HOME-BASED AND MICRO BUSINESSES

CASHING IN ON BUSINESS OPPORTUNITIES

GETTING YOUR JUST DEDUCTIONS

PREFACE

The material contained in the following lesson is designed to provide the home-based or small business owner with general information about business taxes. Even if the business's taxes are handled by a professional preparer, the information contained in this lesson should be useful in helping the home-based and micro business owner-manager: (1) assemble his or her records for the preparer, and (2) have a fuller understanding of business taxes so that she or he can better work with the tax preparer. The information contained in this publication is based on the tax law for the calendar year 2011. It is always important for the business owner to stay current in terms of tax law changes.

NOTE: The information contained in this section introduces the topic of taxes in general. The specifics provided deal most often with the business formed by a sole proprietor.

NOTE: A C.P.A., an attorney who specializes in tax law or an enrolled agent, is the most appropriate person to present this information. A lay person who presents legal information, even in an educational setting, runs a fairly significant risk in giving legal advice in response to questions from an audience. Only a licensed professional can do so without incurring significant penalties.

This program is designed to be delivered in a seminar/workshop format. Presentation of the materials takes at least an hour and a half to two hours.

Goal: To introduce the micro/home business owner-manager to relevant income tax regulations.

Objectives: As a result of this lesson, micro/home business owner-managers will learn:

- To walk the micro/home business owner-manager through the process of completing IRS Schedule C: Profit or Loss from Business - a tax form designed for sole propritiorships.
- To assist micro/home business owner/managers in understanding the rules surrounding some business deductions and to inform them of some recent Supreme Court decisions governing home office deductions.
- To assist the micro/home business owner-manager in organizing his or her financial records.

HANDOUTS

Handout 1 – Schedule C
Handout 2 – Home Office Worksheet
Handout 3 – Getting Your Just Deductions Text

How To Get IRS Forms and Publications:
You can download or order the tax forms and publications mentioned in this workbook online at www.IRS.gov (http://www.irs.gov/formspubs/index.html), from the IRS Forms Distribution Center found online (http://www.irs.gov/formspubs/page/0,,id=10768,00.html), or by calling 1-800-829-3676.

INSTRUCTIONAL MATERIALS

SLIDE 1-2

An old French proverb describes taxation as the "art of plucking the goose to obtain the largest amount of feathers with the least amount of hissing." Historically, taxes have either been money, services, or payment-in-kind demanded by a government for its support. The start of modern income taxes was a 10 percent tax levied on personal incomes by England's Parliament in 1799. It was passed as a temporary measure during wartime. The first U.S. tax act was passed during the Civil War and was reversed at the War's end. The second income tax law was passed in the United States in 1895 but was declared unconstitutional by the Supreme Court. It was not until the16th Amendment to the Constitution was ratified in 1934 that Congress had the power to tax income.

You may wish to seek assistance from a professional in preparing your tax returns for your business. Please use a professional tax preparer whenever it is more convenient, reassuring, or helpful to you. But use of a tax preparer does not mean you do not have to know the tax laws that apply to your business. Most tax preparers will rely on you and your records to give them the complete information they need to prepare your return, anyway. This doesn't mean you need to understand exactly how to calculate every deduction; you just need to know that such deductions exist and which ones you are entitled to claim. You also need an understanding of taxes to help you evaluate financial moves you may make during the year. Finally, you need to have an understanding of tax regulations in order to have meaningful conversations with your tax preparer.

Before going on to the next sections in this lesson, you may wish to review the information in "Keeping Tabs on Your Cash" (Part 3, Lesson 4). Keeping good records means you can document and benefit from all the tax deductions and benefits you have coming. Organized records also mean a savings in your tax preparer's time, and consequently, the final tax bill you pay. Furthermore, if your return is audited, you will have the necessary information to substantiate your claims.

This lesson is not a general tax guide, nor is it designed to substitute for necessary advice from accountants, attorneys, and other qualified advisors. It was written to provide an overview of tax concerns particular to home-based and micro business owners.

SLIDE 3

The first step in understanding taxes and tax regulations starts with understanding how taxes vary by governmental entity and by how your business is structured. For home-based, micro and small business owners, you most typically will need to consider three general categories of taxes: federal, state, and local.

SLIDE 4

A second major classification that will influence the taxes paid by a business involves the type of business structure used to form and operate the business. The typical business forms include: a sole proprietorship; a partnership; a C corporation; an S Corp; or a limited liability company or partnership (LLC or LLP).

To understand how governmental entity and business structure work together, the following is an example of the basic business tax form you would complete for each type on the Federal level.

If you are:	**Use:**
A sole proprietor	Schedule C (Form 1040)
A partnership	Schedule K-1 (Form 1065)
A corporation	Form 1120 or 1120-A
An S corporation	Form 1120S
An LLC	Schedule K-1 (Form 1065)

FILING YOUR TAXES

Who Must File

Income Tax

If you are self-employed, you must file a return if you had net earnings of $400 or more. Net earnings are the income you have after deducting the cost of the items or services you sold, your operating expenses, and depreciation. If you must file a return because you meet the gross income requirements for taxpayers in general, you must include your net self-employment income in your gross income, even if your net self-employment income is less than $400.

Most sole proprietors will file Schedule C or Schedule C-EZ as part of their Form 1040 and their overall tax return. (NOTE: For other business structure types, the forms you should use depends upon the size and legal structure of your business). To file form C-EZ in 2011, you must have had:

- A profit from your business (you cannot use this form if you had a net loss) and:
  - your expenses are not greater than $5,000,
  - use the cash method of accounting,
  - you have no employees,
  - had only one business as either a sole proprietor, qualified joint venture, or statutory employee,
  - no credit card or similar payments that included amounts not included in your income,
  - you have no inventory, and
  - you are not using depreciation or deducting the cost of your home;
- Plus
  - Had no employees during the year,
  - Are not required to file Form 4562, Depreciation and Amortization, and
  - Do not have prior year unallowed passive activity losses from this business.

To file Form C to report income or loss from a business you operated or a profession you practiced as a sole proprietor, the same rules basically apply if you are a sole proprietor but cannot file form C-EX.

Remember that tax laws change every year and this information is only a guide. You need to check with the IRS or a qualified tax professional on a yearly basis for help on which form/s you may be required to file.

Self-Employment Tax. Self-employment tax is a Social Security tax for individuals who work for themselves. As a sole proprietor or partner, your contribution to Social Security (FICA) and Medicare is not withheld and deposited regularly like an employee's contribution. Instead it is calculated at the end of the year and added to your income tax liability on Form 1040.

Self-employment tax is treated as part of your income tax and must be taken into account in figuring your estimated tax (see above). Self-employment tax, which is reported on Form 1040, Schedule SE, is paid in addition to your business's income tax. You are self-employed if you are an independent contractor, carry on your own trade or business, or if you are active in the operation of a partnership. What sets you apart from other taxpayers is that no one withholds Social Security or Medicare taxes from your earnings. You are responsible for these taxes yourself.

Self-employment tax is based upon your net earnings (profit) from self-employment as well as your share of income from a partnership. There is a two-tier rate schedule for calculating self-employment tax. You are self-employed if you are an independent contractor, practice your own trade or own your own business, or if you are active in the operation of a partnership. What sets you apart from other taxpayers is that no one withholds Social Security or Medicare taxes from your earnings. You are responsible for remitting to the IRS these taxes yourself.

The amount of earnings subject to self-employment tax and the rate of the tax changes from year to year. The self-employed tax rate for 2009 was 15.30 percent of the first $106,800 of net income from self-employment and an additional 2.9 percent of net business income in excess of $106,800. (Note: If you have more than one business, the net income or loss from all your businesses is combined before calculating your self-employment tax.).

Use Schedule SE (Form 1040), Computation of Social Security Self-Employment Tax, to figure your tax. Two versions of Schedule SE are available, the short form and the long form. You can use the short form if you have only self-employment income. If you are self-employed and also earn wages, you will have to use the long form to avoid paying more in Social Security taxes than you are required to. Your last calculation is a deduction equal to one-half of your actual self-employment tax, the purpose of which is to equalize the Social Security taxes paid by self-employed persons with the taxes paid by employees with the same income.

How To File. Filing an income tax return consists of filling out the various tax forms, signing the return, and sending them to one of the ten Internal Revenue Service Centers scattered around the U.S.

When To File. Almost all businesses (particularly sole-proprietorships and the

more simple partnership forms) are calendar-year taxpayers, which means income and expenses are reported between January 1 to December 31. The actual, legally due date of your tax return is the 15th day of the 4th month after the close of your tax year. For calendar year taxpayers that is April 15. If you are a corporation, your due date is the 15th day of the 3rd month after the close of the calendar year or your fiscal year. If you use a fiscal year that is not the calendar year, you will report all income and expenses that can be attributed to the 12 consecutive months of your choosing. Unless you own a seasonal business, there is no particular advantage to using a fiscal year. The traditional calendar year suits most business owners better. If you are a sole proprietor, you must use a calendar year.

Estimated Taxes - If you are filing as a sole proprietor, partner, S corporation shareholder, and/or a self-employed individual, you generally have to make estimated tax payments if you expect to owe tax of $1,000 or more when you file your return.

If you are filing as a corporation you generally have to make estimated tax payments for your corporation if you expect it to owe tax of $500 or more when you file its return.

You **do not** have to pay estimated tax for the current year if you **meet all three** of the following conditions.

- You had no tax liability for the prior year
- You were a U.S. citizen or resident for the whole year
- Your prior tax year covered a 12 month period

You had no tax liability for the prior year if your total tax was zero or you did not have to file an income tax return.
For additional information on how to figure your estimated tax, refer to Publication 505, Tax Withholding and Estimated Tax.

You may also have to pay estimated tax if not enough tax is being withheld from your salary, pension, or other income.

