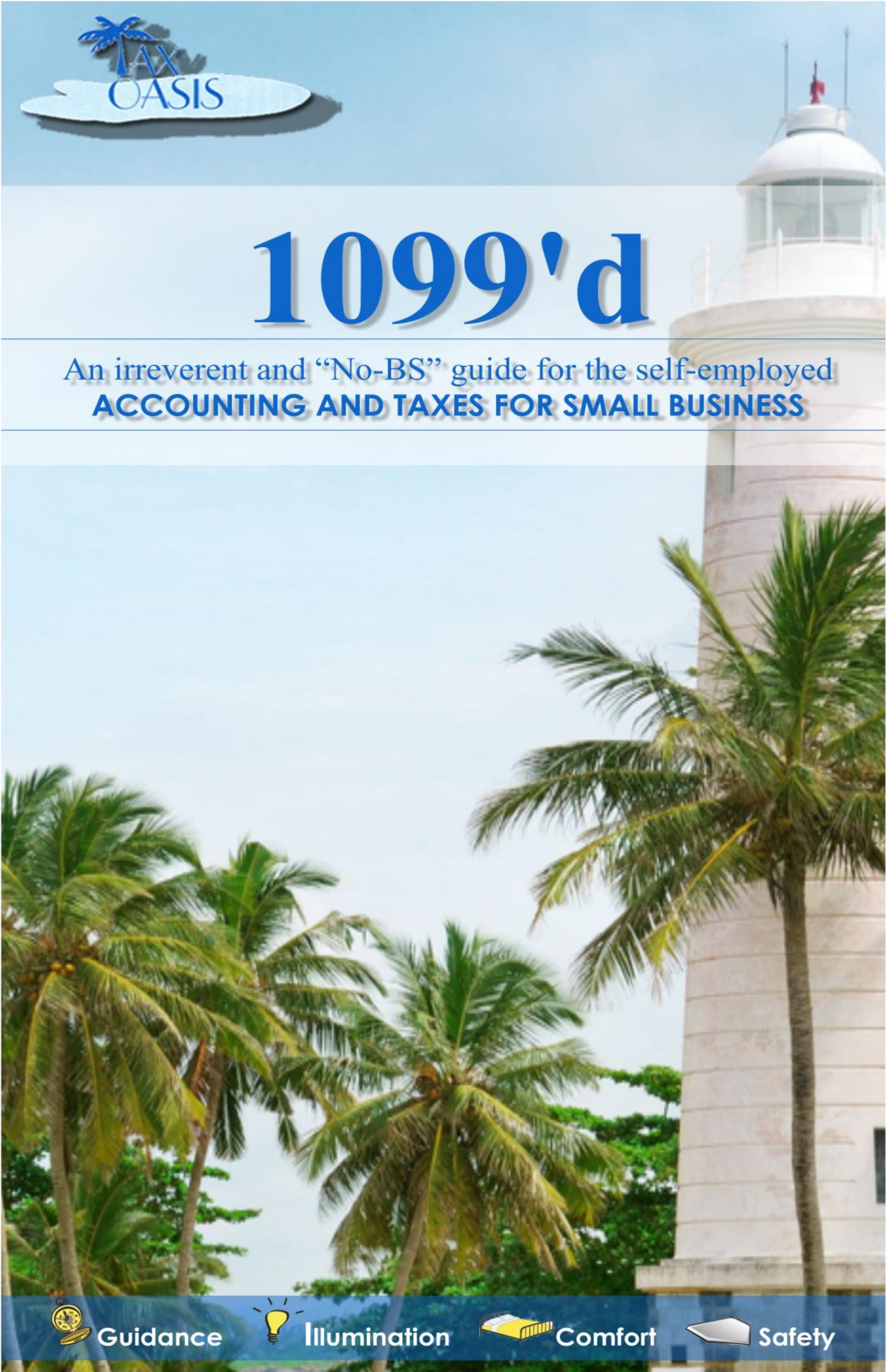

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INTRODUCTION

I have prepared over 15,000 tax returns in the past 37 years, and met with over 3,000 clients. When it comes to being self-employed, the same questions keep coming up year after year. "How do I keep books? What is deductible? Should I claim a home office? What records do I need for mileage? Should I buy or lease a car? What kind of travel is deductible? What the heck is depreciation? Should I form a corporation or LLC? How do I pay my taxes? How do I keep from getting audited?" - and my favorite: "What else do I need to know?"

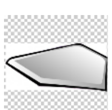
I needed an efficient way to answer these questions so I decided to write down all the answers (along with a few trade secrets from a life as a tax preparer).

In my experience there are four things that my clients are looking for in dealing with the IRS:

 Guidance

 Illumination

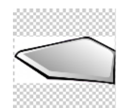
 Comfort

 Safety

 guidance provides simple instructions to point you in exactly the right direction

 illumination reveals tricks and shortcuts that really work to save you tax dollars.

 comfort is the feeling that your tax returns matters are being handled creatively and cost-effectively

 safety comes from the knowledge that you are not at risk for any surprises.

 danger appears whenever a warning is appropriate.

Use these symbols as your guide throughout the book.

