Business Development Session 13 - Introduction to Tax Deductions

A simple, basic knowledge of tax and accounting is CRITICAL to your business' success. Businesses do not fail because of lack of customers or a poor idea - they fail because the owners didn't know what their costs or taxes were. In addition to seeking competent professionals, we urge you to take a community college class on business finance and record keeping.

Caution!

Tax laws are continually changing and vary for each type of business. The following is a basic introduction to some federal tax information for new business owners. We STRONGLY recommend that you meet with a tax advisor and/or request the IRS' Tax Guide for Small Business (Publication 334) for a more complete explanation of current IRS rules. Call 800-829-1040. Also, please remember that some tax laws differ from federal tax laws - so talk with the Franchise Tax Board or your tax advisor. If you do not have a tax advisor or accountant, e-mail JLS and we will give you the name and telephone number of our tax advisor and accountant so she can help you with your business.

Two Basic Rules

1. You can't deduct an expense unless it meets federal and state rules. Generally, the expenses must be reasonable and necessary for your type of business.
2. If you buy something that will be used for more than one year, it must be capitalized...i.e. deducted as a business expense over several years. Capitalized expenses include equipment, buildings, cars, etc. If you buy an existing business, you can capitalize the purchase price of the equipment, buildings, etc. However, you may not capitalize (or deduct) the amount you paid for goodwill. If you start your own business, capitalized expenses include your start-up costs plus equipment and property that you purchase. Note: The IRS and accountants call the spread-out deductions "depreciation" (on physical items like equipment) and "amortization" (on non-physical items, like patent rights).
3. Capitalized expenses usually cannot be fully deducted during your first year! Thus, you may think you broke even or lost money your first year (because of large capital expenses), but the IRS may say you can't deduct all these expenses this year and you actually OWE taxes!

Start-up Costs

Start up costs are expenses you made to investigate and set up your business. Basically, they are any normally deductible expenses incurred prior to when you "began business operations". These expenses cannot be fully deducted during your first year, but can be amortized over five years. Because of this, most businesses wait until they have "begun business operations" (i.e. opened their doors for business), before purchasing supplies so that these expenses can be deducted during their first year. Since the date you "began business operations" can be vague, we suggest that you talk with your tax advisor or the IRS about which initial expenses are "start-up costs".

Bottom Line

For tax purposes, it is often better to delay major purchases until after you have begun business operations.

Limited partnerships

Watch out for the effect of your "beginning business operations" date on your minimum annual state tax. If your "beginning business date" is vague and you had small start-up costs at the end of a tax year, it may be worth delaying the "beginning date" to the following year in order to avoid the $800 minimum annual tax. Please talk with your tax advisor.

Are these expenses deductible?

Meals and Entertainment

50% of "reasonable" business entertainment and meals with your customers are deductible. If you reimburse employees on a per diem basis, contact the IRS and request publication 1542 "Per Diem Rates" to determine the allowable per diem rates.

Cars and Mileage

You must keep a mileage log of personal versus business use. You can either keep track of all your car expenses, or use a standard mileage rate. At time of publication, the 1998 mileage rate had not been released. However, the 1997 mileage rate was 31.5 cents a mile, regardless of the number of miles driven. In addition to the standard mileage rate, you can deduct business parking fees, toll charges, and a portion of interest charges on your car. We suggest that you request Publication 917, Business Use of a Car, for further details. Call the IRS at 800-829-1040.

Social Security Self-Employment Tax (Schedule SE)

Business owners may deduct half of their self-employment taxes as a normal business expense.

Health Insurance Deduction for Self-Employed

45% of health insurance premiums for self-employed individuals are deductible as a business expense for federal tax purposes. The California deduction is limited to 25% of your health insurance premiums. This tax deduction is not available if health insurance is available through a spouse or another job or if the health plan is subsidized.

Club Membership

Club membership is not deductible for federal tax purposes, but it is deductible for state taxes.

Existing Furniture and Computers now used for New Business

If your business uses furniture or computers that you previously owned, you may deduct the value of these items at the time they were converted to business use. Computers must be depreciated (deducted) over a 3 year period; furniture over a 5 year period. You can either determine the fair market value at the time you began using the item for business, or use the depreciated value. Here is an example of calculating the depreciated value:

A $3500 computer was purchased 7 months prior to putting it into business use. The normal write-off for equipment is 3 years = 36 months. In this case, it is $97.22 per month. Subtract 97.22 x 7 months (680.54) from the original $3500 purchase price. The remaining, $2,819, can be deducted as a business expense over 3 years.

