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Increase Your Bottom-line and Keep More Money in Your Pocket – A Practical Guide to the Self-Employed

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ABSTRACT

This paper outlines some common and not so common deductions which will help you increase your profit margins. It highlights and explains fourteen (14) deductions with certain pitfalls for some.

INTRODUCTION

Smart and successful business owners get the most bang for their hard-earned bucks by keeping an eye on their bottom line. Am I claiming all valid expenses? Are there legitimate loopholes for me? You may have an accountant handling your tax matters but knowing what can be claimed as a legitimate write off and the consequence of claiming such deductions may help you understand more about your business operations and plan accordingly. It is also important for you to be aware of pitfalls of certain deductions so that they do not come back to haunt you in case of an audit.

DISCLAIMER

Opinions from this presentation are those of the author. Tips presented are not "one size fits all". Individuals are advised to consult with their own tax advisor for their unique and specific tax situation.

DEDUCTIONS OF BUSINESS EXPENSE

This is not a comprehensive list which has only those that the author wants to pinpoint their significance and pitfalls. A business expense must be ordinary and necessary. An ordinary expense is one that is common in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business.

START-UP COST

You incur your startup expenses prior to the time that your business is born. Typical costs include fees to hire someone to set up a corporation/LLC, marketing to determine the feasibility of starting a business investigating whether to open a business, ordering supplies needed and obtain necessary training. You cannot deduct these expenses all at one time. These startup costs have to be amortized over 180 months. If your startup efforts end in the creation of an active business, the amount of expenses that you can deduct will be the lesser of your actual expenses with respect to the new business Or $5000. The remainder of your startup expenditures is deducted ratably over the 180-month period beginning with the month in which your business opens. Examples of Startup costs: state incorporation fees, legal service costs, analysis or survey of potential markets and products, travel and other necessary costs for securing prospective customers, professional service fees for consultants. Costs that do not qualify include research and experimental costs.

Pointer –If you decide not to go into business, the costs are considered personal costs and are not deductible. However, the total costs you paid in your attempt to start would be considered a capital expense and you can claim it as a capital loss.

AUTO EXPENSE

Driving your vehicle for business can be a significant expense. When you operate your business at home, the mileage from your home office to your client's place is deductible business mileage. There are two ways to deduct mileage expense – the Actual Expense and Mileage. Regardless of which way, an accurate mileage record is to be kept showing dates, where to, location, business purpose, and number of miles. Record keeping also includes the total mileage driven on the vehicle each year.

Actual Auto Expense – Depreciation of vehicle, upkeep and maintenance, lease payment, renewal of tag, car loan interests, gasoline, and car repair. All these expenses are to be prorated by the % of the business miles over the total miles driven of the year.

Standard Mileage Rate – You must use the standard mileage rate the First Year you use your car for business. Take the number of business mile times the yearly federal mileage rate. For 2016, it is $0.54 per mile. Claiming Mileage is less labor intensive, more simplified, and with much less receipts. You can re-build your Mileage Log in case of an audit.

Pointer – If you use the mileage rate the first year, *you can switch from the Mileage to Actual method but you cannot change back to Mileage once you are on Actual. For this reason, if you are not sure of which method to use, use the standard mileage rate the first year you use the car for business.*

HOME OFFICE

Home office space has to be exclusive to only one business. Based on the square footage of the home office over the total area of the property, you can deduct a portion of your rent, maintenance, insurance, property taxes, utilities and depreciation. In lieu of keeping all these home office records, you can take the Safe Harbor Method with $5 per sq. ft. of your home office up to 300 sq. ft. for a maximum of $1500. No record keeping and calculation is necessary.

A S Corp employer can reimburse the shareholder employee for direct expenses associated with bossiness use of the home such as supplies and allocated expenses such as utilities and maintenance costs under an accountable plan. Reimbursements are deductible by the employer but tax free to the employee. One catch: the deduction is limited to the net income that the business generates. So, if you have a loss for the year, you will not be able to claim the deduction.

Pointer: By taking the Safe Harbor Method of Home Office and not taking depreciation means that you do not have to worry about depreciation recapture when selling your primary residence.

COMMISSIONS & FEES

A 1099 MISC is to be issued to individuals to whom you have paid $600 or more annually. This rule covers payments to LLC also. For payments of 600+ to foreign persons (non resident aliens - NRA) without a SSN/ITIN, you should issue a 1042S and make backup withholding – withhold 30% taxes from the NRA unless there is a tax treaty.

