment at all with an auditor; it's optional. You can wait until you are contacted by the IRS collection division, but the IRS interest meter is running.

If you want to pay the IRS in installments, your request usually will be granted, if all of the following are true:

- the total owed is under $10,000
- all of your tax returns due have been filed, and
- all current year's tax payments are made (such as quarterly estimated taxes for self-employed people).

If you owe more than $10,000, the auditor may process the forms to request an installment agreement, but it is up to the collection division to grant or deny the request.

It's okay not to commit to pay at the end of an audit. You may need time to think it over, or ask a relative for a loan, or whatever. Your case will simply be shipped off to your IRS Service Center for billing.

2. Argue

Examination reports aren't chiseled in stone. If you don't think a report is fair, call the auditor and tell her why. If she can't be persuaded, ask to speak to her manager. *Don't be shy—you have rights as a taxpayer. Take the problem over the auditor's head.*

The manager does not have to meet with you, but she will let you make your case on the phone. Tell her just where you think the auditor missed the boat. Politely let her know you will continue to fight (see next chapter on how to do this) if she won't intercede. You don't have anything to lose by trying.

EXAMPLE: Phil, a full-time college professor and part-time jazz musician at small clubs on weekends, is audited. The IRS disallows Phil's expenses for piano lessons of $675 and opera singing lessons of $290. (The auditor couldn't see how these lessons were business-related, since Phil is a drummer.) Phil calls the auditor's manager and explains that both types of lessons enhance his musical abilities. He offers to accept disallowance of the opera lessons ($290) if the IRS allows the piano lessons ($675) deduction. The manager agrees to the compromise and the report is changed.

3. Do Nothing

Eventually, IRS audit reports become final—with or without your signature. However, the IRS may sit on your case for several months before formally closing the case. If you really have no points to negotiate or money to pay, choose the do-nothing option. This delays your final audit bill, but remember that interest is mounting.

M. When Your Audit Is Final

When the audit is finished, the IRS will mail a letter advising you of your right to either:

- appeal within 30 days (see the next chapter on how to appeal an audit), or
- contest the audit in the U.S. Tax Court within 90 days of the date of the letter to stop the audit from being finalized. (See the next chapter, Appealing IRS Audits.)

Resources

- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This self-help book discusses IRS audit, appeal, and tax court strategies in more detail than covered here.
- *Representing the Audited Taxpayer Before the IRS*, by Robert McKenzie (Clark Boardman Callaghan). As the title suggests, this book is written for tax professionals, but much of it is understandable to laypeople as well.
- IRS Publication 1, *Your Rights as a Taxpayer*. This pamphlet is clearly written and is a must-read for all taxpayers.
- *Surviving an IRS Tax Audit*, by Frederick W. Daily (Nolo).
- IRS Publication 556, *Examination of Returns, Appeal Rights and Claims for Refund*.

■

CHAPTER

20

Appealing IRS Audits

"Nor shall any person ... be deprived of life, liberty or property, without due process of law."

— Fifth Amendment, Constitution of the United States

You don't have to accept an IRS bill. In most instances, you can appeal it within the IRS. Or, you can go to federal tax court before paying the bill. (IRC §§ 9011, 9041.) An audit appeal is simple to initiate, and for small tax court cases—under $50,000—you can do it without a lawyer.

IRS statistics reveal that 85% of taxpayers who appeal get their bill reduced! The average appeals settlement produces a 40% reduction. Many folks do even better. And even if you don't win your appeal, you will have delayed the final tax bill for many months.

Appealing IRS Audits in a Nutshell

1. If you can't live with an audit result, you can usually appeal within the IRS—and you always have the right to go to court.
2. The majority of audit appeals are successful in reducing tax bills.
3. Collection of your audit bill is greatly delayed if you appeal, but interest and penalties still keep accumulating.
4. Prepare for an appeal hearing by carefully organizing your records, researching basic tax law, and, perhaps, getting advice from a tax pro.
5. Filing in tax court is simple; most folks do it without a lawyer when contesting $50,000 or less in taxes and penalties for any one tax year.

Recommended Reading. Appealing an audit is discussed in much greater detail in *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

A. IRS Appeals

If you don't sign off on an auditor's examination report, in most cases the IRS mails you a 30-day letter. This is your invitation to go to the IRS Appeals Office, which is completely separate from the audit division. Until and unless this letter is received, you cannot appeal (but you don't have to pay the audit bill, either).

The IRS is not required by law to let you internally appeal an audit, and sometimes it doesn't. But don't worry—the IRS always must notify you in writing of your right to contest the audit in the U.S. Tax Court. (See Section B, below.)

1. Writing an Appeal Letter

An appeal is begun by writing a protest letter to the IRS. (If you owe less than $2,500, you can simply tell the auditor that you want to appeal; but play it safe and put it in writing.) A sample protest letter is shown below. It should include:

- Your name (or the name of your business, depending on which one the audit report specifies) and your taxpayer identification number (either your Social Security number, if you are a sole proprietor without employees, or federal employer identification number).
- A statement that you are appealing an examination report.
- The specific findings in the report that you dispute—something like this: "I disagree with the auditor's disallowance of business expense for travel in the amount of $797," or "I disagree with the finding by the auditor that my dog obedience business was not carried on for profit."
- A brief explanation of why the report is wrong. For example, "The trip in question was necessary to see a potential customer who lived in South Dakota," or, "I operated in a businesslike manner and trained many dogs to be responsible members of the community."

- Your signature, date, and these magic words: "Under penalty of perjury, I declare that the facts presented in this protest and in any accompanying documents are, to the best of my knowledge and belief, true, correct, and complete."

Attach a copy of the examination report and the 30-day letter from the IRS. Send the letter to the IRS office that audited you, addressed to the "District Director." Your letter will be processed and forwarded to the IRS Appeals Office.

Sample Protest Letter

October 1, 20xx

District Director
Internal Revenue Service
Your town, Your state 99999

Protest of Sam Smith
SSN 666-66-6666

Dear Sir/Madam:

I wish to appeal from the examination report of 9/5/xx, a copy of which is attached. I request a hearing. The tax year protested is 20xx.

I disagree with the disallowance of business expense deductions shown on Schedule C of $13,937 and penalties and interest in the amount of $2,817.

The adjustments were incorrect because the deductions were for legitimate expenses of advertising, promotion, travel, and entertainment and were reasonable and necessary for my business.

Under penalty of perjury, I declare that the facts presented in this protest and in any accompanying documents are, to the best of my knowledge and belief, true, correct, and complete.

Sincerely,
Sam Smith
Sam Smith

cc: IRS auditor
Enclosed: Copy of IRS 30-day letter
Examination Report

2. Settling Without a Hearing

Within a few months after requesting an appeal, you'll get a call or letter from the IRS Appeals Office asking you to come for a meeting. Or an appeals officer may offer to handle the case just by phone or correspondence. This is worth a try. Send in explanations, copies of documents, citations to legal authority, affidavits of witnesses, or whatever else you believe supports your position. A tax pro can help put things together if you are unsure.

If the appeals officer phones to discuss your case and you are ready, go ahead. A better idea is to request a later time to talk when you can be fully prepared. (See Section 3, below, on how to present a case to an appeals officer.) If you have a lot of documents to present, or feel that you could do a better job in person, then insist on a meeting. Most things go better when done face to face, but maybe you are more comfortable at a distance.

It's time to consult a tax pro. Even if you handle your IRS appeal yourself, consider seeing a tax pro for some advice. A good one can offer insights on what went wrong at the audit and how to prepare your appeal in a professional manner. Appeals officers appreciate a well-organized presentation and will often reward you with a favorable settlement. The same advice applies for contesting an audit in tax court (see below.)

3. The Appeals Hearing

If you don't get anywhere with an appeals officer by phone or mail, ask for a face-to-face meeting. Some IRS offices don't have appeals officers, so you may have to travel to another city.

Your hearing will probably be one on one with the appeals officer in his office. Auditors or other IRS personnel seldom attend. No formal or electronic recordings of appeals hearings are made. It's okay for you to take notes, as will the officer.

Most folks find appeals officers easier to deal with than auditors. They work for the IRS but are not there to just rubber-stamp auditors' decisions. Their aim is to mediate a settlement so you won't go to court. Use this second chance to sell your position that your tax return was correct—or closer to it than the auditor's report says.

Winning your audit appeal. Expect an appeal hearing to last an hour or two. Start with a brief explanation of why you think the examination report is wrong. Show any papers supporting your position. Emphasize any material you didn't have at the audit, such as new documents or a reconstruction of lost items. If something's still missing, explain why.

Convince the appeals officer that you have some chance—no matter how small—of winning in court. However, an appeals officer can't make a purely nuisance settlement—that is, give in just so you will go away. Some evidence—even if only substitute records to replace missing ones—can provide the appeals officer with a hook on which to override the auditor. (Chapter 19, Audits, explains how reconstructed records can be used.)

Almost any kind of auditor's adjustment is fair game for appeals negotiation. Common small business appeal issues include entitlements to a home office deduction, travel and entertainment expenses, and advertising and business car write-offs.

Making a deal on appeal is often done by trading issues. Get the appeals officer to see that you have an arguable point on at least one issue and you are willing to concede on another issue.

Don't expect total victory in an appeal, although it is certainly possible. It's better to stay flexible; give-and-take is the proper attitude.

EXAMPLE: Rusty is an independent building materials sales rep. He regularly calls on customers in his car and wines and dines his larger accounts. But an IRS auditor disallows Rusty's auto expenses of $1,740 as well as his business entertainment expenses of $820, due to spotty record keeping and missing receipts.

Rusty argues to the appeals officer that he needs his car to make calls and that it is customary for salespersons in his business to buy customers lunch or take them to baseball games. Although Rusty lost his receipts, he can back up his claims with signed statements from customers he's entertained. Rusty offers to trade issues by accepting the disallowance of the entertainment expenses if the appeals officer allows his automobile expense deduction, or offers to accept a 50% disallowance of each.

Mention your tax court option. If the appeals officer is not amenable to any kind of settlement, tell him politely your next stop is tax court. If he thinks you are serious, he may make a last-ditch effort to work things out.

4. Payment After an Appeals Settlement

If and when you reach a settlement, appeals officers will request—but cannot insist on—immediate payment of any tax due. They can also process a monthly payment plan request. However, an appeals officer is not supposed to make any settlement conditioned on your immediate payment or acceptance of a payment plan.

B. Contesting an Audit in Court

You aren't required to go through the IRS appeals process before going to court. If you don't appeal—or do but aren't happy with the way it comes out—you can go to one of three courts: United States Tax Court, United States District Court, or the Court of Federal Claims.

Almost everyone chooses tax court, for two good reasons: First, the district and claims courts require you to first pay the tax and then sue for a refund. Second, few people succeed in the latter two courts without lawyers.

Tax court, on the other hand, allows you to contest an audit for a filing fee of $60 and offers a reasonable chance of success without a lawyer.

1. About Tax Court

The U.S. Tax Court is an independent federal court, *not* part of the IRS. (IRC §§ 7441-46.) Contesting an audit in tax court requires filing a one-page form petition, for a small case. (See Section 2, below.)

The chances of at least partial victory are good: Over half of those filing in tax court either settle with the IRS lawyers before trial or get some reduction in court. For instance, the judge may uphold the IRS on a tax adjustment, but knock off all penalties.

In cases under $50,000, 47% of taxpayers win at least partial victories over the IRS auditor. In larger cases, 60% of taxpayers come out ahead! However, fewer than 10% win a total victory in tax court.

2. Can You Do It Yourself in Tax Court?

Whether or not you want to go it alone in tax court should depend on how much money is at stake. Most tax court disputes involve factual issues—not complex tax law points. Many individuals without law degrees or accounting backgrounds often come out just fine representing themselves in tax court.

a. Under $50,000: Informal "S" Cases

Disputes of less than $50,000 (per tax year audited) are treated under rules much like a small claims court. These "S," or small case, procedures are informal. You simply present your case to a judge in your own words.

b. Over $50,000: Regular Cases

Regular cases (more than $50,000 per year is in dispute) require a lawyer. (A small number of CPAs and Enrolled Agents are also approved to practice in tax court.) If you go in solo (without a lawyer), the judge will expect you to know tax law and court procedures. A compromise solution may be to use a tax lawyer as a legal coach, but who doesn't appear in court. Some tax court judges are tolerant of pro se petitioners (people without lawyers), but others may give you short shrift for not knowing your tax law.

Filing a petition is a wise move. Often, just filing a tax court case produces a settlement. If not, you can always chicken out before going into court, and you'll only be out the $60 filing fee. Alternatively, you can file and try to settle the case yourself, bringing in a lawyer only if you fail. At the very least, your petition delays the final tax bill (although the interest continues to run).

3. Filing Your Petition in Tax Court

To go to tax court, you must have first received an IRS Statutory Notice of Deficiency, also called a 90-day letter. Expect this letter within one to six months after your audit, assuming you did not agree to the examination report. The notice is sent by certified or registered mail. If you move during this time, make sure the IRS has your new address. (File Form 8822, *Change of Address*.)

To get a small case before the tax court (under $50,000 per year), call or write to:

Clerk of the U.S. Tax Court
400 Second Street, NW
Washington, DC 20217
202-606-8754

or go to the tax court's website at www.ustaxcourt.gov/faq.htm.

Request or download a petition form and pamphlet explaining the court's small case rules. If you request the information by mail, the tax court will get these items to you within a few days. Don't expect any advice on winning your case from the clerk, however.

Carefully follow the instructions for filling in the forms. Mail the petition (preferrably via U.S. Postal Service, certified mail, return receipt requested). Enclose your check or money order for the filing fee. You'll get an acknowledgment letter and case number from the tax court in about a week. The clerk sends the IRS attorneys a copy of your petition. You are on your way! The next move belongs to the IRS.

4. Tax Court Pretrial Procedure

Within a few months, you'll hear from the IRS, either an appeals officer or a lawyer. This is an important contact, since most tax court cases are settled by these folks without going to court. You might even negotiate a deal by phone or through the mail without ever meeting these people. (See the discussion in Section A, above, on how to negotiate an appeal.)

If no compromise is reached, you'll get a notice of a trial date, which comes six to 12 months after you file. Trials are held in about 100 U.S. cities. You may have to travel several hundred miles to court—another reason to settle before trial.

5. Settling Before Trial

IRS lawyers frequently agree to last-minute deals—even in the hallway outside the courtroom—minutes before your trial is to begin. If they don't try, you should. Try something new—such as agreeing to some adjustment that you previously did not accept. Fewer than 10% of all folks get a total victory in a tax court trial, so be realistic.

> **EXAMPLE:** Karen's auto parts business was audited, and additional taxes of $5,100 were found, including $1,300 for disallowed business expenses. Karen could offer to accept $1,300 in taxes if the IRS will concede the other issues and wipe out the remaining $3,800. This might be accepted by the IRS attorney or, more likely, bring a counteroffer. In any case, it doesn't cost Karen anything to try.

If you reach a settlement, a stipulated tax court decision is prepared for your signature. It is sent to the IRS and then to a judge for approval. It takes a few months to complete the paperwork, so don't be concerned if you don't get anything back right away. (The only thing to worry about now is paying the bill.)

6. Your Tax Court Trial

How your trial will be conducted may depend on whether you qualify for the simplified tax court procedures for small cases (less than $50,000 contested per tax year) or as a regular case.

a. All Cases

On the date you are scheduled for trial, show up early. Typically, many other IRS victims will be there, and the clerk will start by calling roll. Chances are your case won't be heard on that day; more likely you'll be assigned a time and date later in that week (or the next one) for trial.

The judge sits on a wooden throne (as on TV), or at the end of a conference table if there is no formal courtroom. Once your case is called, come forward and sit at a table facing the judge. The IRS attorney will be at another table.

Bring all papers you want the judge to see. If you have witnesses, have them sitting nearby. Address the judge as "Your Honor."

The judge won't know any facts of your case. He has only your petition, the IRS's response (called an answer), and a copy of the audit report. The judge does *not* have the IRS's file or any of the documents that you submitted to the auditor or appeals officer. You are starting with a clean slate.

You and your witnesses will be sworn to tell the truth. You may sit or stand, according to the instruction of the judge, as you present your case. A table will be provided for you to lay out your documents and sit at when the IRS attorney is presenting his case.

Presenting your case. Start by asking the judge if you can give a brief explanation of why you disagree with the IRS, but don't go into the details just yet. Next, either ask permission to start calling your witnesses or begin by presenting your documents (whatever you want the judge to consider). Important: Bring an extra copy of everything you give the judge for the IRS's attorney—and don't forget to keep originals.

Explain the significance of each document, even if it seems obvious. For instance, "Your Honor, this is a bill from Jake, the plumber who fixed the pipes, which the IRS auditor would not allow as a business expense deduction."

Expect the judge and the IRS attorney to ask you questions. The whole thing is relatively informal, especially if yours is an S case. Speak and show documents as if you were trying to convince a friend that you are right and the IRS is wrong.

EXAMPLE: Thom's Hardware store was damaged by a flood. Thom quickly hired Jim, an out-of-town handyman, to make emergency repairs. Jim insisted on payment of $3,800 in cash. Thom got a receipt from Jim for payment but lost it in the confusion. Jim is now in parts unknown after his parole officer came looking for him. An IRS auditor disallowed the $3,800 deduction—not because this type of expense was not legally allowed, but because Thom couldn't prove payment. So Thom's dispute with the IRS is over the factual issue of whether he paid $3,800—not whether it's a legitimate business expense.

At the tax court hearing, Thom starts by explaining what happened in his own words. Thom brings in a witness, Deena, who observed the flood damage and saw Jim do the work. Even though Deena didn't see Thom pay Jim, she can tell the judge that Thom needed help fast, and that Jim worked seven full days. The judge can easily infer that Jim didn't work without pay.

Thom also shows the judge a news clipping and photos of the flooded store. It is up to the judge to determine if Thom, Deena, and the documentation are believable enough to overturn the auditor's findings.

Watch and learn. On the day of your trial, there may be other cases heard before yours. You may find it enlightening (or stupefying) to spend a few hours watching and learning about the judge's habits and courtroom procedures firsthand.

b. Cases Over $50,000 Only

If the IRS claims you owe more than $50,000 per tax year, you must be familiar with tax law and tax court procedures if you hope to win. Start by consulting the books listed at the end of this chapter, or bring in a tax lawyer.

7. Tax Court Decisions

Unlike Judge Judy, who wraps it all up in 15 minutes and rules on the spot, tax court judges usually mail out their decisions a few weeks or months after a trial.

Small case tax court decisions (under $50,000) are final; they cannot be appealed by you or by the IRS.

Regular tax court decisions (cases over $50,000) may be appealed to the U.S. Court of Appeals. Appealing a tax court decision is expensive and requires an attorney. Fewer than 15% of all tax court decisions are reversed.

Assuming you don't win outright, it will be several months after receiving the judge's decision before you get a tax bill. Interest is added to the bill starting from the time the original tax return was filed—or the date it should have been filed, if earlier.

Resources

- IRS Publication 1, *Your Rights as a Taxpayer*.
- IRS Publication 5, *Appeal Rights and Preparation of Unagreed Cases*.
- IRS Publication 556, *Examination of Returns, Appeal Rights and Claims for Refund*.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This companion book has detailed information and tips on handling appeals and tax court cases.
- *Represent Yourself in Court*, by Paul Bergman and Sara J. Berman-Barrett (Nolo). This book is full of practical tips on how to present documents to a court and what to say (and not to say) to a judge.
- *Rules of Practice and Procedure*, United States Tax Court. If you are handling a tax court case on your own, you must familiarize yourself with the rules of court. This free booklet is available through the Tax Court Clerk, 400 Second St., NW, Washington, DC 20217, 202-606-8754. These rules are also available on the U.S. Tax Court's website, www.ustaxcourt.gov, and in most federal court buildings and law school libraries.

CHAPTER

21

Penalties and Interest

"Laws and institutions require to be adapted, not to good men, but to bad."

— John Stuart Mill

When the IRS hits you or your business with a tax bill, it usually adds penalties and interest. These extra charges can be shocking—an old $7,000 tax bill could have $15,000 in penalties and interest tacked on to it.

Some penalties, such as for late payments, are added automatically by IRS computers. Or, IRS personnel may impose penalties if you violated a tax code provision, such as filing a return late. The IRS doesn't just dream up penalties—each one has been authorized by our elected representatives in Washington.

Once penalties are decreed, if you don't complain, the IRS assumes you accept them. Happily, the IRS can remove a penalty just as easily as it added one. The key to the kingdom of tax penalty relief is showing a reasonable cause for your failure to comply with tax law.

Note: Tax penalties are *not* tax deductible.

Penalties and Interest in a Nutshell

1. Whenever the IRS finds a business or its owner was late in filing a return or making a payment or otherwise breached the tax laws, it is likely to impose a penalty.
2. If your business is hit with a penalty, it may be canceled if you can show reasonable cause.
3. You are entitled to a full explanation from the IRS of any penalty imposed and how it was calculated.
4. It is difficult, but not impossible, to get the IRS to drop interest charges on tax bills.

A. Common Reasons for Penalties

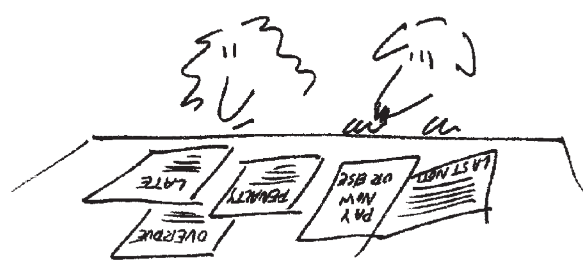
The number of different tax code penalties is staggering. This section covers only the penalties most likely to be imposed on a small business owner.

1. Inaccuracies

The IRS can hit you with a 20% penalty if you were negligent (unreasonably careless) or substantially understated your taxes. This accuracy-related penalty is applied when you can't prove a deduction in an audit, or you didn't report all of your income and the IRS discovers it.

2. Civil Fraud

If the IRS finds that you underreported your income with a fraudulent intent (it doesn't look like an honest mistake to the IRS), a fine of 75% can be added. (IRC § 6651(f).) Breathe easy—this civil (noncriminal) tax fraud penalty is imposed in fewer than 2% of all audits. (You may also be charged with the crime of tax fraud, which is even rarer.) (IRC § 7201.)



3. Late Payment

The IRS usually adds a penalty from ¼% to 1% per month to an income tax bill that's not paid on time. This late payment penalty is automatically tacked on by the IRS computer whenever you file a return without paying the balance owed, or when you pay it late. (IRC § 6651(a).)

Penalties for failing to make payroll tax deposits on time are much higher.

4. Late Filing

If you're late in filing required forms, the IRS can penalize you an additional 5% per month on any balance due. However, this penalty can be applied only for the first five months following the return's due date, up to a 25% maximum charge. If there is no balance due, the IRS can still tack on lesser penalties.

5. Filing and Paying Late

A special rule applies if you both file late and underpay. The IRS can (and probably will) impose a combined penalty of 25% of the amount owed if not paid in the first five months after the return and tax are due. After five months, the failure to pay penalty continues at ½% per month until the two penalties reach a combined maximum of 47½%. This is a slightly lower (2½% less overall) penalty than if the two penalties were applied separately. (IRC § 6651(c).) Wow, those IRS folks sure can be generous.

> **EXAMPLE:** Mortimer the mortician lets April 15 pass without filing his tax return or making any payment. He finally gets around to filing on September 16 and owes $4,000. The IRS will tack on a 25% penalty ($1,000), bringing the bill up to $5,000. Interest will be charged as well. In recent years, the IRS has charged 6%–8% interest annually.

IRS penalties are stackable. Late filing and paying penalties can be imposed by the IRS in addition to any other penalties, such as for fraud or filing an inaccurate return. Congress and the IRS believe the more the merrier when it comes to penalizing delinquent or erring taxpayers.

6. Underpaying Estimated Taxes

Self-employed folks occasionally get dinged for the estimated tax penalty. All self-employed individuals must estimate their income tax for the year ahead and pay it in quarterly installments.

Quarterly estimated tax payments are due on April 15, June 15, September 15, and January 15 of each year. Quarterly payments should be equal—generally you can't play catch-up with larger payments later in the year and still avoid this penalty.

You must come pretty close to paying everything you will owe, although you don't have to guess the total amount precisely.

Here are the rules for avoiding the penalty:

- If you earn less than $150,000, your quarterly tax payments must equal at least 90% of your final income tax bill, or at least 100% of your last year's tax bill.
- If you earn more than $150,000, you must pay at least 110% of your last year's tax bill in estimated payments or risk the underpayment penalty on whatever amount you come up short.

B. Interest on Tax Bills

Congress requires the IRS to charge interest on delinquent tax bills and has given the IRS very limited discretion in canceling interest charges.

The interest rate is adjusted every quarter by a formula and compounded daily—recently ranging from 6%–8% per year. It is charged on a monthly basis.

If you are audited and end up owing more tax, interest is charged starting on the original date the tax return was due.

C. Understanding Penalty and Interest Notices

If you receive a tax bill with penalty and interest charges, it may not show how these charges were computed. For an explanation, call the IRS taxpayer assistance line (800-829-1040) and/or request that a penalty and interest explanation notice (PINEX) be sent to you.

A PINEX is a multipaged computer printout that includes:

- a listing of your business (or personal) tax accounts for the specific years or tax periods you request, showing all tax penalty and interest computations
- dates, interest rates, penalties assessed, and any credits to your account, such as your quarterly payments, abatements (reductions) by the IRS, or any refunds applied
- explanations of why particular penalties were charged, with tax code citations authorizing each penalty
- a summary of your account with balance due, including up-to-date penalty and interest amounts.

D. How to Get Penalties Reduced or Eliminated

Once you understand why and how the IRS hit you with penalties, you may request that they be reduced or eliminated. The IRS term for this process is abatement. About one-third of all penalties are eventually abated. I suspect that even more penalties would be canceled if people knew how to contest them.

Just telling the IRS that you don't like a penalty, or can't afford to pay it, won't work. You must show reasonable cause, meaning a good excuse. The IRS instruction book for its agents, called The Internal Revenue Manual (IRM), says, *"Any sound reason advanced by a taxpayer as the cause for delay in filing a return, making deposits ... or paying tax when due will be carefully analyzed."*

The IRM lists seven categories of excuses for abating any tax penalty except fraud:

1. Death or serious illness of the taxpayer or immediate family
2. Unavoidable absence
3. Destruction by fire or other casualty of the business or records
4. Inability to determine the tax because of reasons beyond the taxpayer's control
5. Civil disturbances
6. Lack of funds, but only when the taxpayer can demonstrate the exercise of ordinary business care and prudence
7. Other reasons establishing that the taxpayer exercised ordinary business care but couldn't comply within the time limits.

When requesting an abatement, try to fit your excuse into categories 1 to 6 first. If you honestly can't, try the catch-all number 7. This category covers just about any excuse you can come up with.

1. How to Request a Penalty Abatement

As soon as you receive a tax notice with penalties, request an abatement in writing, following the form letter below. Be brief and straightforward. State that you are requesting an abatement of penalties, identify the tax bill, and tell the IRS what your reasonable cause is.

Attach a photocopy of the IRS notice showing the penalty, along with any documentation supporting your request. Keep several copies of your letters and attachments.

Most penalties are imposed by the IRS Service Center that sent the tax bill, so mail your abatement request there—not to the local IRS office. The IRS is notorious for ignoring, losing, or taking forever to answer correspondence, so you may need to send additional copies later. Wait at least 45 days before sending your follow-up request. Photocopies of your first request and documents should be sufficient—just change the date of the request.

Stress your clean IRS record. If true, emphasize that you have never before had a penalty, been behind in paying taxes, or asked for an abatement. Even if your record is not squeaky clean, the IRS penalty examiner may let it go, so let your conscience be your guide.

Sample Letter Requesting Abatement of Penalties

To: Penalty Abatement Coordinator
IRS Service Center
P.O. Box 9941
Ogden, UT 84409

Re: Request for Penalty Abatement

From: Sanford Majors
43 Valley Road
Salt Lake City, UT 84000

SSN: 555-55-5555

November 3, 20xx

To Whom It May Concern:

I am requesting an abatement of penalties asserted in the IRS notice enclosed dated 5/5/xx of $2,312.10.

The reason I *[select one or more]*: filed late, paid late, didn't report some income was that *[fill in your reason, such as]*:

- I was suffering from a nervous breakdown.
- My wife had just passed away.
- My house burned down on April 14 with all of my tax records.
- *[any other excuse]*.

Enclosed is a *[describe your documents, such as]*:

- Letter from Dr. Freud explaining my condition, which prevented me from filing my tax return on time
- Death certificate confirming my wife's passing
- Report from the fire department
- *[any other documentation]*.

I have also enclosed payment that covers the amount of the underlying taxes I owe. *[optional, but a good idea if you can afford to make the payment]*

Please abate these penalties for reasonable cause. I can be reached at 801-555-3444 during daytime hours.

Thank you,

Sanford Majors

Sanford Majors

Enclosed: IRS Tax Notice; doctor's letter, death certificate, fire report, letter from State Department *[or whatever]*

2. If Your Abatement Request Is Rejected

If the IRS Service Center officially rejects your request, it will send you a written notice. To go farther, take one or more of these actions:

1. Write back asking for IRS appeals consideration. There is no IRS form for this—just write a clear letter headed "Penalty Appeal" and explain your reasonable cause. Attach the tax bill in question and any documentation supporting your case, like a doctor's letter or accident report.
2. Call or visit your local IRS office and speak with a customer service representative or a collection employee. They are authorized to consider reasonable cause applications and cancel penalties. Don't mention that a Service Center turned you down. If you're turned down again, ask orally and follow up in writing requesting that they forward your case for appeals consideration.
3. File an offer in compromise (IRS Form 656) based on doubt as to your liability for the penalty. This is a formal procedure for negotiating any unpaid IRS bill, including penalties. Don't offer any money when contesting a penalty, because you are claiming that you don't owe it. Follow the directions accompanying Form 656 precisely. Attach your explanation and documents supporting your position, if any. (Offers in compromise are discussed in Chapter 18, When You Can't Pay Your Taxes.)
4. Pay the penalty and then file IRS Form 843, *Claim for Refund and Request of Abatement*. Attach a letter and substantiating documents (as you did to your abatement request letter), or write your explanation in the space provided on the form. If your claim is refused, theoretically you can sue in U.S. District Court or the Court of Federal Claims for a refund. Seldom are tax penalties large enough to justify the expense of a lawsuit, however.

E. How to Get Interest Charges Removed

It is never easy to get interest removed from a tax bill, unless it resulted from an IRS error. In four instances, however, you might win:

1. Logically enough, if a tax or penalty is abated, interest on that amount should be canceled, too. The IRS computer should do this automatically, but always check a tax bill to verify that the excess interest was removed. If you suspect a mistake, call the IRS at the number on the notice or at 800-829-1040. Ask them to explain on the phone or send you a PINEX. (See Section C, above.) If you continue to get incorrect bills, write and call the IRS office that sent the bill.
2. Did the interest charges result from delays by the IRS? For instance, say you settled an audit agreeing to pay more tax, and the IRS didn't send a bill until a year later. The year's interest should be canceled. However, you can't get interest abated if it accumulated while you were (unsuccessfully) challenging an IRS bill in an audit appeal or in court.
3. If the IRS concludes that you will never be able to pay the tax and interest charges, it may accept less in an offer in compromise. (See Chapter 18, When You Can't Pay Your Taxes.)
4. Interest, along with the tax and penalties, may be reduced or eliminated through bankruptcy. (See Chapter 18, When You Can't Pay Your Taxes.)

F. Designating Payments on Delinquent Tax Bills

When paying tax bills that include both penalties and interest, tell the IRS how to apply the payments. It might make a difference. For instance, if the bill is for a business-related tax, request the IRS in writing that the payment is to be first applied to interest. Your request may not be granted, but if it is, the business-related interest is a deductible business expense. (Tax penalties, however, are never deductible.)

One exception to paying the interest first is for past due payroll or employment taxes. With payroll taxes for your incorporated business, payments should be designated to be first applied to the trust fund portion of the delinquent payroll tax. (See Chapter 5, Section B, for the reason why.)

