



**Internal Revenue Service**

**Small Business and Self-Employed**

**Taxpayer Education and Communication**

# **Welcome to the Small Business Tax Workshop**

## **Lesson 1**



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## Agenda

- Introduction
- Employer Identification Number (EIN)
- Recordkeeping
- Income Statement and Balance Sheet -  
Accounting Methods



# Agenda (cont'd)

- Types of Business Organizations
- Business Returns
- Net Profit or Loss
- Business Deductions and Credits



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# Employer Identification Number





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# Employer Identification Number

- May be required to identify your business for filing with the IRS
- Apply for one by
  - ◆ logging on at [www.irs.gov](http://www.irs.gov)
  - ◆ phoning the IRS toll free number or
  - ◆ completing Form SS-4 -- Application for Employer Identification Number



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# Recordkeeping



**You must be able to substantiate income, deductions, and credits.**



# Recordkeeping

Good records can help you:

- Identify the source of receipts,
- Prevent omission of deductible expenses,
- Establish earnings for self-employment tax, and
- Explain items on the income tax return.



# Special Rules For Recordkeeping

- For travel, transportation, entertainment, business gifts, and certain other business property, you must be able to substantiate:
  - the amount you are claiming,
  - the time and the place of the expenditure,
  - the business purpose, and
  - your business relationship to others involved.





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# How Long to Keep Records?

Keep your records as long as their contents may be material in the administration of any Internal Revenue Service law.



# How Long is That?

- Tax Returns & Supporting Records

The later of...

- 3 years after the return is due
- 3 years after the return is filed
- 2 years after the tax is paid

- Employment Tax Records

The later of....

- 4 years after the return is due
- 4 years after the return is filed
- 4 years after the tax is paid



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# Records to Keep Indefinitely

- Change in method of accounting
- Establish the basis of property



# Bookkeeping/Accounting Methods

- Open a separate business bank account to maintain accounting efficiency
- Use the single or double entry system of bookkeeping
- On your return, use the same accounting method you use to keep your records (cash or accrual)



# Bookkeeping Systems

## Single Entry

- Summaries of income and expense
- Simple
- Not a complete accounting system

## Double Entry

- Built-in checks and balances
- Self-balancing
- More accurate



# Accounting Methods

## Cash

- Report all income the year you receive it
- Usually deduct expenses in the year paid

## Accrual

- Report income the year you earn it
- Deduct expenses the year you incur them



# Cash Method for Small Businesses

- Gross receipts of \$10 million or less?
- Not manufacturing, wholesale, retail, mining, certain publishing, or certain sound recording (unless principally service business or doing certain kinds of custom manufacturing)?
- If yes -- may be able to use cash method – Refer to
  - IR-2001-114
  - Notice 2001-76
  - Rev. Proc. 99-49
  - I.R.B. 1999-52



# Computerized Recordkeeping

- Many commercial software packages are available in retail stores that can help you with your business recordkeeping
- If you use a computerized system, you must be able to:
  - produce legible records from the system, and
  - provide the information needed to determine your correct tax liability.





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# Income Statement & Balance Sheet





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## Definitions

- Income Statement
  - Income
  - Expenses
- Cash Flow Analysis
  - Shows how money comes in and leaves your company
- Balance Sheet
  - Assets
  - Liabilities
  - Net Worth (Capital)



# Types of Business Organizations



**and Returns**



# Types of Business Organizations

- Sole Proprietorship
- Partnership
- Limited Liability Partnership (LLP)
- Limited Liability Company (LLC)
- Corporations/S Corporations



# Sole Proprietorship

- Easy to start
- Unlimited liability -- no distinction between the individual and the business
- Cannot be an employee of your own business
- Business income/losses reported on owner's Form 1040, Schedule C; self-employment tax on Schedule SE



# Partnerships

- Written partnership agreement
- One partner can legally bind the partnership (and the other partner)
- Business income and losses reported on Form 1065; partner's share on Schedule K-1; profits taxed on the partners' returns
- Must have an Employer Identification Number (EIN)



# LLCs and LLPs

- Separate legal entity formed by filing articles of organization with your State
- Not a federal tax entity-- generally treated as a sole-proprietor or partnership by IRS
- Limited liability for members
- Little legal precedent



# Corporation

- Separate legal entity that pays its own tax
- Files Form 1120 or Form 1120-A
- Limited liability
- Double taxation on dividends
- Can easily be changed to S-Corporation
- Subject to many state and federal controls





# S Corporation

- Corporation pays no tax on income -- taxed on the shareholders' returns
- Files Form 2553 and Form 1120S
- Active officers should receive wages and a Form W-2
- Limited personal liability with no double taxation



# Business Returns

- Sole Proprietor -- Form 1040 Schedule C or C-EZ, Schedule SE, and Form 1040-ES
- Partnership - Form 1065
- S Corporation - Form 1120S
- Corporation - Form 1120 or 1120-A



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# Net Profit or Loss





# Net Profit or Loss - Definitions

- **Gross Receipts or Sales is income**
  - that a business receives from the sale of its products and services
- **Net Receipts/Sales =**  
**Gross Receipts/Sales - Returns and Allowances**