You may be newly-self-employed or you may have been running your business for a long time. Chances are, this book will plug gaps in your preparedness.

I have pared-down my experience to include only that which is most relevant, important, and useful. A true expert in any field must know what you need to know, but also what you don't need to know. Trust me, you need to know everything in this book (and not much else) to successfully navigate the IRS

CHAPTER ONE - Employee v. Independent Contractor.

Question 1: I have to choose between getting a W-2 or a 1099. Which one is better?

Another way to phrase this question is: should I pursue a freelance career or become an employee?

There is no one right answer here – each treatment has its advantages and disadvantages. You need to weigh them and decide which is best for your circumstances.

Advantages of employee (W-2) status (lots of comfort and safety):

- Benefits - worker's compensation, state disability insurance, and certain protections against discrimination, wrongful discharge, and sexual harassment. Employees often receive fringe benefits such as medical insurance, education reimbursement, and retirement plan contributions.
- Social Security - As an employee, ½ of your Social Security benefits are paid by your employer, and the benefit you earn is based on your gross income.
- Evidence of employability and stability which will assist you in future jobsearches.
- Your wages are tracked by your employer and you receive form W-2 at the end of the year – which relieves you of keeping records of your income and withholdings.
- Income reported on a W-2 is almost never subject to an IRS audit.

Disadvantages of employee status:

- You pay social security on your gross income without any deductions, which in 2014 is 7.65% of the first $117.000, and 1.45% above that.
- You pay State Disability Insurance (in California this rate for 2014 is 1% of the first $101,636) or other state and local taxes.
- Your upside potential, earnings capacity, and future success are all tied to your employer's success.

Disadvantages of independent contractor (1099) status:

- You have to keep track of your income and deductions yourself.
- Your income and deductions are more frequently subject to IRS audit.
- No job security or benefits, unless you set them up and pay for them yourself.
- You build up a track record as an independent contractor and it becomes increasingly more difficult to convince a prospective employer that you would make a good employee. You may have trouble finding a job when you want one.
- As an independent contractor, you pay 100% of your own social security, but it is called self-employment tax and it is based on your net income (after deducting

business expenses) so you earn fewer benefits but pay tax at a higher rate.

Example: On wages of $50,000 with related expenses of $10,000, you pay $3,825 in withholding tax ($50,000*.0765).

You earn benefits based on the $50,000. On Self-employment income of $50,000 with $10,000 of related expenses you pay $5,642 in self-employment tax but earn benefits on only $40,000.

If earning social security benefits is one of your most important goals in life, you should strongly consider a career as an employee. I have many clients who were self-employed all their careers and are disappointed with their social security benefits upon retirement.

Advantages of independent contractor (1099) status:

- Your earnings potential and range of business activities is not limited by your employer – only by your own imagination and energy.
- You may establish your own benefit plans, potentially more generous than most employers.
- If your business shows a profit, your health insurance premiums are deductible even if you don't itemize deductions.
- You get to deduct business expenses **before** calculating your Social Security and Medicare taxes (referred to jointly as "self-employment" tax), and these deductions are "above-the-line" (see Question 2 below).

Question 2: What are deductions, exemptions, and tax credits?

DEDUCTIONS: They reduce your taxable income. A deduction results in a percentage reduction in your tax equal to your income tax rate. For example, a $10,000 deduction saves $1500 if your tax rate is 15%.

A $10,000 deduction never saves you $10,000. It only saves you what you would have paid in taxes on that amount of income. Accordingly, tax-deductibility should not be the major consideration in whether to spend money on something. Only spend money when your business will benefit.

THE LINE

There used to be a "line" across the first page of the 1040 tax return. Items "above the line" were income items and business-type deductions. Items "below the line" were more personal in nature, such as itemized deductions for charity and home mortgage interest, and personal exemptions. Now the 1040 Form has two sides, and what used to be "the line" is now the bottom of the first page. We still use the terms to describe the nature of deductions. The line is also known as **Adjusted Gross Income (AGI)** – an extremely important figure which enters into a lot of tax calculations.

To take advantage of deductions "below the line" (on the back of the 1040) you must itemize deductions, and itemized deductions are subject to limitations and must exceed the standard deduction before they provide any benefit at all. "Above the line" (on the front of the 1040) deductions are better because they have fewer limitations and are available **IN ADDITION** to the standard deduction.

EMPLOYEE EXPENSES: BELOW THE LINE

Expenses associated with employee status are deducted on Schedule A and are given a "haircut" before they have any impact. Only when employee expenses exceed 2% of your income do they contribute anything to your overall tax deductions, and then only the excess is helpful. Furthermore, since they are deduction on Schedule A, or "**below the line**." and then (when combined with other itemized deductions like home mortgage interest, charity, and state taxes) the total must exceed the standard deduction, most of the time they are of no tax benefit.

Standard Deduction (below the line) for 2014:

single:	$6,200
head of household:	$9,100
married filing joint:	$12,400
married filing sep:	$6,200

On page two of your 1040, you get to subtract either the standard deduction, or your itemized deductions (whichever is higher) from your income, before you calculate your income tax.