Tell the IRS how to apply payments. Always direct the IRS to apply payments to specific tax periods, if there is more than one for which you are delinquent. You want payments first applied to the most recent—not the oldest—tax period, because:

- The heaviest penalties are charged in the first few months after a tax return is due.
- The older a tax bill gets, the more likely the IRS is to compromise it, lose it in the shuffle, or let the ten-year statute of limitations on collection run out.
- Tax debts may qualify for discharge in bankruptcy.

If you don't tell the IRS which tax period to apply the payment to, it will automatically apply it to the oldest tax period.

To designate payments, write the tax period on the face of the payment check, along with your taxpayer identification number (your Social Security number or the employer identification number of your business). Also, send a letter with the check stating specifically what the payment is for. For instance, state "Apply to interest first for 2005 income taxes for TIN 555-55-5555."

Resources

- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book discusses penalties, interest, and how to deal with them in greater detail than we go into in this chapter.
- IRS Notice 746, *Information About Your Notice, Penalty and Interest*. This notice is usually sent with your first tax bill that contains a penalty or interest charge. Download it from the IRS's website at www.irs.gov, call 800-829-1040, or go to your local IRS office.
- Bobby Covic (E.A.), one of the most knowledgeable tax pros I know in this area of practice, is available for telephone consultations on tax collection matters. He can be reached at 775-831-7694 or P.O. Box 6206, Incline Village, NV 89450.

■

CHAPTER

22

Help Beyond the Book

"The avoidance of taxes is the only intellectual pursuit that still carries any reward."

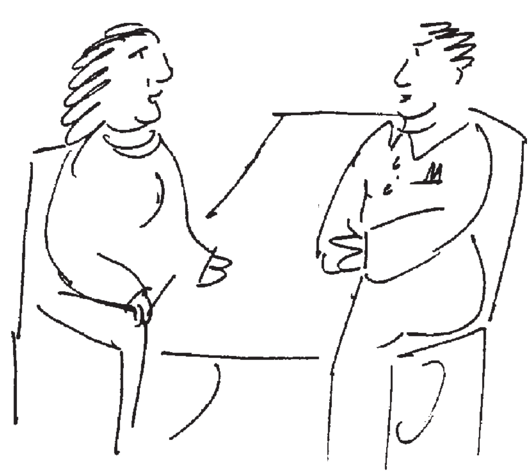
— John Maynard Keynes

Our tax code is a moving target; tax laws are always being reworked by Congress. Keeping up with changes affecting you, your business, or your industry can be a challenge.

Small business owners can't afford to call a tax pro with every question. Fortunately, good tax information is available for free (or close to it). The IRS offers free publications on basic tax law—always from the IRS's point of view, of course. Trade associations put out newsletters and magazines covering tax concerns common to their members. General tax newsletters, books, and annual tax preparation publications are plentiful, and small business tax material is widely available in libraries. Of course, the Internet is a prime source of tax material.

You should have a good tax adviser on call. Keep professional fees under control by learning as much as you can on your own. The more you know about dealing with a tax pro, the better you can judge his capabilities. And, of course, the less tax advice you'll have to pay for. I've tried to alert you to the occasions you'll need professional help beyond this book by using "warning" and "see an expert" symbols.

For instance, a tax pro can help set up your record-keeping system and choose an accounting method. Use a pro if you don't feel comfortable doing your own tax return. (Who does?) Everyone's business and individual tax situation is unique; like your wardrobe, some custom fitting always works better than off-the-rack. Here are some places to do your shopping.



Tax Help in a Nutshell

1. There are a lot of good resources for answering tax questions, starting with free IRS publications.
2. Oral advice from the IRS is not legally binding on the IRS.
3. Small business owners should establish a working relationship with a tax professional.

A. Finding Answers to Tax Questions

The income tax law is a product of all three branches of our federal government:

- The legislative branch, Congress, writes the Internal Revenue Code (IRC), or tax code, for short.
- The executive branch, specifically the Treasury Department, of which the Internal Revenue Service is a part, publishes interpretations of many tax code provisions. These writings show how the IRS applies the tax code in different situations.
- The judicial branch, the federal courts, interprets the tax code in light of the Constitution and what it divines as Congress's intent. When the IRS applies the tax code contrary to the Constitution or differently than Congress intended, it may be overruled by the federal courts. These court decisions are published ("reported") and serve to guide taxpayers on how to interpret the tax code.

This section discusses the many resources available to augment the tax information in this book: IRS publications, self-help tax preparation guides, textbooks, websites, court decisions, and periodicals. Some are free, and most others are reasonably priced. Tax publications for professionals are expensive, but are often available at public or law libraries.

IRS Small Business Website

There is a IRS small business community website to assist the nation's 45 million business and self-employed taxpayers. This free site provides:

- answers to basic tax questions and a calendar of tax deadlines
- online access to most IRS forms
- industry-specific tax info for specific industries like construction and food service
- tips to avoid common tax problems
- links to court opinions and to rulings and regulations on specific industries
- links to non-IRS sites for general tax information, and
- links to helpful small business resources.

Go to the IRS home page (www.irs.gov). Click on "Business" and then "Small Business and Self-Employed."

1. IRS Booklets and CD-ROM

The IRS publishes over 350 free booklets explaining the tax code. But where there is a gray area in the law, you can bet you'll get only the IRS's interpretation—even if federal courts have made contrary rulings.

These IRS Publications ("Pubs," for short), range from several pages to several hundred pages in length. Get them at IRS offices, download them online at www.irs.gov, call 800-829-FORM (3676), or send in an order form. There is no charge, not even for postage. (A list of free IRS tax publications for small businesses is in the appendix.)

Every small business person should order a package of IRS forms and publications called *Your Business Tax Kit*. The kit includes Forms SS-4, *Application for Employer Identification Number,* and 1040-ES, *Estimated Tax for Individuals*. And it includes several key publications mentioned throughout this book:

- Pub 334, *Tax Guide for Small Business* (at 325 pages, the largest booklet)
- Pub 583, *Taxpayers Starting a Business*
- Pub 910, *Guide to Free Tax Services*
- Pub 1057, *Small Business Tax Education Program Brochure*
- Pub 1544, *Reporting Cash Payments of Over $10,000,* and
- Pub 1779, *Employee or Independent Contractor*.

You can get all IRS publications, plus 600 forms, IRS Regulations, and back-year tax forms (to 1991) on CD-ROM Publication 1796. Call this toll-free number to order: 877-233-6767, or order online at www.irs.gov (search for Publication 1796). The cost is $22.

All you may need, however, is a free CD-ROM product called the *Small Business Resource Guide,* Publication 3207, which contains:

- information on small business topics from various regulatory agencies
- business tax forms, instructions, and publications
- valuable insight on a wide range of topics, from preparing a business plan to keeping records of financing and retirement plans
- informative tutorials, updates, and a multi-agency electronic newsletter.

Order this CD-ROM from the IRS's website at www.irs.gov (go to "Business" and then "Small Business and Self-Employed") or by calling 800-829-3676.

Don't rely exclusively on the IRS for information. The IRS's free publications run the gamut from good to bad to plain ugly. While some are clearly written and useful, others are misleading, and a few are in an unknown language. I am always amused to see IRS publications with disclaimers warning you against relying on them. The IRS is not legally bound to follow its own writings that explain the tax law. Amazing, isn't it?

2. Free IRS and Social Security Telephone Information

The IRS offers prerecorded tapes on tax topics on its toll-free telephone service (TELETAX) at 800-829-4477. See IRS Publication 910 for a list of topics.

You may talk to a live IRS taxpayer service representative at 800-829-4933 (business tax line). It can be hard to get through from January to May. Avoid calling on Mondays or during lunchtime.

The Social Security Administration (SSA) also has an 800 number: 800-772-1213. It is staffed 7 a.m. to 7 p.m., and has prerecorded business-related topics available 24 hours a day. Among other info available from the SSA, you or an employee of your business can get a statement of earnings, Form W-2, and Form 1099 income information for past years, an estimate of benefits, and new or replacement Social Security cards.

Be alert for bad IRS advice. The IRS is notorious for giving misleading or outright wrong answers to tax questions. IRS folks just aren't trained to answer more than very simple tax questions. In the IRS's defense, often taxpayers don't know how to ask the right questions, or really understand the answers given. Our overly complex tax code is as much to blame as the IRS. Unfortunately, the IRS does not stand behind incorrect oral advice. If you rely on what someone at the IRS tells you and it is wrong, you'll be liable for any resulting tax plus interest and penalties. If it's important, double check what the IRS tells you with a tax pro.

3. Free IRS Programs

In larger metropolitan areas, the IRS offers small business seminars on various topics, such as payroll tax reporting. You can ask questions at these half-day meetings given at schools and federal buildings. Call the IRS at 800-829-1040 to see if programs are offered near you and to get on the IRS small business mailing list.

4. IRS Written Advice

The IRS is only bound by specific advice it gives in writing called an IRS Letter Ruling. If you want one, you'll have to pay a fee of $500 to $3,000 to the IRS; expect to wait many months for your answer.

A better (and far cheaper) bet is to look up letter rulings issued to other taxpayers with a similar question—if you can find one. Letter rulings are published in the *Internal Revenue Cumulative Bulletin*, and in private tax service publications found in larger public and law libraries.

Be warned: It is not easy to find letter rulings on point. (See Section 6, below, for more information.) If you want to try, you should know how these rulings are identified and indexed. For example, "Ltr. Rul. 892012" refers to a ruling issued in 1989, in the 20th week, and which was the 12th letter ruling issued that week. My suggestion is that you hire a tax pro to do this for you.

5. Internal Revenue Code

The Internal Revenue Code (IRC) is written by Congress and is nicknamed the code or the tax code. It's a thick book with tiny print and is found in the reference section of most libraries, IRS offices, tax pros' offices, and larger bookstores. The IRC is revised once (or twice) a year, mostly minor changes by Congress. More significant revisions to the tax code are made every three to four years.

The IRC is found in Title 26 of the United States Code (U.S.C. for short). The U.S.C. encompasses all of our federal laws. Title simply refers to the place within the massive U.S.C. where the IRC is found.

> **EXAMPLE:** "IRC § 179(b)(4)(A)" means that this particular tax law is found in Title 26 of the U.S.C., the Internal Revenue Code, Section 179, subsection b, paragraph 4, subparagraph A.

The IRC is divided up into sections, which, in turn, are subdivided into more parts, ad infinitum. The tax code is a crazy quilt of laws that apply to everyone along with provisions just for left-handed sheep breeders in New Jersey.

The IRC is available at larger bookstores and online. Amazon.com offers it for $86.50. The U.S. Code (including the IRC) is also available on CD-ROM from the Government Printing Office for under $40. And some, but not all, of the IRC can be found at the IRS website. You can view the entire IRC from Nolo's website at www.nolo.com.

6. IRS Interpretations of the Tax Code

Congress, when enacting a broadly applicable tax law, can't foresee all possible situations. So the Treasury Department (the IRS is a part of it) is authorized to issue interpretations of broad tax code provisions. The primary IRS interpretations are found in the Regulations, Revenue Rulings, Letter Rulings, Revenue Procedures, Announcements, Notices, the Internal Revenue Manual, and IRS forms and instructions.

a. Regulations

The most authoritative IRS interpretations are called Treasury Regulations or just Regulations or Regs. Regulations provide the mechanics of how many (but not all) tax code provisions operate. Regulations often include examples, like the ones in this book. They are usually bound in a four- to six-volume set and are found in most larger libraries and some bookstores. Many regulations are downloadable from the IRS website (www.irs.gov). Regulations are marginally easier to read than the tax code on which they are based.

To go beyond the IRC, first check to see if there is a matching regulation. Start with the number of the IRC section; if there is a corresponding regulation, it will bear the same number, usually preceded by the numeral "1."

> **EXAMPLE:** "Reg. 1.179" refers to a Treasury regulation interpreting IRC Section 179.

b. Other IRS Pronouncements

The IRS publishes various statements of its position on various tax matters. These pronouncements guide IRS personnel and taxpayers as to how specific tax laws will be applied by the IRS.

IRS Revenue Rulings (Rev. Rul.) are IRS announcements of how the tax law applies to a hypothetical set of facts.

Tax book publishers Prentice-Hall, Commerce Clearing House, and Research Institute of America reprint IRS Revenue Rulings. They are indexed by IRC section and subject matter. A Revenue Ruling usually contains a factual example, followed by an explanation of how the tax code applies to those facts. While looking for a Revenue Ruling might pay off, it is not always easy to find one that precisely covers your situation.

> **EXAMPLE:** "Rev. Rul. 92-41" refers to IRS Revenue Ruling number 41, issued in 1992.

IRS Letter Rulings are IRS answers to specific written questions about more complex tax situations posed by taxpayers. (See Section 4, above.)

IRS Revenue Procedures (Rev. Procs.) are another way the IRS tells taxpayers exactly how to comply with certain tax code provisions. Rev. Procs. are primarily relied on by tax return preparers. They often explain when and how to report tax items, such as claiming a net operating loss on a tax return. They are contained in the weekly *Internal Revenue Cumulative Bulletin*, found in larger public and law libraries, and also are reprinted by the tax book publishers mentioned above and on the IRS website (www.irs.gov).

> **EXAMPLE:** "Rev. Proc. 91-15" refers to a published Revenue Procedure number 15, issued in 1991.

IRS announcements and notices. Periodically, the IRS gives general guidance and statements of policy in official announcements and notices similar to press releases. They appear in the weekly *Internal Revenue Cumulative Bulletin,* which is published at www.irs.gov. Seldom does it pay to search IRS announcements or notices, as they weren't intended to answer specific questions.

The Internal Revenue Manual (IRM) is a series of handbooks for IRS employees on tax law. The IRM tells its auditors and collectors how specific tax code provisions should be enforced. The manual is for IRS internal use, but most of it is public and reprinted by private tax book publishers. It is available to the public in larger IRS offices and in law libraries and some tax pros' offices. Portions of the IRM are also on the IRS website.

The IRM is revealing of IRS positions—for example, the criteria the IRS uses to determine whether reasonable cause exists for cancelling a tax penalty.

IRS forms and instructions are well known to us all, starting with Form 1040, the annual personal income tax return. More than 650 other forms are listed in Publication 676, *Catalog of Federal Tax Forms*. They are free at IRS offices or by calling 800-829-FORM or 800-829-1040 or at the IRS website at www.irs.gov. Many IRS forms come with instructions and explanations of the tax law. Need I say that one should always read the instructions before attempting to fill in an IRS form?

7. Court Cases

Federal courts have interpreted the tax law in thousands of court cases. Tax Court decisions are found in the *Tax Court Reports*. Also, U.S. District Courts, U.S. Courts of Appeal, Court of Federal Claims, U.S. Bankruptcy Courts, and the Supreme Court all rule on tax issues. These court decisions explain tax code sections. Chances are that at least one of these courts has adjudged the point you are interested in; the trick is finding it.

Researching court decisions goes beyond this book, but I can make a few suggestions. Go to Nolo's Legal Research Center at www.nolo.com. Or, find your nearest law library with public access. Call a federal court, college library, or lawyer's office to find out where to go. Instead of volumes that simply reprint court decisions, look for books by private tax services that summarize the cases and put them into a coherent order.

The key to tax research, whether on the Web or in a law library, is to start with the number of an IRC section, or a court case name, or a general topic, such as depreciation. If you are in a law library, head for the tax section or, better, ask the law library staff for help. A friendly librarian (if she knows her way around the tax section) can show you how to use the books and its computer research services. Also look at the legal research books listed at the end of this chapter, which are available from their publishers or at bookstores.

8. Federal Small Business Programs

The Small Business Administration (SBA) guarantees business loans and also puts out some good publications.

Personal counseling from the SBA is offered by the Service Corps of Retired Executives (SCORE) program. These folks are not necessarily tax experts, but if they were in business, they know the tax game. Call the SBA at 800-827-5722 or visit the SBA office nearest you. The SBA also has a very helpful website at www.sba.gov. Or write to the SBA at 1441 L Street, NW, Washington, DC 20461.

Small Business Development Centers (SBDCs) are cosponsored by the SBA and state governments. They are usually affiliated with state universities and provide free or low-cost seminars and counseling to small business owners. To locate an SBDC near you, call the SBA at 800-827-5722.

Other federal agencies offer publications—either free or at reasonable prices—to assist small businesses. For a list of federal publications, write to:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250-7954.

9. Private Tax Guides and Software

There is a multitude of commercially published tax guides and newsletters. Annual tax preparation guidebooks, like *Ernst & Young's Tax Guide,* sell for

$20 or less. Most are directed at taxes for individuals, but many deal with self-employment tax issues as well. Some of my favorites are listed at the end of this chapter.

Tax professional desk books are one-volume guides with more detailed tax information for corporations, partnerships, and LLCs. They presume some basic tax knowledge on the reader's part and are priced at under $35. See the "Resources" list at the end of the chapter.

Tax preparation computer programs usually include basic tax guidance. I recommend, *TurboTax* (Intuit)—other programs may be cheaper but they don't match up to *TurboTax* for ease of use!

10. Trade Association Publications

Every business or trade has specialized publications and newsletters that track tax issues in your industry that your tax pro might not know of—perhaps a new case or IRS ruling. Also, speakers on tax topics are often found at conventions and trade shows.

11. Tax Info Online

There has been an explosion of tax information on the Internet in the last year or two. Surprisingly, the IRS itself has a good website.

Start your Internet search with the IRS home page at www.irs.gov. You can download over 600 IRS forms and publications and peruse summaries of 150 tax topics. Email simple tax questions to the IRS (but remember what I have said about taking tax advice from the IRS with a block of salt).

Internet services providers and commercial online services—like America Online—offer tax information from a number of good sources, including the National Association of Enrolled Agents and *TurboTax*. Some sites allow you to post tax questions to experts and receive answers.

Keep in mind you don't know the person giving the answer, and they don't know you and your tax needs. The right tax answer is usually the one tailored to your individual situation—and for that you need the personal touch of meeting with a tax pro.

Here are some other helpful tax sites:

- www.taxsites.com has a comprehensive list of links to tax topics.
- www.unclefed.com includes all IRS forms (downloadable) as well as tax articles from tax pros (including yours truly).
- www.sisterstates.com has state tax forms and info.

To go still deeper into cyberspace, use one of the popular search engines such as Google or Yahoo. Be prepared for thousands of listings to pop up. There is a lot of tax nonsense on the chaotic World Wide Web. People can express their views or promote harebrained "untax yourself" schemes. So, watch out.

B. Finding and Using a Tax Pro

Mastering the tax rules is a Herculean task, given everything else a businessperson has to do. Armed with the basics (from reading this book and other resources), it makes sense to get to know a tax professional. Form a long-term relationship, calling any time a tax issue arises. Just what are tax pros, and how can you find one? Read on.

1. Types of Tax Advisers

Tax advisers are of many varieties, and not all professionals are created equal. Just about anyone can claim to be a tax expert.

Look for someone specifically knowledgable in helping small businesses—not the storefront outfit that advertises rapid refunds or a big five national CPA firm. Ideally, pick a professional who already understands your particular type of business—whether you are a manufacturer, a restaurateur, or a retail clothing seller. Look for one of the following types of tax pros:

Tax return preparer. Surprisingly, people who prepare tax returns don't have to be licensed by the IRS. Make sure your tax preparer has one of these three professional designations:

- **Enrolled Agent (EA).** An EA is a tax adviser and preparer who is licensed by the IRS. This professional designation is earned by either passing a difficult IRS test or having at least five years of experience working for the IRS. There are 24,000 EAs in the United States. Enrolled Agents are the least expensive of the true tax pro. Many EAs offer bookkeeping and accounting assistance.
- **Tax attorney.** A tax attorney is a lawyer with either a special tax law degree (LL.M. in taxation) or a tax specialization certification from a state bar association. If you have a serious tax or IRS problem, require legal representation in court, or need business and estate planning, go to a tax attorney.
- **Certified Public Accountant (CPA) and other accountants.** CPAs are licensed and regulated by each state, like attorneys. They perform sophisticated accounting and business-related tax work and prepare tax returns. CPAs should be considered by larger businesses or for complex business tax returns. CPAs are found in large national firms or in small local outfits. (Some states also license Public Accountants, who are not as highly regarded as CPAs.)

For typical small business tax needs I lean toward EAs and small CPA firms. National CPA firms and tax attorneys are too costly. Interview several tax pros to get a feel for the right one for your business.

2. How Tax Pros Can Help

A tax pro can assist you with the following:

Information and advice. A good tax pro can be a very effective teacher. (If your present adviser told you about this book or gave it to you, hurrah! You are working with someone who respects your ability to help yourself.) She can help make key tax decisions, such as choosing the best entity for your business and preparing financial statements necessary for obtaining loans.

Record keeping. Some people would do about anything to avoid record keeping. That's why God created bean counters and small business software that makes record keeping (almost) fun. See Chapter 3, Bookkeeping and Accounting, to see what record keeping entails before deciding what's best. Or see a pro for setting up a system tailored for your business.

Tax form preparation. Once you get past the record keeping, you'll face various tax filings. Congress talks about tax simplification, but don't hold your breath. Until that day, seriously consider professional assistance for your business tax forms. If you insist on doing it yourself, run it by a tax pro before filing it. For do-it-yourselfers, I recommend Intuit's *TurboTax for Business* or *TurboTax Home and Business*. However, a tax pro can point out tax deductions or other benefits that you and your computer might miss, as well as keep you out of trouble.

Advice in dealing with the IRS. For help in dealing with the IRS, a tax pro can be an on-call coach. Some thorny questions may be answered in a minute or two by a canny tax pro.

Representation. You don't have to deal with the IRS at all if you hire an attorney, CPA, or Enrolled Agent to represent you. These folks know how to handle IRS bureaucracy. A tax pro can neutralize the intimidation factor the IRS knows that it holds over you. And if you have something you would rather not have the IRS see, a pro might be able to keep the lid on it.

3. How to Choose a Tax Pro for Your Business

There are several ways to find a good tax pro; asking the IRS is not one of them. Instead, try the following:

- **Personal referrals.** Ask friends, family, your attorney or banker, business associates, or even competitors for the names of tax pros they know or have dealt with.
- **Advertising.** Trade journals, directories, phone books, and newspapers carry lists of

tax pros. Look under "accountants," "tax return preparers," and "attorneys—tax." Some offer free initial consultations. If they are advertising, they have time for new clients.

- **Professional associations and referral panels.** Check the phone book for local bar associations and CPA societies that can refer you to a tax attorney or accountant. A referral shouldn't be construed as a recommendation or certification of competence. Find a CPA online at www.cpadirectory.com. The National Association of Enrolled Agents (800-424-4339 or www.nea.org) can help you locate an EA.

Once you have the names of tax pros, start weeding through them. Interview at least three pros to see how well you relate to each other. Break the ice by telling the pro where you got his name. Then discuss your situation, and ask if he has clients in similar businesses. Ask if he is too busy or has the experience you are looking for. If he doesn't, ask him to recommend someone who fits the bill.

If you worked with a tax preparer before you went into business, maybe this is the person you want to stick with, but maybe not. Ask about her experience with small businesses like yours.

Test a tax pro's attitude toward the IRS and knowledge of small business taxes by pulling out questions from this book. Someone with prior IRS work experience is not necessarily desirable—they may have been permanently imprinted with the IRS point of view.

Ask if she has represented clients before the IRS, and specifiically in IRS audits. If she hasn't, she's probably not as experienced as you would like.

Also ask yourself some questions as you go through the selection process: Does the tax pro give you a feeling of confidence? Is she knowledgeable? How long has she been doing tax work? Can you envision her going to bat for you in front of the IRS? Finally, ask yourself, "Is this someone I would feel comfortable working with?"

Don't be in a hurry to hire a tax pro. Looking for the right tax pro should be more like looking for a mate for life than a casual date. After all, complying with the tax laws is a key to whether your business lives or dies. The best time to look is in the summer or fall—not the January to May tax season.

4. Tax Pros' Fees

Good tax pros aren't cheap. A start-up business without much cash flow may be tempted to price shop. But an expensive expert who saves you from getting in trouble is a bargain in the long run.

Get a clear understanding of professional fees at your first meeting. Does the pro charge by the hour or have flat (fixed) fees for bookkeeping, accounting, and tax form preparation? Professionals working on an hourly basis charge from a low of $50 per hour up to $500 for top CPAs and tax attorneys.

Ask for a written fee agreement so you have a basis for disputing a tax pro bill later on, if necessary.

You control costs here. Tax pros can be consulted as needed or hired to take over tasks from bookkeeping to IRS filings and representation.

Everything is negotiable. Do you like the tax pro, but not her fee? Ask if she can do it for less. Try something like, "I am new in business and need to watch my pennies." If she believes you'll be a long-term client, or if you catch her in a slow period, she may discount her normal rates. The best time to hire a tax pro is after the tax season—meaning the summer or fall.

Resources

- At the end of each chapter is a list of resources specific to that topic. Start there first, and then go to the more general list here.
- *Internal Revenue Code (IRC).* This book has more fine print than you ever thought you would find in one place, but it is the tax bible.
- *Regulations (Federal Income Tax Regulations).* Only slightly more comprehensible than the IRC, Regulations are written by the Treasury Department to elaborate on the tax code. Find the IRC and regulations online at www.irs.gov.
- *Legal Research: How to Find & Understand the Law*, by Stephen Elias and Susan Levinkind (Nolo). This book is not directed toward tax research, but is an excellent guide to law library research. Also see Nolo's Legal Research Center at www.nolo.com.
- *The Ernst and Young Tax Guide* (John Wiley & Sons). This is my favorite annual tax preparation guidebook. It includes tips and explanations of the tax law far superior to the IRS's publications.
- *Master Tax Guide* (Commerce Clearing House), *Master Federal Tax Manual* (Research Institute of America), and *Federal Tax Guide* (Prentice-Hall). These books are written for tax pros and may be over your head, but you might want to check them out.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This is a good companion book to the one in your hand; it covers the nontax aspects of small business as well as any book I have ever seen.
- *Kleinrock's Federal Bulletin*. The bulletin is published biweekly and is an excellent resource used by tax professionals. Order by calling 800-678-2315 or going to www.kleinrock.com.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book contains more detailed information on dealing with the IRS.
- *The Employer's Legal Handbook*, by Fred Steingold (Nolo). This book covers all aspects of being an employer, including tax obligations, in greater detail than covered here.
- *Working with Independent Contractors*, by Stephen Fishman (Nolo). Explains how to reap the benefits—and avoid the pitfalls—of using independent contractors.
- *The Home Office and Small Business Answer Book*, by Janet Attard (Owl Books). Lists guilds, associations, and societies that might have publications that touch on specialized tax issues.
- *Tax Hotline*, P.O. Box 58477, Boulder, CO 83028 (800-288-1051). This inexpensive monthly newsletter is full of current tax tips from experts all over the U.S., including me.
- *TurboTax* (Intuit). This software will make your life much easier at tax preparation time.
- IRS business tax line. 800-829-4933. For general questions on business-related tax forms, such as Forms 940 and 941.

■

C H A P T E R

23

Answers to 25 Frequently Asked Tax Questions

1. Do I have to file a federal income tax return for my business if I lost money?

Technically no, but you should do it anyway. Your loss could provide you with a tax benefit by reducing your other taxable income in that year or in past or future years. To report this loss, either attach a written statement to the loss year's tax return, or attach IRS Form 3621, *Net Operating Loss Carry-Over*. (Note: If you weren't active in the business, but merely an investor, your ability to deduct a business loss is limited.)

If your business is incorporated, you *must* file an annual tax return whether or not you have any income. Plus, the loss rules for small corporate shareholders are more generous. (See Chapter 4, Section B.)

2. What does the term "depreciation" mean?

Depreciation refers to the annual tax deduction the IRS allows for a business asset that has a useful life of more than a year. The theory is that an asset loses value as it wears out over time, and you get a tax break reflecting that. The amount you may deduct per year, and the length of time over which you must take these deductions, depends on how the tax code classifies the property. (See Chapter 2.)

3. How long do I have to keep my business records?

The bare minimum period for keeping those dust-catching boxes is three years from the date you file your tax return. This is the normal IRS statute of limitations on audits. However, some state tax agencies have longer periods to audit, and the IRS can go beyond three years for serious underreporting. For this reason, as much as it may pain you, hold on to those boxes for at least six years. (See Chapters 3 and 19.)

4. I'm a doctor and I had patients who didn't pay their medical bills. Can I deduct this as bad debt expense?

The prognosis is not favorable, Doctor. The tax code specifically excludes the value of services provided from the definition of tax deductible bad debt. However, any out-of-pocket expenses (medications, needles, or supplies) in connection with providing these services to deadbeat patients are deductible. (See Chapter 1.)

5. If I incorporate my one-man consulting operation, will I reduce my audit risks?

Probably. In the past, the IRS audit rate for incorporated small businesses with under $1,000,000 gross receipts has been less than half of similar unincorporated ventures. The IRS vows that it will equalize audit rates in the future, but who knows? Investigate the initial costs and recurring expenses of incorporating before you rush out and add "Inc." to your name—operating a corporation is more complex than operating as a sole proprietor. (See Chapter 7.)

6. Do I need any kind of prior IRS approval or registration before I start my business?

Not if you are starting off as a sole proprietor without employees. Just use your own Social Security number when corresponding or filing anything with the IRS.

But if you form any kind of business entity (a corporation, a partnership, or an LLC) or have one or more employees, you must get a federal employer identification number at the time you begin operations.

You can obtain a federal employer identification number using IRS Form SS-4. You will use this number on any forms you file with the IRS. Also, check with your state employment and tax authorities for their requirements. (See Chapter 5.)

7. I make dollhouse furniture in my spare time and sell a few items to friends and at craft fairs. Overall, I lose money every year, but have a good time at it. Are my losses tax deductible?

Possibly. The best way to pass muster with the IRS is to show that you had a profit motive and operated in a businesslike fashion. If you are ever audited, the auditor may try to argue that the dollhouse business was really a nondeductible hobby, and disallow your losses. Keep good records to show your efforts to turn a profit, and do some advertising or business promotion, just like any real business. Keep in mind that you only have to show that you *tried* to make a profit—it doesn't matter whether you actually did (although an IRS auditor might try to tell you otherwise). (See Chapter 13.)

8. Do IRA, SEP, 401(k), and other retirement plans for the self-employed really provide much of a tax break?

Absolutely. There is no better tax benefit available to the small business owner than a retirement plan. With the exception of the Roth IRA, you'll get an immediate tax savings for every year you contribute, and the money you invest in your plan will accumulate interest, dividends, and capital gains—with the tax deferred until you withdraw it.

Also, although retirement may be many years away, you can often make early withdrawals for buying a home or for medical reasons. Don't wait—the sooner you start contributing to a plan, the sooner your money can start making money for you. (See Chapter 15.)

9. Should I choose a fiscal year or calendar tax year accounting period for my business?

For most small-time operators, the accounting period is rarely a big deal either way. The vast majority of small businesses use a calendar year (January 1 to December 31).

To choose any other tax period, you must have a good reason and get permission from the IRS. If, for instance, your business is seasonal, such as farming, and you think you might benefit from a noncalendar fiscal year, see an accountant to discuss the ramifications. (See Chapter 3.)

10. If I claim a home office deduction for my consulting business, will I be audited?

Several years ago, home offices were IRS targets. Today, while a home office deduction increases your chances of audit, it's only a slight increase—unless the deduction is particularly large (50% or more) relative to your business income. (See Chapter 19.)

11. I use my car to call on customers and make deliveries. Am I better off leasing a vehicle or buying it?

As a rule, the more expensive the car, the bigger tax deduction you get from leasing. The price point at which leasing becomes more favorable is about $15,800. When you get up in $50,000 territory, vehicle deductions are much greater than with owning. However, if you are thinking of a big truck or a heavy SUV, you might be better off buying, because the annual tax deductions are far bigger than with passenger car tax rules. And, using Section 179, you might be able to write 100% off in the year of purchase! (See Chapter 2, Sections B and C.)

12. There is a trade show in San Francisco coming up and I'd like to take my wife and spend a few extra days after the show. Can I still deduct the trip expenses?

Yes, but you can't deduct any expenses (such as airfare and food) solely attributable to your wife unless she is an employee of your business and is there for business reasons, too. (Hint, hint.) However, you can deduct all of your airfare, the full cost of your shared hotel room (for the business days, but not the extra days), and the rental car for the business days. And, if you can find one of those "companion flies free" deals, you don't have to account for your wife's airfare at all. Make sure to take her for a drink at the Cliff House at sunset. (See Chapter 14, Section E.)