# **Net Profit or Loss - Definitions** (cont'd)

- **Cost of Goods Sold** is the cost to a business to buy and make the product to be sold.
- **Cost of Goods Sold =**  
Beginning Inventory + Purchases, Labor, Materials, and Other Costs - Ending Inventory
- **Gross Profit =**  
Net Receipts/Sales - Cost of Goods Sold



# Net Profit or Loss - Definitions (cont'd)

- **Gross Income =**  
Gross Profit + Other Income
- **Business Expenses are the**
  - ordinary and necessary expenses
  - incurred in the operation of the business



# **Net Profit or Loss – Definitions** (cont'd)

- **Net Profit or Loss** is the amount:
  - by which gross income for a period is more (or less) than business expenses,
  - of depreciation, and
  - for the same period.
- **Net Profit or (Loss) =**  
**Gross Income - Expenses**



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# Business Deductions & Credits







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# **Business Deductions & Credits**

- Deductions are subtracted from income
- Credits are subtracted from tax



# Travel and Transportation

- **Travel Expenses**  
incurred in traveling away from home for business
- **Transportation Expenses**  
incurred in the course of your business while you are not away from home while getting from one workplace to another; not commuting



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# Entertainment and Gift Expenses

- Must be ordinary and necessary
- Must be able to prove them
- See Pub. 463, *Travel, Entertainment, Gift, and Car Expenses* for details



# Car Expenses

- **Standard Mileage Rate**

Use the standard mileage rate for the current year

You can change from ....

- the standard mileage rate to actual costs

- **Actual Costs**

Use actual costs – prorate business/personal

You cannot change from....

- actual costs to the standard mileage rate



# Depreciation

- Depreciation allows you to deduct the cost or other basis of some property over a number of years
- Depreciable property does not include:
  - Land,
  - Inventory, and
  - Property placed in service and disposed of in the same year.



# Depreciation Requirements

The property must:

- Be used in business or held for the production of income,
- Have a determinable useful life longer than one year, and
- Be something that wears out, decays, gets used up, becomes obsolete, etc.



# MACRS

MACRS -

Modified Accelerated Cost Recovery System

- Most tangible property placed in service after 1986 is depreciated under MACRS
- See Publication 946



# Section 179

- Deduct the cost of certain depreciable property in the year you purchase it, and place it in service
- Deduct the total cost (up to the annual limit) in the first year
- Compute the deduction on Form 4562
- See Publication 946





# Other Kinds of Expenses

- Retirement plan costs
- Percentage of the amount paid for medical insurance for yourself or your family
- Start-up costs incurred before you start your business operations

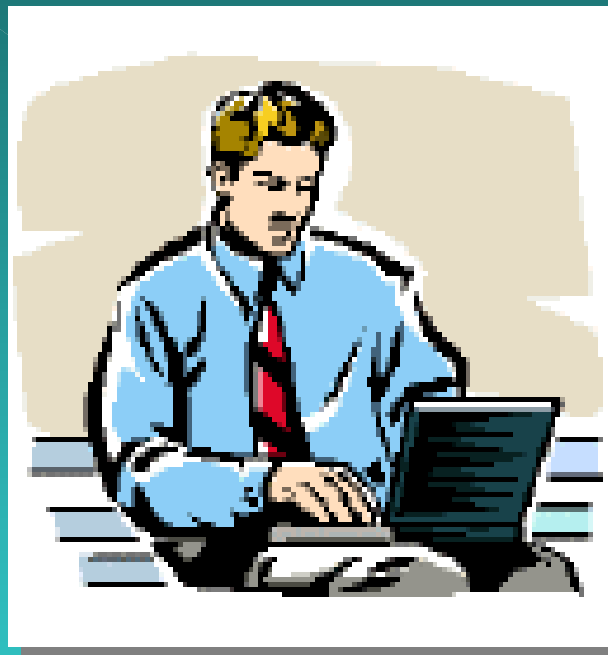


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# **Self-Employment Tax**



## **and Estimated Taxes**



# Schedule SE - Self-Employment Tax

- Use the rate for the current year
- Provides Social Security coverage
- Subject to SE, if net profit is \$400 or more
- Use the maximum earnings cut-off for the current year



# Schedule SE -- Multiple Businesses

If you have more than one business...

- Use one Schedule SE
- Combine the profits and losses from all of your businesses



# Self-Employment/Social Security Tax

- Self-Employment Tax
- Self-employed people (sole proprietors)
- Partners in a partnership
- Social Security Tax
  - Withheld from employees' wages
  - Matched by employer
- Social Security maximum applies to the person



# Estimated Tax

- Estimate how much your tax liability will be for the current year
- Use Form 1040-ES (Estimated Tax for Individuals) worksheet to see if you will need to make estimated deposits
- You do not need to pay Estimated Tax if you reasonably expect your tax due to be less than \$1,000 (after withholding and other credits)



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# Need More Information?

- Publication 3207, *Small Business Resource Guide CD*
- Publication 463, *Travel, Entertainment, Gift, and Car Expenses*
- Publication 534, *Self Employment Tax*
- Website: [www.irs.gov](http://www.irs.gov)
- Call 1-800-829-4933 for the Business and Specialty Tax Line