Here is a list of the categories of itemized deductions:

Medical expense that exceeds 10% of your AGI (remember AGI?).

Taxes – State income tax, property tax, real estate tax.

Interest – Only home mortgage and investment interest, not credit cards and auto loans, except in certain circumstances when you are self-employed (read on).

Charity – You must itemize deductions to benefit from charitable contributions, except in certain circumstances when you are self-employed (keep reading on).

Miscellaneous Expenses – This category includes your employee expenses along with tax preparation and investment fees. Only expenses in excess of 2% of AGI are deductible. If you keep good records and put the right 'spin' on your expenditures, you should be able to exceed this limit in most cases.

Personal Exemptions (below the line) for 2013:

In addition to the standard deduction, you also receive exemptions for yourself, your spouse, and your dependents. These exemptions ($3,900 per person in 2013) act like additional below-the-line deductions and are subtracted from your income before calculating your income tax.

SELF-EMPLOYED EXPENSES: ABOVE THE LINE

Independent contractor status (also referred to as "self-employment" or "opening your own business") allows you to take more advantage of deductions because they are taken **above the line** (directly against the self-employment income), and **in addition** to the standard or itemized deductions. You may deduct any expense that is "ordinary and necessary" for your business. There expenses will be described fully in a later section of the book.

Question 3: If I am self-employed, how do I pay my taxes? Do I have to prepare a tax return every three months? Aren't there penalties?

PAYING YOUR TAXES

Employees have their taxes withheld from wages and forwarded to the IRS and State by their employers. The self-employed generally pay their taxes in quarterly installments. To "file quarterly" you do not need to prepare a tax return - you just send a check to the IRS and/or State (In California it is the Franchise Tax Board). Look up the address for Form 1040-ES/540-ES at www.IRS.gov or www.ftb.ca.gov. Be sure to include your social security number, the tax year, and the form (1040 or 540) that you are filing.

If you are married, you may also "cover" your tax liability by increasing the withholding on your spouse's wages. Any way you pay the tax is okay with the IRS – it's all the same to them. You may even increase the withholding late in the year to cover taxes owed for the entire year.

It is not against the law to skip your estimated tax payments. The penalty is actually very small, similar to paying 3% interest at the time of this publication. **Do not sweat the small stuff – estimated taxes are the small stuff.**

Safe Harbor Estimates –There are several ways to "exempt" yourself from penalty. One of these is "safe harbor" estimates, which means paying your prior year's total tax in 4 equal installments. Last year's tax is the amount on Line 61 of your 2012 1040 or line 64 of your 2012 540.

Tax Credits pay your tax

Different (and more powerful) are tax credits. The deductions above are subtracted from your income and tax is calculated on the remainder. Once the tax is calculated, credits actually pay your taxes for you, and in some cases they are even refundable (i.e., you get the money from Uncle Sam). The most common credits are from having children, paying for childcare, paying for higher education, and the earned income credit (or EIC, for low-income taxpayers, especially those with children).

Some credits are non-refundable, meaning that they can only be used to offset income tax calculated on your return that year. Some may be carried forward to the extent they are not used.

The best credits are refundable, meaning you may get a refund from the IRS even if you did not pay any estimates. If your income is low (especially if you have children), check out the Earned Income Credit (EIC) which is refundable and can be as high as $6,143 if you have three or more children.

There is a peculiarity in the EIC tables that creates a situation where claiming fewer tax deductions can actually increase the size of your refund. A good way to test out a tax preparer to see if he knows his stuff is to ask him to explain how this is possible.

The earned income credit has been abused by unscrupulous tax preparers and taxpayers, so it is subject to special scrutiny by the IRS. Use this fabulous tax-saving tool with caution and be prepared to defend yourself. Consult the IRS website for guidance.

REVIEW: ABOVE THE LINE, BELOW THE LINE

Above the line: business deductions for the self-employed, including the self-employed health insurance deduction, and all ordinary and necessary business expenses.

Below the line: standard deduction or itemized deductions if higher: medical, taxes, interest, charity, and miscellaneous.

Question 4: What kind of records should I keep? Do I need a business license? Should I file a DBA? What about a separate checking account? - A Business Credit Card?

Important considerations for running a small business:

Separate checking account – this is a good idea for ease of record-keeping and to provide evidence to the IRS that you are seriously in business. It also makes it easy to see how much money you are making (after expenses), when you periodically transfer the accumulated funds to your non-business account.

A **"fictitious business name" (DBA)** is something that is filed with your County. You will need one if you are going to use a name for your business other than your own, and especially if you are going to receive checks payable to your business name. You need to complete a form and publish the name in a local newspaper. The County Recorder will have all the instructions. The cost is generally between $150 and $200.

You will want a DBA if your business will benefit from the brand recognition. If you are not going to use a business name, then open a separate personal account for your business.

Checks payable to a business name are more difficult to cash than checks payable to you. Most banks will require you to open an account in the business name and deposit all the checks. Keep this in mind just in case cashing checks is important to you (see **Reporting all your Income** later). Also, "business-type" checking accounts are more expensive than personal accounts at many banks.