13. Two friends and I want to go into business building and fixing stock cars for racing. What's the simplest way to do this tax-wise?

Consider forming a limited liability company (LLC). Your other alternatives are a partnership or a corporation, which may be more complicated tax-wise and legally than an LLC.

The best advice I can give you is to meet with a business lawyer and talk to a tax pro about your plans and get advice tailored to your situation. See you at Daytona. (See Chapter 10.)

14. Will the IRS be upset if I hire my 14-year-old kid to help in my video store after school, sweeping floors, answering the phone, and so on? I would pay him about $50 a week.

Hiring Junior and Little Susie is perfectly okay (and it keeps the kids off the streets). In fact, it's a good family tax saver, too. It takes income from your tax bracket and transfers it to the child's lower bracket. Make the kids do real work, and don't overpay them—their (tax deductible) salaries shouldn't be just disguised weekly allowances.

As an added benefit, the kids can put money into retirement plans and deduct the contributions. This makes good tax sense even if they take the money out for college—long before retirement age. (See Chapter 12.)

15. My cousin Luigi and his wife own a multi-million-dollar floor covering business. His daughter and one son work in the business. Could operating the business as a family limited partnership save estate taxes on his death?

If Luigi plans far enough ahead, yes, putting the floor covering operation into a family limited partnership (FLP) can reduce the size of his taxable estate and cut probate time and costs.

Luigi could gradually transfer ownership of the business to his children over a period of years through annual tax-free gifts (right now, the maximum amount Luigi and his wife can contribute tax-free is $22,000 in partnership assets to each family member per year). (See Chapter 12.)

16. I frequently give my employees gift certificates and special occasion items to keep them loyal. What are the tax rules for deducting the costs of these things?

First, congratulations for your enlightened approach to holding on to valuable employees. You can deduct all of the costs of gifts to employees; the catch is that anything totaling more than $25 per year must be reported as additional income by the employee.

For a service business, you can provide "excess capacity" things (services that wouldn't be used anyway, such as an available hotel room) to your employees tax-free. And, owners can give "good habit" rewards of up to $400 per year, or with a qualified award plan, you can give items valued up to $1,600 per year. Check with your tax pro for more information. (Also see Chapter 14, Section K.)

17. I'm buying a small injection molding company that has gross receipts of about $500,000 per year. Do I have to tell the IRS about this deal?

If you are buying an unincorporated business, both you and the seller must agree on the value of each category of assets being transferred. This means things like equipment, real property, goodwill, the seller's covenant not to compete, and so on. Both sides report these allocations with their annual tax return filings on an IRS Form 8594, *Asset Acquisition Statement*.

However, if you buy shares of stock in a corporation, then there is no special IRS reporting form to file. (See Chapter 16.)

18. My auto dealership went through some rough times last year. I got behind in payroll tax deposits for $120,000 and I owe suppliers, the landlord, and others even more. Can these payroll taxes be wiped out in bankruptcy?

Sorry, no can do. Congress (in conjunction with the IRS, no doubt) says that payroll taxes can never be discharged in a bankruptcy. The best thing to do is use whatever assets you can to make the payroll tax payments and then file for bankruptcy. The suppliers' bills are most likely dischargeable in bankruptcy, so pay the IRS first.

The IRS is tenacious when it comes to collecting payroll taxes, and you could lose more than just your business. You may be able to make a deal with the IRS under an offer in compromise. (See Chapter 18, Section E.)

19. I am being audited by the IRS. The auditor says a number of my business expenses will be disallowed in his report. Do I have to accept this?

Absolutely not. The IRS has an administrative process that allows you to appeal an auditor's decision to the IRS Appeals Office—a completely separate division of the IRS. Their job is to settle the dispute with you so you don't take the IRS to tax court. And, in most cases, they will compromise on an audit report—although your odds of being let off the hook completely are slim.

If you can't reach a compromise, the filing fee for tax court is only $60 and, if the amount you are contesting is less than $50,000, the procedures are fairly simple. (See Chapter 20, Section B.)

20. I save a lot of taxes hiring independent contractors for my print shop instead of employees, but my accountant says I'm crazy to take the risk that they'll be reclassified as employees. What do you think?

Your accountant is right to be wary. Most small business owners love the tax savings they get from hiring independent contractors—they don't pay the employer's share of payroll taxes or unemployment taxes, or withhold income taxes as required by law. That's fine if the workers are legally independent contractors.

But if you are providing a workplace on your premises, setting the hours of work, and presumably directing the workers, then they probably aren't independent contractors, but employees—and you could be in big trouble with the IRS. The IRS is very aware of the tax benefits of hiring independent contractors and makes a habit of auditing businesses that hire a lot of independent contractors. Also, watch out for fines and penalties from your state tax agency as well if—and when—you are caught. (See Chapter 5.)

21. I'm thinking of opening a cosmetic store and I project about $250,000 in sales the first year. Should I try to keep records by hand or with my computer?

Unless you are completely hopeless with a computer—and most people can pick up at least a few skills—forget the pencil and paper. Tracking many relatively small sales, keeping inventory, sales tax reporting, and other such items is the stuff computers were made for. Most small business owners wouldn't dream of operating their business without a computer and a program like Intuit's *Quicken* or *QuickBooks*. (See Chapter 3.)

22. Our state has both a corporate and personal income tax. I've read that incorporating out of state (like in Delaware or Nevada) will save on costs and taxes; is this true?

No, just the opposite. You will still have to register and file corporate and personal tax returns in your home state, because that is where you are doing business. (That's the law in 50 of the 50 states.) Incorporating in a no- or low-tax state will result in higher overall costs and taxes, considering the expenses of forming and maintaining the out-of-state corporation. The legitimate reasons for incorporating out of state are all nontax—like favorable liability laws or greater privacy. If you're still tempted, talk to a business attorney and tax pro first. (See Chapters 7 and 8.)

23. I am a sole proprietor with a huge self-employment tax bill. Is there any way to lower my tax bite?

Yes, by putting your business into an S corporation, and becoming an employee of the corporation. You would no longer pay self-employment taxes. However, there are payroll taxes, but you would probably come out ahead.

The catch: There are costs and legal fees for setting up and maintaining the corporation as well as tax pro fees for corporate tax return filings. For the average small business these costs shouldn't be more than $2,000 per year—and they are all tax deductible. And, a side benefit is the personal liability shield that a corporation provides. But before spending the money, get legal and tax advice from pros in your area (See Chapter 8.)

24. I notice that you often recommend hiring tax professionals, but I can't afford that. Why can't I just read your book and call the IRS for free if I have any tax questions?

There are at least two reasons for not relying on this (or any other) book and the IRS as your sole sources of tax advice. First, everyone's overall tax circumstances are different. For instance, a $1,000 tax deduction may save a high-earner like Patricia $400 in federal and state income taxes but may not save a part-time student like Patrick a dime. It depends, on their tax rates, other deductions, dependents, and dozens of other highly individual considerations. This book or an IRS publication is only a one-size-fits-all overview.

Second, calling a live person at the IRS or relying on something in its publications or website is dangerous. Why? Believe it or not, the IRS is not legally liable for its oral advice or what is stated in its publications! Also, keep in mind that paying a private tax pro for advice is tax deductible, which should take part of the sting out of paying those fees. (See Chapter 22.)

25. My tax preparer typically says "no" whenever I ask if I can take a deduction that she thinks might bring down the IRS on me. Is she being too careful, or is she acting in my best interests?

Get someone else to do your taxes … you are likely overpaying your income taxes by hundreds or even thousands of dollars every year. Of course the powers of the IRS should be respected, but you don't have to be a scared rabbit. For one thing, chances of an IRS audit nowadays are very low, and even if you are audited, it doesn't necessarily mean you will lose. Interview several tax pros. Ask them about taking deductions, and about their attitude toward the IRS. When you find a good fit, make the switch. (See Chapter 22.) ■

Glossary

The terms in this glossary are defined as they are used by the IRS or by the author. Some terms may have different meanings in other contexts.

Abatement. The IRS's partial or complete cancellation of taxes, penalties, or interest owed by a taxpayer.

Accelerated Depreciation. A method of tax deducting the cost of a business-used asset more rapidly than by using straight-line depreciation. *See* Depreciation.

Accountant. Someone who works with financial data. Often denotes a person with special training, such as a Certified Public Accountant.

Accounting. Process by which financial information about a business is recorded.

Accounting Methods. *See* Cash Method *and* Accrual Method.

Accounting Period. *See* Calendar Year Accounting Period *and* Fiscal Year Accounting Period.

Accounts Payable. Money owed by a business to suppliers, vendors, and other creditors; a business liability.

Accounts Receivable. Money owed to a business for goods or services rendered. A business asset.

Accrual Method of Accounting (also called Accrual Basis). Accounting for income in the 12-month period earned, and for expenses when the liability was incurred. This is not necessarily in the period when it is received or paid. *See also* Cash Method.

Adjusted Basis. *See* Basis (Tax Basis).

Adjusted Gross Income (AGI). On personal income tax returns, Form 1040, this figure is the result of reducing a taxpayer's total income by certain adjustments allowed by the tax code, such as a contribution to a traditional IRA. From this figure, personal deductions are subtracted to arrive at taxable income. *See also* Taxable Income.

Adjustment. (1) An IRS change, usually by an auditor, to a tax liability as reported originally on a tax return. (2) Deductions from an individual taxpayer's total income on Form 1040, lines 23 through 30.

Alternative Minimum Tax (AMT). A federal flat tax on income of individuals or corporations that may apply when a taxpayer claims certain tax benefits that reduce tax liabilities below specified levels. The AMT prevents higher-income taxpayers from getting too many tax benefits from things like accelerated depreciation or investments in municipal bonds.

Amended Tax Return. Generally, amended tax returns may be filed by an individual or entity to correct an error made on a previously filed return or to get a refund of taxes paid.

Amortization. A tax method of recovering costs of certain assets by taking deductions evenly over time. This is similar to straight-line depreciation and unlike an accelerated depreciation method. For example, when someone buys a company, the Internal Revenue Code directs that business goodwill costs must be amortized over 15 years by the buyer.

Appeal. (1) Administrative process allowing taxpayers to contest certain decisions, typically audits, within the IRS. (2) Judicial process for reviewing decisions of lower courts.

Assess. The IRS process of recording a tax liability in the account of a taxpayer.

Asset (Business). Any property with a value and useful life of at least one year that is used in a trade or business. Examples: machinery, buildings, vehicles, equipment, patents, and monies held or owed to a business. *See also* Accounts Receivable.

Audit. A review of financial records. An IRS audit is the examination of a taxpayer, his or her tax return, and supporting data to determine whether he or she has violated the tax laws.

Auditor. An IRS Examination Division employee who reviews the correctness of a tax return. *See also* Revenue Agent, Tax Auditor (Examiner).

Bad Debt (Business). Money owed for a business debt that cannot be collected and can be deducted as an operating expense.

Balance Sheet. A statement listing a business's assets (what it owns), liabilities (what it owes), and net worth (the difference between the assets and liabilities). A balance sheet shows the financial position of a business at a given point in time.

Bankruptcy. A federal law providing a way for individuals or businesses to wipe out certain debts. There are different kinds of bankruptcy. A defunct business will likely file Chapter 7 bankruptcy, wherein its assets are distributed to creditors and any remaining debts are canceled. Chapters 11 and 13 bankruptcy allow businesses and individuals to repay debts over time while remaining in operation.

Basis (Tax Basis). The tax cost of an asset, which may be adjusted upward by improvements or downward by depreciation. Basis is used to calculate depreciation and amortization deductions and to determine gain or loss on the sale or other disposition of an asset.

Bookkeeper. Someone who records financial data in the accounting records of a business and maintains the accounting system.

Books (Business). The collection of records of financial accounting of business activity kept on paper or in a computer file.

Business. An activity carried on with the intent to make a profit.

Business License. A permit issued by a local or state governmental agency for a business to operate. Most enterprises are required to have one or more licenses and must go through an application process and pay a fee for this privilege. A business license is not issued by the IRS or required to qualify as a taxable entity, however.

Calendar Year Accounting Period. A 12-month period for tax purposes that ends on December 31. *See also* Fiscal Year Accounting Period.

Capital. The investment in a business by its owners. *See also* Equity.

Capital Asset. Any type of property that has a useful life of more than one year.

Capital Expenditure. Cost to acquire an asset or make improvements to an asset which increases its value or adds to its useful life. *See also* Basis.

Capital Gain or Loss. A gain or loss from the sale or exchange of a capital asset—the difference between the amount realized on the sale or exchange of an asset and the amount of the adjusted basis of the asset.

Capitalized Expenditure. An expenditure for a capital asset that must be tax deducted over more than one year, as opposed to an ordinary expense. For example, repairing a broken window is an ordinary expense, but remodeling a storefront is an expense that must be capitalized.

Carryovers. Tax rules often limit the ability of a taxpayer to use deductions, losses, and credits in the year incurred. The excess of a tax deduction, loss, or credit over what can be used in a current year is called a carryover, which may be taken in past or future years.

Cash Method of Accounting. Accounting for income by reporting it when actually or constructively received, and reporting expenses when paid. Also called cash basis method. *See also* Accrual Method, Constructive Receipt of Income.

Certified Public Accountant (CPA). The most highly qualified of all accounting professionals. CPAs are licensed by the state and must meet rigorous educational and testing requirements.

Chart of Accounts. A complete list of a business's expense and income accounts by category. It includes all accounts that appear on the business's balance sheet, as well as the accounts that track particular kinds of expenses or income.

Cohan Rule. A federal court decision allowing taxpayers to use reasonable approximations of expenses when records are missing. The Cohan rule has its limitations and cannot be used to approximate travel and entertainment business expenses.

Constructive Receipt (of Income). Income not physically received but treated by the tax code as if it had been because it is accessible to the recipient without qualification. *See also* Cash Method.

Corporation. A state-registered business that is owned by shareholders. The tax code considers all corporations to be taxable entities, called C corporations, unless the shareholders have elected S status. *See* S Corporation.

Cost of Goods Sold (CGS). The amount paid by a business for inventory that is sold during a tax year. The formula for determining the CGS is: the beginning inventory plus the cost of purchases during the period, minus the ending inventory at the end of the period. Also called cost of sales.

Death Benefit. A fringe benefit payment that is tax deductible to a C corporation, within dollar limitations, and not taxable to the recipient.

Deductible Business Expense. An expenditure by a business that may be deducted from the business's taxable income under the tax code.

Deduction. An expense that the IRC allows an individual or business to subtract from its gross income to determine its adjusted gross income or taxable income. Example: the cost of this book if you are in business.

Deferred Compensation. Earned income of a taxpayer that is put into a retirement account and not taxable until removed from the account, such as a 401(k) plan.

Deficiency (Tax). Any difference found by the IRS between a taxpayer's reported tax liability and the amount of tax the IRS says that the taxpayer should have reported.

Dependent Care Plan. A fringe benefit that can be given tax-free to eligible employees of a business to care for their dependents and is deductible to the business, within limitations.

Depreciable Asset. Property used in a business with a useful life of at least one year and deductible over a period set by the IRC. Includes buildings, vehicles, and equipment used in a business, but not land, which is never depreciable.

Depreciable Basis. *See* Basis.

Depreciation. An annual tax deduction allowed for the loss of value of an asset due to wear over a period of years, such as a business auto or real estate improvement. The amount of the deduction each year depends on which of the depreciation methods allowed in the tax code for the kind of asset is applied.

Disallowance (Audit). An IRS finding at audit that a taxpayer was not entitled to a deduction or other tax benefit claimed on a tax return.

Dividend. Corporation earnings distributed to shareholders. *See also* Unearned Income.

Documentation. Any tangible proof that substantiates an item on a tax return, such as a canceled check for an expense claimed as a deduction.

Double-Entry System. A system of accounting that records each business transaction twice (once as a debit and once as a credit), and is more accurate than single-entry accounting.

Earned Income. Compensation for services rendered, such as wages, commissions, and tips. *See also* Unearned Income.

Education Benefits. Financial assistance to an employee that is tax-free to the recipient and a tax deductible expense to the business, within tax code limitations.

Employee. A worker under the direction or control of an employer and subject to payroll tax code rules. *See also* Independent Contractor.

Employer Identification Number (EIN). A 13-digit number assigned to a business by the IRS, upon application. *See also* Taxpayer Identification Number.

Employment Taxes. *See* Payroll Taxes.

Enrolled Agent (EA). A type of tax professional permitted to practice before the IRS along with attorneys and CPAs. An EA must demonstrate competence by passing an IRS test or have at least five years' work experience with the IRS.

Entry. A transaction recorded in the accounting records of a business.

Equity. The net worth of a business, equal to its assets minus its liabilities. Also refers to an owner's investment in the business.

ERISA (Employees' Retirement Security Act). A federal law that governs employee benefits, such as pension and retirement plans. *See also* Pension Plan.

Estate Tax. A tax imposed by the federal government (and many states) on the net value of a decedent's assets.

Estimated Taxes (ES). Tax payments to the IRS by self-employed individuals, quarterly, for their anticipated income tax liability for the year. If payments are not made timely a penalty may be imposed by the IRS.

Examination. *See* Audit.

Examination Report. The findings issued by an IRS auditor after an audit is concluded.

Excise Tax (Federal). A tax, usually at a flat rate, imposed on some businesses for a certain type of transaction, manufacturing, production, or consumption.

Exemption. An annual amount allowed to a taxpayer as a deduction for herself and for each dependent on her Form 1040 tax return.

Expense. A business cost. *See also* Deductible Business Expense.

Fair Market Value. The price a buyer and seller of any kind of property agree on as just, when neither is under any compulsion to buy or sell.

Family Limited Partnership. A business that is a limited partnership of only related members. It can be used to shift present business income and to transfer a business to succeeding generations at a tax savings. *See also* Limited Partnership.

Federal Insurance Contributions Act (FICA). Social Security and Medicare taxes, which are generally applicable to everyone with earned income. Employers and employees split the tax; self-employeds pay the entire tax. *See also* Payroll Taxes, Self-Employment Tax.

Federal Tax Deposits (FTD). An employer is required to place payroll taxes withheld from employees, as well as employer contributions for Social Security and Medicare taxes, in a federal depository (bank).

File (a Return). To mail or electronically transmit to the IRS the taxpayer's information in a specified format about income and tax liability.

Fiscal Year Accounting Period. A 12-month period ending on the last day of any month except December. *See also* Calendar Year Accounting Period.

Fixed Asset. A business asset with a useful life of greater than one year as determined by the Internal Revenue Code. *See also* Depreciable Asset.

401(k) Plan. A tax-advantaged deferred compensation arrangement in which a portion of a worker's pay is withheld by the business and invested in a plan to earn income tax-deferred until withdrawn.

Fraud. *See* Tax Fraud.

Fringe Benefit. Any tax-advantaged benefit allowed a business owner or employee. A fringe benefit may be partially or totally tax-free to the recipient and tax deductible to the business. Prime examples are health and retirement plans.

FUTA (Federal Unemployment Tax Act). An annually paid tax on all employers for unemployment insurance.

General Journal. A book or computer file where all financial transactions of a business are recorded. Also called General Ledger.

Goodwill. The excess value of a going business, over and above the worth of all of its other assets.

Gross Income. Money, goods, and property received from all sources required to be reported on a tax return, before subtracting any adjustments, exemptions, or deductions allowed by law.

Group Life Insurance Benefit. *See* Fringe Benefit.

Hobby Loss Provision (IRC § 183). An IRC limitation on tax deducting losses or expenses of any activity that is not carried on with a profit motive.

Home Office. That portion of a taxpayer's home in which he or she carries on a business activity. If the home office is used regularly and exclusively for business and meets other tax code tests, then a deduction—up to the amount of business income—may be taken for the business portion of the home, for depreciation on the structure, or for rent paid.

Improvements. Additions to or alterations of a capital asset, which either increase its value or extend its useful life. *See also* Capitalized Expenditure.

Incentive Stock Option (ISO). An option to purchase corporate stock granted to an employee. Generally not taxed until the stock is sold.

Income. All money and other things of value received, except items specifically exempted by the tax code. *See also* Gross Income.

Income Statement. *See* Profit and Loss Statement.

Income Taxes. Federal and state taxes, levied on an individual or corporation for earned (such as wages) and unearned (such as dividends) income.

Independent Contractor. A self-employed individual whose work hours and methods are not controlled by anyone else; not subject to payroll tax rules. *See also* Employee.

Individual Retirement Account (IRA). A retirement plan established by an individual allowing annual contributions of earned income, and tax deferred accumulation of income in the account. Contributions may or may not be tax deductible, depending on the individual's annual income, and whether the IRA is a Roth IRA.

Information Return (Income). A report filed with the IRS by a business showing amounts paid to a taxpayer, such as Form W-2 (wages) or Form 1099 (independent contractor and other types of income). No tax is due with an information return, but there are penalties for not filing one or for filing late.

Installment Payment Agreement (IA). An IRS monthly payment plan for unpaid federal taxes.

Installment Sale. The purchaser of an asset pays the seller over several years, allowing the tax liability on any gain to be spread over the same period of time instead of all in the year of the sale.

Intangible Property. Assets that consist of rights rather than something material. For example, the accounts receivable of a business is an intangible asset because it is the right to receive payment rather than the money itself. The funds, when received, become a tangible asset.

Intent to Levy. A notice to a delinquent taxpayer that the IRS intends to seize (levy) his or her property to satisfy a tax obligation. This warning is usually issued at least 30 days prior to any confiscation. Intent to Levy notices don't necessarily mean the IRS will actually make any seizures. *See* Levy.

Interest. Cost of borrowing or owing money, usually a tax deductible business expense. The IRS adds interest to overdue tax bills.

Internal Revenue Code (IRC). The tax laws of the U.S. as enacted by Congress. Also called the tax code or simply the code.

Internal Revenue Service (IRS). The branch of the U.S. Treasury Department that administers the federal tax law. Also called the Service by tax professionals, and worse by most other folks.

Inventory. Goods a business has on hand for sale to customers, and raw materials that will become part of merchandise.

Investment. Money spent to acquire an asset, such as the purchase of a partnership interest or stock in a corporation.

IRC § 179. A tax rule allowing a deduction for the purchase of certain trade or business property in the year the property is placed in service.

IRC § 1244 Stock. Corporation stock issued under the rules of IRC § 1244, which allow an ordinary tax loss to be claimed, within tax code limitations, by the shareholder.

Itemized Deductions. Expenses allowed by the tax code to be subtracted from your tax-reported income, such as medical expenses, mortgage interest, and charitable expenses.

Joint Tax Return. A combined income tax return filed by a husband and a wife. Alternatively, a spouse may file a separate tax return.

Journal. *See* General Journal.

Keogh Plan. A type of retirement plan for self-employed people, allowing part of their earnings to be taken from their income to accumulate tax-deferred in an investment account until with-drawn.

Lease. A rental agreement for the use of property, such as buildings or equipment. Lease payments are deductible if the property is used in a trade or business.

Levy. An IRS seizure of property or wages from an individual or business to satisfy a delinquent tax debt. *See* Intent to Levy.

Liability (Business). Money owed by a business to others, such as a mortgage debt, payroll taxes, or an Account Payable.

Lien. *See* Tax Lien.

Limited Liability Company (LLC). A form of busi-ness that is taxed much like a partnership and shields its owners from liability for business debts, like a corporation.

Limited Partnership. An entity consisting of at least one general partner with unlimited liability for business debts, and one or more limited partners whose liability is limited to their investment in the partnership. *See also* Limited Liability Com-pany.

Listed Property. Certain types of depreciable assets used in a business on which the IRC requires special record keeping, such as cellular phones, home-based computers, boats, airplanes, and personal cars used for business.

Loss (Operating). An excess of a business's expenses over its income in a given period of time, usually a tax year.

Loss Carryover. *See* Carryovers, Loss (Operating).

MACRS (Modified Accelerated Cost Recovery System). An IRC-established method for rapidly claiming depreciation tax deductions.

Manual Accounting System. An accounting system maintained by hand, using paper.

Marginal Tax Rate. The income tax rate at which an individual's next dollar of income is taxed.

Medical Expense Reimbursement Benefit. *See* Fringe Benefits.

Medicare Tax. A portion of the Social Security tax of 2.9% on all of an individual's net earned income. *See* Self-Employment Tax, Payroll Taxes.

Mileage Log. A record of miles traveled in a vehicle used for business.

Net Income. Gross income less expenses; a business's profit for a given tax year.

Net Loss. *See* Loss (Operating), Net Operating Loss.

Net Operating Loss (NOL). An annual net loss from a business operation. For tax-reporting purposes, an NOL may be used to offset income of unin-corporated business owners from other sources in the year of the loss. An NOL may be carried back two years to reduce tax liabilities or secure refunds of taxes. *See* Carryovers.

Net Worth. *See* Equity.

Ninety-Day Letter. Official notice from the IRS that a taxpayer has 90 days to contest an IRS audit by filing a Petition to the United States Tax Court, or else the decision will become final.

Notice of Deficiency. *See* Ninety-Day Letter.

Notice of Tax Lien. *See* Tax Lien Notice.

Offer in Compromise. A formal written proposal to the IRS to settle a tax debt for less than the amount the IRS claims is owed.

Operating Expense. A normal out-of-pocket cost incurred in a business operation, as opposed to depreciation or amortization expense. Examples are rent, wages, and supplies.

Ordinary Income. Any earned income, such as wages, and not from the sale of a capital asset or from an investment. *See* Unearned Income, Capi-tal Gain.

Partnership. A business of two or more individuals (or other entities) which passes its income or losses to its individual partners. A partnership does not pay taxes but is required to file an annual tax return.

Payroll Taxes. The federal income taxes withheld by employers and FICA contributions—including both Social Security and Medicare—that must be deposited to an IRS account for their employees. States may also impose payroll taxes.

Penalties (Tax). Fines imposed by the IRS on tax-payers who disobey tax rules.

Pension Plan. Typically, a tax-advantaged arrangement under which annual deposits are made to an account for an owner's or employee's benefit on retirement. Income tax on the accumulated funds is deferred until the year in which they are withdrawn.

Personal Asset. Property owned by an individual, which may also be used in a business.

Personal Income Tax. Annual tax based on an individual's taxable income, less adjustments, deductions, and exemptions allowed by the tax code.

Personal Property. Anything of value that is not real estate—such as cash, equipment, or vehicles. *See also* Real Property.

Personal Service Corporation (PSC). A tax code-qualified incorporated business composed of one or more members of a specific profession. It must file an annual tax return.

Posting. The act of entering financial transactions into an accounting record, or transferring data from a book of original entry to a ledger.

Profit and Loss Statement (Income Statement). A writing showing a business's gross income, and subtracting from that figure its expenses and the cost of goods sold to reveal a net profit or loss for a specific period.

Profit Motive. An intention to make a profit is imposed by the IRC on anyone going into business. *See also* Hobby Loss Provision.

Proprietorship. A business owned by an individual that is not a partnership, an LLC, a corporation, or any other type of legal tax entity.

Prorate. To allocate or split one figure between two items, such as prorating business and personal use of an asset.

Protest. A request to appeal a decision within the IRS. *See* Appeal.

Qualified Plan. A tax code-qualified and IRS-approved employee benefit plan, usually a pension or profit-sharing plan. *See* ERISA.

Qualified Small Business Stock. Certain small business corporation shares held for more than five years, with any gain upon sale being taxed at 50% of the normal rate.

Real Property. Real estate, consisting of land and structures built on it. *See also* Personal Property.

Record Keeping. The listing of financial transactions for a business. *See also* Records.

Records. Tangible evidence, usually in writing, of the income, expenses, and financial transactions of a business or individual.

Regulations (Regs). Treasury Department interpretations of selected Internal Revenue Code provisions.

Representative. A tax professional who is permitted to represent a taxpayer before the IRS. He or she must be a Certified Public Accountant, Tax Attorney, or Enrolled Agent.

Research and Development Expenses. Certain tax deductible costs for developing new products or services.

Retained Earnings. The accumulated and undistributed profits of a corporation. Retained earnings are subject to tax.

Retirement Plan. *See* Pension Plan.

Revenue Agent. An IRS examiner who performs audits of taxpayers or business entities in the field, meaning outside IRS offices. *See* Tax Auditor.

Revenue Officer. Certain IRS tax collectors.

S Corporation (Sub-Chapter S Corporation). A state-incorporated business that elects special tax treatment to pass its income or loss through to shareholders instead of being directly taxed on its income. *See* Corporation, Partnership.

Sales Tax. A state (not federal) tax imposed on sales of retail products based on a percentage of the price.

Schedule. A form on which taxpayers report details about an item, usually income or expense, which is attached to the main tax return.

Section 179. *See* IRC § 179.

Section 1231 Assets. Property used in a trade or business that is depreciable and for which gains, when sold, are taxed at capital gains rates, while losses are treated as ordinary losses.

Seizure (IRS). *See* Levy.

Self-Employed. A person who works in his or her own business, either full or part time.

Self-Employment (SE) Tax. Social Security and Medicare taxes on net self-employment income. The SE tax is reported on the individual's income tax return.

Service Business. Any enterprise that derives income primarily from providing personal services, rather than goods. Examples: consultants, physicians, and accountants.

Shareholder (Stockholder). An investor in a corporation whose ownership is represented by a stock certificate. A shareholder may or may not be an officer or employee of the corporation.

Sideline Business. A for-profit activity carried on in addition to an individual's full-time employment or principal trade or business.

Simplified Employee Pension (SEP, SIMPLE, or SEP-IRA). A pension plan allowing self-employed business owners and their employees to deduct and put part of their earnings into a retirement account to accumulate tax-deferred until withdrawn. *See also* Individual Retirement Account (IRA), Keogh Plan.

Single-Entry Accounting. A system of tracking business income and expenses that requires only one recording of each financial transaction. *See also* Double-Entry System.

Sole Proprietorship. *See* Proprietorship.

Standard Deduction. An annual tax deduction granted to each taxpayer who does not choose to itemize deductions. The amount depends on your age, your filing status, and whether you can be claimed as a dependent on someone else's tax return.

Standard Mileage Rate. A method for deducting automobile expenses based on the mileage driven for business. This is an alternative to claiming actual operating and depreciation expenses.

Statutes of Limitation (Tax). Varying limits imposed by Congress on assessing and collecting taxes, charging tax crimes, and claiming tax refunds.

Stock Dividend. *See* Dividend.

Straight-Line Depreciation. Depreciating assets of a business by deductions in equal annual amounts. The period of time is specified by the tax code for different categories of property, typically from three to 39 years.

Summons. A legally enforceable order issued by the IRS compelling an individual taxpayer or business to provide information, usually financial records.

Tangible Personal Property (Asset). Anything of value that is physically movable, such as equipment, vehicles, machinery, and fixtures not attached to a building or land.

Tax. Required payment of money to governments to provide public goods and services.

Tax Attorney. A lawyer who specializes in tax-related legal work and has a special degree (LL.M.–Tax) or certification from a state bar association.

Tax Auditor (Examiner). An IRS employee who determines the correctness of tax returns filed by individual taxpayers and business entities at the IRS offices. *See also* Revenue Agent, Audit.

Tax Basis. *See* Basis.

Tax Bracket. The percentage rate on which an individual's or taxable entity's last dollar of income is taxed.

Tax Code. *See* Internal Revenue Code (IRC).

Tax Court (U.S.). A federal court where an individual or business taxpayer can contest an IRS action, typically a tax assessment, without first paying the taxes claimed due.

Tax Deduction. *See* Deduction.

Tax-Exempt Income. Receipt of income that is specifically made exempt from taxation by Congress. Example: municipal bond interest.

Tax Fraud. Conduct meant to deceive the government or cheat in the assessment or payment of any tax liability. Tax fraud can be punished by both civil penalties (money) and criminal ones (imprisonment and fines), by both the IRS and tax agencies.

Tax Law. The Internal Revenue Code (IRC) and the decisions of federal courts interpreting it.

Tax Lien. Whenever you owe money to the IRS and don't pay after the IRS has demanded payment, the IRS has a claim against your property. This is called a tax lien, which arises automatically by operation of law. The IRS has the right to inform the public that you are subject to a tax lien. This is done by recording a Notice of Federal Tax Lien at the county recorder's office or with your secretary of state's office. A tax lien allows the IRS to seize (levy on) your property to satisfy your tax debt. Also, most state tax agencies are given lien powers for state taxes due. *See also* Levy.