The due dates for quarterly estimated taxes are April 15, June 15, and September 15 of the current year and January 15 of the succeeding year. (See Publication 550, Tax Withholding and Estimated Tax). For fiscal-year filers, the first estimated tax payment is due by the 15th day of the 4th month of your fiscal year. Remaining installments are due in the 6th and 9th month of your fiscal year and the first month after the end of your fiscal year.

Use the Estimated Tax Worksheet in the instructions for Form 1040ES to figure your estimated tax, remembering to account for any changes in the tax law that will take effect before you file. Use the tax rate schedules found at www.IRS.gov to calculate your taxes. You need to have your estimate within 90 percent of the tax shown on your return to avoid being charged a penalty. If you underpay your estimated tax, you need to file Form 2210 to show that you either (1) fall within one of the exceptions allowed by IRS, or (2) to compute the penalty. You are not required to file Form 2210, but if you meet one of the exceptions, attaching Form 2210 can prevent the IRS from assessing a penalty and save acres and acres of red tape. For calendar-year taxpayers here are the due dates for estimated taxes:

For the period:	Due date:
January 1 – March 31	April 15
April 1 – May 31	June 15
June 1 – August 31	September 15
September 1 – December 31	January 15 of the next year

Source: IRS Publication 505 - http://www.irs.gov/publications/p505/index.html

Limited Liability Companies (LLC) are relatively new form of business structures. Properly organized, an LLC provides its members with the tax advantages of a partnership and the limited liability protection of a corporation (See Part 2, Lesson 3 - "Choosing a Business Structure" for more information). For federal tax purposes, most LLCs are treated like a partnership and the income, gains, losses, deductions and credits from the business are "passed through" to its members, who file Schedule K-1 (Form 1065), "Partner's Share of Income, Credits, Deductions, etc."

Retention of Records. How long should you keep your records? Since the IRS can audit your tax return for a minimum of three years beyond the tax year affected, you must keep all supporting records, both primary (receipts, canceled checks) and secondary (ledgers, journals) for at least three years. For some items such as capital equipment, it is required that you hold the records for three years beyond the time when you dispose of the item. Contracts, government documents such as trademarks and copyrights, claims and papers regarding legal suits should be kept permanently. The best advice is to talk to your tax professional about the length of time that individual record types should be kept.

Source: IRS Publication 583 - http://www.irs.gov/publications/p583/index.html

SLIDE 6

HANDOUT 1

FEDERAL TAXES

Filling out Schedule C. If you operate your business as a sole proprietor, you must file a Schedule C, Profit or Loss from Business tax form, with your Form 1040. If you have more than one business, or if you and your spouse have separate businesses, you need to complete a Schedule C for each separate business.

Items A-H. Your business code (**Item B**) is found in the instructions for Schedule C. If your business does not fit any of the specific classifications, you should use 999999, "unable to classify," and describe your business on the back of the form. You do not have to have a business name to fill out **Item C**. You may use your own name, as many professional people do (attorneys, physicians, therapists). Use a street address instead of a box number for your business address if possible. An employer identification number (EIN), **Item D**, is required if you (1) have employees for whom you paid employment taxes; (2) were required to file an excise or alcohol, tobacco, and firearms tax return; or (3) have a Keogh plan.

Check the accounting method you have chosen: cash, accrual, or hybrid (see above) on **line F.** If you have chosen a combination of cash and accrual methods, check "Other" and write "hybrid" on the line to the right. You "materially participate" in a business (**Item G**) if you take an active part in the business's year-round activities. The IRS lists seven material

participation tests and includes work you did in connection with an activity in which you had an interest at the time you did the work. The first of these tests is that you participated in the activity for more than 500 hours per year. For the complete list of tests, see the Instructions to Schedule C that are issued each year.

Part I - Income. Part I is a summary of the gross receipts earned by your business less the cost of goods sold. Gross receipts, **line 1**, is the total amount of money you collected from selling your product(s) or services(s). On **line 2**, enter the amount of any money refunded or credited to customers that was included in gross receipts. Subtract line 2 from line 1 to get net sales, entered on **line 3**.

If you are a product maker or buy goods for resale, you may deduct the cost of goods sold on your tax return (**line 4**). If you provide only services, you may skip to **line 5**. **Part III**, on the back of Schedule C, is used as a worksheet to compute the cost of goods sold (see below).

Your net sales (**line 3**) are reduced by your cost of goods sold (**line 4**) to give you gross profit (**line 5**). Add in any other income, including Federal tax credits, to arrive at gross income (**line 6**). "Other income" includes any amounts recovered from bad debts, interest, space you rent for parking, and any other miscellaneous income collected by your business. If your business is primarily a service business, you will not have to figure the cost of goods sold. Your gross income will be equal to your gross receipts minus any refunds or returns, increased by other business income and Federal tax credits **(line 7)**.

Part II - Expenses. All "ordinary," "necessary," and "reasonable" expenses directly related to running your business are deductible. "Ordinary" means similar expenses are common or accepted for your particular business. A "necessary" expense is one that is appropriate and helpful in developing and maintaining your business. Following are some of the more common business expenses that are deducted on Schedule C, **Part II**.

Most of the items in the list are fairly self-explanatory. "Other" expenses that are commonly deducted include bank service charges, dues for professional associations such as the Chamber of Commerce, the cost of trade journals or other periodicals related to your business, laundry and dry cleaning of uniforms required to wear for your business, and security services.

Line 28, the total of your Part II deductions, is subtracted from **line 7** (gross income) to arrive at your net profit or loss. If you have more than one business, you must figure your net income or loss for each business separately. Your profit is entered on **line 29**, and expenses for the business use of your home are subtracted before calculating your net profit or loss on **line 31**. Net profit is transferred to **line 12**, Form 1040, where it will be added to your other income. Net profit also forms the basis for self employment tax if it exceeds $400, so **line 31** is also transferred to Schedule SE, Computation of Social Security Self-Employment Tax, **line 2**.

Part III - Cost of Goods Sold. Calculating the cost of goods sold is a three-step process: (1) determining the value of inventory on hand at the beginning of your tax year; plus (2) purchases (which includes transportation costs), paid labor, materials and supplies, and any other costs getting inventory to the point of purchase; minus (3) the value of your ending inventory. Unless

this is your first year in business, the value of your ending inventory on your previous year's tax return is the value of your beginning inventory (**line 35**).

Labor (**line 37**) is the cost of hired labor used to produce a product for sale, not your salary (usually only manufacturers have "labor" that can be deducted here. Businesses who buy goods for resale deduct their employees' wages in **Part II**, **line 26**). Materials and supplies (**line 38**) is the cost of all raw materials used in making a product for sale; "other" costs (**line 39**) are expenses needed to deliver your product to the customer, such as boxes, mailing tubes, sacks and other containers, freight or delivery charges, and overhead if you are a product maker. Expenses such as postage and office supplies are not "purchases" but operating expenses that are deducted in Part II. "Materials and supplies" does not include the purchase of any equipment or machinery. Because these items have a useful life of more than one year, they must be depreciated (see below) and the total depreciation expense deducted under Part II.

When beginning inventory, purchases, labor, supplies, and other costs are added up on **line 40**, the total represents the costs of goods you had available for sale during the year. Subtract the value of your ending inventory (see above), **line 41**, to determine the actual cost of goods sold in the year, which is entered on **line 42**.

If you maintain an inventory, your method of valuing the items in it is indicated in **Part III, Cost of Goods Sold**. There is more than one method of valuing inventory: "cost" and "lower of cost or market" are the most common. If you use LIFO (last in, first out) you must use "cost" to value your inventory. If you use FIFO (first in, first out), you may use either "cost" or "lower of cost or market" to value your closing inventory. See more about LIFO and FIFO below.

LIFO and FIFO. Generally the cost of an item to you is the basis for its valuation. But you may not always know the specific cost of every item in your inventory. If this is the case, then you have to make an assumption as to when items were sold and when the items that remain were acquired. This assumption may be made by either the **LIFO** (last-in, first out) method or the **FIFO** (first in, first out) method.

The last-in, first out method (LIFO) assumes that the newest product you make or buy for resale is the one that sells first. If you use this method, you must value your inventory at "cost." Under the "cost" method, you value your inventory according to the price you originally paid for each item or the cost of materials, supplies and employee labor needed to produce them. Some fairly complex rules are involved in using LIFO, and you are required to file Form 970, Application To Use LIFO Inventory Method, the first year you use it.

FIFO (first in, first out) presumes that the first item you make or buy for resale is the first item you sell. If you use FIFO, you may use either "cost" or "lower of cost or market" method to value your inventory. Under the "cost" method, you value inventory by determining the cost of each item to you. Remember: cost to you includes freight or transportation costs (to bring the item to point of sale), materials and supplies, and the cost of your employees' labor, but not the value of your labor.

When using the "lower of cost or market" method, you set the value of each item by comparing its current market value with its original cost and use the lower value. Under this method, each item must be compared separately to arrive at the value of your entire inventory. FIFO is more commonly used than LIFO and can be adopted without the filing of any other forms.

Whichever method you choose, you must use the same method to value your entire inventory, and you may not change to another method without permission of the IRS.

Part IV - Vehicle Expenses. If you plan to deduct car and truck expenses in Part II (**line 10**), you will need to fill out **Part IV,** Information on Your Vehicle, found on the reverse side of Schedule C. Also see the section below entitled, "Transportation Expenses."

TAX ISSUES FOR THE SMALL BUSINESSES SOLE PROPRIETOR

Depreciation. Depreciation rules changes substantially with the Small Business Jobs Act of 2010. While straight line depreciation was once commonly used, today the Modified Accelerated Cost Recovery System (MACRS) is, as noted by IRS http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/A-Brief-Overview-of-Depreciation the "proper depreciation method for most property. Business owners should get Publication 946 , How to Depreciate Property along with Form 4562 and the Instructions for Form 4562. This also might be an area where you contact a professional tax preparer for assistance.

It is possible to expense, that is deduct, a part of the cost of business assets you buy in a year instead of depreciating them. For 2011, this election, known as Section 179, allowed you to expense $500,000. Assets though allowed under this section are limited. Also these rules were changing after the 2011 tax year.