Separate credit card – It is usually very difficult to get a credit card in your business name, so dedicate one of your personal credit cards to be used exclusively for business purchases. If you do this, any credit card fees and finance charges on that card will be deductible above the line as business expenses. If you need to run a balance on a card and pay interest, do so on the designated "business" card so that the finance charge is deductible.

Question 5: Do I need a business license? Should I incorporate? What about a Nevada corporation? Is there anything else I need to know?

Business license in your city – Different cities have different requirements. Some cities are very rigorous about requiring a license and others are more lax. Generally you will only need a business license if you have a "situs" or permanent business location within city limits, although some cities require a license if you are performing services in their city. Some cities also have special licensing requirements for specific businesses, such as massage therapists. It is best to consult an attorney if you are worried about being busted by your city. Don't just "ignore" the license issue if you are running your business out of your home, the consequences of getting caught are too severe to risk ($$$$).

You will need a **sales tax permit** if you sell taxable products. In California, you register with the State Board of Equalization at www.boe.ca.gov. The BOE also requires a business receiving at least $100,000 in gross receipts to register as a "Qualified Purchaser" and report and pay "use" tax on purchases made from out-of-state retailers. You may register online at http://www.boe.ca.gov/elecsrv/esrvcont.htm. Failure to register and pay use tax can lead to significant penalties.

If you have employees or are going to be taxed as a partnership or corporation, you will need to get a Federal Employer Identification Number (FEIN). You may obtain this number online at www.irs.gov. Search for Form SS-4 and print out a copy to fill in before you try to use the online registration process. If you have employees, you will also need to file form DE-1 with the State of California to get a State Tax ID#.

Incorporation is desirable primarily for personal protection from liabilities of the business. You should consider this when you have significant personal assets to protect (home equity, investments, etc.). You may also obtain this protection by forming an LLC. Either of these entities may be formed inexpensively without the involvement of an attorney or corporate service company.

Numerous companies are advertising the advantages of forming a corporation or LLC in Nevada or Delaware. It is true that these states have liberal laws that favor these business entities, but if you are operating a business in California, you will have to register with the State of California anyway, and abide by the laws of California. Accordingly, I do not recommend registering in another state, at least for tax purposes. Please consult your attorney for more information in this area.

Choosing the right entity for your business can be a very important tax-planning decision. I have seen businesses save tens of thousands of dollars by electing the right business entity. For legal purposes you may be a sole proprietor, partnership, LLC, or corporation, but single-member LLCs, partnerships, and corporations may also elect to be taxed as either a C corporation or S Corporation. This topic is so important that you should discuss the options in person with a professional. It would be irresponsible of me to try to give you enough information to make the decision on your own.

Insurance – Insurance is a form of risk management that protects your clients (by compensating them for damages) and protects you (by protecting your assets from claims against your business). The more assets you have (house, car, retirement plans, mutual funds, etc.) the more insurance you should have. Many industry groups have an amazingly affordable insurance program in which (at a minimum) you should enroll. Even if your business is only part-time you have the same liability exposure as any other business. Get a good insurance agent and discuss comprehensive coverage if you have assets to protect. We live in a litigious society and well-meaning acts can sometimes lead to serious lawsuits. If you have multiple exposures (rental property, automobile, homeowner, business, etc.) look into getting an umbrella policy to cover the gaps between the policies.

If you are operating a business out of your home, or driving your car for your small business, your regular policy may not cover a claim. In this day and age, it is so expensive to defend yourself against bogus claims it is helpful to have an insurance company on your side to settle for you.

Question 6: Do I need to file a return for my business? What forms do I use? What is taxable income? How does the IRS know how much I made? What deductions can I claim?

As a sole proprietor, you will be filing Schedule C – Profit or Loss From Business.

There is an optional Schedule **C-EZ** for businesses with expenses of $5,000 or less and other certain qualifications. If you file this form you do not have to list the detail of your business expenses except auto mileage.

The use of this form almost surely means that the IRS is not going to scrutinize your business very closely, almost like taking the "standard deduction" for your business.

The normal Schedule **C** is used for most businesses.

A ROADMAP TO SCHEDULE C

Go to www.IRS.gov and print out a Schedule C. I will describe the various boxes and my recommendations for completing them properly.

BOX A – Use a broad description of your business, one that would permit you to deduct a variety of expenses. For example, if your primary business is massage therapy, list your profession as "alternative healthcare" or "healing arts." This would permit you to deduct yoga classes, ear candling, card reading, and a variety of other healing modalities. If you list "massage therapy" the IRS would not consider these classes ordinary and necessary business expenses within the scope of your business.

BOX B – Business codes are available in the instructions or on the internet. Use the broadest category possible such as "Independent Artists, Writers, and Performers" for the same reasons stated above.

BOX C – Use this <u>only</u> if you have filed a DBA or formed a single-member LLC.

BOX D – For the ID# you received by filing form SS-4

BOX E – If you are claiming a deduction for office-in-home, be sure to use that address here, even if you have another business address. If you are not claiming an office-in-home, you should consider doing so. Read on.

BOX F – This is an important decision that should not be taken lightly. Cash is the preferred accounting method for most businesses that pay their bills up front (so don't have accounts payable) but have to wait for their clients to pay them (so they do have accounts receivable).