Tax Lien Notice (Federal). An IRS announcement of a tax debt placed in the public records where the debtor resides or the business is located.

Tax Loss Carryover. *See* Carryovers.

Tax Pro. An expert working privately in the tax field. *See* Certified Public Accountant, Enrolled Agent, Tax Attorney.

Tax Rate. A percentage of tax applied to income, which may be fixed or may change at different income levels, and is set by Congress.

Tax Withholding. *See* Withholding.

Taxable Income. An individual's or entity's gross income minus all allowable deductions, adjustments, and exemptions. Tax liability is figured on the net result.

Taxpayer Bill of Rights. Federal tax laws restricting IRS conduct and establishing taxpayer rights in dealing with the IRS. Highlights of this law are contained in IRS Publication 1.

Taxpayer Identification Number (TIN). An IRS-assigned number used for computer tracking of tax accounts. For sole proprietors without employees, it is their Social Security number. For other business entities the TIN is a separate 13-digit number called an Employer Identification Number. *See* Employer Identification Number.

Three-of-Five Test. A rebuttable IRS presumption that a business venture that doesn't make a profit in three out of five consecutive years of operation is a not a business for tax purposes. *See also* Profit Motive, Hobby Loss Provision.

Transaction. A financial event in the operation of a business. Examples: paying an expense, making a deposit, or receiving payment for selling a service.

Trust Fund Recovery Penalty. Also known as the 100% penalty. A tax code procedure for shifting payroll tax obligations from a business (usually an insolvent corporation) to individuals associated with the business operation.

Unearned Income. Income from investments, such as interest, dividends, and capital gains or any other income that isn't compensation for services. *See* Earned Income, Dividend.

Useful Life. The period of months or years the tax code directs to be used to write off a business asset.

Withholding. Money held back by an employer from an employee's wages to pay Social Security, Medicare, and income taxes. Withholding is also required by most states as well.

Write-Off. A tax deductible expense, usually referring to depreciating or taking a Section 179 expense for an asset used in business. *See* Depreciation.

■

Appendix

IRS Publications List

Forms Checklist and Due Dates

Quick and Easy Access to IRS Tax Help and Tax Products (Publication 2053A)

Your Rights as a Taxpayer (Publication 1)

Recordkeeping for Individuals (Publication 552)

Interest and Penalty Information (Notice 433)

Deposit Requirements for Employment Taxes (Notice 931)

Form 2553, Election by a Small Business Corporation

Form 4506, Request for Copy of Tax Return

Form 4797, Sales of Business Property

Form 7018, Employer's Order Blank for Forms

Form 8594, Asset Acquisition Statement

Form 8821, Tax Information Authorization

Form 8822, Change of Address

Form SS-4, Application for Employer Identification Number

Form W-4, Employee's Withholding Allowance Certificate

Form W-9, Request for Taxpayer Identification Number and Certification

Form 1040, Schedule SE, Self-Employment Tax

IRS Publications List

General Guides

1	Your Rights as a Taxpayer
17	Your Federal Income Tax (For Individuals)
225	Farmer's Tax Guide
334	Tax Guide for Small Business
509	Tax Calendars for 2002
595	Tax Highlights for Commercial Fishermen
910	Guide to Free Tax Services

Employer's Guides

15	Employer's Tax Guide (Circular E)
15-A	Employer's Supplemental Tax Guide
51	Agricultural Employer's Tax Guide (Circular A)
80	Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

Specialized Publications

378	Fuel Tax Credits and Refunds
463	Travel, Entertainment, Gift and Car Expenses
505	Tax Withholding and Estimated Tax
510	Excise Taxes for 2002
515	Withholding of Tax on Nonresident Aliens and Foreign Corporations
517	Social Security and Other Information for Members of the Clergy and Religious Workers
521	Moving Expenses
523	Selling Your Home
525	Taxable and Nontaxable Income
526	Charitable Contributions
527	Residential Rental Property
529	Miscellaneous Deductions
530	Tax Information for First-Time Homeowners
531	Reporting Tip Income
533	Self-Employment Tax
534	Depreciating Property Placed in Service Before 1987
535	Business Expenses
536	Net Operating Losses
537	Installment Sales
538	Accounting Periods and Methods
541	Partnerships
542	Corporations
544	Sales and Other Dispositions of Assets
547	Casualties, Disasters and Thefts
550	Investment Income and Expenses
551	Basis of Assets
552	Recordkeeping for Individuals
553	Highlights of 2001 Tax Changes
554	Older Americans' Tax Guide
555	Community Property
556	Examination of Returns, Appeal Rights, and Claims for Refund
557	Tax-Exempt Status for Your Organization
559	Survivors, Executors and Administrators
560	Retirement Plans for Small Business
561	Determining the Value of Donated Property
564	Mutual Fund Distributuions
570	Tax Guide for Individuals With Income From U.S. Possessions
571	Tax-Sheltered Annuity Programs for Employees of Public Schools
575	Pension and Annuity Income (Including Simplified General Rule)
578	Tax Information for Private Foundations
583	Starting a Business
587	Business Use of Your Home
590	Individual Retirement Arrangements (IRAs)
593	Tax Highlights for U.S. Citizens and Residents Going Abroad
594	The IRS Collection Process
596	Earned Income Credit
597	Information on the United States–Canada Income Tax Treaty
598	Tax on Unrelated Business Income of Exempt Organizations
901	U.S. Tax Treaties
907	Tax Highlights for Persons with Disabilities
908	Bankruptcy Tax Guide
911	Direct Sellers
915	Social Security and Equivalent Railroad Retirement Benefits
917	Business Use of a Car
919	How Do I Adjust My Tax Withholding?
925	Passive Activity and At-Risk Rules
926	Household Employers
929	Tax Rules for Children and Dependents
936	Home Mortgage Interest Deduction
938	Real Estate Mortgage Investment Conduits
939	General Rule for Pensions and Annuities
946	How to Depreciate Property
947	Practice Before the IRS and Power of Attorney
950	Introduction to Estate and Gift Taxes
953	International Tax Information for Business
1045	Information for Tax Practitioners
1542	Per Diem Rates
1544	Reporting Cash Payments of Over $10,000
1546	The Taxpayer Advocate Service of the IRS

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1SP	Derechos del Contribuyente
556SP	Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolsos
579SP	Cómo Preparar la Declaración de Impuesto Federal
594SP	Comprendiendo el Proceso de Cobro
596SP	Crédito por Ingreso del Trabajo
850	English–Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

Forms Checklist and Due Dates

Some of the federal taxes for which a sole proprietor, corporation, or partnership may be liable are listed below. If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

You May Be Liable For	If You Are	Use Form	Due on or Before
Income tax	Sole proprietor	Schedule C or C–EZ (Form 1040)	Same day as Form 1040
	Individual who is a partner, S corporation shareholder, or LLC member	Schedule C or E (Form 1040)	15th day of 4th month after end of tax year
	Corporation	1120 or 1120–A	15th day of 3rd month after end of tax year
	S corporation	1120S	15th day of 3rd month after end of tax year
Self-employment tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	Schedule SE (Form 1040)	Same day as Form 1040
Estimated tax	Sole proprietor, or individual who is a partner, LLC member, or S corporation shareholder	1040–ES	15th day of 4th, 6th, and 9th months of tax year, and 15th day of 1st month after the end of tax year
	Corporation	1120–W	15th day of 4th, 6th, 9th, and 12th months of tax year
Annual return of income	Partnership or LLC after end of tax year	1065 (one-person LLC reports on Schedule C (Form 1040))	15th day of 4th month
Social Security and Medicare taxes (FICA taxes) and the withholding of income tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	941	4-30, 7-31, 10-31, and 1-31
		8109 (to make deposits)	See IRS Publication 334, Chapter 34
Providing information on Social Security and Medicare taxes (FICA taxes) and the withholding of income tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	W–2 (to employee)	1-31
		W–2 and W–3 (to the Social Security Administration)	Last day of February
Federal unemployment (FUTA) tax	Sole proprietor, corporation, S corporation, partnership, or LLC	940–EZ or 940	1-31
		8109 (to make deposits)	4-30, 7-31, 10-31, and 1-31, but only if the liability for unpaid tax is more than $100
Information returns for payments to nonemployees and transaction with other persons	Sole proprietor, corporation, S corporation, partnership, or LLC	Forms 1099, 1098 See IRS Publication 334, Chapter 36	Form 1099—to the recipient by 1-31, and to the IRS by 2-28. See also IRS Publication 334, Chapter 34
Excise taxes		See IRS Publication 334, Chapter 37	See the instructions to the forms

Quick and Easy Access to IRS Tax Help and Tax Products

Personal Computer

You can access the IRS website 24 hours a day, 7 days a week, at ***www.irs.gov*** to:

- Access commercial tax preparation and *e-file* services available for FREE to eligible taxpayers
- Check the status of your 2004 refund
- Download forms, instructions, and publications
- Order IRS products online
- See answers to frequently asked tax questions
- Search publications online by topic or keyword
- Figure your withholding allowances using our Withholding Calculator
- Send us comments or request help by email
- Sign up to receive local and national tax news by email

IRS TaxFax Service

*Dial **703-368-9694** from your fax machine to get up to 3 items per call. Long-distance charges may apply. Follow the directions of the prompts and your items will be immediately faxed back to you.*

For help with transmission problems, call the FedWorld Help Desk at **(703) 487-4608.**

Phone

Obtain forms, instructions, and publications by calling:

1-800-829-3676 to order current year forms, instructions, and publications and prior year forms and instructions. You should receive your order within 10 days.

Walk-In

Pick up certain forms, instructions and publications at many post offices, libraries and IRS offices. Some grocery stores, copy centers, city and county government offices, credit unions and office supply stores have a collection of reproducible tax forms available to photocopy or print from a CD-ROM.

Mail

Send your order for tax products to the Distribution Center nearest you. You should receive your products within 10 days after we receive your order.

- **Western part of U.S.**
  Western Area Distribution Center
  Rancho Cordova, CA 95743-0001
- **Central part of U.S.**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261-5074

CD-ROM

Order IRS Publication 1796, Federal Tax Products on CD-ROM, and obtain:

- Current tax forms, instructions, and publications
- Prior-year tax forms and instructions
- Popular tax forms which may be filled-in electronically, printed out for submission, and saved for recordkeeping
- Internal Revenue Bulletin

Purchase the CD-ROM via Internet at **http://www.irs.gov/cdorders** from the National Technical Information Service (NTIS) for $22 (no handling fee). Order by phone at 1-877-CDFORMS (1-877-233-6767) for $22 (plus $5 handling fee).

Availability: First release—early January
Final release—late February

Minimum System Requirements:

The 2004 Federal Tax Products CD-ROM can be used with the following operating systems (Windows 98SE, NT 4 (w/ SP 6), ME, 2000 (w/ SP 2), XP; Mac OS X v.10.2.2-10.3). It requires a minimum of 64 MB RAM, 128 MB RAM recommended; and a minimum of 120 MB available hard drive space. System requires either an Intel® Pentium® processor or PowerPC® G3 processor. Software is provided to view, search, **fill-in and save forms** using the free Adobe® Reader® 6.02. IRS applies document rights to their PDF forms so they can be filled in and saved locally using the free Adobe Reader. Some forms on the CD-ROM are intended as information only and may not be filled in and submitted as an official IRS form (e.g., Forms 1099, W-2, and W-3). **Additionally, this CD-ROM does not support electronic filing.**

Department of the Treasury
Internal Revenue Service
www.irs.gov

Publication 2053 (2004)
Cat. No. 23265D

IRS
Department of the Treasury
Internal Revenue Service
Publication 1
(Rev. May 2005)
Catalog Number 64731W
www.irs.gov

Your Rights as a Taxpayer

The first part of this publication explains some of your most important rights as a taxpayer. The second part explains the examination, appeal, collection, and refund processes. This publication is also available in Spanish.

Declaration of Taxpayer Rights

I. Protection of Your Rights

IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

II. Privacy and Confidentiality

The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

III. Professional and Courteous Service

If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to the IRS director for your area or the center where you file your return.

IV. Representation

You may either represent yourself or, with proper written authorization, have someone else represent you in your place. Your representative must be a person allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

V. Payment of Only the Correct Amount of Tax

You are responsible for paying only the correct amount of tax due under the law—no more, no less. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

VI. Help With Unresolved Tax Problems

The Taxpayer Advocate Service can help you if you have tried unsuccessfully to resolve a problem with the IRS. Your local Taxpayer Advocate can offer you special help if you have a significant hardship as a result of a tax problem. For more information, call toll free 1–877–777–4778 (1–800–829–4059 for TTY/TDD) or write to the Taxpayer Advocate at the IRS office that last contacted you.

VII. Appeals and Judicial Review

If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the Appeals Office to review your case. You may also ask a court to review your case.

VIII. Relief From Certain Penalties and Interest

The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. We will waive interest that is the result of certain errors or delays caused by an IRS employee.

THE IRS MISSION

PROVIDE AMERICA'S TAXPAYERS TOP QUALITY SERVICE BY HELPING THEM UNDERSTAND AND MEET THEIR TAX RESPONSIBILITIES AND BY APPLYING THE TAX LAW WITH INTEGRITY AND FAIRNESS TO ALL.

Examinations, Appeals, Collections, and Refunds

Examinations (Audits)

We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W-2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include newspapers, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund, explains the rules and procedures that we follow in examinations. The following sections give an overview of how we conduct examinations.

By Mail

We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. You can respond by mail or you can request a personal interview with an examiner. If you mail us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write to us about anything you do not understand.

By Interview

If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

Repeat Examinations

If we examined your return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.

Appeals

If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, Your Appeal Rights and How To Prepare a Protest If You Don't Agree, and Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund.

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through the appeals system, and you gave us the information necessary to resolve the case.

Collections

Publication 594, The IRS Collection Process, explains your rights and responsibilities regarding payment of federal taxes. It describes:

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.

Your collection appeal rights are explained in detail in Publication 1660, Collection Appeal Rights.

Innocent Spouse Relief

Generally, both you and your spouse are each responsible for paying the full amount of tax, interest, and penalties due on your joint return. However, if you qualify for innocent spouse relief, you may be relieved of part or all of the joint liability. To request relief, you must file Form 8857, Request for Innocent Spouse Relief no later than 2 years after the date on which the IRS first attempted to collect the tax from you. For example, the two-year period for filing your claim may start if the IRS applies your tax refund from one year to the taxes that you and your spouse owe for another year. For more information on innocent spouse relief, see Publication 971, Innocent Spouse Relief, and Form 8857.

Potential Third Party Contacts

Generally, the IRS will deal directly with you or your duly authorized representative. However, we sometimes talk with other persons if we need information that you have been unable to provide, or to verify information we have received. If we do contact other persons, such as a neighbor, bank, employer, or employees, we will generally need to tell them limited information, such as your name. The law prohibits us from disclosing any more information than is necessary to obtain or verify the information we are seeking. Our need to contact other persons may continue as long as there is activity in your case. If we do contact other persons, you have a right to request a list of those contacted.

Refunds

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund, has more information on refunds.

If you were due a refund but you did not file a return, you generally must file your return within 3 years from the date the return was due (including extensions) to get that refund.

Tax Information

The IRS provides the following sources for forms, publications, and additional information.

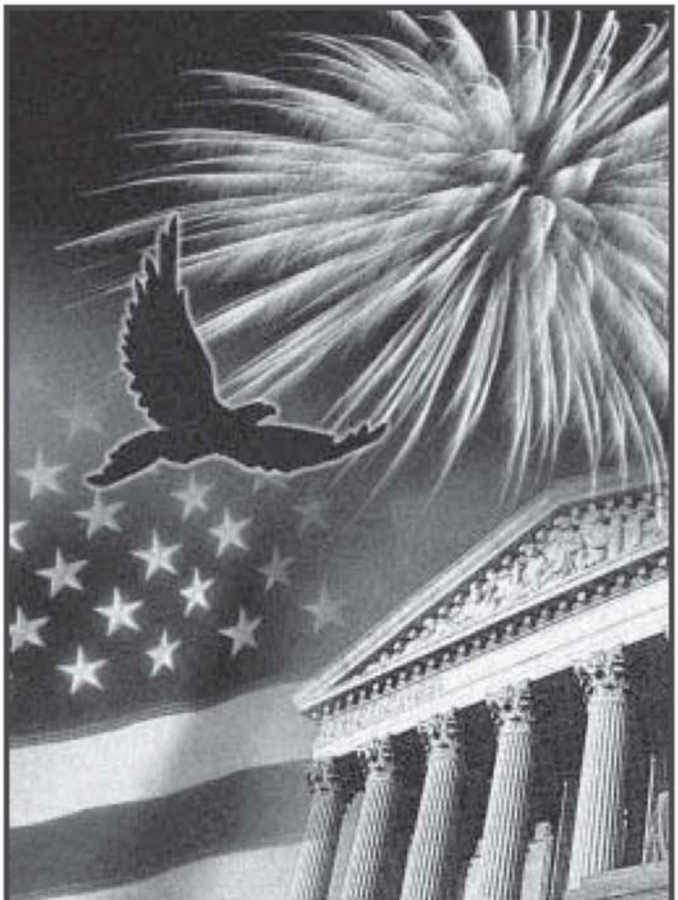
- ***Tax Questions:*** 1–800–829–1040 (1–800–829–4059 for TTY/TDD)
- ***Forms and Publications:*** 1–800–829–3676 (1–800–829–4059 for TTY/TDD)
- ***Internet:*** *www.irs.gov*
- ***Small Business Ombudsman:*** A small business entity can participate in the regulatory process and comment on enforcement actions of IRS by calling 1-888-REG-FAIR.
- ***Treasury Inspector General for Tax Administration:*** You can confidentially report misconduct, waste, fraud, or abuse by an IRS employee by calling 1–800–366–4484 (1–800–877–8339 for TTY/TDD). You can remain anonymous.

Printed on recycled paper

Department of the Treasury
Internal Revenue Service

Publication 552
(Rev. April 2005)
Cat. No. 15100V

Recordkeeping for Individuals



Get forms and other information faster and easier by:

Internet • www.irs.gov

FAX • 703–368–9694 (from your fax machine)

Contents

Introduction

This publication discusses why you should keep records, what kinds of records you should keep, and how long you should keep them.

You probably already keep records in your daily routine. This includes keeping receipts for purchases and recording information in your checkbook. Use this publication to determine if you need to keep additional information in your records.

Throughout this publication we refer you to other IRS publications for additional information. See *How To Get Tax Help* in the back of this publication for information about getting publications and forms.

This publication does not discuss the records you should keep when operating a business. For information on business records, see Publication 583, Starting a Business and Keeping Records.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at the following address.

Internal Revenue Service
Individual Forms and Publications Branch
SE:W:CAR:MP:T:I
1111 Constitution Ave. NW, IR-6406
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at **taxforms@irs.gov*. (The asterisk must be included in the address.) Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit *www.irs.gov* or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit *www.irs.gov/formspubs* to download forms and publications, call 1-800-829-3676, or write to the National Distribution Center at the address shown under How To Get Tax Help in the back of this publication.

Why Keep Records?

There are many reasons to keep records. In addition to tax purposes, you may need to keep records for insurance purposes or for getting a loan. Good records will help you:

- **Identify sources of income.** You may receive money or property from a variety of sources. Your records can identify the sources of your income. You need this information to separate business from nonbusiness income and taxable from nontaxable income.
- **Keep track of expenses.** You may forget an expense unless you record it when it occurs. You can use your records to identify expenses for which you can claim a deduction. This will help you determine if you can itemize deductions on your tax return.
- **Keep track of the basis of property.** You need to keep records that show the basis of your property. This includes the original cost or other basis of the property and any improvements you made.
- **Prepare tax returns.** You need records to prepare your tax return. Good records help you to file quickly and accurately.
- **Support items reported on tax returns.** You must keep records in case the IRS has a question about an item on your return. If the IRS examines your tax return, you may be asked to explain the items reported. Good records will help you explain any item and arrive at the correct tax with a minimum of effort. If you do not have records, you may have to spend time getting statements and receipts from various sources. If you cannot produce the correct documents, you may have to pay additional tax and be subject to penalties.

Kinds of Records To Keep

The IRS does not require you to keep your records in a particular way. Keep them in a manner that allows you and the IRS to determine your correct tax.

You can use your checkbook to keep a record of your income and expenses. In your checkbook you should record amounts, sources of deposits, and types of expenses. You also need to keep documents, such as receipts and sales slips, that can help prove a deduction.

You should keep your records in an orderly fashion and in a safe place. Keep them by year and type of income or expense. One method is to keep all records related to a particular item in a designated envelope.

In this section you will find guidance about basic records that everyone should keep. The section also provides guidance about specific records you should keep for certain items.

Computerized records. Many retail stores sell computer software packages that you can use for recordkeeping. These packages are relatively easy to use and require little knowledge of bookkeeping and accounting.

If you use a computerized system, you must be able to produce legible records of the information needed to determine your correct tax liability. In addition to your computerized records, you must keep proof of payment, receipts, and other documents to prove the amounts shown on your tax return.

Copies of tax returns. You should keep copies of your tax returns as part of your tax records. They can help you prepare future tax returns, and you will need them if you file an amended return. Copies of your returns and other records can be helpful to your survivor or the executor or administrator of your estate.

If necessary, you can request a copy of a return and all attachments (including Form W-2) from the IRS by using Form 4506, Request for Copy of Tax Return. There is a charge for a copy of a return. For information on the cost and where to file, see the Form 4506 instructions.

If you just need information from your return, you can order a transcript by calling 1-800-829-1040, or using Form 4506-T, Request for Transcript of Tax Return. There is no fee for a transcript. Transcripts are available for the current year and returns processed in the 3 prior years.

Basic Records

Basic records are documents that everybody should keep. These are the records that prove your income and expenses. If you own a home or investments, your basic records should contain documents related to those items. Table 1 lists documents you should keep as basic records. Following Table 1 are examples of information you can get from these records.

Table 1. **Proof of Income and Expense**

FOR items concerning your...	KEEP as basic records...
Income	• Form(s) W-2 • Form(s) 1099 • Bank statements • Brokerage statements • Form(s) K-1
Expenses	• Sales slips • Invoices • Receipts • Canceled checks or other proof of payment
Home	• Closing statements • Purchase and sales invoices • Proof of payment • Insurance records
Investments	• Brokerage statements • Mutual fund statements • Form(s) 1099 • Form(s) 2439

Income. Your basic records prove the amounts you report as income on your tax return. Your income may include wages, dividends, interest, and partnership or S corporation distributions. Your records also can prove that certain amounts are not taxable, such as tax-exempt interest.

Note. If you receive a Form W-2, keep Copy C until you begin receiving social security benefits. This will help protect your benefits in case there is a question about your work record or earnings in a particular year. Review the information shown on your annual (for workers over age 25) Social Security Statement.

Expenses. Your basic records prove the expenses for which you claim a deduction (or credit) on your tax return. Your deductions may include alimony, charitable contributions, mortgage interest, and real estate taxes. You may also have child care expenses for which you can claim a credit.

Home. Your basic records should enable you to determine the basis or adjusted basis of your home. You need this information to determine if you have a gain or loss when you sell your home or to figure depreciation if you use part of your home for business purposes or for rent. Your records should show the purchase price, settlement or closing costs, and the cost of any improvements. They may also show any casualty losses deducted and insurance reimbursements for casualty losses. Your records should also include a copy of Form 2119, Sale of Your Home, if you sold your previous home before May 7, 1997, and postponed tax on the gain from that sale.

For information on which settlement or closing costs are included in the basis of your home, see Publication 530, Tax Information for First-Time Homeowners. For information on basis, including the basis of property you receive other than by purchase, see Publication 551, Basis of Assets.

When you sell your home, your records should show the sales price and any selling expenses, such as commissions. For information on selling your home, see Publication 523, Selling Your Home.

Investments. Your basic records should enable you to determine your basis in an investment and whether you have a gain or loss when you sell it. Investments include stocks, bonds, and mutual funds. Your records should show the purchase price, sales price, and commissions. They may also show any reinvested dividends, stock splits and dividends, load charges, and original issue discount (OID).

For information on stocks and bonds, see Publication 550, Investment Income and Expenses. For information on mutual funds, see Publication 564, Mutual Fund Distributions.

Proof of Payment

One of your basic records is proof of payment. You should keep these records to support certain amounts shown on your tax return. Proof of payment alone is not proof that the item claimed on your return is allowable. You should also keep other documents that will help prove that the item is allowable.

Generally, you prove payment with a cash receipt, financial account statement, credit card statement, canceled check, or substitute check. If you make payments in cash, you should get a dated and signed receipt showing the amount and the reason for the payment.

If you make payments by electronic funds transfer you may be able to prove payment with an account statement.

Table 2. **Proof of Payment**

IF payment is by...	THEN the statement must show the...
Cash	• Amount • Payee's name • Transaction date
Check	• Check number • Amount • Payee's name • Date the check amount was posted to the account by the financial institution
Debit or credit card	• Amount charged • Payee's name • Transaction date
Electronic funds transfer	• Amount transferred • Payee's name • Date the transfer was posted to the account by the financial institution
Payroll deduction	• Amount • Payee code • Transaction date

Account statements. You may be able to prove payment with a legible financial account statement prepared by your bank or other financial institution. These statements are accepted as proof of payment if they show the items reflected in Table 2.

Pay statements. You may have deductible expenses withheld from your paycheck, such as union dues or medical insurance premiums. You should keep your year-end or final pay statements as proof of payment of these expenses.

Specific Records

This section is an alphabetical list of some items that require specific records in addition to your basic records.

Alimony

If you receive or pay alimony, you should keep a copy of your written separation agreement or the divorce, separate maintenance, or support decree. If you pay alimony, you will also need to know your former spouse's social security number. For information on alimony, see Publication 504, Divorced or Separated Individuals.

Business Use of Your Home

You may be able to deduct certain expenses connected with the business use of your home. You should keep records that show the part of your home that you use for business and the expenses related to that use. For information on how to allocate expenses between business and personal use, see Publication 587, Business Use of Your Home.

Casualty and Theft Losses

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. Your records also must be able to support the amount you claim.

For a casualty loss, your records should show:

- The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- That the loss was a direct result of the casualty.
- That you were the owner of the property.

For a theft loss, your records should show:

- When you discovered your property was missing,
- That your property was stolen, and
- That you were the owner of the property.

For more information, see Publication 547, Casualties, Disasters, and Thefts. For a workbook designed to help you figure your loss, see Publication 584, Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property).

Child Care Credit

You must give the name, address, and taxpayer identification number for all persons or organizations that provide care for your child or dependent. You can use Form W-10, Dependent Care Provider's Identification and Certification, or various other sources to get the information from the care provider. Keep this information with your tax records. For information on the credit, see Publication 503, Child and Dependent Care Expenses.

Contributions

The kinds of records you must keep for charitable contributions depend on the amount of the contribution and whether the contribution is in cash. For information on contributions, see Publication 526, Charitable Contributions.

Contributions from which you benefit. Generally, if you make a charitable contribution that is more than $75 and is partly for goods or services, the organization must give you a written statement that you should keep.

Cash. Cash contributions include those paid by cash, check, credit card, or payroll deduction. For each cash contribution, you must keep one of the following:

- A canceled check or other proof of payment,
- A receipt from the organization showing the name of the organization, the amount, and date of the contribution, or
- Other reliable written records that are reasonable under the circumstances and that include the name of the organization, the amount, and the date of the contribution.

Contributions of $250 or more. You can deduct a contribution of $250 or more only if you have a written acknowledgment of your contribution from the organization.

Out-of-pocket expenses. You should keep records of your out-of-pocket expenses when you perform services for a charitable organization. You can record these expenses in a diary. For example, if you use your car when doing volunteer work, you should record the name of the organization and the unreimbursed gas and oil expenses directly related to the volunteer work. If you do not want to keep records of your actual expenses, you can keep a log of the miles you drove your car for the charitable purpose and use the standard mileage rate shown in Publication 526. You should also keep records of any parking fees, tolls, taxi fares, and bus fares.

Property. For each contribution of property, you must keep a receipt from the organization showing:

- The name of the organization,
- The date and location of the contribution, and
- A reasonably detailed description of the property.

A letter or other written communication from the organization containing the above information will serve as a receipt.

You also must keep reliable written records for each item of donated property. These records must include the:

- Fair market value of the property at the time of the contribution,
- Cost or other basis of the property, and
- Terms of any conditions attached to the contribution.

Cars, boats, and aircraft. If the claimed value of a car, boat, or aircraft you donate to a qualified organization after December 31, 2004, is over $500, your deduction may be limited. You must have a written acknowledgement of your donation from the organization and must attach it to your return. This also applies to donations of any vehicle manufactured for use on public streets, roads, and highways. You should keep a copy of the acknowledgement for your records.

Credit for the Elderly or the Disabled

If you are under age 65, you must have your physician complete a statement certifying that you were permanently and totally disabled on the date you retired.

You do not have to file this statement with your Form 1040 or Form 1040A, but you must keep it for your records.

Veterans. If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can substitute VA Form 21-0172, Certification of Permanent and Total Disability, for the physician's statement you are required to keep. See Publication 524, Credit for the Elderly or the Disabled, for more information.

Education Expenses

If you have the records to prove your expenses, you may be entitled to claim certain tax benefits for your education expenses. You may qualify to exclude from income items such as a qualified scholarship, interest on U.S. savings bonds, or reimbursement from your employer. You may also qualify for certain credits or deductions. For information on qualified education expenses, see Publication 970, Tax Benefits for Education.

Exemptions

If you are claiming an exemption for a person under a multiple support agreement, you must get a signed statement from all other eligible individuals who could have claimed the exemption. You must keep these statements in your records. For information on exemptions, see Publication 501, Exemptions, Standard Deduction, and Filing Information.

Employee Business Expenses

If you have employee business expenses, see Publication 463, Travel, Entertainment, Gift, and Car Expenses, for a discussion of what records to keep.

Gambling Winnings and Losses

You must keep an accurate diary of your winnings and losses that includes the:

- Date and type of gambling activity,
- Name and address or location of the gambling establishment,
- Names of other persons present with you at the gambling establishment, and
- Amount you won or lost.

In addition to your diary, you should keep other documents. See the discussion related to gambling losses in Publication 529, Miscellaneous Deductions, for documents you should keep.

Health Savings Account (HSA) and Medical Savings Account (MSA)

For each qualified medical expense you deduct or pay with a distribution from your HSA or MSA, you must keep a record of the name and address of each person you paid and the amount and date of the payment. For more information, see Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.

Individual Retirement Arrangements (IRAs)

Keep copies of the following forms and records until all distributions are made from your IRA(s).

- Form 5498, IRA Contribution Information, or similar statement received for each year showing contributions you made, distributions you received, and the value of your IRA(s).
- Form 1099-R, Distribution From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., received for each year you received a distribution.
- Form 8606, Nondeductible IRAs, for each year you made a nondeductible contribution to your IRA or received distributions from an IRA if you ever made nondeductible contributions.

For a worksheet you can use to keep a record of yearly contributions and distributions, see Publication 590, Individual Retirement Arrangements (IRAs).

Medical and Dental Expenses

In addition to records you keep of regular medical expenses, you should keep records on transportation expenses that are primarily for and essential to medical care. You can record these expenses in a diary. You should record gas and oil expenses directly related to that transportation. If you do not want to keep records of your actual expenses, you can keep a log of the miles you drive your car for medical purposes and use the standard mileage rate. You should also keep records of any parking fees, tolls, taxi fares, and bus fares.

For information on medical expenses and the standard mileage rate, see Publication 502, Medical and Dental Expenses.

Mortgage Interest

If you paid mortgage interest of $600 or more, you should receive Form 1098, Mortgage Interest Statement. Keep this form and your mortgage statement and loan information in your records. For information on mortgage interest, see Publication 936, Home Mortgage Interest Deduction.

Moving Expenses

You may be able to deduct qualified moving expenses that are not reimbursed. For more information on what expenses qualify and what records you need, see Publication 521, Moving Expenses.