Meals and Entertainment. Probably no other group of expenses raises more questions than travel and entertainment expenses. Let's begin with entertainment expenses and work back to meals and travel. Under current tax law, you may deduct 50 percent of your business-related expenses for entertaining a client, customer, or employee, provided these expenses are "ordinary and necessary" expenses related to or associated with carrying on your trade or business. According to the IRS, an expense is "ordinary" if it normally occurs or is customary within an industry. "Ordinary" does not mean normal in the sense that the expense is incurred often or frequently.

A "necessary" expense is one made in the interest of your business. To prove the deduction, the entertainment must occur directly before, during, or after a business discussion. In some situations, such as hunting and fishing trips, meetings at night clubs or Broadway shows, and cruises on pleasure boats, the deduction would be difficult to prove. Most of these situations have an element of "distraction" about them and so might be considered not directly related to increasing your business income or obtaining new business. In addition,

dues paid to a club are no longer deductible. For entertainment you need the name and location of the restaurant or the place where you did the entertaining, the number of people served, the date and amount, and the business purpose.

Meals, whether treated as a travel expense, entertainment expense, or business meeting expense, are deductible up to 50 percent of the actual cost, including taxes and tips. You may also deduct 50 percent of business meals for your client, provided the surroundings are "conducive" to business—no rowdy sports bars! Again, business must be discussed before, during, or after the meal to qualify. The IRS tends to be skeptical about the business nature of home entertaining. Be prepared to back up your deductions with hard evidence. Be sure to buy the food and drink you intend to serve to business guests separately from your other groceries. Keep the supermarket receipt and write the date, place, amount spent, name of the person(s) entertained, and the business purpose of the meal on it.

Transportation Expenses. Ordinary people tend to use "transportation" and "travel" as interchangeable words, to some extent. Not so to the IRS. "Transportation" expenses are costs incurred in conducting business while not away from home overnight (the most common transportation expense is the cost of driving an automobile or van locally) and does not include the cost of meals. You don't incur "travel" expenses unless you are away from home overnight. You must keep accurate, timely records for every travel and transportation expense you claim for business. If you do not, and you are ever audited, the IRS will disallow any deduction you cannot prove.

As a business owner, you may deduct the cost of business-related local transportation.

For the home-based business owner working from home and having no other job, he or she can deduct the cost of driving to and from your office at home to different business locations. However, if you also hold a job, figuring your deductible business mileage is slightly more complicated, because commuting between your home and place of employment is considered a personal expense and, therefore, not deductible (even though it is travel between two business locations if your office is in your home). The rules related to trips that combine commuting to your place of employment and errands for the home office are particularly tricky. For example, if you stop by the printer's to check on a brochure on your way to work, be sure to conduct some business in your home before you leave, or you will lose the deduction. Keep a daily record of your business activities at home to prove you were traveling between two business locations.

The size of your automobile (van, pickup) deduction is based upon your percentage of business use. Record the number of miles driven for business along with the date, your destination, and the business purpose of the trip in a diary or small notebook each time you drive for business. Your percentage of business use is your total mileage for the year divided into the total business miles you logged. Make a note of your odometer reading in your driving diary at the beginning

and ending of the year.

Business mileage = % of business use Total mileage

Two methods of computing the cost of transportation are the standard mileage rate and actual expenses.

Standard mileage rate. As of 2011, the IRS approved standard mileage rates is 55.0 cents per mile. You can combine the mileage rate for all cars (trucks, pickups, vans) driven for the same business. However, you cannot use the standard mileage rate if you operate two or more vehicles simultaneously (at the same time). If you use two or more vehicles alternatively (not at the same time), the standard mileage rate is allowed. If you itemize, you can also take deductions for parking fees, state and local fuel taxes, and some of the interest paid on an auto loan. Depreciation is built into the rate, so you cannot claim an additional deduction for depreciation when you use the mileage rate method.

When the standard rate may be used. You may choose to use the standard mileage rate in the first year you place your car in service in your business. In later years you may use the standard mileage rate or actual expenses. If you do not choose the standard mileage rate in the first year and you used MACRS depreciation, you may not use the standard mileage rate for that car in any future year.

If you use the standard mileage rate in the first year, you are considered to have made an election not to use the modified accelerated cost recovery system (MACRS). You also may not claim the Section 179 deduction. If you change to the actual cost method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

To use the standard mileage rate you must:

1. Own or lease the car,
2. Not use the car for hire, such as for a taxi, and
3. Not operate two or more cars at the same time in your business.

Actual expenses. You may be better off computing the actual expense of operating your car for business use during the year. The deductible items include the cost of gas, oil, tires, insurance, depreciation, interest to buy the car, taxes, licenses, garage rent, car washes, parking fees, and tolls if those expenses can be attributed to your business. This means you must keep accurate records (and receipts) throughout the year. If you do not, you should use the mileage rate.

Travel Expenses. Transportation expenses (above) are the ordinary and necessary expense of getting from one business location to another in your local area. Deductible "travel" expenses are the costs of domestic and foreign travel away from home overnight and include (but are not necessarily limited to) the following:

1. Air, rail, and bus fares
2. Meals and lodging en route and at your destination

3. Cost of operating your own or a rental car
4. Cost of transporting samples and display materials
5. Baggage charges
6. Tips
7. Laundry and dry cleaning
8. Telephone and telegraph expenses
9. Cost of local travel at your destination, such as taxis and airport buses
10. Cost of a public stenographer.

Business purpose. Before you can deduct the costs of traveling away from home you must be able to show that your motive was strictly business. If your travel is primarily for personal reasons, even if you conduct business once you arrive, your transportation costs are not deductible, nor is the cost of meals and lodging for the time spent on nonbusiness activities (sightseeing, personal social entertainment). However, expenses directly attributable to conducting business are deductible. Keep an accurate diary of business vs. personal activities each day you are away from home. If you attend a convention, you must be able to show a connection between the convention and your trade or business, and your presence must benefit or advance your business's position.

"Away from home." Generally your tax home is your principal place of business or employment. Business demands, not personal considerations, must motivate your travel away from this home. If you regularly conduct business in more than one location, only one can be your principal place of business for tax purposes. Being "away" from your tax home is a function of time, not distance. If you are not away from your principal place of business overnight, your travel expenses are not deductible.

Meals and lodging. You may deduct 50 percent of your business-related meal and entertainment expenses (including tips and taxes) when you are traveling. There is nothing more frustrating than trying to locate all those scraps of paper known as restaurant receipts, especially when "meals" are fast-food hamburgers snatched between appointments. For those folks who have trouble keeping track, the IRS allows a deduction for meals of $45 a day. If you travel to what the IRS considers a high-cost area, you can use higher amounts (see IRS Publication 463, Travel, Entertainment, and Gift Expenses for high-cost areas and IRS Publication 1542 for city-by-city per diem rates).

SLIDE 9

EMPLOYEES AND SMALL BUSINESS

Employer Identification Number. Often sole proprietors may not acquire an Employer Identification Number (EIN) if they are not going to hire employees. Other reasons you may need one include:

- Filing Employment, Excise, or Alcohol, Tobacco and Firearms tax returns
- Withholding taxes on non-resident aliens
- Having a Keogh plan
- Plus some other kinds of organizations

If you have, or plan to have, employees, including your spouse and children, you must get an Employer Identification Number (EIN) from the Internal Revenue Service and your state, do

withholding, and give the employee (including family members) a W-2 form at the end of the year.

You can obtain your Employer Identification Number using Form SS4 available from the Internal Revenue Center nearest you. Publication 15, Circular E, Employer's Tax Guide, is an excellent source of information on federal employee taxes and includes tables to help you figure out employee withholding. Another good source of information is IRS Publication 583, Starting a Business and Keeping Records, and IRS Publication 334, Tax Guide for Small Business. All of these publications can be ordered or downloaded in PDF format online at the IRS web site at http://www.irs.gov.

Wages of Family Members. If you're a sole proprietor rather than a partnership, do not overlook the possibility of paying your spouse or your children for work they actually do for the business. These wages will reduce your self-employment income, since they are deductible as a business expense provided you meet the following four tests:

1. You must be able to show the wages you pay your relatives are part of the "ordinary and necessary" expenses of carrying on your trade or business.
2. The amount of compensation must be "reasonable;" generally it is the amount you would pay someone else to do the same work if you were not hiring your child. And the work must be genuine, not make-work jobs that do not benefit your business.
3. You must be able to prove that the work for which payment was made was actually performed by the employee. This involves keeping careful time records—tracking actual hours spent working and the jobs performed. Pay the salary by check, and make sure your child deposits the money in an account in his or her name.
4. If you use the cash method of accounting, the deduction for wages is allowable only in the year actually paid. If you use the accrual method, the deduction for wages is allowable in the year when the work was performed, even if payments were made at a later date.

It makes good sense to hire relatives for several financial reasons:

- At the time this publication went into print, your unmarried dependent child could earn up to $5350 a year in earned income without owing income tax and you could still claim a dependency deduction for him or her.
- Even if your child earns more than the standard allowable deduction for dependents, his or her wages are probably going to be taxed at a lower rate than yours.
- You reduce the amount subject to self-employment tax because his or her salary is deductible as a business expense.
- Wages paid to your children under the age of 18 years are exempt from Social Security tax but not from state and federal income tax withholding. Wages paid to your spouse are subject to both Social Security and state and federal income tax withholding.

If you have employed your children, the wages on your children's W-2 form should be shown in the box marked "non-FICA wages." You should also write "family income" on the W-2 to alert the Social Security Administration that these wages are not subject to Social Security tax. The family member other than your spouse receiving the wages does not have to pay self-employment tax on them.

Employees. Record keeping expands significantly when you hire employees. Federal and state employment taxes must be paid and reports submitted on a regular schedule. Failure to do so can lead to significant penalties.