Pointer: You should have signed W9 from each subcontractor that you hired. For NRA, a W8 BEN.

BIG TICKET ITEM PURCHASE – SECTION 179 DEDUCTION

Section 179 of the IRS tax code allows businesses to deduct the full purchase price of qualifying equipment bought (or financed) during the tax year. These are items with useful life of over one year such as laptops, printer, scanner, and office furniture (not low cost items). Both new and used equipment qualify for the 179 Deduction (as long as the used equipment is "new" to you). The deduction limit is $25,000 with the total amount of equipment purchased up to $500,000 for 2015 and 2016. Section 179 is permanent at the $500,000 level.

To qualify for Section 179 deduction, the asset must be tangible, purchased for business use (new or used), used more than 50% in your business, and acquired from a non-related party.

Pointer: You may have to recapture the section 179 deduction if, in any year during the property's recovery period, the percentage of business use drops to 50% or less. Include the recapture amount as ordinary income on Form 4797 (Part IV) and include the basis of the property by the recapture amount.

BIG TICKET ITEM PURCHASE – BONUS DEPRECIATION

Similar to those properties qualified for Section 179 except that these properties must be New and for original use with recovery of 20 years or less. 50% Bonus Depreciation will be extended through 2019. Businesses of all sizes will be able to depreciate 50 percent of the cost of equipment acquired and put in service during 2015, 2016 and 2017. Then bonus depreciation will phase down to 40 percent in 2018 and 30 percent in 2019.

Can elect to opt out of Section 179 and Bonus depreciation. Beware of selling depreciated properties. When you sell a depreciated asset, any profit relative to the item's depreciated price is a capital gain.

Pointer: Have to take Section 179 first and then Bonus Depreciation

HEALTH INSURANCE – SCH C FILER VS. S CORP OWNER

If you are either self-employed or own more than 2% of the stock of an S corporation and the S corporation established the plan, you can deduct 100% of the premiums paid for medical and dental insurance, and qualified long-term care insurance for yourself, your spouse, and your dependents. For those who are self-employed and receive Medicare, your Medicare premiums are also deductible as the self-employed health insurance deduction.

Pointer: If you (as a 2% or more owner) are on payroll of your S Corp and the company paid your health insurance, the amount must be added to your W2 as Wages which is NOT subject to FICA taxes and then you can take this insurance amount as an adjustment on your personal return.

PHONE EXPENSE

If use your cellphone for business, you can claim the business use of your phone as a tax deduction. If 30 percent of your time on the phone is spent on business, you could legitimately deduct 30 percent of your phone bill. Alternatively, can get a second phone number for exclusive business use.

For a landline at home, you cannot deduct the cost in its entirety but can deduct those costs added just for your business such as voice message recorder and fax.

Pointer: Keep cell phone usage details for calculating business usage and for audit

INTERNET EXPENSE

If you do not have a separate internet for your business, you deduct the actual amount of time you use the Internet for business purposes and you document the time used. This can easily be tracked by documenting the actual amount of time you use the internet for business purposes. Keep your monthly internet bills, so when tax time comes you know exactly how much you paid to your internet provider over the course of the year. This makes it easier to prorate costs for the business versus the time you used for personal use.

Pointer: Web-related expenses may also qualify for write-offs such as web hosting, domain registration, webmaster consulting and other web services in connection with your business. Do not forget internet access expense while traveling so that you can work,

TRAVEL EXPENSE **

Travel expense is claimed when you are "away from home overnight" and/or for a "temporary assignment"' and an overnight stay is required. An employer can use the federal (GSA) per diem rate for meals and lodging to reimburse the employee in lieu of requiring the employee to substantiate the actual out-of-pocket expenses. However, if you own 10% or more of your company (S or C Corp), the deduction for lodging is limited to the actual out-of-pocket expense, i.e., no per diem rate is allowed.

** This deduction requires additional substantial documentation (not just receipts) which includes business purpose.

Pointer: If you pay an employee, owner or not, a flat per diem amount and no overnight stay is involved, that amount is taxable wages subject to all payroll taxes and included as wages on W2.

MEALS & ENTERTAINMENT (M&E) – 50% VERSUS 100% **

There are three categories of M&E. In order to deduct business M&E expenses, they must be directly related to, or associated with the active conduct of a trade or business or for the production or collection of income.