Pensions and Annuities

Use the worksheet in your tax return instructions to figure the taxable part of your pension or annuity. Keep a copy of the completed worksheet until you fully recover your contributions. For information on pensions and annuities, see Publication 575, Pension and Annuity Income, or Publication 721, Tax Guide to U.S. Civil Service Retirement Benefits.

Taxes

Form(s) W-2 and Form(s) 1099-R show state income tax withheld from your wages and pensions. You should keep a copy of these forms to prove the amount of state withholding. If you made estimated state income tax payments, you need to keep a copy of the form or your check(s).

You also need to keep copies of your state income tax returns. If you received a refund of state income taxes, the state may send you Form 1099-G, Certain Government Payments.

Keep mortgage statements, tax assessments, or other documents as records of the real estate and personal property taxes you paid.

If you deducted actual state and local general sales taxes instead of using the optional state sales tax tables, you must keep your actual receipts showing general sales taxes paid.

Tips

You must keep a daily record to accurately report your tips on your return. You can use Form 4070A, Employee's Daily Record of Tips, which is found in Publication 1244, Employee's Daily Record of Tips and Report to Employer, to record your tips. For information on tips, see Publication 531, Reporting Tip Income.

How Long To Keep Records

You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support items shown on your return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund or the IRS can assess additional tax. Table 3 contains the periods of limitations that apply to income tax returns. Unless otherwise stated, the years refer to the period beginning after the return was filed. Returns filed before the due date are treated as being filed on the due date.

Table 3. **Period of Limitations**

	IF you...	**THEN the period is...**
1	Owe additional tax and (2), (3), and (4) do not apply to you	3 years
2	Do not report income that you should and it is more than 25% of the gross income shown on your return	6 years
3	File a fraudulent return	No limit
4	Do not file a return	No limit
5	File a claim for credit or refund after you filed your return	Later of 3 years or 2 years after tax was paid.
6	File a claim for a loss from worthless securities	7 years

Property. Keep records relating to property until the period of limitations expires for the year in which you dispose of the property in a taxable disposition. You must keep these records to figure your basis for computing gain or loss when you sell or otherwise dispose of the property.

Generally, if you received property in a nontaxable exchange, your basis in that property is the same as the basis of the property you gave up. You must keep the records on the old property, as well as the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition.

Keeping records for nontax purposes. When your records are no longer needed for tax purposes, do not discard them until you check to see if they should be kept longer for other purposes. Your insurance company or creditors may require you to keep certain records longer than the IRS does.

Department of the Treasury
Internal Revenue Service
www.irs.gov
Notice **433** (Rev. 4-2005)
Catalog Number 26242I

Interest and Penalty Information

The interest rate on underpayment and overpayment of taxes and the penalty for underpayment of estimated tax are as follows:

Period	Underpayment Interest Rate and Estimated Tax Penalty Rate	Overpayment Interest Rate
10/1/94-3/31/95	9%	8%
4/1/95-6/30/95	10%	9%
7/1/95-3/31/96	9%	8%
4/1/96-6/30/96	8%	7%
7/1/96-3/31/98	9%	8%
4/1/98-12/31/98	8%	7%
1/1/99-3/31/99	7%	7%
4/1/99-3/31/00	8%	8%
4/1/00-3/31/01	9%	9%
4/1/01-6/30/01	8%	8%
7/1/01-12/31/01	7%	7%
1/1/02-12/31/02	6%	6%
1/1/03-9/30/03	5%	5%
10/1/03-3/31/04	4%	4%
4/1/04-6/30/04	5%	5%
7/1/04-9/30/04	4%	4%
10/1/04-3/31/05	5%	5%
Beginning 4/1/05	6%	6%

The law requires us to determine these interest rates quarterly. We compound interest daily except on late or underpaid estimated taxes for individuals or corporations.

We charge 120% of the underpayment interest rate if: (1) the return was due before January 1, 1990, excluding extensions; (2) the underpayment was over $1,000; and (3) the underpayment was from a tax-motivated transaction.

For (C) Corporations with underpayments over $100,000, we charge the underpayment interest rate plus 2%.

We'll continue to charge interest until you pay the amount you owe in full.

The penalty for late filing is 4 and 1/2% a month when the 1/2% a month penalty for late payment applies at the same time. The late filing penalty applies on the amount showing due on the return for any month (or part of a month) the return is filed after the return due date (including extensions) but cannot exceed 5 months. If you don't file your tax return within 60 days of the due date, the minimum penalty is $100 or 100% of the tax due on your return, whichever is less.

The penalty for late payment is 1/2% (1/4% for months covered by an installment agreement) of the tax due for each month or part of a month your payment is late. The penalty increases to 1% per month if we send a notice of intent to levy, and you don't pay the tax due within 10 days from the date of the notice. The late filing penalty cannot be applied at monthly rates totaling more than 25%.

The deposit penalty for employment, excise, or railroad retirement tax varies from 2% to 15% depending on how late the deposit is.

The penalty for filing an exempt organization return late prior to 1998 is $10 a day for each day the return is late, but not more than $5,000 or 5% of the gross receipts for the year, whichever is less. For 1998 and subsequent, if gross receipts are equal to or less

(over)

than $1 million, the penalty is $20 a day for each day the return is late, not to exceed $10,000 or 5% of gross receipts for the year, whichever is less. If gross receipts exceed $1 million the penalty is $100 a day for each day the return is late, not to exceed $50,000.

Appeal Rights—Arithmetic Error

You may appeal the changes shown on the enclosed notice within 60 days from your notice date. Send your explanation with a copy of the notice to the address shown on your notice.

We'll notify you if we don't accept your explanation. If we accept it, we'll reduce any tax increase due to the change. We'll refund any tax you overpaid if you owe no other tax or have no other debts the law requires us to collect.

We'll continue to charge interest if you don't pay the balance you owe by the date requested in this enclosed notice.

Interest on Certain Penalties

We charge interest on penalties from the return due date for late filing, valuation overstatements or understatements and substantial understatement of the tax due. The interest rate on penalties is the same as the underpayment interest rate. On fraud and negligence penalties for returns due after December 31, 1988, we charge interest from the return due date or a valid extended due date.

Removal of Penalty and Interest

Reasonable Cause

The law allows us to remove or reduce a penalty based on reasonable cause. To request a penalty reduction, send a statement to us fully explaining the facts. You or your representative with your power of attorney must sign your statement under penalty of perjury. In some cases, we may request that you pay the tax in full before we remove or reduce the late payment penalty. The law does not allow us to remove or reduce *interest* based on reasonable cause.

Erroneous Written Advice from IRS

We'll remove the penalty (but not the interest) if: (1) you wrote to us and asked for advice on a specific issue; (2) you gave us complete and accurate information; (3) we wrote back to you and told you what to do or explained what not to do; (4) you followed our written advice in the way we told you to; and (5) you received a penalty for the action we advised you to take.

If you meet this criteria, complete Form 843, Claim for Refund and Request for Abatement, and ask us to remove the penalty.

Attach to your Form 843: (1) a copy of your original request for advice; (2) a copy of the written advice we gave you; and (3) the notice (if any) showing the penalty we charged.

Send Form 843 to the IRS Service Center where you filed your return for the year you relied on erroneous advice from us.

Interest on Erroneous Refunds

The law requires us to remove interest up to the date we request you to repay the erroneous refund when: (1) you did not cause the erroneous refund in any way; and (2) the refund doesn't exceed $50,000.

IRS may remove or reduce interest on other erroneous refunds or on errors due to an IRS ministerial act, based on the facts and circumstances of each case.

If we reduce interest that you previously reported as a deduction on your tax return, you must report this reduction of interest as income on your tax return for the year we reduce it.

Department of the Treasury
Internal Revenue Service

Notice 931

(Rev. February 2005)

Deposit Requirements for Employment Taxes

There are two deposit schedules—**monthly** or **semiweekly**—for determining when you deposit social security and Medicare taxes and withheld income tax. These schedules tell you when a deposit is due after a tax liability arises (for example, when you have a payday). Prior to the beginning of each calendar year, you must determine which of the two deposit schedules you are required to use. The deposit schedule you must use is based on the total tax liability you reported during a **lookback period.** Your deposit schedule is **not** determined by how often you pay your employees or make deposits. See *Application of Monthly and Semiweekly Deposit Schedules* on page 2.

These rules do not apply to federal unemployment (FUTA) tax. See the Instructions for Form 940 for information on depositing FUTA tax.

Exception. If you, as an employer, accumulate a tax liability of less than $2,500 during a quarter for Form 941 (during a calendar year for Form 943, Form 945, and Form CT-1), no deposits are required if you pay in full with a timely filed return. However, if you are unsure that you will accumulate less than $2,500, deposit under the appropriate deposit rules so that you will not be subject to the failure-to-deposit penalties.

Deposit rules for Form 941. Your deposit schedule (monthly or semiweekly) for Form 941 is based on the total tax liability you reported on Form 941 during a four-quarter lookback period discussed below.

Deposit rules for Form 943, Form 945, and Form CT-1. Generally, the deposit rules for Form 941 also apply to tax liabilities for Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, Form 945, Annual Return of Withheld Federal Income Tax, and Form CT-1, Employer's Annual Railroad Retirement Tax Return. However, because Forms 943, 945, and CT-1 are annual returns, the rules for determining your deposit schedule apply to a calendar year rather than a calendar quarter. See *Lookback period for annual returns* below. For more information about deposit rules for annual returns, see Pub. 15 (Circular E), Employer's Tax Guide (for Form 945), Pub. 51 (Circular A), Employer's Agricultural Tax Guide (for Form 943), and the Instructions for Form CT-1.

Electronic deposit requirement. You must make electronic deposits of all depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2005 if:

- Your total deposits of such taxes in 2003 were more than $200,000 or
- You were required to use EFTPS in 2004.

If you are required to use EFTPS and use Form 8109 instead, you may be subject to a 10% penalty. If you are not required to use EFTPS, you may participate voluntarily. To get more information or to enroll in EFTPS, call 1-800-555-4477. You can also visit the EFTPS website at *www.eftps.gov,* or get Pub. 966, Electronic Choices for Paying ALL Your Federal Taxes.

Depositing on time. For EFTPS deposits to be on time, you must initiate the transaction at lease one business day before the date the deposit is due.

Lookback period for Form 941. Your deposit schedule for a calendar year is determined from the total taxes (not reduced by any advance earned income credit payments) reported on your Forms 941 in a four-quarter lookback period. The lookback period begins July 1 and ends June 30 as shown in the chart below. If you reported $50,000 or less of Form 941 taxes for the lookback period, you are a monthly schedule depositor; if you reported more than $50,000, you are a semiweekly schedule depositor. There are two exception rules—the $2,500 rule (see *Exception* above) and the *$100,000 Next-Day Deposit Rule* on page 2.

Lookback Period for Calendar Year 2005

Lookback Period 2003		Lookback Period 2004			2005
July 1 thru Sept. 30	Oct. 1 thru Dec. 31	Jan. 1 thru Mar. 31	Apr. 1 thru June 30	◄	Calendar Year Jan.–Dec.

Lookback period for annual returns. For annual returns (Form 943, Form 945, and Form CT-1), the lookback period is the calendar year preceding the previous year. For example, the lookback period for 2005 is 2003.

Monthly Deposit Schedule

You are a monthly schedule depositor for a calendar year if the total taxes during your lookback period were $50,000 or less.

Under the monthly deposit schedule, deposit accumulated taxes on payments made during a calendar month by the 15th day of the following month.

Monthly schedule depositors are **not** required to file Form 941 on a monthly basis. Do not file Form 941-M, Employer's Monthly Federal Tax Return, unless you are instructed to do so by an IRS representative.

New employers. During the 1st calendar year of your business, your tax liability for each quarter in the lookback period is considered to be zero. Therefore, you are a monthly schedule depositor for the 1st year of your business. However, see the *$100,000 Next-Day Deposit Rule* on page 2.

Semiweekly Deposit Schedule

You are a semiweekly schedule depositor for a calendar year if the total taxes during your lookback period were more than $50,000.

Under the semiweekly deposit schedule, deposit accumulated taxes on payments made on Wednesday, Thursday, and/or Friday by the following Wednesday. Deposit amounts accumulated on payments made on Saturday, Sunday, Monday, and/or Tuesday by the following Friday.

Deposit Period (Payment Days)	Deposit By
Wednesday, Thursday, and/or Friday	Following Wednesday
Saturday, Sunday, Monday, and/or Tuesday	Following Friday

Semiweekly deposit period spanning two quarters. If a quarter ends on a day other than Friday or Tuesday, taxes accumulated on the days during the quarter just ending are subject to one deposit obligation, and taxes accumulated on the days covered by the new quarter are subject to a separate deposit obligation. For example, if one quarter ends on Thursday, taxes accumulated on Wednesday and Thursday are subject to one deposit obligation and taxes accumulated on Friday are subject to a separate obligation. Separate deposits are required because two different quarters are affected.

Example of Monthly and Semiweekly Schedules

Hazel Co. reported Form 941 tax liabilities as follows:

2004 Lookback Period	2005 Lookback Period
3rd Quarter 2002 - $12,000	3rd Quarter 2003 - $12,000
4th Quarter 2002 - $12,000	4th Quarter 2003 - $12,000
1st Quarter 2003 - $12,000	1st Quarter 2004 - $12,000
2nd Quarter 2003 - $12,000	2nd Quarter 2004 - $15,000
$48,000	$51,000

Hazel Co. is a monthly schedule depositor for 2004 because its tax liability for the four quarters in its lookback period (3rd quarter 2002 through 2nd quarter 2003) was not more than $50,000. However, for 2005, Hazel Co. is a semiweekly schedule depositor because its liability exceeded $50,000 for the four quarters in its lookback period (3rd quarter 2003 through 2nd quarter 2004).

Deposits are Due on Banking Days Only

If a deposit is due on a day that is not a banking day, the deposit is considered to have been made timely if it is made by the close of the next banking day. In addition to federal and state bank holidays, Saturdays and Sundays are treated as nonbanking days. For example, if a deposit is due on a Friday and Friday is not a banking day, the deposit will be considered timely if it is made by the following Monday (if that Monday is a banking day).

Semiweekly schedule depositors have at least three banking days to make a deposit. That is, if any of the three weekdays after the end of a semiweekly period is a banking holiday, you will have one additional banking day to deposit. For example, if a semiweekly schedule depositor accumulated taxes for payments made on Friday and the following Monday is not a banking day, the deposit normally due on Wednesday may be made on Thursday. This allows three banking days to make the deposit.

Application of Monthly and Semiweekly Deposit Schedules

The terms "monthly schedule depositor" and "semiweekly schedule depositor" **do not** refer to how often your business pays its employees or even how often you are required to make deposits. The terms identify which set of deposit rules you must follow when an employment tax liability arises. The deposit rules are based on the dates wages are paid; **not** on when employment tax liabilities are accrued.

Monthly schedule example. Pine Co. has a monthly deposit schedule. It paid wages each Friday during January but did not pay any wages during February. Under the monthly schedule, Pine Co. must deposit the combined tax liabilities for the January paydays by February 15. Pine Co. does not have a deposit requirement for February (due by March 15) because no wages were paid and, therefore, it did not have a tax liability for the month.

Semiweekly schedule example. Maylen, Inc., which has a semiweekly deposit schedule, pays wages once each month on the last Friday of the month. Although Maylen, Inc. has a semiweekly deposit schedule, it will deposit just once a month because it pays wages only once a month. The deposit, however, will be made under the semiweekly deposit schedule as follows: Maylen, Inc.'s tax liability for the October 28, 2005 (Friday) payday must be deposited by November 2, 2005 (Wednesday). Under the semiweekly deposit schedule, liabilities for wages paid on Wednesday through Friday must be deposited by the following Wednesday.

$100,000 Next-Day Deposit Rule

If you accumulate a tax liability (reduced by any advance EIC payments) of $100,000 or more on any day during a deposit period, you must deposit the tax by the next banking day, whether you are a monthly or semiweekly schedule depositor. The deposit period for monthly schedule depositors is a calendar month. For semiweekly schedule depositors, the deposit periods are Wednesday through Friday and Saturday through Tuesday.

For purposes of the $100,000 next-day deposit rule, do not continue accumulating tax liabilities after the end of a deposit period. For example, if a semiweekly schedule depositor has accumulated a liability of $95,000 on a Tuesday (of a Saturday-through-Tuesday deposit period) and accumulated a $10,000 liability on Wednesday, the $100,000 next-day deposit rule does not apply. Therefore, $95,000 must be deposited by Friday and $10,000 by the following Wednesday.

In addition, once you accumulate at least $100,000 in a deposit period, stop accumulating at the end of that day and begin to accumulate anew the next day. For example, Fir Co. is a semiweekly schedule depositor. On Monday, Fir Co. accumulates taxes of $110,000 and must deposit this amount on Tuesday, the next banking day. On Tuesday, Fir Co. accumulates additional taxes of $30,000. Because the $30,000 is not added to the previous $110,000 and is less than $100,000, Fir Co. must deposit the $30,000 by Friday, following the semiweekly deposit schedule.

If you are a monthly schedule depositor and accumulate a $100,000 tax liability on any day, you become a semiweekly schedule depositor on the next day and remain so for at least the rest of the calendar year and for the following calendar year.

Example of $100,000 next-day deposit rule. Fir Co. started its business on April 4, 2005. On April 11, it paid wages for the first time and accumulated a tax liability of $40,000. On April 18, Fir Co. paid wages and accumulated a liability of $60,000, making its accumulated Form 941 tax liability total $100,000. Because this was the 1st year of its business, the tax liability for its lookback period is considered to be zero, and it would be a monthly schedule depositor based on the lookback rules. However, because Fir Co. accumulated $100,000 on April 18, it became a semiweekly schedule depositor on April 19. It will be a semiweekly schedule depositor for the remainder of 2005 and for 2006. Fir Co. is required to deposit $100,000 by April 19, the next banking day.

Adjustments and the Lookback Rule

Determine your tax liability for the lookback period (four-quarter lookback period for Form 941 and calendar-year lookback period for Form 943, Form 945, and Form CT-1) based on the tax liability as **originally** reported. If you made adjustments to correct errors on previously filed returns, these adjustments do not affect the amount of tax liability for purposes of the lookback rule. If you report adjustments on your current return to correct errors on prior period returns, include these adjustments as part of your tax liability for the current quarter. If you filed Form 843, Claim for Refund and Request for Abatement, to claim a refund for a prior period overpayment, your tax liability does not change for either the prior period or the current period quarter for purposes of the lookback rule.

Example of adjustments and the lookback rule for Form 941. An employer originally reported a tax liability of $45,000 for the four quarters in the lookback period ending June 30, 2004. The employer discovered during January 2005 that the tax during one of the lookback period quarters was understated by $10,000 and corrected this error with an adjustment on the 2005 1st quarter Form 941. This employer is a monthly schedule depositor for 2005 because the lookback period tax liabilities are based on the amounts originally reported and they were less than $50,000. The $10,000 adjustment is part of the 2005 1st quarter tax liability.

Accuracy of Deposits Rule

You are required to deposit 100% of your tax liability on or before the deposit due date. However, penalties will not be applied for depositing less than 100% if **both** of the following conditions are met.

1. Any deposit shortfall does not exceed the greater of $100 or 2% of the amount of taxes otherwise required to be deposited.

2. The deposit shortfall is paid or deposited by the shortfall makeup date as described below.

Makeup Date for Deposit Shortfall

- **Monthly schedule depositor.** Deposit or pay the shortfall with your return by the due date of the return. You may pay the shortfall with your return even if the amount is $2,500 or more.
- **Semiweekly schedule depositor.** Deposit by the **earlier** of:

1. The first Wednesday or Friday that falls on or after the 15th of the month following the month in which the shortfall occurred or

2. The due date of your return (for the return period of the tax liability).

For example, if a semiweekly schedule depositor has a deposit shortfall during February 2005, the shortfall makeup date is March 16, 2005 (Wednesday). However, if the shortfall occurred on the required April 1 deposit date for the March 26 tax liability, May 2 (due date of return) would come before the May 18 (Wednesday) shortfall makeup date. In this case, the shortfall would have to be deposited by May 2.

Form **2553**
(Rev. March 2005)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)

▶ **See Parts II and III on back and the separate instructions.**

▶ **The corporation may either send or fax this form to the IRS. See page 2 of the instructions.**

OMB No. 1545-0146

Notes: 1. ***Do not*** *file* ***Form 1120S,*** *U.S. Income Tax Return for an S Corporation, for any tax year before the year the election takes effect.*
2. *This election to be an S corporation can be accepted only if all the tests are met under* ***Who May Elect*** *on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed this form; and the exact name and address of the corporation and other required form information are provided.*

Part I Election Information

Please Type or Print		
	Name (see instructions)	**A Employer identification number**
	Number, street, and room or suite no. (If a P.O. box, see instructions.)	**B** Date incorporated
	City or town, state, and ZIP code	**C** State of incorporation

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its name ☐ or address ☐

E Election is to be effective for tax year beginning (month, day, year) . . . . ▶ / /

F Name and title of officer or legal representative who the IRS may call for more information

G Telephone number of officer or legal representative ( )

H If this election takes effect for the first tax year the corporation exists, enter month, day, and year of the **earliest** of the following: (1) date the corporation first had shareholders, (2) date the corporation first had assets, or (3) date the corporation began doing business . . . . ▶ / /

I Selected tax year: Annual return will be filed for tax year ending (month and day) ▶

If the tax year ends on any date other than December 31, except for a 52-53-week tax year ending with reference to the month of December, complete Part II on the back. If the date you enter is the ending date of a 52-53-week tax year, write "52-53-week year" to the right of the date.

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K)	**K** Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		**L** Stock owned or percentage of ownership (see instructions)		**M** Social security number or employer identification number (see instructions)	**N** Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer ▶ **Title** ▶ **Date** ▶

Part II Selection of Fiscal Tax Year (All corporations using this part must complete item O and item P, Q, or R.)

O Check the applicable box to indicate whether the corporation is:

1. ☐ A new corporation **adopting** the tax year entered in item I, Part I.

2. ☐ An existing corporation **retaining** the tax year entered in item I, Part I.

3. ☐ An existing corporation **changing** to the tax year entered in item I, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2002-38, 2002-22 I.R.B. 1037, to request **(1)** a natural business year (as defined in section 5.05 of Rev. Proc. 2002-38) or **(2)** a year that satisfies the ownership tax year test (as defined in section 5.06 of Rev. Proc. 2002-38). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ▶ ☐ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year as defined in section 5.05 of Rev. Proc. 2002-38 and has attached a statement verifying that it satisfies the 25% gross receipts test (see instructions for content of statement). I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2002-38 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ▶ ☐ I represent that shareholders (as described in section 5.06 of Rev. Proc. 2002-38) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item I, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2002-38. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2002-38 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note: *If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.*

Q Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ▶ ☐ if the fiscal year entered in item I, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?
☐ Yes ☐ No

2. Check here ▶ ☐ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. (See instructions for more information.)

3. Check here ▶ ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ▶ ☐ to show the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item I, Part I. To make the election, you must complete **Form 8716,** Election To Have a Tax Year Other Than a Required Tax Year, and either attach it to Form 2553 or file it separately.

2. Check here ▶ ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Part III Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)*

Income beneficiary's name and address	Social security number
Trust's name and address	Employer identification number

Date on which stock of the corporation was transferred to the trust (month, day, year) . . . . ▶ / /

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election Date

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Form **4506**
(Rev. January 2004)
Department of the Treasury
Internal Revenue Service

Request for Copy of Tax Return

► **Do not sign this form unless all applicable parts have been completed. Read the instructions on page 2.**
► **Request may be rejected if the form is incomplete, illegible, or any required part was blank at the time of signature.**

OMB No. 1545-0429

TIP: You may be able to get your tax return or return information from other sources. If you had your tax return completed by a paid preparer, they should be able to provide you a copy of the return. The IRS can provide a **Tax Return Transcript** for many returns free of charge. The transcript provides most of the line entries from the tax return and usually contains the information that a third party (such as a mortgage company) requires. See new **Form 4506-T,** Request for Transcript of Tax Return, to order a transcript or you can call 1-800-829-1040 to order a transcript.

1a Name shown on tax return. If a joint return, enter the name shown first.

1b First social security number on tax return or employer identification number (see instructions)

2a If a joint return, enter spouse's name shown on tax return

2b Second social security number if joint tax return

3 Current name, address (including apt., room, or suite no.), city, state, and ZIP code

4 Address, (including apt., room, or suite no.), city, state, and ZIP code shown on the last return filed if different from line 3

5 If the tax return is to be mailed to a third party (such as a mortgage company), enter the third party's name, address, and telephone number. The IRS has no control over what the third party does with the tax return.

CAUTION: *Lines 6 and 7 must be completed if the third party requires you to complete Form 4506.* ***Do not*** *sign Form 4506 if the third party requests that you sign Form 4506 and lines 6 and 7 are blank.*

6 **Tax return requested** (Form 1040, 1120, 941, etc.) and all attachments as originally submitted to the IRS, including Form(s) W-2, schedules, or amended returns. Copies of Forms 1040, 1040A, and 1040EZ are generally available for 7 years from filing before they are destroyed by law. Other returns may be available for a longer period of time. Enter only one return number. If you need more than one type of return, you must complete another Form 4506. ► ______________

Note: *If the copies must be certified for court or adminstrative proceedings, check here* . . . . ☐

7 **Year or period requested.** Enter the ending date of the year or period, using the mm/dd/yyyy format. If you are requesting more than four years or periods, you must attach another Form 4506.

___/___/_____   ___/___/_____   ___/___/_____   ___/___/_____

8 **Fee.** There is a $39 fee for each return requested. **Full payment must be included with your request or it will be rejected. Make your check or money order payable to "United States Treasury." Enter your SSN or EIN and "Form 4506 request" on your check or money order.**

a	Cost for each return	$ 39.00
b	Number of returns requested on line 7	
c	Total cost. Multiply line 8a by line 8b	$

9 If we cannot find the tax return, we will refund the fee. If the refund should go to the third party listed on line 5, check here . . ☐

Signature of taxpayer(s). I declare that I am either the taxpayer whose name is shown on line 1a or 2a, or a person authorized to obtain the tax return requested. If the request applies to a joint return, **either** husband or wife must sign. If signed by a corporate officer, partner, guardian, tax matters partner, executor, receiver, administrator, trustee, or party other than the taxpayer, I certify that I have the authority to execute Form 4506 on behalf of the taxpayer.

Telephone number of taxpayer on line 1a or 2a
(   )

Sign Here

Signature (see instructions)   Date

Title (if line 1a above is a corporation, partnership, estate, or trust)

Spouse's signature   Date

Changes To Note

Section references are to the Internal Revenue Code.

- **Form 4506,** Request for Copy of Tax Return, is now used to request copies of tax returns. Use **new Form 4506-T**, Request for Transcript of Tax Return, to request tax return transcripts, tax account information, W-2 information, 1099 information, verification of non-filing, and record of account.
- The fee for a photocopy of a tax return has increased to $39.

Instructions

Purpose of form. Use Form 4506 to request a copy of your tax return. You can also designate a third party to receive the tax return. See line 5.

How long will it take? It may take up to 60 calendar days for us to process your request.

Where to file. Attach payment and mail Form 4506 to the address below for the state you lived in when that return was filed. There are two address charts: one for individual returns (Form 1040 series) and one for all other returns.

Note: *If you are requesting more than one return and the chart below shows two different service centers, mail your request to the service center based on the address of your most recent return.*

Chart for individual returns (Form 1040 series)

If you lived in and filed an individual return:	Mail to the Internal Revenue Service at:
Maine, Massachusetts, New Hampshire, New York, Vermont	RAIVS Team 310 Lowell St. Stop 679 Andover, MA 01810
Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, West Virginia, Rhode Island	RAIVS Team 4800 Buford Hwy. Stop 91 Chamblee, GA 30341
Arkansas, Colorado, Kentucky, Louisiana, New Mexico, Oklahoma, Tennessee, Texas	RAIVS Team 3651 South Interregional Hwy. Stop 6716 Austin, TX 78741
Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming	RAIVS Team Stop 38101 Fresno, CA 93888
Delaware, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, South Dakota, Wisconsin	RAIVS Team Stop B41-6700 Kansas City, MO 64999
Ohio, Virginia	RAIVS Team 5333 Getwell Rd. Stop 2826 Memphis, TN 38118
Connecticut, District of Columbia, Maryland, New Jersey, Pennsylvania, a foreign country, or A.P.O. or F.P.O. address	RAIVS Team DP SE 135 Philadelphia, PA 19255-0695

Chart for all other returns

If you lived in:	Mail to the Internal Revenue Service at:
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming	RAIVS Team Mail Stop 6734 Ogden, UT 84201
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	RAIVS Team P.O. Box 145500 Stop 2800F Cincinnati, OH 45250

Line 1b. Enter your employer identification number if you are requesting a copy of a business return. Otherwise, enter the first social security number (SSN) shown on the return. For example, if you are requesting Form 1040 that includes Schedule C (Form 1040), enter your SSN.

Signature and date. Form 4506 must be signed and dated by the taxpayer listed on line 1a or 2a. If you completed line 5 requesting the return be sent to a third party, the IRS must receive Form 4506 within 60 days of the date signed by the taxpayer or it will be rejected.

Individuals. Copies of jointly filed tax returns may be furnished to either spouse. Only one signature is required. Sign Form 4506 exactly as your name appeared on the original return. If you changed your name, also sign your current name.

Corporations. Generally, Form 4506 can be signed by: (1) an officer having legal authority to bind the corporation, (2) any person designated by the board of directors or other governing body, or (3) any officer or employee on written request by any principal officer and attested to by the secretary or other officer.

Partnerships. Generally, Form 4506 can be signed by any person who was a member of the partnership during any part of the tax period requested on line 7.

All others. See section 6103(e) if the taxpayer has died, is insolvent, is a dissolved corporation, or if a trustee, guardian, executor, receiver, or administrator is acting for the taxpayer.

Documentation. For entities other than individuals, you must attach the authorization document. For example, this could be the letter from the principal officer authorizing an employee of the corporation or the Letters Testamentary authorizing an individual to act for an estate.

Signature by a representative. A representative can sign Form 4506 for a taxpayer only if this authority has been specifically delegated to the representative on Form 2848, line 5. Form 2848 showing the delegation must be attached to Form 4506.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to establish your right to gain access to the requested return(s) under the Internal Revenue Code. We need this information to properly identify the return(s) and respond to your request. Sections 6103 and 6109 require you to provide this information, including your SSN or EIN, to process your request. If you do not provide this information, we may not be able to process your request. Providing false or fraudulent information may subject you to penalties.

Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and cities, states, and the District of Columbia for use in administering their tax laws. We may also disclose this information to Federal and state agencies to enforce Federal nontax criminal laws and to combat terrorism.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file Form 4506 will vary depending on individual circumstances. The estimated average time is: **Learning about the law or the form,** 10 min.; **Preparing the form,** 16 min.; and **Copying, assembling, and sending the form to the IRS,** 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making Form 4506 simpler, we would be happy to hear from you. You can write to the Tax Products Coordinating Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the form to this address. Instead, see **Where to file** on this page.

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶Attach to your tax return. ▶See separate instructions.

OMB No. 1545-0184

2004

Attachment Sequence No. **27**

Name(s) shown on return | **Identifying number**

1 Enter the gross proceeds from sales or exchanges reported to you for 2004 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

	(a) Description of property	**(b)** Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)	**(d)** Gross sales price	**(e)** Depreciation allowed or allowable since acquisition	**(f)** Cost or other basis, plus improvements and expense of sale	**(g) Gain or (loss)** Subtract (f) from the sum of (d) and (e)
2							

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on Schedule D (see instructions)	9	

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **7018** (Rev. August 2004) Department of the Treasury Internal Revenue Service

Employer's Order Blank for Forms

Visit the IRS website @ www.irs.gov.

▶ Please send your order to IRS as soon as possible

OMB No. 1545–1059

Instructions. Enter the quantity next to the form you are ordering. **Please order the number of forms needed, not the number of sheets. Note:** None of the items on the order blank are available from the IRS in a continuous-feed version. All forms on this order blank that require multiple copies are carbonized so that you will not have to insert carbons. You will automatically receive one instruction with any form on this order blank. **Type or print** your name and complete mail delivery address in the space provided below. An accurate mail delivery address is necessary to ensure delivery of your order.