There are three federal employment taxes:

1. Federal income tax that you withhold from employee's wages;
2. Social Security (FICA) and Medicare taxes, both the amount you pay and the amount you must withhold from employee's wages; and
3. Federal unemployment (FUTA) tax.

All businesses with employees are also required to withhold income or Social Security taxes and file, at a minimum, quarterly returns, reporting the amounts withheld. For calendar-year taxpayers, here are the due dates for employment tax returns for each quarter:

Quarter	Due Dates
January, February, March	April 30
April, May, June	July 31
July, August, September	October 31
October, November, December	January 31

(Refer to IRS Publication 15, Circular E – Employer's Tax Guide for more detailed information.)

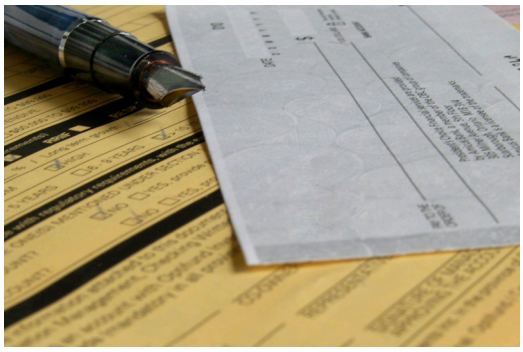
SLIDE 10

Federal Withholding. These are specific records you must keep for income tax withholding:

1. Each employee's name, address, and Social Security number
2. The total amount and date of each paycheck and the period of time the payment covers
3. For each paycheck, the amount subject to withholding
4. The amount of withholding tax collected on each payment and the date it was collected

An employee's earnings record form, available at most office supply stores, normally has spaces for all this information. A payroll register compiles all employee payroll records for a given pay period. The register provides you with the amount of money paid to all employees, the amounts deducted for taxes, and the amounts deducted for Social Security and Medicare all in one place. A new payroll register is made out each time your employees are paid.

As soon as you hire an employee, have him or her fill out a W-4 form. The IRS will supply you with as many as you want for free, or you can buy them in stationery stores. The employee fills out the form with his/her address, Social Security number, and number of withholding exemptions. The amount you withhold is based on the number of exemptions the employee claims. The federal income tax withholding schedule is used with the employee's W-4 form to calculate the correct amount of tax money to withhold from each paycheck. If the employee's W-4 form indicates s/he had no income tax liability last year and expects none this year, you don't withhold taxes.



By January 31 of each year, you have to give each employee three copies of his W-2 form (a summary of all taxes withheld the previous year). The W-2 form gives the employer's name, address, and EIN; the employee's name, address, and Social Security number, total wages, and the amount withheld. By February 28, a copy of each W-2 must be sent to the Social Security Administration along with Form W-3. A copy of all withholding statements and Form W-3 goes to the IRS by the same date.

Social Security and Medicare. You must also withhold a certain percentage of an employee's income and pay this amount, along with your required employer's match, to Social Security. As an employer you are required to provide the employee with an accounting of this deduction and make periodic deposits electronically through the Electronic Federal Tax Payment System (EFTPS). If you do not have employees, you still must pay the required Self-Employment Tax (see Publication 505 – Tax Withholding and Estimated Tax).

It is important to note that the funds you withhold is no longer your money anymore. You if use it for other purposes and fail to pay the required tax, your Federal liability remains and you will be assessed additional penalties and interest.

Currently the amount deducted for Social Security and Medicare has changed on a yearly basis. Check the IRS.gov site for updates or with your tax professional.

Federal Unemployment. You report and pay FUTA tax separately from Federal Income tax, and Social Security and Medicare taxes. You pay FUTA tax only from your own funds. Employees do not pay this tax or have it withheld from their pay. Refer to Publication 15, Employer's Tax Guide and Publication 15-A, Employer's Supplemental Tax Guide (PDF) for more information on FUTA tax.1

The general test for FUTA responsibility is:

You are subject to FUTA tax in 2012 on the wages you pay employees who are not farmworkers or household workers if:

a. You paid wages of $1,500 or more in any calendar quarter in 2011 or 2012, or
b. You had one or more employees for at least some part of a day in any 20 or more different weeks in 2011 or 20 or more different weeks in 2012.

For 2012 , the FUTA tax rate is 6%. The tax applies to the first $7,000 you pay to each employee as wages during the year. The $7,000 is the federal wage base. Your state wage base may be different.

Generally, you can take a credit against your FUTA tax for amounts you paid into state unemployment funds. The credit may be as much as 5.4% of FUTA taxable wages. If you are entitled to the maximum 5.4% credit, the FUTA tax rate after credit is 0.6%. You are entitled to the maximum credit if you paid your state unemployment taxes in full, on

time, and on all the same wages as are subject to FUTA tax, and as long as the state is not determined to be a credit reduction state. See the Instructions for Form 940 to determine the credit.

Earned Income Credit. The earned income credit (EIC) is a tax credit for certain people who work and have earned income under $13,660, or $18.740 if married and filing jointly, and you do not have any qualifying children. This amount changes yearly and on the number of qualifying children so check at IRS.gov for the updated regulations.. A tax credit usually means more money in your pocket. It reduces the amount of tax you owe. The EIC may also give you a refund. The amount you may receive is based on your income. If you also have qualifying children, you may receive additional support. Publication 596, Earned Income Credit, from the IRS can provide additional information about this regulation.

SLIDE 13

DEDUCTIBLE HOME OFFICE EXPENSES

For home-based business owners, there is one additional deduction that you may qualify for the use of your home as your place of business. See IRS Publication 587. To take the deduction for using a part of your home for business, that part must be "used exclusively and regularly

- "as the principal place of business for any trade or business in which you engage;
- "as a place to meet or deal with your patients, clients, or customers in the normal course of your trade or business; or
- "in connection with your trade or business, if you are using a separate structure not attached to your house or residence."

NOTE: Home day care providers have different rules in terms of what can be deducted for the use of the home. Please check the IRS regulations for that information, included in IRS Publication 587.

Exclusive use. "Exclusive use" means you must use a specific part of your home only for the purpose of carrying on your trade or business. If you use part of your home as your business office and also for personal purposes, you have not met the exclusive-list test.

Example: You use a back bedroom in your home to sew and fit customers. The bedroom is also used for overnight guests. You cannot claim a business deduction for any of the expenses for the use of your home.

Regular use. "Regular use" means the part of your home you use exclusively for your business is also used on a continuing basis. The occasional or incidental business use of a part of your home does not meet the regular-use test even if that part of your home is used for no other purpose.

Business part of home. If you use part of your home for your business and you meet the requirements, you must divide the expenses of operating your home between the personal use and the business use before taking the deduction. Some expenses are divided on an area basis. Certain expenses are totally deductible, while others are not. The total expenses you

can deduct for the business use of your home are limited to the income from the home-based/micro business reduced by all business expenses except those for the home office.

Figuring the business percentage. To figure deductions for the business use of your home, you have to figure what percentage of your home is used for business. This is calculated by measuring the area used in your business in square feet. Then measure the total square footage of your home. Divide the total square footage into the square footage of the area that is used just for your business.

Example: You use one 120-square foot room in your home for business. Your home measures 1,200 total square feet. Therefore, you are using (120 divided by 1,200) = 1/10 or 10 percent of the total area for business. If the rooms in your home are about the same size and you use one room for business in a five-room house, you are using 1/5 or 20 percent of the total area for business.

What to deduct. Some expenses you pay to maintain your home are directly related to its business use, others are indirectly related, and some are not related at all. You may deduct direct expenses and part of the indirect expenses, subject to the limitations discussed below. If you are a cash-basis taxpayer, only the expenses you pay during the tax year (January to December) are deductible.

Unrelated expenses are expenses that benefit only the parts of your home you do not use for business—for example, repairs to areas of your home not used for the business.

Direct expenses are expenses that benefit only the business part of your home. They include painting or repairs made to the specific area or room used for business. Expenses directly related to the business use of your home are fully deductible.

Indirect expenses are those you have for keeping up and running your entire home. That is, they affect both the business and personal parts of your home. Examples of indirect expenses are real estate taxes, mortgage interest, casualty losses, rent, utilities and services, insurance, repairs, security system, and depreciation.

To be deductible, an indirect expense must be related in some way to the part of your home used for the business. The business part of these expenses is deductible, calculated by applying the business percentage to the indirect expenses incurred. In the example above, 10 percent of the home was being used for the business. Therefore, the homeowner can take 10 percent of the taxes, mortgage interest, utilities, homeowner's insurance, general repairs such as a roof for the entire dwelling, and depreciation.

Mortgage interest. If you pay interest on a home mortgage, you may deduct part of the interest as a business expense. To figure the business part of your home mortgage interest, multiply the interest figure by the calculated percentage of your home used for business. Interest on a second mortgage or home equity loan may also be included in this computation in most cases. If you itemize your deductions, the personal part of your home mortgage interest deduction is reported on Schedule A of Form 1040. Real estate

(property) taxes. If you own your own home, you may deduct as a business expense part of the real estate (property) taxes you pay on your home. To figure the business part of your real estate taxes, multiply the real estate taxes paid by the percentage of your home used for business (in the example above, 10 percent). If you itemize your deductions, the personal (nonbusiness) part of your real estate taxes is deductible on Schedule A of Form 1040.

Rent. If you rent a home, rather than own, you may deduct part of the rent you pay. To figure the amount you may deduct, multiply your rent payments by the percentage of your home used for business.

Utilities and services. Expenses for utilities and services (electricity, gas, water and trash removal, and cleaning services) are primarily personal expenses. However, if you use part of your home for business, you may deduct the business part of these expenses. Generally, the business percentage for utilities is the same as the percentage of your home used for business.

Any expenses for utilities or services related only to your business, such as business long distance telephone calls, or a second line for a fax machine, are fully deductible. You are not allowed to deduct any portion of the base service charge for the first telephone line into your home, but you may deduct the cost of added features (such as call waiting) if installed for business purposes.