50% Deductions – usually only 50% of otherwise deductible M&E expense is deductible. Examples: Lunch/dinner with customer, client or employee associated with a business discussion, taxes and tips, ticket price for sporting event associated with a business discussion, and room rental for a dinner or party.

100% Deductions – Meals provided as part of a business event, promotional activities that are made available to the general public, employer-provided social expenses primarily for the benefits of employees (sky as a summer picnic or a holiday party)

Non-deductible M&E – Lunch/dinner with clients without a business purpose, ticket price for sporting event that you do not attend, club dues, lavish or extravagant entertainment expenses.

If you use the standard meal allowance, you MUST use it for ALL of your business trips you take during the year. You cannot use it for some trips and then se the actual expense method for others.

This is another expense category that requires substantiate documentation (other than just the receipt) showing business purpose, date, location and names of people attended the M&E.

Pointer: Meals reimbursed under an accountable plan is not income to an independent contractor.

BUSINESS GIFT

The tax rules limit the business gift deduction to only $25 per person per year. There are a few exceptions to this very restrictive limit.

Gifts to a Married Couple – If you have a business connection with both spouses and the gift is for both of them, the $25 limit doubles to $50.

Gifts to a Business Entity versus an Individual – Gifts given to a company for use in the business are not subject to the $25 limit. For example, a gift of $150 of an online newsletter subscription is fully deductible because it is used in the company's business.

Pointer: *Turn a "gift" to be a promotional item by engraving your business's name (in small print) on a silver platter*.

SEP & 401K RETIREMENT PLANS

These are the two most common retirement plans for sole proprietors and LLC/S Corp owners due to the high contribution limits and flexible annal contribution's. Solo 401K plans have greater administrative responsibilities than a SEP. but may allow a larger annual contribution at the same income levels due to the way the annal contribution is calculated. Another issue to consider is that IRS rules permit a solo 401K loan of up to half of the plan's value up to a $50K maximum.

SEP IRA

Contribution is 20% of Net self-employment income

a. 2015/2016 contribution limit is $53,000
b. Easy to set up and low administrative responsibilities
c. Smaller contribution (therefore less tax deduction) as compared to a solo 401K
d. For those age 50+ there is no additional $6000 catch up contribution

Solo 401K

a. 2015/2016 contribution limit is $53,000 and additional $6,000 if age 50+
b. Loans are permitted up to 50% of the total value with $50,000 maximum
c. More paperwork and administrative fees

Contribution example:

Solo 401K – 100% of the first $18,000 ($24,000 if age 50+) of W2 compensation PLUS 25% of W2 wages by Employer/Business

SEP IRA – 20% of the Net self-employment income (gross income minus expenses + half of the SE taxes)

Pointer: Can set up a SEP IRA first and convert to an individual 401K later with minor administrative paper work.

MISCELLANEOUS

The $75 Receipt

For travel, meals & entertainment, gifts, or transportation expenses, your documentary evidence is not needed if either these conditions apply –

a. Your expense – other than lodging – is less than $75
b. You have a transportation expense (such as taxi) for which a receipt is not readily available

Commented [MH1]:

The $25 Receipt

Can claim expenses less than $25 without a receipt. Suggest to document the reason why there is no receipt.

Interest Expense

Set up one credit card/debit card to pay for your business expense. Finance charge can then be deducted.

Business Bad Debt

Goods and services customers have not paid for are shown in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. You can take a bad debt deduction for these accounts and notes receivable only if the amount you were owed was included in your gross income either for the year the deduction is claimed or for a prior year.

CONCLUSION

There are many straightforward and not so straightforward tax deductions for your business. Some require minimum documentation while some require extra substantiation. As a small business owner, it is important for you to know and understand these write-offs for business planning as well as the basic rules and consequence of claiming these deductions. By claiming the appropriate tax write-offs, you are keeping more of your hard-earned money while enjoying the fruit of your success.

REFERENCES & WEB LINKS

- IRS.gov – Starting point for verifying business deductions → Business Deductions. Get the appropriate IRS Publications such as IRS Pub 535 and specific form instructions for further details
- H&R Block User Community – community.hrblock.com – Browse a library of tax topics
- Bankrate - http://www.bankrate.com/taxes.aspx?ic_id=home_smart-spending_taxes_globalnav – more on personal taxes
- Kiplinger – http://www.kiplinger.com/fronts/channels/taxes/index.html - For general reading
- TurboTax User Community – Ttlc.intuit.com - Post your Question and get an answer

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