USE THIS PORTION FOR 2004 FORMS ONLY

Item	Quantity	Title	Item	Quantity	Title
W-2		Wage and Tax Statement	1099 C		Cancellation of Debt
W-2 C		Corrected Wage and Tax Statement	1099 CAP		Changes in Corporate Control and Capital Structure
W-2 G		Certain Gambling Winnings	1099 DIV		Dividends and Distributions
W-3		Transmittal of Wage and Tax Statements	1099 G		Certain Government Payments
W-3 C		Transmittal of Corrected Wage and Tax Statements	1099 H		Health Coverage Tax Credit (HCTC) Advance Payments
W-4		Employee's Withholding Allowance Certificate (2004)	1099 INT		Interest Income
W-4 P		Withholding Certificate for Pension or Annuity Payments	1099 LTC		Long-Term Care and Accelerated Death Benefits
W-4 S		Request for Federal Income Tax Withholding From Sick Pay	1099 MISC		Miscellaneous Income
W-5		Earned Income Credit Advance Payment Certificate	1099 SA		Distributions From HSA Archer MSA, or Medicare+Choice MSA
941		Employer's Quarterly Federal Tax Return	1099 OID		Original Issue Discount
941 SCH B		Employer's Record of Federal Tax Liability	1099 PATR		Taxable Distributions Received From Cooperatives
941 C		Supporting Statement To Correct Information	1099 Q		Payments From Qualified Education Programs (Under Sections 529 and 530)
943		Employer's Annual Federal Tax Return for Agricultural Employees	1099 R		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
943 A		Agricultural Employer's Record of Federal Tax Liability			
945		Annual Return of Withheld Federal Income Tax	1099 S		Proceeds From Real Estate Transactions
945 A		Annual Record of Federal Tax Liability	5498		IRA Contribution Information
1096		Annual Summary and Transmittal of U.S. Information Returns	5498 ESA		Coverdell ESA Contribution Information
1098		Mortgage Interest Statement	5498 SA		HSA, Archer MSA, or Medicare+Choice MSA Information
1098 E		Student Loan Interest Statement	Pub 213		Check Your Withholding
1098 T		Tuition Statement	Pub 1494		Table for Figuring Amount Exempt From Levy On Wages, Salary, and Other Income (Forms 668-W(c) and 668-W(c)(DO))
1099 A		Acquisition or Abandonment of Secured Property			
1099 B		Proceeds From Broker and Barter Exchange Transactions			

Use This Portion For **2005** Forms Only

QUANTITY

______________ W-4

______________ W-4 P

______________ W-4 S

______________ W-5

(2005 Revisions)

Attention:	Daytime Telephone Number ( )
Company Name	
Postal Mailing Address	Ste/Room
City State	Zip Code
Foreign Country	International Postal Code

Where To Send Your Order

Send your order to the Internal Revenue Service address for the Area Distribution Center closest to your state.

Central Area Distribution Center
P.O. Box 8908
Bloomington, IL 61702-8908

Western Area Distribution Center
Rancho Cordova, CA 95743-0001

Eastern Area Distribution Center
P.O. Box 85075
Richmond, VA 23261-5075

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. Your response is voluntary.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete this form will vary depending on the individual circumstances. The estimated average time is 3 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, Washington, DC 20224.

Please **do not** send your order Form 7018 to the Tax Products Coordinating Committee. Send your forms order to the IRS Area Distribution Center closest to your state.

Form **8594** (Rev. October 2002)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

▶ **Attach to your income tax return.** ▶ **See separate instructions.**

OMB No. 1545-1021
Attachment Sequence No. **61**

Name as shown on return	Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I **General Information**

1 Name of other party to the transaction	Other party's identifying number
Address (number, street, and room or suite no.)	
City or town, state, and ZIP code	
2 Date of sale	**3** Total sales price (consideration)

Part II **Assets Transferred—**All filers of an original statement must complete.

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document?. . . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . . ☐ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

Part III **Supplemental Statement-** Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Instructions for Form 8594

(Rev. October 2002)

Asset Acquisition Statement Under Section 1060

Department of the Treasury
Internal Revenue Service

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Changes To Note

New regulations have made significant changes to the rules applicable under section 1060. The regulations are effective for allocations of assets acquired or deemed acquired after March 15, 2001. Among the most important changes are the addition of new Class III, which is applicable to mark-to-market assets, certain debt instruments, and new Class IV, which is applicable to inventory.

Purpose of Form

Both the seller and purchaser of a group of assets that makes up a trade or business must use Form 8594 to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.

Form 8594 must also be filed if the purchaser or seller is amending an original or a previously filed supplemental Form 8594 because of an increase or decrease in the purchaser's cost of the assets or the amount realized by the seller.

Who Must File

Subject to the exceptions noted below, both purchaser and seller of the assets must file Form 8594 and attach it to their income tax returns (Forms 1040, 1041, 1065, 1120, 1120S, etc.) when there is a transfer of a group of assets that make up a trade or business (defined below) and the purchaser's basis in such assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both.

If the purchaser or seller is a controlled foreign corporation (CFC), each U.S. shareholder should attach Form 8594 to its Form 5471.

Exceptions. You are **not** required to file Form 8594 if any of the following apply:

- A group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which section 1031 applies. If section 1031 does not apply to all the assets transferred, however, Form 8594 is required for the part of the group of assets to which section 1031 does not apply. For information about such a transaction, see Regulations sections 1.1031(j)-1(b) and 1.1060-1(b)(8).
- A partnership interest is transferred. See Temporary Regulations section 1.755-2T for special reporting requirements.

When To File

Generally, attach Form 8594 to your income tax return for the year in which the sale date occurred.

If the amount allocated to any asset is increased or decreased after the year in which the sale occurs, the seller and/or purchaser (whoever is affected) must complete Parts I and III of Form 8594 and attach the form to the income tax return for the year in which the increase or decrease is taken into account.

Penalty

If you fail to file a correct Form 8594 by the due date of your return and you cannot show reasonable cause, you may be subject to a penalty. See sections 6721 through 6724.

Definitions

Trade or business. A group of assets makes up a trade or business if goodwill or going concern value could under any circumstances attach to such assets. A group of assets can also qualify as a trade or business if it qualifies as an active trade or business under section 355 (relating to distributions of stock in controlled corporations.

Factors to consider in determining whether goodwill or going concern value could attach include **(a)** the presence of any section 197 or other intangible assets (but the transfer of such an asset in the absence of other assets will not be a trade or business), **(b)** any excess of the total paid for the assets over the aggregate book value of the assets (other than goodwill or going concern value) as shown in the purchaser's financial accounting books and records, or **(c)** a license, a lease agreement, a covenant not to compete, a management contract, an employment contract, or other similar agreements between purchaser and seller (or managers, directors, owners, or employees of the seller).

Consideration. The purchaser's consideration is the cost of the assets. The purchaser's consideration is the amount realized.

Fair market value. Fair market value is the gross fair market value unreduced by mortgages, liens, pledges, or other liabilities. However, for determining the seller's gain or loss, generally, the fair market value of any property is not less than any nonrecourse debt to which the property is subject.

Classes of assets. The following definitions are the classifications effective for deemed or actual asset acquisitions on or after March 16, 2001.

Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions.

Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and Regulations section 1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

Class III assets are assets that the taxpayer marks-to-market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include **(a)** debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707; **(b)** contingent debt instruments subject to Regulations sections 1.1275-4 and 1.483-4, or section 988, unless the instrument is subject to the noncontingent bond method of Regulations section 1.1275-4(b) or is described in Regulations section 1.988-2(b)(2)(i)(B)(2); and **(c)** debt instruments convertible into the stock of the issuer or other property.

Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

Class V assets are all assets other than Class I, II, III, IV, VI and VII assets.

Class VI assets are all section 197 intangibles (as defined in section 197) except goodwill and going concern value. Section 197 intangibles include:

- Workforce in place;
- Business books and records, operating systems, or any other information base, process, design, pattern, know-how, formula, or similar item;
- Any customer-based intangible;
- Any supplier-based intangible;
- Any license, permit, or other right granted by a government unit;
- Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business; and
- Any franchise (other than a sports franchise), trademark, or trade name.

However, the term "section 197 intangible" does not include any of the following:

- An interest in a corporation, partnership, trust, or estate;
- Interests under certain financial contracts;
- Interests in land;
- Certain computer software;
- Certain separately acquired interests in films, sound recordings, video tapes, books, or other similar property;
- Interests under leases of tangible property;
- Certain separately acquired rights to receive tangible property or services;
- Certain separately acquired interests in patents or copyrights;
- Interests under indebtedness;
- Professional sports franchises; and
- Certain transactions costs.

See section 197(e) for further information.

Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

Allocation of consideration. An allocation of the purchase price must be made to determine the purchaser's basis in each acquired asset and the seller's gain or loss on the transfer of each asset. Use the residual method for the allocation of the sales price among the amortizable section 197 intangibles and other assets transferred. See Regulations section 1.1060-1(c). The amount allocated to an asset, other than a Class VII asset, cannot exceed its fair market value on the purchase date. The amount you can allocate to an asset also is subject to any applicable limits under the Internal Revenue Code or general principals of tax law. For example, see section 1056 for the basis limitation for player contracts transferred in connection with the sale of a franchise.

Consideration should be allocated as follows: **(a)** reduce the consideration by the amount of Class I assets transferred, **(b)** allocate the remaining consideration to Class II assets in proportion to their fair market values on the purchase date, **(c)** allocate to Class III assets in proportion to their fair market values on the purchase date, **(d)** allocate to Class IV assets in proportion to their fair market values on the purchase date, **(e)** allocate to Class V assets in proportion to their fair market values on the purchase date, **(f)** allocate to Class VI assets in proportion to their fair market values on the purchase date, and **(g)** allocate to Class VII assets. If an asset in one of the classifications described above can be included in more than one class, choose the lower numbered class (e.g., if an asset could be included in Class III or IV, choose Class III).

Reallocation after an increase or decrease in consideration. If an increase or decrease in consideration that must be taken into account to redetermine the seller's amount realized on the sale, or the purchaser's cost basis in the assets, occurs after the purchase date, the seller and/or purchaser must allocate the increase or decrease among the assets. If the increase or decrease occurs in the same tax year as the purchase date, consider the increase or decrease to have occurred on the purchase date. If the increase or decrease occurs after the tax year of the purchase date, consider it in the tax year in which it occurs.

For an increase or decrease related to a patent, copyright, etc., see **Specific Allocation** on page 3.

Allocation of increase. Allocate an increase in consideration as described under **Allocation of consideration.** If an asset has been disposed of, depreciated, amortized, or depleted by the purchaser before the increase occurs, any amount allocated to that asset by the purchaser must be properly taken into account under principles of tax law applicable when part of the cost of an asset (not previously reflected in its basis) is paid after the asset has been disposed of, depreciated, amortized, or depleted.

Allocation of decrease. Allocate a decrease in consideration as follows: **(a)** reduce the amount previously allocated to Class VII assets, **(b)** reduce the amount previously allocated to Class VI assets in proportion to their fair market values on the purchase date, **(c)** reduce the amount previously allocated to Class V assets in proportion to their fair market values on the purchase date, **(d)** reduce the amount previously allocated to Class IV assets in proportion to their fair market values on the purchase date, **(e)** reduce the amount previously allocated to Class III assets in proportion to their fair market values on the purchase date, and **(f)** reduce the amount previously allocated to Class II assets in proportion to their fair market values on the purchase date.

You cannot decrease the amount allocated to an asset below zero. If an asset has a basis of zero at the time the decrease is taken into account because it has been disposed of, depreciated, amortized, or depleted by the purchaser under section 1060, the decrease in consideration allocable to such asset must be properly taken into account under the principles of tax law applicable when the cost of an asset (previously reflected in basis) is reduced after the asset has been disposed of, depreciated, amortized, or depleted. An asset is considered to have been disposed of to the extent the decrease allocated to it would reduce its basis below zero.

Patents, copyrights, and similar property. You must make a specific allocation (defined below) if an increase or decrease in consideration is the result of a contingency that directly relates to income produced by a particular intangible asset, such as a patent, a secret process, or a copyright, and the increase or decrease is related only to such asset and not to other assets. If the specific allocation rule does not apply, make an allocation of any increase or decrease as you would for any other assets as described under **Allocation of increase** and **Allocation of decrease.**

Specific allocation. Limited to the fair market value of the asset, any increase or decrease in consideration is allocated first specifically to the patent, copyright, or similar property to which the increase or decrease relates, and then to the other assets in the order described under **Allocation of increase** and **Allocation of decrease.** For purposes of applying the fair market value limit to the patent, copyright, or similar property, the fair market value of such asset is redetermined when the increase or decrease is taken into account by considering only the reasons for the increase or decrease. The fair market values of the other assets are not redetermined.

Specific Instructions

For an original statement, complete Parts I and II. For a Supplemental Statement, complete Part I and III.

Enter your name and taxpayer identification number (TIN) at the top of the form. Then check the box for purchaser or seller.

Part I—General Information

Line 1. Enter the name, address, and TIN of the other party to the transaction (purchaser or seller). You are required to enter the TIN of the other party. If the other party is an individual or sole proprietor, enter the social security number. If the other party is a corporation, partnership, or other entity, enter the employer identification number.

Line 2. Enter the date on which the sale of the assets occurred.

Line 3. Enter the total consideration transferred for the assets.

Part II—Assets Transferred

Line 4. For a particular class of assets, enter the total fair market value of all the assets in the class and the total allocation of the sales price. For Classes VI and XII, enter the total fair market value of Class VI and Class VII combined, and the total portion of the sales price allocated to Class VI and Class VII combined.

Line 6. This line must be completed by the purchaser and the seller. To determine the maximum consideration to be paid, assume that any contingencies specified in the agreement are met and that the consideration paid is the highest amount possible. If you cannot determine the maximum consideration, state how the consideration will be computed and the payment period.

Part III—Supplemental Statement

Complete Part III and file a new Form 8594 for each year that an increase or decrease in consideration occurs. Give the reason(s) for the increase or decrease in allocation. Also, enter the tax year(s) and form number with which the original and any supplemental statements were filed. For example, enter "2001 Form 1040".

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this tax form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	11 hr.
Learning about the law or the form	2 hr., 34 min.
Preparing and sending the form to the IRS	2 hr., 52 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS at the address listed in the instructions for the tax return with which this form is filed.

Form **8821**
(Rev. April 2004)
Department of the Treasury
Internal Revenue Service

Tax Information Authorization

► **Do not use this form to request a copy or transcript of your tax return. Instead, use Form 4506 or Form 4506-T.**

OMB No. 1545-1165

For IRS Use Only
Received by:
Name
Telephone ( )
Function
Date / /

1 Taxpayer information. Taxpayer(s) must sign and date this form on line 7.

Taxpayer name(s) and address (type or print)	**Social security number(s)**	**Employer identification number**
	Daytime telephone number ( )	Plan number (if applicable)

2 Appointee. If you wish to name more than one appointee, attach a list to this form.

Name and address

CAF No. ....
Telephone No. ....
Fax No. ....
Check if new: Address ☐ Telephone No. ☐ Fax No. ☐

3 Tax matters. The appointee is authorized to inspect and/or receive confidential tax information in any office of the IRS for the tax matters listed on this line. Do not use Form 8821 to request copies of tax returns.

(a) Type of Tax (Income, Employment, Excise, etc.) or Civil Penalty	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s) (see the instructions for line 3)	(d) Specific Tax Matters (see instr.)

4 Specific use not recorded on Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions on page 3. If you check this box, skip lines 5 and 6 . ► ☐

5 Disclosure of tax information (you **must** check a box on line 5a or 5b unless the box on line 4 is checked):

a If you want copies of tax information, notices, and other written communications sent to the appointee on an ongoing basis, check this box . . . . ► ☐

b If you do not want any copies of notices or communications sent to your appointee, check this box . . . . . ► ☐

6 Retention/revocation of tax information authorizations. This tax information authorization automatically revokes all prior authorizations for the same tax matters you listed on line 3 above unless you checked the box on line 4. If you do not want to revoke a prior tax information authorization, you **must** attach a copy of any authorizations you want to remain in effect **and** check this box . . . . ► ☐

To revoke this tax information authorization, see the instructions on page 3.

7 Signature of taxpayer(s). If a tax matter applies to a joint return, **either** husband or wife must sign. If signed by a corporate officer, partner, guardian, executor, receiver, administrator, trustee, or party other than the taxpayer, I certify that I have the authority to execute this form with respect to the tax matters/periods on line 3 above.

▶ **IF NOT SIGNED AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.**

Signature Date | Signature Date

Print Name Title (if applicable) | Print Name Title (if applicable)

☐☐☐☐☐ PIN number for electronic signature | ☐☐☐☐☐ PIN number for electronic signature

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

Authorization to file Form 8821 electronically. Your appointee may be able to file Form 8821 with the IRS electronically. PIN number boxes have been added to the taxpayer's signature section. Entering a PIN number will give your appointee authority to file Form 8821 electronically using the PIN number as the electronic signature. You can use any five digits other than all zeroes as a PIN number. You may use the same PIN number that you used on other filings with the IRS. See **Where To File** on page 3 if completing Form 8821 only for this purpose.

Purpose of Form

Form 8821 authorizes any individual, corporation, firm, organization, or partnership you designate to inspect and/or receive your confidential information in any office of the IRS for the type of tax and the years or periods you list on Form 8821. You may file your own tax information authorization without using Form 8821, but it must include all the information that is requested on Form 8821.

Form 8821 does not authorize your appointee to advocate your position with respect to the Federal tax laws; to execute waivers, consents, or closing agreements; or to otherwise represent you before the IRS. If you want to authorize an individual to represent you, use Form 2848, Power of Attorney and Declaration of Representative.

Use Form 4506, Request for Copy of Tax Return, to get a copy of your tax return.

Use new Form 4506-T, Request for Transcript of Tax Return, to order: (a) transcript of tax account information and (b) Form W-2 and Form 1099 series information.

Use Form 56, Notice Concerning Fiduciary Relationship, to notify the IRS of the existence of a fiduciary relationship. A fiduciary (trustee, executor, administrator, receiver, or guardian) stands in the position of a taxpayer and acts as the taxpayer. Therefore, a fiduciary does not act as an appointee and should not file Form 8821. If a fiduciary wishes to authorize an appointee to inspect and/or receive confidential tax information on behalf of the fiduciary, Form 8821 must be filed and signed by the fiduciary acting in the position of the taxpayer.

When To File

Form 8821 must be received by the IRS within 60 days of the date it was signed and dated by the taxpayer.

Where To File Chart

IF you live in . . .	THEN use this address . . .	Fax Number*
Alabama, Arkansas, Connecticut, Delaware, District of Columbia, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, or West Virginia	Internal Revenue Service Memphis Accounts Management Center Stop 8423 5333 Getwell Road Memphis, TN 38118	901-546-4115
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, or Wyoming	Internal Revenue Service Ogden Accounts Management Center 1973 N. Rulon White Blvd. Mail Stop 6737 Ogden, UT 84404	801-620-4249
All APO and FPO addresses, American Samoa, nonpermanent residents of Guam or the Virgin Islands**, Puerto Rico (or if excluding income under Internal Revenue Code section 933), a foreign country: U.S. citizens and those filing Form 2555, 2555-EZ, or 4563.	Internal Revenue Service Philadelphia Accounts Management Center DPSW 312 11601 Roosevelt Blvd. Philadelphia, PA 19255	215-516-1017

*These numbers may change without notice.

**Permanent residents of Guam should use Department of Taxation, Government of Guam, P.O. Box 23607, GMF, GU 96921; permanent residents of the Virgin Islands should use: V.I. Bureau of Internal Revenue, 9601 Estate Thomas Charlotte Amaile, St. Thomas, V.I. 00802.

Where To File

Generally, mail or fax Form 8821 directly to the IRS. See the **Where To File Chart** on page 2. Exceptions are listed below.

- If Form 8821 is for a specific tax matter, mail or fax it to the office handling that matter. For more information, see the instructions for line 4.
- If you complete Form 8821 only for the purpose of electronic signature authorization, do not file Form 8821 with the IRS. Instead, give it to your appointee, who will retain the document.

Revocation of an Existing Tax Information Authorization

If you want to revoke an existing tax information authorization and do not want to name a new appointee, send a copy of the previously executed tax information authorization to the IRS, using the **Where To File Chart** on page 2. The copy of the tax information authorization must have a current signature of the taxpayer under the original signature on line 7. Write "REVOKE" across the top of Form 8821. If you do not have a copy of the tax information authorization you want to revoke, send a statement to the IRS. The statement of revocation must indicate that the authority of the tax information authorization is revoked, list the tax matters, must be signed and dated by the taxpayer, and list the name and address of each recognized appointee whose authority is revoked.

To revoke a specific use tax information authorization, send the tax information authorization or statement of revocation to the IRS office handling your case, using the above instructions.

Taxpayer Identification Numbers (TINs)

TINs are used to identify taxpayer information with corresponding tax returns. It is important that you furnish correct names, social security numbers (SSNs), individual taxpayer identification numbers (ITINs), or employer identification numbers (EINs) so that the IRS can respond to your request.

Partnership Items

Sections 6221–6234 authorize a Tax Matters Partner to perform certain acts on behalf of an affected partnership. Rules governing the use of Form 8821 do not replace any provisions of these sections.

Specific Instructions

Line 1. Taxpayer Information

Individuals. Enter your name, TIN, and your street address in the space provided. Do not enter your appointee's address or post office box. If a joint return is used, also enter your spouse's name and TIN. Also enter your EIN if applicable.

Corporations, partnerships, or associations. Enter the name, EIN, and business address.

Employee plan. Enter the plan name, EIN of the plan sponsor, three-digit plan number, and business address of the plan sponsor.

Trust. Enter the name, title, and address of the trustee, and the name and EIN of the trust.

Estate. Enter the name, title, and address of the decedent's executor/personal representative, and the name and identification number of the estate. The identification number for an estate includes both the EIN, if the estate has one, and the decedent's TIN.

Line 2. Appointee

Enter your appointee's full name. Use the identical full name on all submissions and correspondence. Enter the nine-digit CAF number for each appointee. If an appointee has a CAF number for any previously filed Form 8821 or power of attorney (Form 2848), use that number. If a CAF number has not been assigned, enter "NONE," and the IRS will issue one directly to your appointee. The IRS does not assign CAF numbers to requests for employee plans and exempt organizations.

If you want to name more than one appointee, indicate so on this line and attach a list of appointees to Form 8821.

Check the appropriate box to indicate if either the address, telephone number, or fax number is new since a CAF number was assigned.

Line 3. Tax Matters

Enter the type of tax, the tax form number, the years or periods, and the specific tax matter. Enter "Not applicable," in any of the columns that do not apply.

For example, you may list "Income tax, Form 1040" for calendar year "2003" and "Excise tax, Form 720" for the "1st, 2nd, 3rd, and 4th quarters of 2003." For multiple years, you may list "2001 through (thru or a dash (—)) 2003" for an income tax return; for quarterly returns, list "1st, 2nd, 3rd, and 4th quarters of 2001 through 2002" (or 2nd 2002 — 3rd 2003). For fiscal years, enter the ending year and month, using the YYYYMM format. Do not use a general reference such as "All years,""All periods," or "All taxes." Any tax information authorization with a general reference will be returned.

You may list any tax years or periods that have already ended as of the date you sign the tax information authorization. Also, you may include on a tax information authorization future tax periods that end no later than 3 years after the date the tax information authorization is received by the IRS. The 3 future periods are determined starting after December 31 of the year the tax information authorization is received by the IRS. You must enter the type of tax, the tax form number, and the future year(s) or period(s). If the matter relates to estate tax, enter the date of the decedent's death instead of the year or period.

In **column (d),** enter any specific information you want the IRS to provide. Examples of column (d) information are: lien information, a balance due amount, a specific tax schedule, or a tax liability.

For requests regarding Form 8802, Application for United States Residency Certification, enter "Form 8802" in column (d) and check the specific use box on line 4. Also, enter the appointee's information as instructed on Form 8802.

Line 4. Specific Use Not Recorded on CAF

Generally, the IRS records all tax information authorizations on the CAF system. However, authorizations relating to a specific issue are not recorded.

Check the box on line 4 if Form 8821 is filed for any of the following reasons: (a) requests to disclose information to loan companies or educational institutions, (b) requests to disclose information to Federal or state agency investigators for background checks, (c) application for EIN, or (d) claims filed on Form 843, Claim for Refund and Request for Abatement. If you check the box on line 4, your appointee should mail or fax Form 8821 to the IRS office handling the matter. Otherwise, your appointee should bring a copy of Form 8821 to each appointment to inspect or receive information. A specific-use tax information authorization will not revoke any prior tax information authorizations.

Line 6. Retention/Revocation of Tax Information Authorizations

Check the box on this line and attach a copy of the tax information authorization you do not want to revoke. The filing of Form 8821 will not revoke any Form 2848 that is in effect.

Line 7. Signature of Taxpayer(s)

Individuals. You must sign and date the authorization. Either husband or wife must sign if Form 8821 applies to a joint return.

Corporations. Generally, Form 8821 can be signed by: (a) an officer having legal authority to bind the corporation, (b) any person designated by the board of directors or other governing body, (c) any officer or employee on written request by any principal officer and attested to by the secretary or other officer, and (d) any other person authorized to access information under section 6103(e).

Partnerships. Generally, Form 8821 can be signed by any person who was a member of the partnership during any part of the tax period covered by Form 8821. See **Partnership Items** on page 3.

All others. See section 6103(e) if the taxpayer has died, is insolvent, is a dissolved corporation, or if a trustee, guardian, executor, receiver, or administrator is acting for the taxpayer.

Privacy Act and Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. Form 8821 is provided by the IRS for your convenience and its use is voluntary. If you designate an appointee to inspect and/or receive confidential tax information, you are required by section 6103(c) to provide the information requested on Form 8821. Under section 6109, you must disclose your social security number (SSN), employer identification number (EIN), or individual taxpayer identification number (ITIN). If you do not provide all the information requested on this form, we may not be able to honor the authorization.

Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. We may also give this information to other countries pursuant to tax treaties. We may also disclose this information to Federal and state agencies to enforce Federal nontax criminal laws and to combat terrorism. The authority to disclose information to combat terrorism expired on December 31, 2003. Legislation is pending that would reinstate this authority.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 6 min.; **Learning about the law or the form,** 12 min.; **Preparing the form,** 24 min.; **Copying and sending the form to the IRS,** 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making Form 8821 simpler, we would be happy to hear from you. You can write to the Tax Products Coordinating Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send Form 8821 to this address. Instead, see the **Where To File Chart** on page 2.

Form **8822**
(Rev. December 2004)
Department of the Treasury
Internal Revenue Service

Change of Address

▶ **Please type or print.**

▶ **See instructions on back.** ▶ **Do not attach this form to your return.**

OMB No. 1545-1163

Part I Complete This Part To Change Your Home Mailing Address

Check **all** boxes this change affects:

1 ☐ Individual income tax returns (Forms 1040, 1040A, 1040EZ, TeleFile, 1040NR, etc.)
▶ If your last return was a joint return and you are now establishing a residence separate from the spouse with whom you filed that return, check here . . . . ▶ ☐

2 ☐ Gift, estate, or generation-skipping transfer tax returns (Forms 706, 709, etc.)
▶ For Forms 706 and 706-NA, enter the decedent's name and social security number below.

▶ Decedent's name ▶ Social security number

3a Your name (first name, initial, and last name)	**3b Your social security number**
4a Spouse's name (first name, initial, and last name)	**4b Spouse's social security number**
5 Prior name(s). See instructions.	
6a Old address (no., street, city or town, state, and ZIP code). If a P.O. box or foreign address, see instructions.	Apt. no.
6b Spouse's old address, if different from line 6a (no., street, city or town, state, and ZIP code). If a P.O. box or foreign address, see instructions.	Apt. no.
7 New address (no., street, city or town, state, and ZIP code). If a P.O. box or foreign address, see instructions.	Apt. no.

Part II Complete This Part To Change Your Business Mailing Address or Business Location

Check **all** boxes this change affects:

8 ☐ Employment, excise, income, and other business returns (Forms 720, 940, 940-EZ, 941, 990, 1041, 1065, 1120, etc.)
9 ☐ Employee plan returns (Forms 5500, 5500-EZ, etc.)
10 ☐ Business location

11a Business name	**11b Employer identification number**
12 Old mailing address (no., street, city or town, state, and ZIP code). If a P.O. box or foreign address, see instructions.	Room or suite no.
13 New mailing address (no., street, city or town, state, and ZIP code). If a P.O. box or foreign address, see instructions.	Room or suite no.
14 New business location (no., street, city or town, state, and ZIP code). If a foreign address, see instructions.	Room or suite no.

Part III Signature

Daytime telephone number of person to contact (optional) ▶ (   )

Sign Here

Your signature	Date	If Part II completed, signature of owner, officer, or representative	Date
If joint return, spouse's signature	Date	Title	

Purpose of Form

You can use Form 8822 to notify the Internal Revenue Service if you changed your home or business mailing address or your business location. If this change also affects the mailing address for your children who filed income tax returns, complete and file a separate Form 8822 for each child. If you are a representative signing for the taxpayer, attach to Form 8822 a copy of your power of attorney.

Changing both home and business addresses? If you are, use a separate Form 8822 to show each change.

Prior Name(s)

If you or your spouse changed your name because of marriage, divorce, etc., complete line 5. Also, be sure to notify the Social Security Administration of your new name so that it has the same name in its records that you have on your tax return. This prevents delays in processing your return and issuing refunds. It also safeguards your future social security benefits.

Addresses

Be sure to include any apartment, room, or suite number in the space provided.

P.O. Box

Enter your box number instead of your street address only if your post office does not deliver mail to your street address.

Foreign Address

Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code. Please do not abbreviate the country name.

Signature

If you are completing Part II, the owner, an officer, or a representative must sign. An officer is the president, vice president, treasurer, chief accounting officer, etc. A representative is a person who has a valid power of attorney to handle tax matters or is otherwise authorized to sign tax returns for the business.

Where To File

Send this form to the Internal Revenue Service Center shown next that applies to you.

CAUTION *If you checked the box on line 2, see* Filers Who Checked the Box on Line 2 or Completed Part II *for where to file this form.*

Filers Who Checked the Box on Line 1 and Completed Part I

IF your old home mailing address was in . . .	**THEN use this address . . .**
Alabama, Florida, Georgia, Mississippi, North Carolina, Rhode Island, South Carolina, West Virginia	Atlanta, GA 39901
Arkansas, Colorado, Kentucky, Louisiana, New Mexico, Oklahoma, Tennessee, Texas	Austin, TX 73301
Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Virginia, Washington, Wyoming	Fresno, CA 93888
Maine, Massachusetts, New Hampshire, New York, Vermont	Andover, MA 05501
Connecticut, Delaware, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, South Dakota, Wisconsin	Kansas City, MO 64999
Ohio*	Memphis, TN 37501
District of Columbia, Maryland, New Jersey, Pennsylvania	Philadelphia, PA 19255
American Samoa	Philadelphia, PA 19255
Guam: Permanent residents	Department of Revenue and Taxation Government of Guam P.O. Box 23607 GMF, GU 96921
Guam: Nonpermanent residents Puerto Rico (or if excluding income under Internal Revenue Code section 933) Virgin Islands: Nonpermanent residents	Philadelphia, PA 19255
Virgin Islands: Permanent residents	V. I. Bureau of Internal Revenue 9601 Estate Thomas Charlotte Amalie St. Thomas, VI 00802
Foreign country: U.S. citizens and those filing Form 2555, Form 2555-EZ, or Form 4563 Dual-status aliens All APO and FPO addresses	Philadelphia, PA 19255

*If you live in Ohio and mail Form 8822 after June 30, 2005, send it to: Internal Revenue Service Center, Fresno, CA 93888.

Filers Who Checked the Box on Line 2 or Completed Part II

IF your old business address was in . . .	**THEN use this address . . .**
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	Cincinnati, OH 45999
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming	Ogden, UT 84201
Outside the United States	Philadelphia, PA 19255

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We may give the information to the Department of Justice and to other Federal agencies, as provided by law. We may give it to cities, states, the District of Columbia, and U.S. commonwealths or possessions to carry out their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

Our legal right to ask for information is Internal Revenue Code sections 6001 and 6011, which require you to file a statement with us for any tax for which you are liable. Section 6109 requires that you provide your social security number on what you file. This is so we know who you are, and can process your form and other papers.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The use of this form is voluntary. However, if you fail to provide the Internal Revenue Service with your current mailing address, you may not receive a notice of deficiency or a notice and demand for tax. Despite the failure to receive such notices, penalties and interest will continue to accrue on the tax deficiencies.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is 16 minutes.