Insurance. You may deduct the business part of insurance on your home. However, if the insurance premium you pay gives you coverage for a period that extends past the end of your tax year, you may deduct only the business part of the portion of the premium that gives you coverage for your tax year.

Repairs. The business percentage of the cost of repairs—including labor other than your own labor and supplies—is a deductible expense. For example, a repair to your home furnace benefits the entire home. If 10 percent of the area of your home is used for business, 10 percent of the cost of the furnace repair is deductible.

Repairs keep your home in good working order over its useful life. Examples of common repairs are patching walls and floors, painting, wallpapering, repairing roofs and gutters, and mending leaks.

Security System. If you install a security system that protects all the doors and windows of your home, the business part of the expense of installing and maintaining it is a deductible expense. You may also take a deduction for depreciation for the part of the cost of the security system that relates to the business use of your home.

Depreciation. The cost of property with a useful life of more than one year, such as a building, a permanent improvement, or furniture, is a capital expense, and the full cost of the item may not be deducted in one year. You may not deduct the principal payments you make on your home mortgage or on improvements to your property because these payments are capital expenditures. However, you may be able to recover part of this cost

by taking annual deductions for depreciation. For complete information on depreciation, see IRS Publication 534, Depreciation. See simple calculations for figuring depreciation earlier in this lesson.
If you take a deduction for depreciation on the portion of your home used in the business, ***be sure to keep a record of it***. If the house is sold at a later date, the amount deducted is a reduction in the tax basis of the home. This figure is critical in establishing an amount payable as capital gain.

Permanent improvements. A permanent improvement increases the value of property, adds to its life, or gives it a new or different use. Examples of improvements are replacement of electrical wiring or plumbing, a new roof, a new addition, remodeling, or other major modifications.

Expenditures that are part of a general plan to recondition, improve, or alter your house to make it suitable for use are capital expenditures, even though some of the work might be properly classified as repairs. You must carefully distinguish between repairs and improvements and keep accurate records of all these expenditures. If you were to sell your home, the cost of improvements will be part of the tax base you have in your home.

Record Keeping. You do not have to use any particular method of record keeping, but you must keep some records containing the information needed to figure your deductions for the business use of your home. Such records are canceled checks, receipts, paid utility bills, work orders, and other evidence of expenses you have paid.

Your records must show these points:

1. The part of your home you use for business. You use this part of your home exclusively and regularly for business as either your principal place of business as a direct seller or as the place where you meet or deal with clients or customers in the normal course of your business.
2. The amount of depreciation and other expenses for keeping up the part of your home for business. For more information on record keeping, see IRS Publication 583, Starting a Business and Keeping Records, as well as the record keeping lesson in these materials.

For tax years beginning after 1986, the deductions for the business use of your home are limited. Your business deductions for the business use of your home are deducted in this order:

- The direct expenses for your business in your home, not allocable to the use of the unit itself, such as expenses for supplies and labor.
- The business percentage of the expenses allowed as indirect expenses, such as mortgage interest, property taxes, and deductible casualty losses.
- The other business expenses for the business use of your home that can be allocated to the use of the unit itself, such as maintenance, utilities, insurance, and depreciation.

Deductions that adjust the basis of your home are taken last. Deductions in this category may not exceed the net income remaining after gross income from the business is reduced

by deductions in the first two categories. Deductions for the business use of your home cannot create a business loss or increase a net loss from your business. If your home-based/micro business is profitable, you may deduct all home office expenses, but if the business is not profitable, home office deductions are limited.

If you file Schedule C, Profit or Loss from Business, to report the income and expenses of your business, and claim expenses for a home office, you are also required to submit Form 8829, Expenses for the Business Use of Your Home to provide a detailed record of the home office expenses.

If your work at home does meet the principal place of business requirements, the home office worksheet on the next page can assist you in calculating your deduction. The rules are slightly different for day-care providers and sales persons who store their inventories at home. See IRS Publication 587, Business Use of Your Home (including use by Day-Care Providers), for details.

Remember: the deduction for your home office can't produce a loss, but you can carry over the deduction to the next year. For example, your business income is $6,000, you have $5,000 in general business expenses (Part II of Schedule C), $1,500 in home office expenses, $1,000 of which is your percentage of mortgage interest and real estate taxes allocated to the use of the house. You must take your deductions in the following order: (1) mortgage interest, property taxes, and casualty losses; (2) operating expenses that can be allocated to home office; (3) depreciation that can be allocated to home office. First, you deduct the interest and taxes of $1,000, then $5,000 in general operating expenses, which brings your business income to zero. The remaining $500 of your home office expenses can't be deducted this year but is carried over to the next year. If you don't have sufficient income to deduct the $500 next year, it can be carried over again.

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HANDOUT 1

SCHEDULE C

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

▶ For information on Schedule C and its instructions, go to www.irs.gov/schedulec
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2011
Attachment Sequence No. **09**

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service (see instructions) | B Enter code from instructions ▶

C Business name. If no separate business name, leave blank. | D Employer ID number (EIN), (see instr.)

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on losses ☐ Yes ☐ No

H If you started or acquired this business during 2011, check here ▶ ☐

I Did you make any payments in 2011 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☐ No

J If "Yes," did you or will you file all required Forms 1099? ☐ Yes ☐ No

Part I Income

1a	Merchant card and third party payments. For 2011, enter -0-	1a			
b	Gross receipts or sales not entered on line 1a (see instructions)	1b			
c	Income reported to you on Form W-2 if the "Statutory Employee" box on that form was checked. **Caution.** See instr. before completing this line	1c			
d	**Total gross receipts.** Add lines 1a through 1c			1d	
2	Returns and allowances plus any other adjustments (see instructions)			2	
3	Subtract line 2 from line 1d			3	
4	Cost of goods sold (from line 42)			4	
5	**Gross profit.** Subtract line 4 from line 3			5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)			6	
7	**Gross income.** Add lines 5 and 6 ▶			7	

Part II Expenses — Enter expenses for business use of your home only on line 30.

8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17		25	Utilities	25	
				26	Wages (less employment credits)	26	
				27a	Other expenses (from line 48)	27a	
				b	**Reserved for future use**	27b	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a ▶	28	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Attach **Form 8829.** Do **not** report such expenses elsewhere	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** If you entered an amount on line 1c, see instr. Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	

32 If you have a loss, check the box that describes your investment in this activity (see instructions).
• If you checked 32a, enter the loss on both **Form 1040, line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** If you entered an amount on line 1c, see the instructions for line 31. Estates and trusts, enter on **Form 1041, line 3.**
• If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11334P **Schedule C (Form 1040) 2011**

Part III **Cost of Goods Sold** (see instructions)

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 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 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 2011, enter the number of miles you used your vehicle for:

a Business b Commuting (see instructions) c Other

45 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

46 Do you (or your spouse) have another vehicle available for personal use? ☐ 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 line 27a	48	

HANDOUT 2

HOME OFFICE WORKSHEET

Housing related expenses:

Mortgage interest _____(a)
Property taxes _____(b)
Casualty losses _____(c)
Home insurance _____(d)
Electricity _____(e)
Gas _____(f)
Water _____(g)
Garbage pick-up _____(h)
Repairs _____(i)
Depreciation (real property) _____(j)
Total housing related expenses (total a-j) _____ (line 1)

Percentage of home used for business

Space used for office _____ sq. ft (k)
Space used for storage _____ sq. ft (l)
Space used for other bus. purposes _____ sq. ft (m)
Total business square footage (k+l+m) _____ (n)
Enter total square footage in home _____ (o)
Percentage of home used in business
(Divide line n by line o) _____% (line 2)

Business portion of housing-related expenses

Current year business portion of housing expenses
(Multiply line 1 by line 2) _____ (line 3)
Add prior year "carry over" if applicable _____ (line 4)
Total business portion of housing-related expenses _____ (line 5)
(Add lines 3 and 4)

Deduction limit

Gross income from business _____ (p)
Less: Inventory, supplies, etc. _____ (q)
Mortgage interest
x business ___% (line 2) _____ (r)
Property taxes
x business ___% (line 2) _____ (s)
Modified net income (Line p minus lines q, r, s) _____ (line 6)

HOME OFFICE DEDUCTION. *[Compare amounts on lines 5 and 6. Enter the* **lesser amount.** *This is your home office deduction.]* [_____]

CARRY OVER. *If line 5 is greater than line 6,* **subtract line 6 from line 5** *and enter the difference here to carry over to the following tax year.* {_____}

Prepared by Barbara R. Rowe, Ph.D., Family Resource Management - Extension Specialist, Purdue University

HANDOUT 3

GETTING YOUR JUST DEDUCTIONS

An old French proverb describes taxation as the art of plucking the goose to obtain the largest amount of feathers with the least amount of hissing." Historically, taxes have been either money, services, or payment-in-kind demanded by a government for its support. The start of modern income taxes was a 10 percent tax levied on personal incomes by England's Parliament in 1799. It was passed as a temporary measure during wartime. The first U.S. tax act was passed in the Civil War and was reversed at the War's end. The second income tax law was passed in the United States in 1895 but was declared unconstitutional by the Supreme Court. It was not until the16th Amendment to the Constitution was ratified in 1934 that Congress had the power to tax income.

Home-based and micro business owners need to be concerned with three general categories of taxes: federal, state, and local.

You may wish to seek assistance from a professional in preparing your tax returns for your business. Please use a professional tax preparer whenever it is more convenient, reassuring, or helpful to you. But don't use a tax preparer because you have to—because you don't know the tax laws that apply to your business. Most tax preparers will rely on you and your records to give them the complete information they need to prepare your return, anyway. This doesn't mean you need to understand exactly how to calculate every deduction; you just need to know that such deductions exist and which ones you are entitled to claim.

Before going on to the next sections in this lesson, you may wish to review the information in "Keeping Tabs on Your Cash" (Lesson 15). Keeping good records means you can document and get all the tax deductions and benefits you have coming. Organized records also mean a savings in your tax preparer's time, and consequently, the bill you pay. Furthermore, if your return is audited, you will have the necessary information to back up your claims. This lesson is not a general tax guide, nor is it designed to substitute for necessary advice from accountants, attorneys, and other qualified advisors. It was written to provide an overview of tax concerns particular to home-based and micro business owners.