Using the cash basis avoids the unpleasant outcome of paying tax on money you haven't received yet.

The accrual method would be advisable if you don't have accounts receivable and you do have accounts payable.

If you receive payments in advance (deposits, down payments, etc.) and don't want to pay tax on them until you perform the services, consider using the accrual method. This is especially important for a business like a school that receives tuition payments before the school year begins.

BOX G – Say yes unless you do not work in this business (that is, you own a business and employees do all the work)

BOX H – Check this box if you did not file a Schedule C for this business last year.

BOX I and J – Both the IRS and the Franchise Tax Board are increasing enforcement of 1099 reporting. If you are paying anyone for outside services, independent contracting, subcontracted services, legal services, medical care, accounting or bookkeeping fees, consulting, research, or non-employee compensation of any kind, you need to comply with 1099 rules. Failure to do so can lead to penalties and/or the loss of the deduction.

If you are about to write a check to any of these people that brings their year-to-date total over $600, you need to get their tax id number on Form W-9 and report them to the state of California EDD on Form DE 542 within 20 days. Do not give them the check unless they give you a completed Form W-9.

If you are a contractor and you hire

an unlicensed subcontractor who performs services that require a license, that person must be treated as a statutory employee and issued a W-2.

The penalty for non-compliance here is as high as $25,000.

How to track your income.

There are many methods acceptable for tracking your income:

- Cash receipts journal – chronological record of your income as received.
- Deposit records – if you deposit all your money into a specific bank account, you can add up the totals from your bank statements at year-end. Be sure not to include any personal money you might have deposited in this account (if any).
- Appointment calendar – Record the amount you receive for each appointment/day.
- Using an accounting system and a bookkeeper is recommended if you are not skilled in this area.

Whichever method you use, remember that you could make mistakes so it is important to reconcile your income with your bank deposits. This will be the first thing the IRS does. It's better for you if there are no surprises here.

What to report on your tax return: the general rule is that you must report all your income, regardless of how it is paid to you or whether it is deposited in your bank account, listed on a 1099, or neither. In addition, when you exchange services, you have received barter income and must report the fair market value of the services given or received (whichever is more readily determinable) as income.

I highly recommend that you report all your income for a variety of reasons, not the least of which is that:

The more integrity you have in dealing with money, the more money will be attracted to you in your lifetime

.

This phenomenon can be explained on two levels:

1) On the spiritual level, the Universe will send more money to those who are the best fiduciaries, or
2) On the psychological level, your clients and customers will see it in your eyes that you are an honest person with nothing to hide. This will increase your business success.

In practice, however, it will be tempting or easier to ignore bartering income, income paid in cash, and even the income paid to you by check if you just cash the check instead of depositing it. In the event that you under-report your income, knowing how the IRS looks at your income might assist you in keeping out of jail.

IRS auditors look for 3 things regarding income:

1) First of all, they add up the income reported on 1099s to make sure you reported at least that much.
2) They do a **gross receipts test** wherein they add up all the deposits made to all your bank accounts for the whole year, compare the total with the amounts you reported, and ask you to explain the difference. Part of the difference is usually explained by transfers between accounts, like from your business to your personal checking. Some of the money may have been a birthday gift from Mom, or the proceeds of a garage sale.
3) Finally, the IRS performs an economic test to determine if you could have supported yourself in the neighborhood in which you live if what you reported is all you made. They may ask you to explain any expensive assets you have accumulated, such as artwork, expensive cars, etc. They have access to property tax and DMV records so they know what you own.

If you are head of household with 3 dependents and only report $15,000 of income, you better live in a double-wide, or be able to show legitimate non-taxable sources of income for the year, such as gifts from mom, or a substantial run-up in your credit card balances.

Popular belief is that the IRS is on the lookout for hobby losses.

There is a widespread misconception that a business must show a profit in three of the first five years or all the deductions will be disallowed. While there is a three out of five rule, it is not nearly that harsh.

The IRS has special rules for hobbies that have significant recreational content and are lacking in profit motive. Hobby income is subject to income tax but not self-employment tax, the deductions are treated like employee expenses (below the line), and the expense deduction cannot exceed the income from the business. This makes hobbies somewhat more unprofitable.

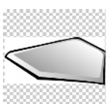
While it is common to think about activities like raising horses, skiing and golfing, or music as hobby-like, **any business** could be considered a hobby if it is engaged in for recreation but not for profit. The burden of proof is on the taxpayer to prove that there was a profit motive. If the activity shows a profit for 3 of the first five years, the burden is removed.

Satisfy the burden of proof by writing a business plan that shows the profit potential, following your business plan with appropriate continuous and sustained effort, keeping good records, and maintaining all the appearances of a real business – website, letterhead, business cards, advertising, regular activity, etc.

YOUR BUSINESS PLAN should serve as a roadmap to success for your business. Use it as a tool to set goals and monitor progress toward them. Your business is not likely to achieve any goals if you haven't made any.

Question 7 – Do I need to save receipts? Should I group my expenses in categories? What categories should I use?