If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* on this page.

Form **SS-4**

(Rev. December 2001)

Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

► See separate instructions for each line. ► Keep a copy for your records.

EIN

OMB No. 1545-0003

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested

2 Trade name of business (if different from name on line 1)

3 Executor, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box)

5a Street address (if different) (Do not enter a P.O. box.)

4b City, state, and ZIP code

5b City, state, and ZIP code

6 County and state where principal business is located

7a Name of principal officer, general partner, grantor, owner, or trustor

7b SSN, ITIN, or EIN

8a Type of entity (check only one box)
- ☐ Sole proprietor (SSN) ______
- ☐ Partnership
- ☐ Corporation (enter form number to be filed) ► ______
- ☐ Personal service corp.
- ☐ Church or church-controlled organization
- ☐ Other nonprofit organization (specify) ► ______
- ☐ Other (specify) ►
- ☐ Estate (SSN of decedent) ______
- ☐ Plan administrator (SSN) ______
- ☐ Trust (SSN of grantor) ______
- ☐ National Guard
- ☐ Farmers' cooperative
- ☐ REMIC
- ☐ State/local government
- ☐ Federal government/military
- ☐ Indian tribal governments/enterprises

Group Exemption Number (GEN) ► ______

8b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

9 Reason for applying (check only one box)
- ☐ Started new business (specify type) ► ______
- ☐ Hired employees (Check the box and see line 12.)
- ☐ Compliance with IRS withholding regulations
- ☐ Other (specify) ►
- ☐ Banking purpose (specify purpose) ► ______
- ☐ Changed type of organization (specify new type) ► ______
- ☐ Purchased going business
- ☐ Created a trust (specify type) ► ______
- ☐ Created a pension plan (specify type) ► ______

10 Date business started or acquired (month, day, year)

11 Closing month of accounting year

12 First date wages or annuities were paid or will be paid (month, day, year). **Note:** *If applicant is a withholding agent, enter date income will first be paid to nonresident alien. (month, day, year)* . . . . ►

13 Highest number of employees expected in the next 12 months. **Note:** *If the applicant does not expect to have any employees during the period, enter "-0-."* . . . . ►	Agricultural	Household	Other

14 Check **one** box that best describes the principal activity of your business.
- ☐ Construction
- ☐ Rental & leasing
- ☐ Transportation & warehousing
- ☐ Real estate
- ☐ Manufacturing
- ☐ Finance & insurance
- ☐ Health care & social assistance
- ☐ Accommodation & food service
- ☐ Other (specify)
- ☐ Wholesale–agent/broker
- ☐ Wholesale–other
- ☐ Retail

15 Indicate principal line of merchandise sold; specific construction work done; products produced; or services provided.

16a Has the applicant ever applied for an employer identification number for this or any other business? . . . . ☐ **Yes** ☐ **No**
Note: *If "Yes," please complete lines 16b and 16c.*

16b If you checked "Yes" on line 16a, give applicant's legal name and trade name shown on prior application if different from line 1 or 2 above.
Legal name ► Trade name ►

16c Approximate date when, and city and state where, the application was filed. Enter previous employer identification number if known.

Approximate date when filed (mo., day, year)	City and state where filed	Previous EIN

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name	Designee's telephone number (include area code) ( )
Address and ZIP code	Designee's fax number (include area code) ( )

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Applicant's telephone number (include area code) ( )

Name and title (type or print clearly) ►

Applicant's fax number (include area code) ( )

Signature ► Date ►

Do I Need an EIN?

File Form SS-4 if the applicant entity does not already have an EIN but is required to show an EIN on any return, statement, or other document.[1] **See also the separate instructions for each line on Form SS-4.**

IF the applicant...	AND...	THEN...
Started a new business	Does not currently have (nor expect to have) employees	Complete lines 1, 2, 4a-6, 8a, and 9-16c.
Hired (or will hire) employees, including household employees	Does not already have an EIN	Complete lines 1, 2, 4a-6, 7a-b (if applicable), 8a, 8b (if applicable), and 9-16c.
Opened a bank account	Needs an EIN for banking purposes only	Complete lines 1-5b, 7a-b (if applicable), 8a, 9, and 16a-c.
Changed type of organization	Either the legal character of the organization or its ownership changed (e.g., you incorporate a sole proprietorship or form a partnership)[2]	Complete lines 1-16c (as applicable).
Purchased a going business[3]	Does not already have an EIN	Complete lines 1-16c (as applicable).
Created a trust	The trust is other than a grantor trust or an IRA trust[4]	Complete lines 1-16c (as applicable).
Created a pension plan as a plan administrator[5]	Needs an EIN for reporting purposes	Complete lines 1, 2, 4a-6, 8a, 9, and 16a-c.
Is a foreign person needing an EIN to comply with IRS withholding regulations	Needs an EIN to complete a Form W-8 (other than Form W-8ECI), avoid withholding on portfolio assets, or claim tax treaty benefits[6]	Complete lines 1-5b, 7a-b (SSN or ITIN optional), 8a-9, and 16a-c.
Is administering an estate	Needs an EIN to report estate income on Form 1041	Complete lines 1, 3, 4a-b, 8a, 9, and 16a-c.
Is a withholding agent for taxes on non-wage income paid to an alien (i.e., individual, corporation, or partnership, etc.)	Is an agent, broker, fiduciary, manager, tenant, or spouse who is required to file **Form 1042,** Annual Withholding Tax Return for U.S. Source Income of Foreign Persons	Complete lines 1, 2, 3 (if applicable), 4a-5b, 7a-b (if applicable), 8a, 9, and 16a-c.
Is a state or local agency	Serves as a tax reporting agent for public assistance recipients under Rev. Proc. 80-4, 1980-1 C.B. 581[7]	Complete lines 1, 2, 4a-5b, 8a, 9, and 16a-c.
Is a single-member LLC	Needs an EIN to file **Form 8832**, Classification Election, for filing employment tax returns, **or** for state reporting purposes[8]	Complete lines 1-16c (as applicable).
Is an S corporation	Needs an EIN to file **Form 2553,** Election by a Small Business Corporation[9]	Complete lines 1-16c (as applicable).

[1] For example, a sole proprietorship or self-employed farmer who establishes a qualified retirement plan, or is required to file excise, employment, alcohol, tobacco, or firearms returns, must have an EIN. **A partnership, corporation, REMIC (real estate mortgage investment conduit), nonprofit organization (church, club, etc.), or farmers' cooperative must use an EIN for any tax-related purpose even if the entity does not have employees.**

[2] However, **do not** apply for a new EIN if the existing entity only **(a)** changed its business name, **(b)** elected on Form 8832 to change the way it is taxed (or is covered by the default rules), or **(c)** terminated its partnership status because at least 50% of the total interests in partnership capital and profits were sold or exchanged within a 12-month period. (The EIN of the terminated partnership should continue to be used. See Regulations section 301.6109-1(d)(2)(iii).)

[3] Do not use the EIN of the prior business unless you became the "owner" of a corporation by acquiring its stock.

[4] However, IRA trusts that are required to file **Form 990-T,** Exempt Organization Business Income Tax Return, must have an EIN.

[5] A plan administrator is the person or group of persons specified as the administrator by the instrument under which the plan is operated.

[6] Entities applying to be a Qualified Intermediary (QI) need a QI-EIN even if they already have an EIN. **See Rev. Proc. 2000-12.**

[7] See also *Household employer* on page 4. (**Note:** State or local agencies may need an EIN for other reasons, e.g., hired employees.)

[8] Most LLCs **do not** need to file Form 8832. See **Limited liability company (LLC)** on page 4 for details on completing Form SS-4 for an LLC.

[9] An existing corporation that is electing or revoking S corporation status should use its previously-assigned EIN.

Instructions for Form SS-4

(Rev. September 2003)

Department of the Treasury
Internal Revenue Service

For use with Form SS-4 (Rev. December 2001)

Application for Employer Identification Number.

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Use these instructions to complete **Form SS-4,** Application for Employer Identification Number. Also see **Do I Need an EIN?** on page 2 of Form SS-4.

Purpose of Form

Use Form SS-4 to apply for an employer identification number (EIN). An EIN is a nine-digit number (for example, 12-3456789) assigned to sole proprietors, corporations, partnerships, estates, trusts, and other entities for tax filing and reporting purposes. The information you provide on this form will establish your business tax account.

CAUTION *An EIN is for use in connection with your business activities only. Do **not** use your EIN in place of your social security number (SSN).*

Items To Note

Apply online. You can now apply for and receive an EIN online using the internet. See **How To Apply** below.

File only one Form SS-4. Generally, a sole proprietor should file only one Form SS-4 and needs only one EIN, regardless of the number of businesses operated as a sole proprietorship or trade names under which a business operates. However, if the proprietorship incorporates or enters into a partnership, a new EIN is required. Also, each corporation in an affiliated group must have its own EIN.

EIN applied for, but not received. If you do not have an EIN by the time a return is due, write "Applied For" and the date you applied in the space shown for the number. **Do not** show your SSN as an EIN on returns.

If you do not have an EIN by the time a tax deposit is due, send your payment to the Internal Revenue Service Center for your filing area as shown in the instructions for the form that you are filing. Make your check or money order payable to the "United States Treasury" and show your name (as shown on Form SS-4), address, type of tax, period covered, and date you applied for an EIN.

How To Apply

You can apply for an EIN online, by telephone, by fax, or by mail depending on how soon you need to use the EIN. Use only one method for each entity so you do not receive more than one EIN for an entity.

Online. You can receive your EIN by internet and use it immediately to file a return or make a payment. Go to the IRS website at **www.irs.gov/businesses** and click on **Employer ID Numbers** under **topics.**

Telephone. You can receive your EIN by telephone and use it immediately to file a return or make a payment. Call the IRS at **1-800-829-4933.** (International applicants must call 215-516-6999.) The hours of operation are 7:00 a.m. to 10:00 p.m. The person making the call must be authorized to sign the form or be an authorized designee. See **Signature** and **Third Party Designee** on page 6. Also see the **TIP** below.

If you are applying by telephone, it will be helpful to complete Form SS-4 before contacting the IRS. An IRS representative will use the information from the Form SS-4 to establish your account and assign you an EIN. Write the number you are given on the upper right corner of the form and sign and date it. Keep this copy for your records.

If requested by an IRS representative, mail or fax (facsimile) the signed Form SS-4 (including any Third Party Designee authorization) within 24 hours to the IRS address provided by the IRS representative.

TIP *Taxpayer representatives can apply for an EIN on behalf of their client and request that the EIN be faxed to their **client** on the same day. **Note:** By using this procedure, you are authorizing the IRS to fax the EIN without a cover sheet.*

Fax. Under the Fax-TIN program, you can receive your EIN by fax within 4 business days. Complete and fax Form SS-4 to the IRS using the Fax-TIN number listed on page 2 for your state. A long-distance charge to callers outside of the local calling area will apply. Fax-TIN numbers can only be used to apply for an EIN. **The numbers may change without notice.** Fax-TIN is available 24 hours a day, 7 days a week.

Be sure to provide your fax number so the IRS can fax the EIN back to you. **Note:** By using this procedure, you are authorizing the IRS to fax the EIN without a cover sheet.

Mail. Complete Form SS-4 at least 4 to 5 weeks before you will need an EIN. Sign and date the application and mail it to the service center address for your state. You will receive your EIN in the mail in approximately 4 weeks. See also **Third Party Designee** on page 6.

Call 1-800-829-4933 to verify a number or to ask about the status of an application by mail.

Where To Fax or File

If your principal business, office or agency, or legal residence in the case of an individual, is located in:	Call the Fax-TIN number shown or file with the "Internal Revenue Service Center" at:
Connecticut, Delaware, District of Columbia, Florida, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia	Attn: EIN Operation P. 0. Box 9003 Holtsville, NY 11742-9003 Fax-TIN 631-447-8960
Illinois, Indiana, Kentucky, Michigan	Attn: EIN Operation Cincinnati, OH 45999 Fax-TIN 859-669-5760
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, Puerto Rico, South Dakota, Tennessee, Texas, Utah, Washington, Wisconsin, Wyoming	Attn: EIN Operation Philadelphia, PA 19255 Fax-TIN 215-516-3990
If you have no legal residence, principal place of business, or principal office or agency in any state:	Attn: EIN Operation Philadelphia, PA 19255 Telephone 215-516-6999 Fax-TIN 215-516-3990

How To Get Forms and Publications

Phone. You can order forms, instructions, and publications by phone 24 hours a day, 7 days a week. Call 1-800-TAX-FORM (1-800-829-3676). You should receive your order or notification of its status within 10 workdays.

Personal computer. With your personal computer and modem, you can get the forms and information you need using the IRS website at **www.irs.gov** or File Transfer Protocol at **ftp.irs.gov.**

CD-ROM. For small businesses, return preparers, or others who may frequently need tax forms or publications, a CD-ROM containing over 2,000 tax products (including many prior year forms) can be purchased from the National Technical Information Service (NTIS).

To order **Pub. 1796,** Federal Tax Products on CD-ROM, call **1-877-CDFORMS** (1-877-233-6767) toll free or connect to **www.irs.gov/cdorders.**

Tax Help for Your Business

IRS-sponsored Small Business Workshops provide information about your Federal and state tax obligations. For information about workshops in your area, call 1-800-829-4933.

Related Forms and Publications

The following **forms** and **instructions** may be useful to filers of Form SS-4:

- **Form 990-T,** Exempt Organization Business Income Tax Return
- **Instructions for Form 990-T**
- **Schedule C (Form 1040),** Profit or Loss From Business
- **Schedule F (Form 1040),** Profit or Loss From Farming
- **Instructions for Form 1041 and Schedules A, B, D, G, I, J, and K-1,** U.S. Income Tax Return for Estates and Trusts
- **Form 1042,** Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- **Instructions for Form 1065,** U.S. Return of Partnership Income
- **Instructions for Form 1066,** U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return
- **Instructions for Forms 1120 and 1120-A**
- **Form 2553,** Election by a Small Business Corporation
- **Form 2848,** Power of Attorney and Declaration of Representative
- **Form 8821,** Tax Information Authorization
- **Form 8832,** Entity Classification Election

For more **information** about filing Form SS-4 and related issues, see:

- **Circular A,** Agricultural Employer's Tax Guide (Pub. 51)
- **Circular E,** Employer's Tax Guide (Pub. 15)
- **Pub. 538,** Accounting Periods and Methods
- **Pub. 542,** Corporations
- **Pub. 557,** Exempt Status for Your Organization
- **Pub. 583,** Starting a Business and Keeping Records
- **Pub. 966,** Electronic Choices for Paying ALL Your Federal Taxes
- **Pub. 1635,** Understanding Your EIN
- **Package 1023,** Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code
- **Package 1024,** Application for Recognition of Exemption Under Section 501(a)

Specific Instructions

Print or type all entries on Form SS-4. Follow the instructions for each line to expedite processing and to avoid unnecessary IRS requests for additional information. Enter "N/A" (nonapplicable) on the lines that do not apply.

Line 1—Legal name of entity (or individual) for whom the EIN is being requested. Enter the legal name of the entity (or individual) applying for the EIN exactly as it appears on the social security card, charter, or other applicable legal document.

Individuals. Enter your first name, middle initial, and last name. If you are a sole proprietor, enter your individual name, not your business name. Enter your business name on line 2. Do not use abbreviations or nicknames on line 1.

Trusts. Enter the name of the trust.

Estate of a decedent. Enter the name of the estate.

Partnerships. Enter the legal name of the partnership as it appears in the partnership agreement.

Corporations. Enter the corporate name as it appears in the corporation charter or other legal document creating it.

Plan administrators. Enter the name of the plan administrator. A plan administrator who already has an EIN should use that number.

Line 2—Trade name of business. Enter the trade name of the business if different from the legal name. The trade name is the "doing business as" (DBA) name.

CAUTION *Use the full legal name shown on line 1 on all tax returns filed for the entity. (However, if you enter a trade name on line 2 and choose to use the trade name instead of the legal name, enter the trade name on **all returns** you file.) To prevent processing delays and errors, **always** use the legal name only (or the trade name only) on **all** tax returns.*

Line 3—Executor, trustee, "care of" name. Trusts enter the name of the trustee. Estates enter the name of the executor, administrator, or other fiduciary. If the entity applying has a designated person to receive tax information, enter that person's name as the "care of" person. Enter the individual's first name, middle initial, and last name.

Lines 4a-b—Mailing address. Enter the mailing address for the entity's correspondence. If line 3 is completed, enter the address for the executor, trustee or "care of" person. Generally, this address will be used on all tax returns.

TIP *File **Form 8822**, Change of Address, to report any subsequent changes to the entity's mailing address.*

Lines 5a-b—Street address. Provide the entity's physical address **only** if different from its mailing address shown in lines 4a-b. **Do not** enter a P.O. box number here.

Line 6—County and state where principal business is located. Enter the entity's primary **physical** location.

Lines 7a-b—Name of principal officer, general partner, grantor, owner, or trustor. Enter the first name, middle initial, last name, and SSN of **(a)** the principal officer if the business is a corporation, **(b)** a general partner if a partnership, **(c)** the owner of an entity that is disregarded as separate from its owner (disregarded entities owned by a corporation enter the corporation's name and EIN), or **(d)** a grantor, owner, or trustor if a trust.

If the person in question is an **alien individual** with a previously assigned individual taxpayer identification number (ITIN), enter the ITIN in the space provided and submit a copy of an official identifying document. If necessary, complete **Form W-7,** Application for IRS Individual Taxpayer Identification Number, to obtain an ITIN.

You are **required** to enter an SSN, ITIN, or EIN unless the only reason you are applying for an EIN is to make an entity classification election (see Regulations sections 301.7701-1 through 301.7701-3) and you are a nonresident alien with no effectively connected income from sources within the United States.

Line 8a—Type of entity. Check the box that best describes the type of entity applying for the EIN. If you are an alien individual with an ITIN previously assigned to you, enter the ITIN in place of a requested SSN.

CAUTION *This is not an election for a tax classification of an entity. See* **Limited liability company (LLC)** *on page 4.*

Other. If not specifically listed, check the "Other" box, enter the type of entity and the type of return, if any, that will be filed (for example, "Common Trust Fund, Form 1065" or "Created a Pension Plan"). Do not enter "N/A." If you are an alien individual applying for an EIN, see the **Lines 7a-b** instructions above.

- **Household employer.** If you are an individual, check the "Other" box and enter "Household Employer" and your SSN. If you are a state or local agency serving as a tax reporting agent for public assistance recipients who become household employers, check the "Other" box and enter "Household Employer Agent." If you are a trust that qualifies as a household employer, you do not need a separate EIN for reporting tax information relating to household employees; use the EIN of the trust.
- **QSub.** For a qualified subchapter S subsidiary (QSub) check the "Other" box and specify "QSub."
- **Withholding agent.** If you are a withholding agent required to file Form 1042, check the "Other" box and enter "Withholding Agent."

Sole proprietor. Check this box if you file Schedule C, C-EZ, or F (Form 1040) and have a qualified plan, or are required to file excise, employment, alcohol, tobacco, or firearms returns, or are a payer of gambling winnings. Enter your SSN (or ITIN) in the space provided. If you are a nonresident alien with no effectively connected income from sources within the United States, you do not need to enter an SSN or ITIN.

Corporation. This box is for any corporation **other than a personal service corporation.** If you check this box, enter the income tax form number to be filed by the entity in the space provided.

CAUTION *If you entered **"1120S"** after the "Corporation" checkbox, the corporation **must** file Form 2553 **no later than the 15th day of the 3rd month of the tax year the election is to take effect.** Until Form 2553 has been received and approved, you will be considered a Form 1120 filer. See the Instructions for Form 2553.*

Personal service corp. Check this box if the entity is a personal service corporation. An entity is a personal service corporation for a tax year only if:

• The principal activity of the entity during the testing period (prior tax year) for the tax year is the performance of personal services substantially by employee-owners, and
• The employee-owners own at least 10% of the fair market value of the outstanding stock in the entity on the last day of the testing period.

Personal services include performance of services in such fields as health, law, accounting, or consulting. For more information about personal service corporations, see the Instructions for Forms 1120 and 1120-A and Pub. 542.

Other nonprofit organization. Check this box if the nonprofit organization is other than a church or church-controlled organization and specify the type of nonprofit organization (for example, an educational organization).

CAUTION *If the organization also seeks tax-exempt status, you **must** file either Package 1023 or Package 1024. See Pub. 557 for more information.*

If the organization is covered by a group exemption letter, enter the four-digit **group exemption number (GEN).** (Do not confuse the GEN with the nine-digit EIN.) If you do not know the GEN, contact the parent organization. Get Pub. 557 for more information about group exemption numbers.

Plan administrator. If the plan administrator is an individual, enter the plan administrator's SSN in the space provided.

REMIC. Check this box if the entity has elected to be treated as a real estate mortgage investment conduit (REMIC). See the Instructions for Form 1066 for more information.

Limited liability company (LLC). An LLC is an entity organized under the laws of a state or foreign country as a limited liability company. For Federal tax purposes, an LLC may be treated as a partnership or corporation or be disregarded as an entity separate from its owner.

By **default,** a domestic LLC with only one member is **disregarded** as an entity separate from its owner and must include all of its income and expenses on the owner's tax return (e.g., **Schedule C (Form 1040)**). Also by default, a domestic LLC with two or more members is treated as a partnership. A domestic LLC may file Form 8832 to avoid either default classification and elect to be classified as an association taxable as a corporation. For more information on entity classifications (including the rules for foreign entities), see the instructions for Form 8832.

CAUTION ***Do not** file Form 8832 if the LLC accepts the default classifications above. **However, if the LLC will be electing S Corporation status, it must timely file both Form 8832 and Form 2553.***

Complete Form SS-4 for LLCs as follows:

• A single-member domestic LLC that accepts the default classification (above) does not need an EIN and generally should not file Form SS-4. Generally, the LLC should use the name and EIN of its **owner** for all Federal tax purposes. However, the reporting and payment of employment taxes for employees of the LLC may be made using the name and EIN of **either** the owner or the LLC as explained in Notice 99-6. You can find Notice 99-6 on page 12 of Internal Revenue Bulletin 1999-3 at **www.irs.gov/pub/irs-irbs/irb99-03.pdf.** (**Note:** If the LLC applicant indicates in box 13 that it has employees or expects to have employees, the owner (whether an individual or other entity) of a single-member domestic LLC will also be assigned its own EIN (if it does not already have one) even if the LLC will be filing the employment tax returns.)
• A single-member, domestic LLC that accepts the default classification (above) and wants an EIN for filing employment tax returns (see above) or non-Federal purposes, such as a state requirement, must check the "Other" box and write "Disregarded Entity" or, when applicable, "Disregarded Entity—Sole Proprietorship" in the space provided.
• A multi-member, domestic LLC that accepts the default classification (above) must check the "Partnership" box.
• A domestic LLC that will be filing Form 8832 to elect corporate status must check the "Corporation" box and write in "Single-Member" or "Multi-Member" immediately below the "form number" entry line.

Line 9—Reason for applying. Check only **one** box. Do not enter "N/A."

Started new business. Check this box if you are starting a new business that requires an EIN. If you check this box, enter the type of business being started. **Do not** apply if you already have an EIN and are only adding another place of business.

Hired employees. Check this box if the existing business is requesting an EIN because it has hired or is hiring employees and is therefore required to file employment tax returns. **Do not** apply if you already have an EIN and are only hiring employees. For information on employment taxes (e.g., for family members), see Circular E.

CAUTION *You may be required to make electronic deposits of all depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS). See section 11, Depositing Taxes, of Circular E and Pub. 966.*

Created a pension plan. Check this box if you have created a pension plan and need an EIN for reporting purposes. Also, enter the type of plan in the space provided.

TIP *Check this box if you are applying for a trust EIN when a new pension plan is established. In addition, check the "Other" box in line 8a and write "Created a Pension Plan" in the space provided.*

Banking purpose. Check this box if you are requesting an EIN for banking purposes only, and enter the banking purpose (for example, a bowling league for depositing dues or an investment club for dividend and interest reporting).

Changed type of organization. Check this box if the business is changing its type of organization. For example, the business was a sole proprietorship and has been incorporated or has become a partnership. If you check this box, specify in the space provided (including available space immediately below) the type of change made. For example, "From Sole Proprietorship to Partnership."

Purchased going business. Check this box if you purchased an existing business. **Do not** use the former owner's EIN unless you became the "owner" of a corporation by acquiring its stock.

Created a trust. Check this box if you created a trust, and enter the type of trust created. For example, indicate if the trust is a nonexempt charitable trust or a split-interest trust.

Exception. Do **not** file this form for certain grantor-type trusts. The trustee does not need an EIN for the trust if the trustee furnishes the name and TIN of the grantor/owner and the address of the trust to all payors. See the Instructions for Form 1041 for more information.

TIP *__Do not__ check this box if you are applying for a trust EIN when a new pension plan is established. Check "Created a pension plan."*

Other. Check this box if you are requesting an EIN for any other reason; and enter the reason. For example, a newly-formed state government entity should enter "Newly-Formed State Government Entity" in the space provided.

Line 10—Date business started or acquired. If you are starting a new business, enter the starting date of the business. If the business you acquired is already operating, enter the date you acquired the business. If you are changing the form of ownership of your business, enter the date the new ownership entity began. Trusts should enter the date the trust was legally created. Estates should enter the date of death of the decedent whose name appears on line 1 or the date when the estate was legally funded.

Line 11—Closing month of accounting year. Enter the last month of your accounting year or tax year. An accounting or tax year is usually 12 consecutive months, either a calendar year or a fiscal year (including a period of 52 or 53 weeks). A calendar year is 12 consecutive months ending on December 31. A fiscal year is either 12 consecutive months ending on the last day of any month other than December or a 52-53 week year. For more information on accounting periods, see Pub. 538.

Individuals. Your tax year generally will be a calendar year.

Partnerships. Partnerships must adopt one of the following tax years:

- The tax year of the majority of its partners,
- The tax year common to all of its principal partners,
- The tax year that results in the least aggregate deferral of income, or
- In certain cases, some other tax year.

See the Instructions for Form 1065 for more information.

REMICs. REMICs must have a calendar year as their tax year.

Personal service corporations. A personal service corporation generally must adopt a calendar year unless:

- It can establish a business purpose for having a different tax year, or
- It elects under section 444 to have a tax year other than a calendar year.

Trusts. Generally, a trust must adopt a calendar year except for the following:

- Tax-exempt trusts,
- Charitable trusts, and
- Grantor-owned trusts.

Line 12—First date wages or annuities were paid or will be paid. If the business has or will have employees, enter the date on which the business began or will begin to pay wages. If the business does not plan to have employees, enter "N/A."

Withholding agent. Enter the date you began or will begin to pay income (including annuities) to a nonresident alien. This also applies to individuals who are required to file Form 1042 to report alimony paid to a nonresident alien.

Line 13—Highest number of employees expected in the next 12 months. Complete each box by entering the number (including zero ("-0-")) of "Agricultural," "Household," or "Other" employees expected by the applicant in the next 12 months. For a definition of agricultural labor (farmwork), see Circular A.

Lines 14 and 15. Check the **one** box in line 14 that best describes the principal activity of the applicant's business. Check the "Other" box (and specify the applicant's principal activity) if none of the listed boxes applies.

Use line 15 to describe the applicant's principal line of business in more detail. For example, if you checked the "Construction" box in line 14, enter additional detail such as "General contractor for residential buildings" in line 15.

Construction. Check this box if the applicant is engaged in erecting buildings or other structures, (e.g., streets, highways, bridges, tunnels). The term "Construction" also includes special trade contractors, (e.g., plumbing, HVAC, electrical, carpentry, concrete, excavation, etc. contractors).

Real estate. Check this box if the applicant is engaged in renting or leasing real estate to others; managing, selling, buying or renting real estate for others; or providing related real estate services (e.g., appraisal services).

Rental and leasing. Check this box if the applicant is engaged in providing tangible goods such as autos, computers, consumer goods, or industrial machinery and equipment to customers in return for a periodic rental or lease payment.

Manufacturing. Check this box if the applicant is engaged in the mechanical, physical, or chemical transformation of materials, substances, or components into new products. The assembling of component parts of manufactured products is also considered to be manufacturing.

Transportation & warehousing. Check this box if the applicant provides transportation of passengers or cargo; warehousing or storage of goods; scenic or sight-seeing transportation; or support activities related to these modes of transportation.

Finance & insurance. Check this box if the applicant is engaged in transactions involving the creation, liquidation, or change of ownership of financial assets and/or facilitating such financial transactions; underwriting annuities/insurance policies; facilitating such underwriting by selling insurance policies; or by providing other insurance or employee-benefit related services.

Health care and social assistance. Check this box if the applicant is engaged in providing physical, medical, or psychiatric care using licensed health care professionals or providing social assistance activities such as youth centers, adoption agencies, individual/family services, temporary shelters, etc.

Accommodation & food services. Check this box if the applicant is engaged in providing customers with lodging, meal preparation, snacks, or beverages for immediate consumption.

Wholesale–agent/broker. Check this box if the applicant is engaged in arranging for the purchase or sale of goods owned by others or purchasing goods on a commission basis for goods traded in the wholesale market, usually between businesses.

Wholesale–other. Check this box if the applicant is engaged in selling goods in the wholesale market generally to other businesses for resale on their own account.

Retail. Check this box if the applicant is engaged in selling merchandise to the general public from a fixed store; by direct, mail-order, or electronic sales; or by using vending machines.

Other. Check this box if the applicant is engaged in an activity not described above. Describe the applicant's principal business activity in the space provided.

Lines 16a-c. Check the applicable box in line 16a to indicate whether or not the entity (or individual) applying for an EIN was issued one previously. Complete lines 16b and 16c **only** if the "Yes" box in line 16a is checked. If the applicant previously applied for **more than one** EIN, write "See Attached" in the empty space in line 16a and attach a separate sheet providing the line 16b and 16c information for each EIN previously requested.

Third Party Designee. Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of Form SS-4. The designee's authority terminates at the time the EIN is assigned and released to the designee. **You must complete the signature area for the authorization to be valid.**

Signature. When required, the application must be signed by **(a)** the individual, if the applicant is an individual, **(b)** the president, vice president, or other principal officer, if the applicant is a corporation, **(c)** a responsible and duly authorized member or officer having knowledge of its affairs, if the applicant is a partnership, government entity, or other unincorporated organization, or **(d)** the fiduciary, if the applicant is a trust or an estate. Foreign applicants may have any duly-authorized person, (e.g., division manager), sign Form SS-4.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to comply with section 6109 and the regulations thereunder which generally require the inclusion of an employer identification number (EIN) on certain returns, statements, or other documents filed with the Internal Revenue Service. If your entity is required to obtain an EIN, you are required to provide all of the information requested on this form. Information on this form may be used to determine which Federal tax returns you are required to file and to provide you with related forms and publications.

We disclose this form to the Social Security Administration for their use in determining compliance with applicable laws. We may give this information to the Department of Justice for use in civil and criminal litigation, and to the cities, states, and the District of Columbia for use in administering their tax laws. We may also disclose this information to Federal and state agencies to enforce Federal nontax criminal laws and to combat terrorism.

We will be unable to issue an EIN to you unless you provide all of the requested information which applies to your entity. Providing false information could subject you to penalties.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	6 min.
Learning about the law or the form	22 min.
Preparing the form	46 min.
Copying, assembling, and sending the form to the IRS	20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Products Coordinating Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the form to this address. Instead, see **How To Apply** on page 1.

Form W-4 (2005)

Purpose. Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay. Because your tax situation may change, you may want to refigure your withholding each year.

Exemption from withholding. If you are exempt, complete only lines 1, 2, 3, 4, and 7 and sign the form to validate it. Your exemption for 2005 expires February 16, 2006. See Pub. 505, Tax Withholding and Estimated Tax.

Note. You cannot claim exemption from withholding if (a) your income exceeds $800 and includes more than $250 of unearned income (for example, interest and dividends) and (b) another person can claim you as a dependent on their tax return.