BEFORE YOU FILE

Who Must File. If you are self-employed, you must file a return if you had net earnings of $400 or more. Net earnings are the income you have after deducting the cost of the items or services you sold, your operating expenses, and depreciation. If you must file a return because you meet the gross income requirements for taxpayers in general, you must include your net self-employment income in your gross income, even if your net self-employment income is less than $400. Self-employment tax, which is reported on Form 1040, is paid in addition to your business's income tax.

You are self-employed if you are an independent contractor, carry on your own trade or business, or if you are active in the operation of a partnership. What sets you apart from other taxpayers is that no one withholds Social Security tax from your earnings. You are responsible for this tax yourself.

The amount of earnings subject to self-employment tax and the rate of the tax changes from year to year. The self employment tax rate for 2009 was 15.30 percent of the first $106,800 of net income from self-employment. If you have more than one business, the net income or loss from all your businesses is combined before calculating your self-employment tax. However, you are allowed a deduction of half the self-employment tax to equalize the Social Security and Medicare taxes paid by the self-employed with those paid by employees with equivalent income. Use Schedule SE (Form 1040) – Self Employment Tax to figure your tax.

Sources:
Schedule SE (Form 1040) - http://www.irs.gov/pub/irs-pdf/f1040sse.pdf
Instructions for Schedule SE (Form 1040) - http://www.irs.gov/instructions/i1040sse/
IRS Publication 225 Farmers Tax Guide - http://www.irs.gov/publications/p225/index.html
IRS Publication 334 Tax Guide for Small Businesses - http://www.irs.gov/publications/p334

How To File. Filing an income tax return consists of filling out the various tax forms, signing the return, and sending them to one of ten Internal Revenue Service Centers scattered around the U.S. Which forms you should use depends upon the size and legal structure of your business. You can use Schedule C-EZ if you do not have a net loss from your business, you had only one business as a sole proprietor, you had no employees, you do not deduct home office expenses, you are not required to file Form 4562 (depreciation) for the business, your expenses don't exceed $2,500, and you do not carry inventory. Schedule C-EZ is a three-line form that is very simple to complete.

If you are:	**Use:**
A sole proprietor	Schedule C (Form 1040)
A partnership	Schedule K-1 (Form 1065)
A corporation	Form 1120 or 1120-A
An S corporation	Form 1120S
An LLC	Schedule K-1 (Form 1065)

When To File. Almost all businesses are calendar-year taxpayers, which means income and expenses are reported between January 1 to December 31. The actual, legally due date of your tax return is the 15th day of the 4th month after the close of your tax year. For calendar-year taxpayers that is April 15. If you are a corporation, your due date is the 15th day of the 3rd month after the close of the calendar year or your fiscal year. If you use a fiscal year (one beginning on any day other than January 1) you will report all income and expenses that can be attributed to the 12 consecutive months of your choosing. Unless you own a seasonal business, there is no particular advantage to using a fiscal year. The traditional calendar year suits most business owners better. If you are a sole proprietor, you must use a calendar year.

Sole proprietors and partners usually have to file an Estimated Tax for Individuals form (1040-ES) and pay taxes on their estimated taxable income quarterly. The due dates for quarterly estimated taxes are April 15, June 15, and September 15 of the current year and January 15 of the suceeding year. Any business with employees is also required to withhold income or Social Security taxes and file quarterly returns, reporting the amounts withheld. For calendar-year taxpayers here are the due dates for employment tax returns for each quarter:

Quarter	Due Dates
January, February, March	April 30
April, May, June	July 31
July, August, September	October 31
October, November, December	January 31

Limited Liability Companies (LLC) are relatively new forms of businesses. Properly organized, an LLC provides its members with the tax advantages of a partnership and the limited liability protection of a corporation. To form an LLC, your attorney files a Certificate of Formation or Articles of Organization with the secretary of the state in which your LLC is located. Most states require the members of an LLC to file a written Operating Agreement, similar to a limited partnership agreement. For federal tax purposes, most LLCs are treated like a partnership and the income, gains, losses, deductions and credits from the business are "passed through" to its members, who file Schedule K-1 (Form 1065), "Partner's Share of Income, Credits, Deductions, etc."

Retention of Records. How long should you keep your records? Since the IRS can audit your tax return up to three years beyond the tax year affected, you should keep all supporting records, both primary (receipts, canceled checks) and secondary (ledgers, journals), for at least that long. Contracts; government documents, such as trademarks and copyrights; claims; and papers regarding legal suits should be kept permanently.

Choosing an Accounting Method. Generally you may choose either of the two major methods of accounting: (1) cash or (2) accrual. With the cash method, you report income when it is received and deduct expenses when you pay them. With the accrual method you include all income when it is earned whether it is received or not (such as bills sent) and deduct expenses when they are incurred (such as bills received). If you have inventory, you must use the accrual method for purchases and sales of that inventory. You can, however, report other income and expenses of your business using the cash method. Tip: Inventory applies to more than retail stores. If you are a service business that stocks and sells parts, you have inventory. You may also figure your business income/expenses on the accrual basis and nonbusiness income/expenses on a cash basis. A combination of cash and accrual methods is known as a hybrid method. You may not reverse the combination and use the cash method for inventory and accrual for all other items. If you are the sole proprietor of more than one business, you may use a different accounting method for each business as well as for yourself. But once you choose a method, you must get permission from the IRS before changing to another.

Why all this fuss about inventories? Simply this—cash expenditures won't reflect your true financial picture where inventories are involved. For example, if you are a tent maker who spends $1,500 on canvas in a year and sell only three tents at $100 each that year, the IRS would say you haven't put several hundred dollars of supplies into those three tents; rather, you have put it into raw materials, works in progress, and unsold finished products. Therefore, you must spread the cost of supplies over all your unsold and unfinished tents. You cannot deduct the $1,500 from the $300—that would distort your real income for that year. Inventories include the following:

- merchandise or stock in trade
- raw materials
- work in progress
- finished products
- supplies that will become a part of sale items.

You do not include tools, equipment, office supplies, vehicles, or anything else purchased for reasons other than resale, only the cost of sold inventory. This means only a part of your inventory purchases can be deducted as yearly expenses. The cost of unsold inventory at year-end is an asset of the business and will not be a deduction until it is sold or is fully depreciated. So the cost of goods sold involves measuring the change in quantity and value of your inventory from the beginning of the year to the end to get the cost of goods sold.

cost of goods = beginning inventory + (cost of purchase, labor, and supplies) - ending inventory

Ending inventory is determined by actually counting your stock on hand at the end of the year. When all the goods have been counted and listed, the items on the inventory sheet are priced according to the method of valuation you choose (see "LIFO" and "FIFO" below). Then the prices for a single unit are multiplied by the number of items you have on hand to get a total dollar value. The total dollar values of all stock on hand are added together to determine the value of your inventory. If you are selling some items on consignment, be sure to count all your inventory, regardless of location. If you sell to others for resale, goods in shipping are included in your inventory if the terms of shipment are FOB (freight on board).

FEDERAL TAXES

Filling out Schedule C. If you operate your business as a sole proprietor, you must file Schedule C, Profit or Loss from Business, with your Form 1040. If you have more than one business, or if your and your spouse have separate businesses, you need to complete a Schedule C for each business.

Items A - H. Your business code (Item B) is found in the instructions for Schedule C. If your business does not fit any of the specific classifications, you should use 999999, "unable to classify," and describe your business on the back of the form. You do not have to have a business name to fill out Item C. You may use your own name, as many professional people do (attorneys, physicians, therapists). Use a street address instead of a box number for your business address if possible. An employer identification number (EIN), Item D, is required if you (1) have employees for whom you paid employment taxes; (2) were required to file an excise or alcohol, tobacco, and firearms tax return; or (3) have a Keogh plan.

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

▶ For information on Schedule C and its instructions, go to *www.irs.gov/schedulec*
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2011
Attachment Sequence No. **09**

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service (see instructions) | B Enter code from instructions ▶

C Business name. If no separate business name, leave blank. | D Employer ID number (EIN), (see instr.)

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on losses . ☐ Yes ☐ No

H If you started or acquired this business during 2011, check here . . . . . ▶ ☐

If you maintain an inventory, your method of valuing the items in it is indicated in Part III, Cost of Goods Sold. There is more than one method of valuing inventory: "cost" and "lower of cost or market" are the most common. If you use LIFO (last in, first out) you must use "cost" to value your inventory. If you use FIFO (first in, first out), you may use either "cost" or "lower of cost or market" to value your closing inventory. See more about LIFO and FIFO below.

LIFO and FIFO. Generally the cost of an item to you is the basis for its valuation. But you may not always know the specific cost of every item in your inventory. Then you have to make an assumption as to when items were sold and when the items that remain were acquired. This assumption may be made by either the LIFO (last-in, first out) method or the FIFO (first in, first out) method.

The last-in, first out method (LIFO) assumes the newest product you make or buy for resale is the one that sells first. If you use this method, you must value your inventory at "cost." Under the "cost" method, you value your inventory according to the price you originally paid for each item or the cost of materials, supplies and employee labor needed to produce them. Some fairly complex rules are involved in using LIFO, and you are required to file Form 970, Application To Use LIFO Inventory Method, the first year you use it.

FIFO (first in, first out) presumes the first item you make or buy for resale is the first item you sell. If you use FIFO, you may use either "cost" or "lower of cost or market" method to value your inventory. Under the "cost" method, you value inventory by determining the cost of each item to you. Remember: cost to you includes freight or transportation costs (to bring the item to point of sale), materials and supplies, and the cost of your employees' labor, but not the value of your labor.