The IRS allows expenses that are **Ordinary and Necessary** to your business. This allows you a great deal of freedom in determining which expenses are appropriate for you. Each business is unique, and you are the Chairperson of the Board of your own business. If you decide that a trip to Hawaii to visit a lomi-lomi specialist for coaching is necessary for the success of your business, you have the absolute right to the deduction, provided you meet the IRS standards for recordkeeping and substantiation and properly "**spin**" the justification.



IRS requirements:

A) Substantiate that the expense was **paid** by you:
- Cancelled Check
- Credit Card Statement
- Money Order or Cashier's Check
- Debit card entry on Bank Statement
- Vendor statement showing payment
- Invoice marked paid
- Cash Receipt (last resort)

B) Substantiate that the expense was business-related, and not frivolous or extravagant.

If the type of expense is **obvious** from the proof of payment, like "Postmaster" or "Verizon" or "Office Depot," you may not have to provide the actual receipt or invoice but it is recommended that you save it anyway.

If the proof of payment is **ambiguous** (like a check to Best Buy) you would have to provide the actual receipt to prove that the expense was business-related (e.g., a computer used in your office).

In the case of a **recreational** expense (like our trip to Hawaii), you may have to provide a journal or similar level of explanation, particularly for meals and travel.

Use any method that you like to maintain these records, as long as you can retrieve the information efficiently in the event of an audit. For example, if you store your receipts sorted by month, make up a summary page for each category of expense and list on it each individual item with the date so that the receipt may be retrieved quickly.

Expense Categories to Use – as listed on Schedule C

When completing Schedule C, keep in mind that the IRS auditors are looking for certain targets (low-hanging fruit) that increase the likelihood that an audit will produce revenue for the IRS. It is better to use several categories and keep the numbers low, rather than bunch your expenses together and create a big target. Common targets are: automobile expenses (line 9), travel (line 24a), meals and entertainment (line 24b), and other expenses (line 27a). Nothing should go on line 27b.

Line 4 **Cost of Goods Sold:** This category is for direct costs associated with the products or services you sell. Do not be misled by the use of the term "Goods." Directs costs associated with services are included here. These costs are detailed on the second page of Schedule C. Purchases, direct labor and materials are the most common categories. If you carry an inventory, it should be reported at your cost (not selling price) and a physical inventory count (in writing) be made at the end of every year.

Cost of Goods sold is an excellent place to categorize expenses because it is frequently a significant percentage of gross receipts and large numbers posted here will usually attract less IRS scrutiny than they will if posted elsewhere.

Line 5 **Gross profit** is the difference between your sales revenue (line 3, net of returns and discounts) and your cost of goods sold.

Gross profit is one of the key numbers the IRS uses for audit selection.

I do not recommend that you report a negative gross profit, which will definitely catch the eye of the IRS. Instead, re-classify some of the cost of goods sold as "research and development" or "samples" in Part V on page 2.

Line 8 **Advertising:** This category is for production (graphic design, copywriting, video editing, etc.) and media costs (printing, publishing, broadcasting), not donated services.

Gift certificates and other donated services are not deductible, unless you have purchased them from someone else and paid for them. Your time is not deductible – only the money you spend is deductible Even though not deductible, donating services is still a great way to grow your business by increasing exposure and acquiring new customers/clients.

If you donate products, for the most part you may deduct only the **lower** of your cost or the market value of the product. There are exceptions, which you can find in IRS Publication 526.

A note about charitable donations – Generally, charitable donations are not considered a business expense by the IRS. In order to qualify as a business expense, you must have some reasonable expectation that your business will benefit from the donation. Keeping this in mind, support your local charities by buying advertising in their publications and on their bulletin boards. If you are donating to a national charity, send a solicitation letter along with the gift asking them to circulate your cards around the office in case anyone there wants to patronize a business person who shares their values and beliefs.

Line 9 **Car & Truck Expenses.** You may use either of two methods to deduct the business use of a vehicle: standard mileage or actual expense. To use either method, you need to maintain a record of your business miles, prove that you own the car, and document the miles you drove for the year with odometer readings – preferably with a receipt for service.

Have the oil changed on all your business vehicles right around New Year's Eve each year. Save the receipt.

To use the "actual expense" method you also need to prove what you paid for the car, and records all operating costs like gas, repairs, insurance, etc.

If you claim a deduction on line 9 you are required to fill out Part IV (on page 2) or Form 4562. This is where you may wish to employ the services of a professional tax preparer. Without the proper disclosure, your automobile deductions are automatically disallowed in an audit.

What are business miles?

A. Mileage **between** business locations, such as office to client and back to office. Home to office (or to first appointment) and back to home is not business miles.

B. Mileage on out-of-town trips. Town is defined as metropolitan area - so Auburn and Davis are not considered out-of-town from Sacramento unless you work such a long day there that it is impractical to drive home and you stay overnight.

If at all possible, you should establish an office-in home so that you can deduct the miles to your first appointment every day.

Line 10 **Commissions & Fees.** Use this line to deduct payments of referral fees, franchise fees, and commissions on sales.

An entry over $600 on this line may attract IRS scrutiny, because you should send a form 1099 to anyone you paid more than $600.