Basic instructions. If you are not exempt, complete the **Personal Allowances Worksheet** below. The worksheets on page 2 adjust your withholding allowances based on itemized deductions, certain credits, adjustments to income, or two-earner/two-job situations. Complete all worksheets that apply. However, you may claim fewer (or zero) allowances.

Head of household. Generally, you may claim head of household filing status on your tax return only if you are unmarried and pay more than 50% of the costs of keeping up a home for yourself and your dependent(s) or other qualifying individuals. See line **E** below.

Tax credits. You can take projected tax credits into account in figuring your allowable number of withholding allowances. Credits for child or dependent care expenses and the child tax credit may be claimed using the **Personal Allowances Worksheet** below. See Pub. 919, How Do I Adjust My Tax Withholding? for information on converting your other credits into withholding allowances.

Nonwage income. If you have a large amount of nonwage income, such as interest or dividends, consider making estimated tax payments using Form 1040-ES, Estimated Tax for Individuals. Otherwise, you may owe additional tax.

Two earners/two jobs. If you have a working spouse or more than one job, figure the total number of allowances you are entitled to claim on all jobs using worksheets from only one Form W-4. Your withholding usually will be most accurate when all allowances are claimed on the Form W-4 for the highest paying job and zero allowances are claimed on the others.

Nonresident alien. If you are a nonresident alien, see the Instructions for Form 8233 before completing this Form W-4.

Check your withholding. After your Form W-4 takes effect, use Pub. 919 to see how the dollar amount you are having withheld compares to your projected total tax for 2005. See Pub. 919, especially if your earnings exceed $125,000 (Single) or $175,000 (Married).

Recent name change? If your name on line 1 differs from that shown on your social security card, call 1-800-772-1213 to initiate a name change and obtain a social security card showing your correct name.

Personal Allowances Worksheet (Keep for your records.)

A Enter "1" for **yourself** if no one else can claim you as a dependent . . . . **A** ______

B Enter "1" if:
- You are single and have only one job; or
- You are married, have only one job, and your spouse does not work; or
- Your wages from a second job or your spouse's wages (or the total of both) are $1,000 or less.

. . . **B** ______

C Enter "1" for your **spouse.** But, you may choose to enter "-0-" if you are married and have either a working spouse or more than one job. (Entering "-0-" may help you avoid having too little tax withheld.) . . . . **C** ______

D Enter number of **dependents** (other than your spouse or yourself) you will claim on your tax return . . . . **D** ______

E Enter "1" if you will file as **head of household** on your tax return (see conditions under **Head of household** above) . **E** ______

F Enter "1" if you have at least $1,500 of **child or dependent care expenses** for which you plan to claim a credit . . **F** ______
(**Note.** Do **not** include child support payments. See **Pub. 503,** Child and Dependent Care Expenses, for details.)

G **Child Tax Credit** (including additional child tax credit):
- If your total income will be less than $54,000 ($79,000 if married), enter "2" for each eligible child.
- If your total income will be between $54,000 and $84,000 ($79,000 and $119,000 if married), enter "1" for each eligible child plus "1" **additional** if you have four or more eligible children. **G** ______

H Add lines A through G and enter total here. (**Note.** This may be different from the number of exemptions you claim on your tax return.) ▶ **H** ______

For accuracy, complete all worksheets that apply.
- If you plan to **itemize or claim adjustments to income** and want to reduce your withholding, see the **Deductions and Adjustments Worksheet** on page 2.
- If you have **more than one job** or are **married and you and your spouse both work** and the combined earnings from all jobs exceed $35,000 ($25,000 if married) see the **Two-Earner/Two-Job Worksheet** on page 2 to avoid having too little tax withheld.
- If **neither** of the above situations applies, **stop here** and enter the number from line H on line 5 of Form W-4 below.

Cut here and give Form W-4 to your employer. Keep the top part for your records.

Form **W-4**
Department of the Treasury
Internal Revenue Service

Employee's Withholding Allowance Certificate

▶ **Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.**

OMB No. 1545-0010
2005

1 Type or print your first name and middle initial	Last name	2 Your social security number
Home address (number and street or rural route)	3 ☐ Single ☐ Married ☐ Married, but withhold at higher Single rate. **Note.** If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.	
City or town, state, and ZIP code	4 **If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a new card.** ▶ ☐	

5 Total number of allowances you are claiming (from line **H** above **or** from the applicable worksheet on page 2) **5** ______
6 Additional amount, if any, you want withheld from each paycheck . . . . **6** $ ______
7 I claim exemption from withholding for 2005, and I certify that I meet **both** of the following conditions for exemption.
- Last year I had a right to a refund of **all** federal income tax withheld because I had **no** tax liability **and**
- This year I expect a refund of **all** federal income tax withheld because I expect to have **no** tax liability.

If you meet both conditions, write "Exempt" here . . . . ▶ **7** ______

Under penalties of perjury, I declare that I have examined this certificate and to the best of my knowledge and belief, it is true, correct, and complete.

Employee's signature
(Form is not valid unless you sign it.) ▶ **Date** ▶

8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.)	9 Office code (optional)	10 Employer identification number (EIN)

Deductions and Adjustments Worksheet

Note. Use this worksheet *only* if you plan to itemize deductions, claim certain credits, or claim adjustments to income on your 2005 tax return.

1 Enter an estimate of your 2005 itemized deductions. These include qualifying home mortgage interest, charitable contributions, state and local taxes, medical expenses in excess of 7.5% of your income, and miscellaneous deductions. (For 2005, you may have to reduce your itemized deductions if your income is over $145,950 ($72,975 if married filing separately). See *Worksheet 3* in Pub. 919 for details.) . . . 1 $

2 Enter: { $10,000 if married filing jointly or qualifying widow(er); $ 7,300 if head of household; $ 5,000 if single or married filing separately } . . . 2 $

3 **Subtract** line 2 from line 1. If line 2 is greater than line 1, enter "-0-" . . . 3 $

4 Enter an estimate of your 2005 adjustments to income, including alimony, deductible IRA contributions, and student loan interest 4 $

5 **Add** lines 3 and 4 and enter the total. (Include any amount for credits from *Worksheet 7* in Pub. 919) . 5 $

6 Enter an estimate of your 2005 nonwage income (such as dividends or interest) . . . 6 $

7 **Subtract** line 6 from line 5. Enter the result, but not less than "-0-" . . . 7 $

8 **Divide** the amount on line 7 by $3,200 and enter the result here. Drop any fraction . . . 8

9 Enter the number from the **Personal Allowances Worksheet,** line H, page 1 . . . 9

10 **Add** lines 8 and 9 and enter the total here. If you plan to use the **Two-Earner/Two-Job Worksheet,** also enter this total on line 1 below. Otherwise, **stop here** and enter this total on Form W-4, line 5, page 1 . 10

Two-Earner/Two-Job Worksheet (See *Two earners/two jobs* on page 1.)

Note. Use this worksheet *only* if the instructions under line H on page 1 direct you here.

1 Enter the number from line H, page 1 (or from line 10 above if you used the **Deductions and Adjustments Worksheet**) 1

2 Find the number in **Table 1** below that applies to the **LOWEST** paying job and enter it here 2

3 If line 1 is **more than or equal to** line 2, subtract line 2 from line 1. Enter the result here (if zero, enter "-0-") and on Form W-4, line 5, page 1. **Do not** use the rest of this worksheet . . . 3

Note. If line 1 is *less than* line 2, enter "-0-" on Form W-4, line 5, page 1. Complete lines 4–9 below to calculate the additional withholding amount necessary to avoid a year-end tax bill.

4 Enter the number from line 2 of this worksheet . . . 4

5 Enter the number from line 1 of this worksheet . . . 5

6 **Subtract** line 5 from line 4 . . . 6

7 Find the amount in **Table 2** below that applies to the **HIGHEST** paying job and enter it here . . . . 7 $

8 **Multiply** line 7 by line 6 and enter the result here. This is the additional annual withholding needed . . 8 $

9 Divide line 8 by the number of pay periods remaining in 2005. For example, divide by 26 if you are paid every two weeks and you complete this form in December 2004. Enter the result here and on Form W-4, line 6, page 1. This is the additional amount to be withheld from each paycheck . . . 9 $

Table 1: Two-Earner/Two-Job Worksheet

Married Filing Jointly						All Others	
If wages from **HIGHEST** paying job are—	AND, wages from **LOWEST** paying job are—	Enter on line 2 above	If wages from **HIGHEST** paying job are—	AND, wages from **LOWEST** paying job are—	Enter on line 2 above	If wages from **LOWEST** paying job are—	Enter on line 2 above
$0 - $40,000	$0 - $4,000	0	$40,001 and over	30,001 - 36,000	6	$0 - $6,000	0
	4,001 - 8,000	1		36,001 - 45,000	7	6,001 - 12,000	1
	8,001 - 18,000	2		45,001 - 50,000	8	12,001 - 18,000	2
	18,001 and over	3		50,001 - 60,000	9	18,001 - 24,000	3
				60,001 - 65,000	10	24,001 - 31,000	4
$40,001 and over	$0 - $4,000	0		65,001 - 75,000	11	31,001 - 45,000	5
	4,001 - 8,000	1		75,001 - 90,000	12	45,001 - 60,000	6
	8,001 - 18,000	2		90,001 - 100,000	13	60,001 - 75,000	7
	18,001 - 22,000	3		100,001 - 115,000	14	75,001 - 80,000	8
	22,001 - 25,000	4		115,001 and over	15	80,001 - 100,000	9
	25,001 - 30,000	5				100,001 and over	10

Table 2: Two-Earner/Two-Job Worksheet

Married Filing Jointly		All Others	
If wages from **HIGHEST** paying job are—	Enter on line 7 above	If wages from **HIGHEST** paying job are—	Enter on line 7 above
$0 - $60,000	$480	$0 - $30,000	$480
60,001 - 110,000	800	30,001 - 70,000	800
110,001 - 160,000	900	70,001 - 140,000	900
160,001 - 280,000	1,060	140,001 - 320,000	1,060
280,001 and over	1,120	320,001 and over	1,120

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. The Internal Revenue Code requires this information under sections 3402(f)(2)(A) and 6109 and their regulations. Failure to provide a properly completed form will result in your being treated as a single person who claims no withholding allowances; providing fraudulent information may also subject you to penalties. Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, to cities, states, and the District of Columbia for use in administering their tax laws, and using it in the National Directory of New Hires. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is: Recordkeeping, 45 min.; Learning about the law or the form, 12 min.; Preparing the form, 58 min. If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to: Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. **Do not** send Form W-4 to this address. Instead, give it to your employer.

Printed on recycled paper

Form **W-9**
(Rev. January 2005)
Department of the Treasury
Internal Revenue Service

Request for Taxpayer Identification Number and Certification

Give form to the requester. Do not send to the IRS.

Print or type
See Specific Instructions on page 2.

Name (as shown on your income tax return)

Business name, if different from above

Check appropriate box: ☐ Individual/ Sole proprietor ☐ Corporation ☐ Partnership ☐ Other ▶ ....

☐ Exempt from backup withholding

Address (number, street, and apt. or suite no.)

Requester's name and address (optional)

City, state, and ZIP code

List account number(s) here (optional)

Part I Taxpayer Identification Number (TIN)

Enter your TIN in the appropriate box. The TIN provided must match the name given on Line 1 to avoid backup withholding. For individuals, this is your social security number (SSN). However, for a resident alien, sole proprietor, or disregarded entity, see the Part I instructions on page 3. For other entities, it is your employer identification number (EIN). If you do not have a number, see *How to get a TIN* on page 3.

Note. *If the account is in more than one name, see the chart on page 4 for guidelines on whose number to enter.*

Social security number

or

Employer identification number

Part II Certification

Under penalties of perjury, I certify that:

1. The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me), and
2. I am not subject to backup withholding because: (a) I am exempt from backup withholding, or (b) I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or (c) the IRS has notified me that I am no longer subject to backup withholding, and
3. I am a U.S. person (including a U.S. resident alien).

Certification instructions. You must cross out item 2 above if you have been notified by the IRS that you are currently subject to backup withholding because you have failed to report all interest and dividends on your tax return. For real estate transactions, item 2 does not apply. For mortgage interest paid, acquisition or abandonment of secured property, cancellation of debt, contributions to an individual retirement arrangement (IRA), and generally, payments other than interest and dividends, you are not required to sign the Certification, but you must provide your correct TIN. (See the instructions on page 4.)

Sign Here **Signature of U.S. person ▶** **Date ▶**

Purpose of Form

A person who is required to file an information return with the IRS, must obtain your correct taxpayer identification number (TIN) to report, for example, income paid to you, real estate transactions, mortgage interest you paid, acquisition or abandonment of secured property, cancellation of debt, or contributions you made to an IRA.

U.S. person. Use Form W-9 only if you are a U.S. person (including a resident alien), to provide your correct TIN to the person requesting it (the requester) and, when applicable, to:

1. Certify that the TIN you are giving is correct (or you are waiting for a number to be issued),

2. Certify that you are not subject to backup withholding, or

3. Claim exemption from backup withholding if you are a U.S. exempt payee.

Note. *If a requester gives you a form other than Form W-9 to request your TIN, you must use the requester's form if it is substantially similar to this Form W-9.*

For federal tax purposes you are considered a person if you are:

- An individual who is a citizen or resident of the United States,
- A partnership, corporation, company, or association created or organized in the United States or under the laws of the United States, or
- Any estate (other than a foreign estate) or trust. See Regulations sections 301.7701-6(a) and 7(a) for additional information.

Foreign person. If you are a foreign person, do not use Form W-9. Instead, use the appropriate Form W-8 (see Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities).

Nonresident alien who becomes a resident alien. Generally, only a nonresident alien individual may use the terms of a tax treaty to reduce or eliminate U.S. tax on certain types of income. However, most tax treaties contain a provision known as a "saving clause." Exceptions specified in the saving clause may permit an exemption from tax to continue for certain types of income even after the recipient has otherwise become a U.S. resident alien for tax purposes.

If you are a U.S. resident alien who is relying on an exception contained in the saving clause of a tax treaty to claim an exemption from U.S. tax on certain types of income, you must attach a statement to Form W-9 that specifies the following five items:

1. The treaty country. Generally, this must be the same treaty under which you claimed exemption from tax as a nonresident alien.

2. The treaty article addressing the income.

3. The article number (or location) in the tax treaty that contains the saving clause and its exceptions.

4. The type and amount of income that qualifies for the exemption from tax.

5. Sufficient facts to justify the exemption from tax under the terms of the treaty article.

Example. Article 20 of the U.S.-China income tax treaty allows an exemption from tax for scholarship income received by a Chinese student temporarily present in the United States. Under U.S. law, this student will become a resident alien for tax purposes if his or her stay in the United States exceeds 5 calendar years. However, paragraph 2 of the first Protocol to the U.S.-China treaty (dated April 30, 1984) allows the provisions of Article 20 to continue to apply even after the Chinese student becomes a resident alien of the United States. A Chinese student who qualifies for this exception (under paragraph 2 of the first protocol) and is relying on this exception to claim an exemption from tax on his or her scholarship or fellowship income would attach to Form W-9 a statement that includes the information described above to support that exemption.

If you are a nonresident alien or a foreign entity not subject to backup withholding, give the requester the appropriate completed Form W-8.

What is backup withholding? Persons making certain payments to you must under certain conditions withhold and pay to the IRS 28% of such payments (after December 31, 2002). This is called "backup withholding." Payments that may be subject to backup withholding include interest, dividends, broker and barter exchange transactions, rents, royalties, nonemployee pay, and certain payments from fishing boat operators. Real estate transactions are not subject to backup withholding.

You will not be subject to backup withholding on payments you receive if you give the requester your correct TIN, make the proper certifications, and report all your taxable interest and dividends on your tax return.

Payments you receive will be subject to backup withholding if:

1. You do not furnish your TIN to the requester, or

2. You do not certify your TIN when required (see the Part II instructions on page 4 for details), or

3. The IRS tells the requester that you furnished an incorrect TIN, or

4. The IRS tells you that you are subject to backup withholding because you did not report all your interest and dividends on your tax return (for reportable interest and dividends only), or

5. You do not certify to the requester that you are not subject to backup withholding under 4 above (for reportable interest and dividend accounts opened after 1983 only).

Certain payees and payments are exempt from backup withholding. See the instructions below and the separate Instructions for the Requester of Form W-9.

Penalties

Failure to furnish TIN. If you fail to furnish your correct TIN to a requester, you are subject to a penalty of $50 for each such failure unless your failure is due to reasonable cause and not to willful neglect.

Civil penalty for false information with respect to withholding. If you make a false statement with no reasonable basis that results in no backup withholding, you are subject to a $500 penalty.

Criminal penalty for falsifying information. Willfully falsifying certifications or affirmations may subject you to criminal penalties including fines and/or imprisonment.

Misuse of TINs. If the requester discloses or uses TINs in violation of federal law, the requester may be subject to civil and criminal penalties.

Specific Instructions

Name

If you are an individual, you must generally enter the name shown on your social security card. However, if you have changed your last name, for instance, due to marriage without informing the Social Security Administration of the name change, enter your first name, the last name shown on your social security card, and your new last name.

If the account is in joint names, list first, and then circle, the name of the person or entity whose number you entered in Part I of the form.

Sole proprietor. Enter your individual name as shown on your social security card on the "Name" line. You may enter your business, trade, or "doing business as (DBA)" name on the "Business name" line.

Limited liability company (LLC). If you are a single-member LLC (including a foreign LLC with a domestic owner) that is disregarded as an entity separate from its owner under Treasury regulations section 301.7701-3, enter the owner's name on the "Name" line. Enter the LLC's name on the "Business name" line. Check the appropriate box for your filing status (sole proprietor, corporation, etc.), then check the box for "Other" and enter "LLC" in the space provided.

Other entities. Enter your business name as shown on required Federal tax documents on the "Name" line. This name should match the name shown on the charter or other legal document creating the entity. You may enter any business, trade, or DBA name on the "Business name" line.

Note. You are requested to check the appropriate box for your status (individual/sole proprietor, corporation, etc.).

Exempt From Backup Withholding

If you are exempt, enter your name as described above and check the appropriate box for your status, then check the "Exempt from backup withholding" box in the line following the business name, sign and date the form.

Generally, individuals (including sole proprietors) are not exempt from backup withholding. Corporations are exempt from backup withholding for certain payments, such as interest and dividends.

Note. If you are exempt from backup withholding, you should still complete this form to avoid possible erroneous backup withholding.

Exempt payees. Backup withholding is not required on any payments made to the following payees:

1. An organization exempt from tax under section 501(a), any IRA, or a custodial account under section 403(b)(7) if the account satisfies the requirements of section 401(f)(2),

2. The United States or any of its agencies or instrumentalities,

3. A state, the District of Columbia, a possession of the United States, or any of their political subdivisions or instrumentalities,

4. A foreign government or any of its political subdivisions, agencies, or instrumentalities, or

5. An international organization or any of its agencies or instrumentalities.

Other payees that may be exempt from backup withholding include:

6. A corporation,

7. A foreign central bank of issue,

8. A dealer in securities or commodities required to register in the United States, the District of Columbia, or a possession of the United States,

9. A futures commission merchant registered with the Commodity Futures Trading Commission,

10. A real estate investment trust,

11. An entity registered at all times during the tax year under the Investment Company Act of 1940,

12. A common trust fund operated by a bank under section 584(a),

13. A financial institution,

14. A middleman known in the investment community as a nominee or custodian, or

15. A trust exempt from tax under section 664 or described in section 4947.

The chart below shows types of payments that may be exempt from backup withholding. The chart applies to the exempt recipients listed above, 1 through 15.

IF the payment is for . . .	THEN the payment is exempt for . . .
Interest and dividend payments	All exempt recipients except for 9
Broker transactions	Exempt recipients 1 through 13. Also, a person registered under the Investment Advisers Act of 1940 who regularly acts as a broker
Barter exchange transactions and patronage dividends	Exempt recipients 1 through 5
Payments over $600 required to be reported and direct sales over $5,000 [1]	Generally, exempt recipients 1 through 7 [2]

[1] See Form 1099-MISC, Miscellaneous Income, and its instructions.

[2] However, the following payments made to a corporation (including gross proceeds paid to an attorney under section 6045(f), even if the attorney is a corporation) and reportable on Form 1099-MISC are not exempt from backup withholding: medical and health care payments, attorneys' fees; and payments for services paid by a Federal executive agency.

Part I. Taxpayer Identification Number (TIN)

Enter your TIN in the appropriate box. If you are a resident alien and you do not have and are not eligible to get an SSN, your TIN is your IRS individual taxpayer identification number (ITIN). Enter it in the social security number box. If you do not have an ITIN, see *How to get a TIN* below.

If you are a sole proprietor and you have an EIN, you may enter either your SSN or EIN. However, the IRS prefers that you use your SSN.

If you are a single-owner LLC that is disregarded as an entity separate from its owner (see *Limited liability company (LLC)* on page 2), enter your SSN (or EIN, if you have one). If the LLC is a corporation, partnership, etc., enter the entity's EIN.

Note. See the chart on page 4 for further clarification of name and TIN combinations.

How to get a TIN. If you do not have a TIN, apply for one immediately. To apply for an SSN, get Form SS-5, Application for a Social Security Card, from your local Social Security Administration office or get this form online at *www.socialsecurity.gov/online/ss-5.pdf*. You may also get this form by calling 1-800-772-1213. Use Form W-7, Application for IRS Individual Taxpayer Identification Number, to apply for an ITIN, or Form SS-4, Application for Employer Identification Number, to apply for an EIN. You can apply for an EIN online by accessing the IRS website at *www.irs.gov/businesses/* and clicking on Employer ID Numbers under Related Topics. You can get Forms W-7 and SS-4 from the IRS by visiting *www.irs.gov* or by calling 1-800-TAX-FORM (1-800-829-3676).

If you are asked to complete Form W-9 but do not have a TIN, write "Applied For" in the space for the TIN, sign and date the form, and give it to the requester. For interest and dividend payments, and certain payments made with respect to readily tradable instruments, generally you will have 60 days to get a TIN and give it to the requester before you are subject to backup withholding on payments. The 60-day rule does not apply to other types of payments. You will be subject to backup withholding on all such payments until you provide your TIN to the requester.

Note. Writing "Applied For" means that you have already applied for a TIN or that you intend to apply for one soon.

Caution: *A disregarded domestic entity that has a foreign owner must use the appropriate Form W-8.*

Part II. Certification

To establish to the withholding agent that you are a U.S. person, or resident alien, sign Form W-9. You may be requested to sign by the withholding agent even if items 1, 4, and 5 below indicate otherwise.

For a joint account, only the person whose TIN is shown in Part I should sign (when required). Exempt recipients, see *Exempt From Backup Withholding* on page 2.

Signature requirements. Complete the certification as indicated in 1 through 5 below.

1. Interest, dividend, and barter exchange accounts opened before 1984 and broker accounts considered active during 1983. You must give your correct TIN, but you do not have to sign the certification.

2. Interest, dividend, broker, and barter exchange accounts opened after 1983 and broker accounts considered inactive during 1983. You must sign the certification or backup withholding will apply. If you are subject to backup withholding and you are merely providing your correct TIN to the requester, you must cross out item 2 in the certification before signing the form.

3. Real estate transactions. You must sign the certification. You may cross out item 2 of the certification.

4. Other payments. You must give your correct TIN, but you do not have to sign the certification unless you have been notified that you have previously given an incorrect TIN. "Other payments" include payments made in the course of the requester's trade or business for rents, royalties, goods (other than bills for merchandise), medical and health care services (including payments to corporations), payments to a nonemployee for services, payments to certain fishing boat crew members and fishermen, and gross proceeds paid to attorneys (including payments to corporations).

5. Mortgage interest paid by you, acquisition or abandonment of secured property, cancellation of debt, qualified tuition program payments (under section 529), IRA, Coverdell ESA, Archer MSA or HSA contributions or distributions, and pension distributions. You must give your correct TIN, but you do not have to sign the certification.

What Name and Number To Give the Requester

For this type of account:	Give name and SSN of:
1. Individual	The individual
2. Two or more individuals (joint account)	The actual owner of the account or, if combined funds, the first individual on the account [1]
3. Custodian account of a minor (Uniform Gift to Minors Act)	The minor [2]
4. a. The usual revocable savings trust (grantor is also trustee)	The grantor-trustee [1]
b. So-called trust account that is not a legal or valid trust under state law	The actual owner [1]
5. Sole proprietorship or single-owner LLC	The owner [3]
For this type of account:	**Give name and EIN of:**
6. Sole proprietorship or single-owner LLC	The owner [3]
7. A valid trust, estate, or pension trust	Legal entity [4]
8. Corporate or LLC electing corporate status on Form 8832	The corporation
9. Association, club, religious, charitable, educational, or other tax-exempt organization	The organization
10. Partnership or multi-member LLC	The partnership
11. A broker or registered nominee	The broker or nominee
12. Account with the Department of Agriculture in the name of a public entity (such as a state or local government, school district, or prison) that receives agricultural program payments	The public entity

[1] List first and circle the name of the person whose number you furnish. If only one person on a joint account has an SSN, that person's number must be furnished.

[2] Circle the minor's name and furnish the minor's SSN.

[3] You must show your individual name and you may also enter your business or "DBA" name on the second name line. You may use either your SSN or EIN (if you have one). If you are a sole proprietor, IRS encourages you to use your SSN.

[4] List first and circle the name of the legal trust, estate, or pension trust. (Do not furnish the TIN of the personal representative or trustee unless the legal entity itself is not designated in the account title.)

Note. If no name is circled when more than one name is listed, the number will be considered to be that of the first name listed.

Privacy Act Notice

Section 6109 of the Internal Revenue Code requires you to provide your correct TIN to persons who must file information returns with the IRS to report interest, dividends, and certain other income paid to you, mortgage interest you paid, the acquisition or abandonment of secured property, cancellation of debt, or contributions you made to an IRA, or Archer MSA or HSA. The IRS uses the numbers for identification purposes and to help verify the accuracy of your tax return. The IRS may also provide this information to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia to carry out their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

You must provide your TIN whether or not you are required to file a tax return. Payers must generally withhold 28% of taxable interest, dividend, and certain other payments to a payee who does not give a TIN to a payer. Certain penalties may also apply.

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service	**Self-Employment Tax** ▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).	OMB No. 1545-0074 **2004** Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶	

Who Must File Schedule SE

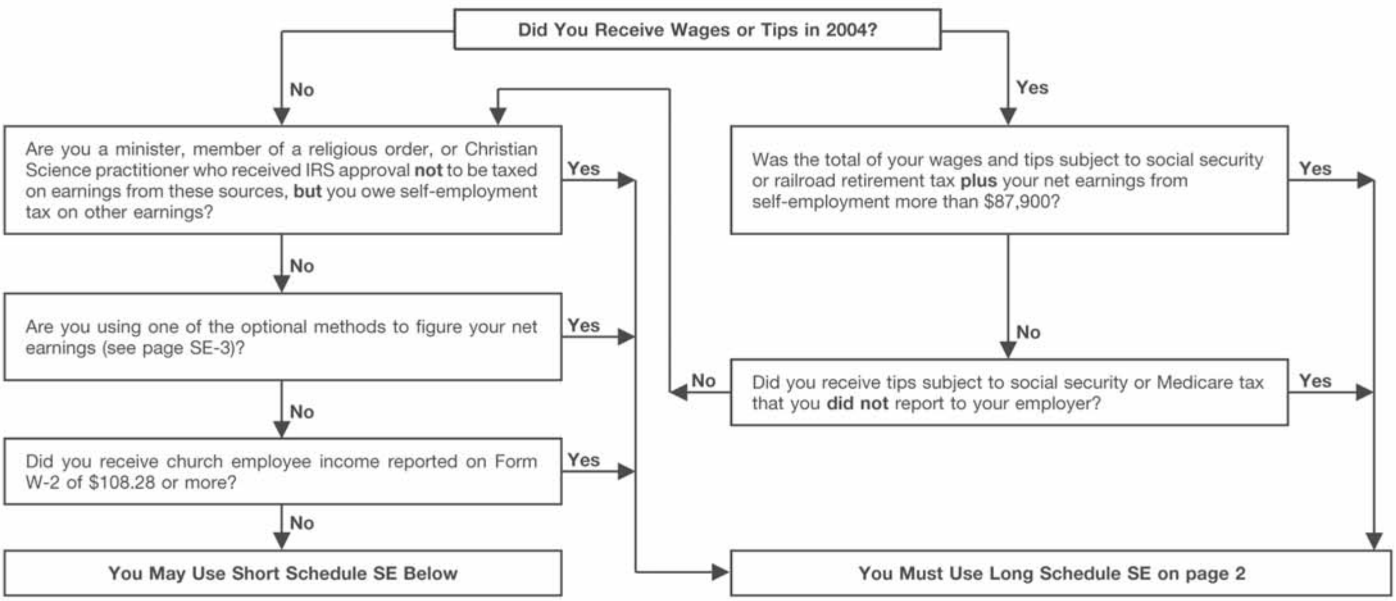
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 57.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	
3	Combine lines 1 and 2	3	
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	
5	**Self-employment tax.** If the amount on line 4 is: • $87,900 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 57.** • More than $87,900, multiply line 4 by 2.9% (.029). Then, add $10,899.60 to the result. Enter the total here and on **Form 1040, line 57.**	5	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 30** 6		

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶

Section B—Long Schedule SE

Part I Self-Employment Tax

Note. If your only income subject to self-employment tax is **church employee income,** skip lines 1 through 4b. Enter -0- on line 4c and go to line 5a. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . . . ▶ ☐

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. **Note.** Skip this line if you use the farm optional method (see page SE-4)		1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report. **Note.** Skip this line if you use the nonfarm optional method (see page SE-4)		2		
3	Combine lines 1 and 2		3		
4a	If line 3 is more than zero, multiply line 3 by 92.35% (.9235). Otherwise, enter amount from line 3		4a		
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here . . .		4b		
c	Combine lines 4a and 4b. If less than $400, **stop**; you do not owe self-employment tax. **Exception.** If less than $400 and you had **church employee income,** enter -0- and continue . . . . . . ▶		4c		
5a	Enter your **church employee income** from Form W-2. See page SE-1 for definition of church employee income	5a			
b	Multiply line 5a by 92.35% (.9235). If less than $100, enter -0-		5b		
6	**Net earnings from self-employment.** Add lines 4c and 5b		6		
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2004		7	87,900	00
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $87,900 or more, skip lines 8b through 10, and go to line 11	8a			
b	Unreported tips subject to social security tax (from Form 4137, line 9)	8b			
c	Add lines 8a and 8b		8c		
9	Subtract line 8c from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 . ▶		9		
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (.124)		10		
11	Multiply line 6 by 2.9% (.029)		11		
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Form 1040, line 57**		12		
13	**Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (.5). Enter the result here and on **Form 1040, line 30**	13			

Part II Optional Methods To Figure Net Earnings (see page SE-3)

Farm Optional Method. You may use this method **only** if **(a)** your gross farm income[1] was not more than $2,400 **or (b)** your net farm profits[2] were less than $1,733.

14	Maximum income for optional methods	14	1,600	00
15	Enter the **smaller** of: two-thirds (⅔) of gross farm income[1] (not less than zero) **or** $1,600. Also include this amount on line 4b above	15		

Nonfarm Optional Method. You may use this method **only** if **(a)** your net nonfarm profits[3] were less than $1,733 and also less than 72.189% of your gross nonfarm income[4] **and (b)** you had net earnings from self-employment of at least $400 in 2 of the prior 3 years.

Caution. You may use this method no more than five times.

16	Subtract line 15 from line 14	16		
17	Enter the **smaller** of: two-thirds (⅔) of gross nonfarm income[4] (not less than zero) **or** the amount on line 16. Also include this amount on line 4b above	17		

[1] From Sch. F, line 11, and Sch. K-1 (Form 1065), box 14, code B.

[2] From Sch. F, line 36, and Sch. K-1 (Form 1065), box 14, code A.

[3] From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9.

[4] From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9.

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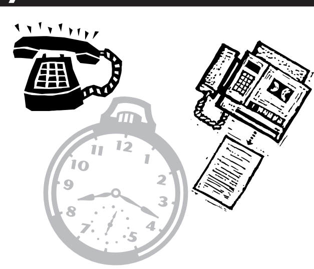

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