When using the "lower of cost or market" method, you set the value of each item by comparing its current market value with its original cost and use the lower value. Under this method, each item must be compared separately to arrive at the value of your entire inventory. FIFO is more commonly used than LIFO and can be adopted without the formality of filing an application. Whichever method you choose, you must use the same method to value your entire inventory, and you may not change to another method without permission of the IRS.

Check the accounting method you have chosen: cash, accrual, or hybrid (see above) on line

F. If you have chosen a combination of cash and accrual methods, check "Other" and write "hybrid" on the line to the right. You "materially participate" in a business (Item G) if you take an active part in the business's year-round activities. One of the IRS litmus tests to determine material participation is if you worked in the business for more than 500 hours in the tax year. Five hundred hours equals 62.5 eight-hour days.

Part I - Income. Part I is a summary of the gross receipts earned by your business less the cost of goods sold. Gross receipts, line 1, is the total amount of money you collected from selling your product(s) or services(s). On line 2, enter the amount of any money refunded or credited to customers that was included in gross receipts. Subtract line 2 from line 1 to get net sales, entered on line 3.

If you are a product maker or buy goods for resale, you may deduct the cost of goods sold on your tax return (line 4). If you provide only services, you may skip to line 5. Part III, on the back of Schedule C, is used as a worksheet to compute the cost of goods sold (see below).

Part I	**Income**				
1a	Merchant card and third party payments. For 2011, enter -0-	1a			
b	Gross receipts or sales not entered on line 1a (see instructions)	1b			
c	Income reported to you on Form W-2 if the "Statutory Employee" box on that form was checked. **Caution.** See instr. before completing this line	1c			
d	**Total gross receipts.** Add lines 1a through 1c			1d	
2	Returns and allowances plus any other adjustments (see instructions)			2	
3	Subtract line 2 from line 1d			3	
4	Cost of goods sold (from line 42)			4	
5	**Gross profit.** Subtract line 4 from line 3			5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)			6	
7	**Gross income.** Add lines 5 and 6 ▶			7	

Your net sales (line 3) are reduced by your cost of goods sold (line 4) to give you gross profit (line 5). Add in any other income, including Federal tax credits, to arrive at gross income (line 7). "Other income" includes any amounts recovered from bad debts, interest, space you rent for parking, and any other miscellaneous income collected by your business. If yours is primarily a service business, you will not have to figure the cost of goods sold. Your gross income will be gross receipts minus any refunds or returns, increased by other business income and Federal tax credits.

Part II - Expenses. All "ordinary," "necessary," and "reasonable" expenses directly related to running your business are deductible. "Ordinary" means similar expenses are common or accepted for your particular business. A "necessary" expense is one that is appropriate and helpful in developing and maintaining your business. Following are some of the more common business expenses that are deducted on Schedule C, Part II.

Most of the items in the list are fairly self-explanatory. "Other" expenses that are commonly deducted include bank service charges, dues for professional associations such as the Chamber of Commerce, the cost of trade journals or other periodicals related to your business, laundry and dry cleaning of uniforms required to wear for your business, and security services.

Part II **Expenses** — Enter expenses for business use of your home only on line 30.

8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance	21	
				22	Supplies (not included in Part III)	22	
				23	Taxes and licenses	23	
				24	Travel, meals, and entertainment:		
14	Employee benefit programs (other than on line 19)	14		a	Travel	24a	
				b	Deductible meals and entertainment (see instructions)	24b	
15	Insurance (other than health)	15					
16	Interest:			25	Utilities	25	
a	Mortgage (paid to banks, etc.)	16a		26	Wages (less employment credits)	26	
b	Other	16b		27a	Other expenses (from line 48)	27a	
17	Legal and professional services	17		b	**Reserved for future use**	27b	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a ▶	28	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Attach **Form 8829.** Do **not** report such expenses elsewhere	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** If you entered an amount on line 1c, see instr. Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both **Form 1040, line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** If you entered an amount on line 1c, see the instructions for line 31. Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

Line 28, the total of your Part II deductions, is subtracted from line 7 (gross income) to arrive at your net profit or loss. If you have more than one business, you must figure your net income or loss for each business separately. Your profit is entered on line 29, and expenses for the business use of your home are subtracted before calculating your net profit or loss on line 31. Net profit is transferred to line 12, Form 1040, where it will be added to your other income. Net profit also forms the basis for self employment tax if it exceeds $400, so line 31 is also transferred to Schedule SE, Computation of Social Security Self-Employment Tax, line 2.

Part III - Cost of Goods Sold. Calculating the cost of goods sold is a three-step process: (1) determining the value of inventory on hand at the beginning of your tax year; plus (2) purchases (which includes transportation costs), paid labor, materials and supplies, and any other costs getting inventory to the point of purchase; minus (3) the value of your ending inventory. Unless this is your first year in business, the value of your ending inventory on your previous year's tax return is the value of your beginning inventory (line 35).

Part III **Cost of Goods Sold** (see instructions)

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 line 4	42	

Purchases (line 36) includes the value of all items bought for resale; labor (line 37) is the cost of hired labor used to produce a product for sale, not your salary (usually only product makers have "labor" that can be deducted here. Businesses who buy goods for resale deduct their employees' wages in Part II, line 26). Materials and supplies (line 38) is the cost of all raw materials used in making a product for sale; "other" costs (line 39) are expenses needed to deliver your product to the customer, such as boxes, mailing tubes, sacks and other containers, freight or delivery charges, and overhead if you are a product maker. Expenses such as postage and office supplies are not "purchases" but operating expenses that are deducted in Part II. "Materials and supplies" does not include the purchase of any equipment or machinery. Because these items have a useful life of more than one year, they must be depreciated (see below) and the total depreciation expense deducted under Part II.

When beginning inventory, purchases, labor, supplies, and other costs are added up on line 40, the total represents the costs of goods you had available for sale during the year. Subtract the value of your ending inventory (see above), line 41, to determine the actual cost of goods sold in the year, which is entered on line 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 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 2011, enter the number of miles you used your vehicle for:

a Business _____ b Commuting (see instructions) _____ c Other _____

45 Was your vehicle available for personal use during off-duty hours? . . . . . ☐ Yes ☐ No

46 Do you (or your spouse) have another vehicle available for personal use?. . . . . ☐ Yes ☐ No

47a Do you have evidence to support your deduction? . . . . . ☐ Yes ☐ No

Part IV - Vehicle Expenses. If you plan to deduct car and truck expenses in Part II (line 10), you will need to fill out Part IV, Information on Your Vehicle, found on the reverse side of Schedule C. Also see the section below entitled, "Transportation Expenses."

Estimated Taxes. See page 6.

Self-employment Tax. Self-employment tax is a Social Security tax for individuals who work for themselves. As a sole proprietor or partner, your contribution to Social Security (FICA) and Medicare is not withheld and deposited regularly like an employee's contribution. Instead it is calculated at the end of the year and added to your income tax liability on Form 1040. Self-employment tax is treated as part of your income tax and must be taken into account in figuring your estimated tax (see above).

Self-employment tax is based upon your net earnings (profit) from self-employment as well as your share of income from a partnership. There is a two-tier rate schedule for calculating selfemployment tax. Tax rates for self-employment earnings change yearly. Check with IRS.gov or your tax professional for the current rates.

If you have more than one business, you are allowed to combine the net income or loss from all your businesses before calculating the self-employment tax. That way, a loss in any business can be used to offset income in other businesses, which reduces the amount of self-employment tax you pay. Two versions of Schedule SE are the short and the long. You can use the short form if you have only self-employment income. If you are self-employed and also earn wages, you will have to use the long form to avoid paying more Social Security than you are required to. Your last calculation is a deduction equal to one-half of your actual self-employment tax, the purpose of which is to equalize the Social Security taxes paid by self-employed persons with the taxes paid by employees with the same income.

Depreciation. See page 10.

TAX ISSUES FOR HOME BUSINESSES

Meals and Entertainment. Probably no other group of expenses raises more questions than travel and entertainment expenses. Let's begin with entertainment expenses and work back to meals and travel.

Under current tax law, you may deduct 50 percent of your business-related expenses for entertaining a client, customer, or employee, provided these expenses are "ordinary and necessary" expenses related to or associated with carrying on your trade or business. According to the IRS, an expense is "ordinary" if it normally occurs or is customary within an industry. "Ordinary" does not mean normal in the sense that the expense is incurred often or frequently.

A "necessary" expense is one made in the interest of your business. To prove the deduction, the entertainment must occur directly before, during, or after a business discussion. In some situations, such as hunting and fishing trips, meetings at night clubs or Broadway shows, and cruises on pleasure boats, the deduction would be difficult to prove. Most of these situations have an element of "distraction" about them and so might be considered not directly related to increasing your business income or obtaining new business. In addition, dues paid to a club are no longer deductible. For entertainment you need the name and location of the restaurant or the place where you did the entertaining, the number of people served, the date and amount, and the business purpose.

Meals, whether treated as a travel expense, entertainment expense, or business meeting expense, are deductible up to 50 percent of the actual cost, including taxes and tips. You may also deduct 50 percent of business meals for your client, provided the surroundings are "conducive" to business—no rowdy sports bars! Again, business must be discussed before, during, or after the meal to qualify.

The IRS tends to be skeptical about the business nature of home entertaining. Be prepared to back up your deductions with hard evidence. Be sure to buy the food and drink you intend to serve to business guests separately from your other groceries. Keep the supermarket receipt and write the date, place, amount spent, name of the person(s) entertained, and the business purpose of the meal on it.

Transportation Expenses. Ordinary people tend to use "transportation" and "travel" as interchangeable words, to some extent. Not so the IRS. "Transportation" expenses are costs incurred in conducting business while not away from home overnight (the most common transportation expense is the cost of driving an automobile or van locally) and does not include the cost of meals. You don't incur "travel" expenses unless you are away from home overnight. You must keep accurate, timely records for every travel and transportation expense you claim for business. If you do not, and you are ever audited, the IRS will disallow any deduction you cannot prove.