Line 11 **Contract Labor.** A similar warning applies here. Use cost of goods sold if you employed an independent contractor in performing services for clients. Use Contract Labor for services you received yourself.

Line 12 **Depletion.** This is for oil and gas and natural resource businesses only.

Line 13 **Depreciation and Section 179.**

This is a big category and you may wish to skip over this if you are using a tax preparer, but **DON'T SKIP THIS**. I am only going to present the information you need to know if you are using a tax preparer. If you want to prepare your own tax return, you will need to refer to IRS Publication 946 for the rest of the story.

Assets with a useful life of more than one year and costing more than a certain amount (say $200 for a small business and $1,000 for a large business) must be "capitalized" and depreciated for them to be deductible.

Keep **permanent** records for each **asset** and hang on to them until at least 3 years **after** you dispose of them. You are going to need to prove the date acquired, description, and cost (including sales tax and installation) to support your deduction for depreciation, and you may need this proof many years down the line as long as you are still depreciating this asset.

Your collection of tools and equipment (like stereos, CD's, office furniture, small tools) that you acquired **before** you started your business could be depreciated from the point at which you "converted them from personal to business use." Many tax preparers are not aware of this and will not ask for these records. Make this list of all the equipment and supplies you had in your possession when you started your business:

Description
Date originally acquired
Original Cost
Value when the business started

Group similar assets together in categories like small tools, professional library, CDs for the office, etc.

Line 14 **Employee Benefit Programs.** Use this category for pensions, health insurance premiums, and other fringe benefits **ONLY** if you have employees.

Line 15 **Insurance.** Use this category for liability and commercial property insurance, **not** disability, life, or health.

Line 16 **Interest.** *Use this category for* business-related interest expense. If you took out a Home Equity Line of Credit or used a credit card exclusively for business, the interest gets deducted here.

If you are planning on taking out a loan or credit card advance, and you want to deduct the interest as a business expense, deposit the entire proceeds of the loan into your business account where it will be co-mingled with your business income. You can systematically draw down on the balance in your business account if it turns out you have excess cash, without jeopardizing the deductibility of the interest.

Line 17 **Legal and Professional Services.** A portion of your tax preparation fee should go here, along with any business-related payments to your attorney, accountant, coaches, or consultants (colleagues).

If you go to a therapist for emotional counseling, it is **not** deductible even if you talk about your business. If you go to a therapist for business coaching, it **is** deductible even if you talk about your emotions.

Line 18 **Office Expense.** Use this category for office supplies, postage, computer supplies, photocopying, printing and duplication, and temporary office help.

The IRS frequently scans through this category for **assets** that should have been depreciated. You should perform this scan and make sure that any assets are properly recorded elsewhere.

Line 20a **Rent or Lease (vehicles, etc.).** Use this category for rental of personal property. Rent of your office, studio space, and storage units go on the next line.

Line 20b **Rent or Lease (other business property).** Use this category for rental of office, studio space, and storage units. Do not use this for your office in home, which is reported on Form 8829 and transferred to Line 30 below.

If you are claiming an office in home deduction, you may wish to leave line 20b empty. One of the provisions of qualifying for an office in home is that you have no other office in which to perform activities that are vital to your business. If you have entries on both lines 20b and 30, the IRS may be alerted. If you have an office in home and also rent studio space or storage, deduct these expenses as cost of goods sold (Line 39) or other expenses (Part V).

Line 21 **Repairs and maintenance.** Use this line for equipment repair, office repair and cleaning, but not for vehicle repairs or office-in-home.

Line 22 **Supplies.** This is a broad category to include a lot of items not listed elsewhere. This category is far too frequently overlooked by taxpayers and tax preparers.

I have a foot-roller under my desk, a heating pad under my seat, a coffee pot, and an exercise ball in my office for stretching between appointments. Supplies! I purchase CDs to play in my office. Supplies! I buy meal bars, cans of nuts, bottled water…..Supplies! Occasionally I might take a half-eaten bar home with me……doesn't mean I lose the deduction.

Line 23 **Tax and licenses.** Use this category for your business license, unsecured property tax, payroll taxes for employees, and any professional licenses you maintain. Do not use this for income taxes, which are not considered business taxes, even if they are on business income.

If your business is an LLC and you pay a fee to the state for your registration, list that fee on line 23. In California, an LLC pays a minimum fee of $800 and additional fees ranging from $900 to $11,790 based on gross receipts. These fees represent an actual cost of doing business and are deductible on Schedule C. Many taxpayers and tax preparers erroneously deduct them as State Taxes on Schedule A.

Line 24a **Travel.** Use this category for airfare, lodging, car rental, fuel for rental cars, taxicabs, and other miscellaneous travel costs such as laundry and incidentals. Do not include meals, which go on line 24b.

You may go anywhere as long as the **primary** purpose of the trip is business. You may visit relatives or have recreation for 2 of every 7 days out of town and still deduct the **entire** travel cost. Otherwise, you can only deduct your actual expenses for the days you were on business. One of my clients recently asked me where I was going on vacation. I replied "I never go on vacation. All my travel is for business. I need to set a good example for my clients. What would they think of me if I went on a trip and didn't get the deduction?"