Home Office Expenses - IRS form 8829

You can deduct home office expenses if you use a part of your home exclusively and regularly for business either:

- as a principal place of business;
- as a place to meet with your customers in the normal course of business; or
- If you are using a separate structure (not attached to your house) for your business.

You can deduct a percentage of your home expenses and depreciate a portion of your house.

WARNING: Sales people generally cannot claim a home office deduction - because a majority of their working time is outside the home office.

Also, if you are in a partnership, you may need a written partnership agreement that your home is to be used as a primary business location. Partners must also report home occupation expenses differently (directly on Schedule E rather than using IRS 8829). Contact the IRS at 800-829-1040 for complete information.

If you use part of your home for the storage of inventory or as a day-care facility, you may not have to meet the exclusive use test. For information on the exceptions and all aspects of deducting home office expenses, call the IRS and ask for Publication 587, Business Use of Your Home.

Warning!

The down-side of deducting home office expenses is that if you sell your house, you will have to pay capital gains tax on the portion of your house used for your business...ouch! Also, if your home office expenses exceeded your business net income, you cannot deduct them as a loss for income tax purposes that year. Instead you must carry forward the home office expenses to future years.

To help you decide whether to deduct home office expenses, you should first evaluate how long you plan to live in the home and whether you are willing to pay capital gains on a portion of the home if you move. If you are audited, the IRS auditor will generally examine the last three years of returns to determine if home office expenses were deducted.

Before making the final decision, calculate the actual tax savings you will gain. Ask for IRS form 8829 to help you. You must complete this form each year that you deduct home office expenses and submit it with Schedule C.

Here is a quick overview of form 8829: First, determine the percentage of your home used for your business (all areas used exclusively for your business plus inventory storage area - even if it isn't used exclusively for business). Then, deduct:

- all direct expenses (which were incurred for your business only);
- a percentage of your indirect expenses (your normal household expenses which indirectly benefit the business);
- the business percentage of your home mortgage (except equity loans which were not used for home improvement);
- Depreciation on a portion of your house (.1% to 3.175% times the percentage of your home used for business).

Add up all these deductions and multiply by your tax rate (usually 15%, 28% or 31%). That is the total write-off you can get from your home office.

Special Deductions

Three more deductions...two for everyone; the other for manufacturers

Letter requesting to Amortize Start-Up Costs

Request us to fax you a form letter to enclose with your first year's tax return, requesting that your start-up costs be amortized (spread out) over five years. Without this letter, IRS rules say you can't write off these costs until you SELL your business!

$18,500 Annual Deduction for Certain Equipment Expenses)

(Called Section 179 Equipment Expense Elections). Since equipment is a capital expense, normally it must be deducted over several years. However, the IRS allows small businesses to deduct the full cost of a computer, rather than spreading the cost over several years. To get this deduction, check with the IRS or your tax advisor to make sure your equipment qualifies. Then when you complete your annual tax return, check the Section 179 box on IRS form 4562 (Depreciation). Note: On your California tax return, you can only deduct $16,000 (beginning 1999, California will match federal Section 179 amounts). Any amounts above that must be depreciated over several years.

Manufacturer's Credit

If you are a manufacturer and your SIC code is 2000 to 3999, you may be eligible for a State tax credit of up to 6% on equipment that you purchase. This credit can be taken on your quarterly Board of Equalization Return (BT-401).

More Information

Call the IRS at 800-829-1040 and request publications: 583 Taxpayers Starting a Business (shows the records you should keep); 535 Business Expenses; 917 Car Deductions; 587 Business Use of Your Home; 334 Tax Guide for Small Business.

CERTIFIED BUSINESS DEVELOPMENT COURSE - SESSION 13 **– QUESTION & ANSWERS**

NAME: ____

ADDRESS: ____

PHONE: ____

FAX: ____

E-MAIL: ____

Please be sure to fill out the information above, complete the test and e-mail or fax it back to us at iridology@netzero.net or 530-878-1119. We will grade your question & answer session and will let you know if we have any questions or concerns.

1. Make a list of your tax deductions that you believe you will have the first year of business.