As a business owner, you may deduct the cost of business-related local transportation. If your home-based or micro business is your only employment, the cost of all your driving to and from your office at home and different business locations is deductible. The cost of going from your office at home to a related business location is deductible, even if your home-based or micro business is not your primary source of income. However, if you also hold a job, figuring your deductible business mileage is slightly more complicated, because commuting between your home and place of employment is considered a personal expense

and, therefore, not deductible (even though it is travel between two business locations if your office is in your home). The rules related to trips that combine commuting to your place of employment and errands for the home office are particularly tricky. For example, if you stop by the printer's to check on a brochure on your way to work, be sure to conduct some business in your home before you leave, or you will lose the deduction. Keep a daily record of your business activities at home to prove you were traveling between two business locations.

The size of your automobile (van, pickup) deduction is based upon your percentage of business use. Record the number of miles driven for business along with the date, your destination, and the business purpose of the trip in a diary or small notebook each time you drive for business. Your percentage of business use is your total mileage for the year divided into the total business miles you logged. Make a note of your odometer reading in your driving diary at the beginning and ending of the year.

Business mileage = % of business use / Total mileage

Two methods of computing the cost of transportation are the standard mileage rate and actual expenses.

Standard mileage rate. As of 2011, the IRS approved standard mileage rates is 55 cents per mile. You can combine the mileage rate for all cars (trucks, pickups, vans) driven for the same business. However, you cannot use the standard mileage rate if you operate two or more vehicles simultaneously (at the same time). If you use two or more vehicles alternately (not at the same time), the standard mileage rate is allowed. If you itemize, you can also take deductions for parking fees, state and local fuel taxes, and some of the interest paid on an auto loan. Depreciation is built into the rate, so you cannot claim an additional deduction for depreciation when you use the mileage rate method.

When the standard rate may be used. You may choose to use the standard mileage rate in the first year you place your car in service in your business. In later years you may use the standard mileage rate or actual expenses. If you do not choose the standard mileage rate in the first year and you used MACRS depreciation, you may not use the standard mileage rate for that car in any future year.

If you use the standard mileage rate in the first year, you are considered to have made an election not to use the modified accelerated cost recovery system (MACRS). You also may not claim the Section 179 deduction. If you change to the actual cost method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

To use the standard mileage rate you must:

1. Own or lease the car,
2. Not use the car for hire, such as for a taxi, and
3. Not operate two or more cars at the same time in your business.

Actual expenses. You may be better off computing the actual expense of operating your car for business use during the year. The deductible items include the cost of gas, oil, tires, insurance, depreciation, interest to buy the car, taxes, licenses, garage rent, car washes, parking fees, and tolls if those expenses can be attributed to your business. This means you must keep accurate records (and receipts) throughout the year. If you do not, you should use the mileage rate.

Travel Expenses. Transportation expenses (above) are the ordinary and necessary expense of getting from one business location to another in your local area. Deductible "travel" expenses are the costs of domestic and foreign travel away from home overnight and include these:

1. Air, rail, and bus fares
2. Meals and lodging en route and at your destination
3. Cost of operating your own or a rental car
4. Cost of transporting samples and display materials
5. Baggage charges
6. Tips
7. Laundry and dry cleaning
8. Telephone and telegraph expenses
9. Cost of local travel at your destination, such as taxis and airport buses
10. Cost of a public stenographer

Business purpose. Before you can deduct the costs of traveling away from home you must be able to show that your motive was strictly business. If your travel is primarily for personal reasons, even if you conduct business once you arrive, your transportation costs are not deductible, nor is the cost of meals and lodging for the time spent on nonbusiness activities (sightseeing, personal social entertainment). However, expenses directly attributable to conducting business are deductible. Keep an accurate diary of business vs. personal activities each day you are away from home. If you attend a convention, you must be able to show a connection between the convention and your trade or business, and your presence must benefit or advance your business's position.

"Away from home." Generally your tax home is your principal place of business or employment. Business demands, not personal considerations, must motivate your travel away from this home. If you regularly conduct business in more than one location, only one can be your principal place of business for tax purposes. Being "away" from your tax home is a function of time, not distance. If you are not away from your principal place of business overnight, your travel expenses are not deductible.

Meals and lodging. You may deduct 50 percent of your business-related meal and entertainment expenses (including tips and taxes) when you are traveling. There is nothing more frustrating than trying to locate all those scraps of paper known as restaurant receipts, especially when "meals" are fast-food hamburgers snatched between appointments. For those folks who have trouble keeping track, the IRS allows a deduction for meals of $45 a day. If you travel to what the IRS considers a high-cost area, you can use higher amounts

(see IRS Publication 463, Travel, Entertainment, and Gift Expenses for high-cost areas and IRS Publication 1542 for city-by-city per diem rates).

Wages of Family Members. If you're a sole proprietor rather than a partnership, don't overlook the possibility of paying your spouse or your children aged 18 or older for work they actually do for the business. These wages will reduce your self-employment income, since they are deductible as a business expense provided you meet the following four tests:

1. You must be able to show the wages you pay your relatives are part of the "ordinary and necessary" expenses of carrying on your trade or business.
2. The amount of compensation must be "reasonable;" generally it is the amount you would pay someone else to do the same work if you were not hiring your child. And the work must be genuine, not make-work jobs that do not benefit your business.
3. You must be able to prove that the work for which payment was made was actually performed by the employee. This involves keeping careful time records—tracking actual hours spent working and the jobs performed. Pay the salary by check, and make sure your child deposits the money in an account in his or her name.
4. If you use the cash method of accounting, the deduction for wages is allowable only in the year actually paid. If you use the accrual method, the deduction for wages is allowable in the year when the work was performed, even if payments were made at a later date.

It makes good sense to hire relatives for several financial reasons:

- At the time this publication went into print, your unmarried dependent child could earn up to $4,300 a year without owing income tax, and you could still claim a dependency deduction for him or her.
- Even if your child earns more than the standard allowable deduction for dependents, his or her wages are probably going to be taxed at a lower rate than yours.
- You reduce the amount subject to self-employment tax because his or her salary is deductible as a business expense.
- Wages paid to your children under the age of 18 years are exempt from Social Security tax but not from state and federal income tax withholding. Wages paid to your spouse are subject to both Social Security and state and federal income tax withholding.

If you have, or plan to have, employees, including your spouse and children, you must get an Employer Identification Number (EIN) from the Internal Revenue Service and your state, do withholding, and give the employee (including family members) a W-2 form at the end of the year. On your children's W-2 form, the wages should be shown in the box marked "non FICA wages." You should also write "family income" on the W-2 to alert the Social Security Administration that these wages are not subject to Social Security tax. The family member other than your spouse receiving the wages does not have to pay self-employment tax on them.

Record Keeping for Employees. Record keeping expands significantly when you hire employees. Federal and state employment taxes must be paid and reports submitted on a regular schedule. Failure to do so can lead to significant penalties.

There are three federal employment taxes:

1. Federal income tax that you withhold from employee's wages;
2. Social Security (FICA) and Medicare taxes, both the amount you pay and the amount you must withhold from employee's wages; and
3. Federal unemployment (FUTA) tax.

You can obtain your Employer Identification Number using Form SS-4 available from the Internal Revenue Center nearest you. Publication 15, Circular E, Employer's Tax Guide, is an excellent source of information on federal employee taxes and includes tables to help you figure out employee withholding. Another good source of information is IRS Publication 583, Starting a Business and Keeping Records, and IRS Publication 334, Tax Guide for Small Business. All of these forms and publications can be downloaded from the IRS website at http://www.irs.gov or ordered from the IRS TAX-FAX Service at 703-368-9694.

Federal Withholding. These are specific records you must keep for income tax withholding:

1. Each employee's name, address, and Social Security number;
2. The total amount and date of each paycheck and the period of time the payment covers;
3. For each paycheck, the amount subject to withholding;
4. The amount of withholding tax collected on each payment and the date it was collected.

An employee's earnings record form, available at most office supply stores, normally has spaces for all this information. A payroll register compiles all employee payroll records for a given pay period. The register provides you with the amount of money paid to all employees, the amounts deducted for taxes, and the amounts deducted for Social Security and Medicare all in one place. A new payroll register is made out each time your employees are paid.

As soon as you hire an employee, have him or her fill out a W-4 form. The IRS will supply you with as many as you want for free, or you can buy them in stationery stores. The employee fills out the form with his/her address, Social Security number, and number of withholding exemptions. The amount you withhold is based on the number of exemptions the employee claims. The federal income tax withholding schedule is used with the employee's W-4 form to calculate the correct amount of tax money to withhold from each paycheck. If the employee's W-4 form indicates s/he had no income tax liability last year and expects none this year, you don't withhold taxes.

By January 31 of each year, you have to give each employee three copies of his W-2 form (a summary of all taxes withheld the previous year). The W-2 form gives the employer's name, address, and EIN; the employee's name, address, and Social Security number, total wages, and the amount withheld. By February 28 a copy of each W-2 must be sent to the Social Security Administration along with Form W-3. A copy of all withholding statements and Form W-3 goes to the IRS by the same date.

Social Security and Medicare. See page 16.

Federal Unemployment. See page 16.

Earned Income Credit. The Earned Income Credit is a tax credit for certain people who work and have earned income under a certain amount. A tax credit usually means more money in the employee's pocket and may also give the employee a refund. For detailed information on this extremely useful program, see IRS Publication 596 – Earned Income Credit (EIC).

Source: IRS Publication 596 Earned Income Credit (EIC) - http://www.irs.gov/pub/irs-pdf/p596.pdf

DEDUCTIBLE HOME OFFICE EXPENSES

Deductions for the use of part of your home have been tightly controlled. Check with http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Home-Office-Deduction and Publication 587, Business Use of Your Home. Also contact your tax professional.

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Prepared by Zoel W. Daughtrey, Ph.D., C.P.A., Professor, Accountancy, Mississippi State University; and Barbara R. Rowe, Ph.D., Family Resource Management-Extension Specialist, Purdue University