Line 24a **Meals and entertainment.**

This category is used for two types of meals:

a) Local business-related meals when you are **not alone**, and
b) All meals when you are travelling out-of-town overnight on business

Your records must include the date, place, amount, persons present, and business purpose of the meal.

You don't need to pay for the other person's meal to get a deduction for your own.

You are not permitted a deduction for meals taken alone, even if you are "out and about" visiting clients, unless you are out-of-town overnight. Your deduction for meals and entertainment is equal to 50% of the amount actually spent, including tips, whether you are eating locally or out of town.

To be considered business-related, meals and entertainment must take place before, during, or after a substantial business discussion. Record the substance of the meeting in your notes, and **be specific**. Generalities like "marketing discussion" are not acceptable.

A description like "discussion of key adaptations of the general client services marketing program to the specific needs of the senior market" would be a better description to use (taking grandmother out to lunch?).

The rules for entertainment (concerts, golf outings, etc.) are the same - but the business purpose may be more difficult to establish - you must show that you expect your business to benefit directly from the event.

For out of town (on business) meals, dining alone is deductible and you may use the optional per diem method, where you simply deduct the allowable meal allowance (found on the GSA website) for each city you visit.

You may alternate between the per diem and actual methods on a day by day basis – so use the per diem on the day you eat yogurt at the supermarket and use your actual receipts on the day you eat at French Laundry.

Certain meals and entertainment are 100% deductible and are claimed as "Other Expenses" on Part V of Schedule C. Company events, where all employees are invited, like the Christmas party or Picnic, are 100% deductible. So are meals purchased by the employer for consumption on business premises, when it is necessary for employees to be at work during meal breaks, and food available to the general public – such as donuts and popcorn at an auto dealer, or candy given out at a trade show.

Line 25 **Utilities.** Use this account for water, electricity, gas, and garbage in a rented office space only, not a home office. Telephone, internet access, and cable TV are not considered utilities and are deducted as "Other expenses."

Line 26 **Wages.** Use this account for actual employees (W-2) only.

Line 27 **Other expenses.** Here is where you transfer the total of the expenses listed in Part V.

Note: many expenses may be listed here, but they are all audited as a group, so try not to make the total too large (which gives the IRS a big target). Even if you are audited, categories with small amounts listed here are likely to be overlooked in favor of examining the large ones.
Common categories: continuing education, telephone, internet access, dues and publications, bank service charges.

Question 8 – What about a home office? Is it true that it's a "red flag?" How is it calculated?

To qualify a space for office-in-home deduction, you must use it regularly and exclusively as an office - you cannot deduct a space that guests sleep in when they are staying with you.

A home office is important for the mileage deduction because every time you leave your house on business, your mileage is considered business miles. If you don't have a home office, your mileage from home to the first place of work is considered a commute, and is not tax deductible.

The amount of the deduction is based on the square footage of office space as a percentage of the total square footage of your house. The percentage is then multiplied times all the expenses (rent or mortgage interest, utilities, property taxes, repairs, insurance, etc.).

If you are a renter, there are virtually no draw-backs to claiming a home office. Previously non-deductible rent payments become business deductions.
If you are a homeowner, you may have to "recapture" the depreciation you claim on your office in home when you sell the property. This is not a big deal.

Question 9 – How do I keep my books? I've heard of Peachtree and Quicken. I'm not too computer savvy, can't I just use a manual method?

For a variety of reasons, the preferred method of keeping records is QuickBooks. Other programs (Peachtree, MYOB, DAC-Easy, One-Write Plus, and Quicken) are much less popular and more difficult to get assistance.

Quicken is inferior to Quickbooks because it considers all deposits to your account as income even if they are loans or transfers, and because it considers all disbursements as expenses, even if they are for asset purchases or draw. This means that you will never have an accurate profit/loss statement from quicken without some level of sophistication at preparing customized reports.

As an alternative, you can us the "envelope" method – label envelopes for each category of expense and put in them all your cancelled checks and receipts. Add them up at the end of the year and put the total on the envelope.

Problem: What about a receipt that is for several items in different categories. Solution: This is not a good method.

Problem: If some receipts were paid by cash and some by check, how do I make sure that I haven't included the same item twice by adding in both the receipt and the check? Solution: This is still not a good method.

The manual ledger is a labor-intensive but satisfactory alternative – where you post to a columnar worksheet and total the columns. The weakness here is that it is difficult to reconcile to bank statements, credit card statements, and cash transactions all in the same spreadsheet, so you need three spreadsheets.

QuickBooks adds everything up for you and contains easy reconciliation routines. It automatically generates all the reports you need. Get it. Also, ask an accountant to help you set it up and show you how to use it. I have seen very intelligent businesspeople make a big mess because they tried to use QuickBooks without any help at the start. Once you get going, it is easy to maintain. Contrary to what Intuit would like you to believe, once you have the program, you never need to upgrade (unless you are using their payroll system).

Now you have all the tax and accounting tools you will need

to stay out of trouble and creatively save yourself some tax dollars. Go out and make money.