



Tax planning and financial strategy. Simplified.®

A photograph of a man and a woman, likely business owners or employees, smiling warmly. They are both wearing dark aprons over their shirts. The woman is on the left, wearing a blue denim shirt, and the man is on the right, wearing a grey button-down shirt. The background is dark and out of focus. The image is framed by white diagonal lines that create a geometric, modern aesthetic.

Small Business Guide to Reducing Your Tax Burden Legally

Guidance and insight with techniques
for reducing small business taxes.



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Small Business Guide to Legally Reducing Your Tax Burden

If you're like most small-business owners, you launched your business with a great idea for a product or service and a passion for delivering it to consumers or other businesses. You were probably unaware at the time of the heavy burden of managing your business, especially the complex financials, and especially those related to taxes. Like other business owners, you most likely started out not even knowing what you didn't know, and that is perfectly understandable.



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Surely you can't be expected to know what you haven't been taught, right? Unfortunately, the government (federal, state, and local) and their corresponding taxing authorities do expect you to know and follow the tax code. You have probably heard the edict, "Ignorance of the law is no excuse." It's true. In fact, what you don't know about the tax code can cost you dearly in both penalties (for non-compliance) and overpayments (for not taking full advantage of your eligible tax breaks).

Many small-business owners are so afraid of the Internal Revenue Service (IRS) or so terrified of making a mistake that they end up paying more than their fair share in taxes – sometimes a lot more. And that makes those of us at SWC (Stees, Walker & Company, LLP) want to scream. Why? Because we know that while making money is hard, keeping it is fairly easy, as long as you know what you're doing and choose to work with a tax and financial planning firm like ours. And, for the most part, all that involves is knowing the tax code and keeping good records, both of which are our areas of expertise.

One way we can help without it costing you any more than your time is to provide free guidance and insight. As part of that focus, we're pleased to present this 12-chapter series to reduce your tax burden legally.

Here's what we'll cover in each chapter:

CHAPTER 1: Tax Planning

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The bad news is that the tax code is so complicated Albert Einstein wouldn't be able to unpack it. The good news is that you don't have to be Einstein to reduce your taxes. You just need to know how to plan ahead – with the tax code in mind – in order to minimize your reported income and maximize the tax savings of deductions and credits. In Chapter 1, we show you how.

CHAPTER 2: Prepping for Audits

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"Audit-proofing" your business return means documenting deductions so that you can provide them in the event you're audited. Today's historically low audit rates make it pay to be aggressive, but you should file your return as though you expect to be audited. That way, if it happens, you can support your deductions and walk away a winner. In this chapter, we explain how to reduce your chances of being audited and prepare ahead just in case the auditors call.

CHAPTER 3: Selecting a Business Entity

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A business entity is a legal/financial structure within which a business operates. Your choice of business entity boils down to answering two fundamental questions: 1) Do you want to remain personally liable for your business debts? and 2) How do you want your business profits taxed? How you answer these two questions can have a significant impact on your personal exposure to risk and on how much you pay in taxes. In Chapter 3, we lead you through the process of answering these questions.

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CHAPTER 4: Deducting a Percentage of Your Qualified Business Income

The 2017 Tax Cuts and Jobs Act (TCJA) lowered the top tax rate on C corporation income from 35 percent to 21 percent. This is considerably lower than the top 37 percent on pass-through income from proprietorships, partnerships, and S corporations. To help balance the scales, the TCJA allows you to deduct up to 20 percent of your qualified business income (QBI) from your taxable income for the year calculated on an activity-by-activity basis. If that last sentence leaves your head spinning, you will want to read Chapter 4 of the series.

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CHAPTER 5: Leveraging the Tax Savings Power of Retirement Accounts

Retirement accounts, such as individual retirement accounts (IRAs) and 401Ks, are good for more than just socking away money for your golden years. They also serve as powerful tax-cutting tools. Understanding the plethora of options can make or break your post-business-life life, and in this chapter, we explain your options and how to use them alone and together to maximize your tax savings.

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CHAPTER 6: Putting Your Family to Work Reducing Your Taxes

“Allowance” and other financial aid you extend to your children, grandchildren, or even parents is a deductible business expense if you pay them reasonable compensation to perform bona fide work for your business. Of course, in that context, it isn’t allowance. It’s wages. And now that they’re earning their keep, they can stop treating you like “The First National Bank of Mom and Dad,” which effectively puts some of that money back in your pocket. Turn to Chapter 6 to see how this works.

07

CHAPTER 7: Improving Your Medical Benefits While Cutting Your Taxes

Taxes used to be a small-business owner’s biggest concern. Now it’s rising health insurance and medical costs. But you can kill two birds with one stone by using tax benefits to cut taxes and using the money you save on taxes to offset the cost of health insurance. Sound too good to be true? Well, it doesn’t entirely eliminate the expense, but you can implement techniques that take some of the sting out of rising costs. In Chapter 7, we explain how.

08

CHAPTER 8: Maximizing Your Home Office Deduction

Home offices may be the most misunderstood deduction available. Many entrepreneurs and business owners fear that by claiming the deduction, they increase their chance of being audited. Turns out, home offices can save thousands in taxes, and it’s easier than ever to qualify. In Chapter 8, you find out how to qualify for and max out this deduction.

continued

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CHAPTER 9: Deducting Qualifying Car and Truck Expenses

Car and truck expenses for trips on behalf of your trade or business are a deductible business expense. The only challenge is, you need to keep and maintain impeccable records. Calculating your deduction is simple arithmetic. In this chapter, we reveal the two options for calculating this business expense and show you how to do the math.

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CHAPTER 10: Deducting the Costs of Qualifying Meals and Entertainment

Meals you host in the course of doing business are deductible if they're directly related to the active conduct of your business or they take place directly before or after substantial, bona fide discussion directly related to the active conduct of your business. How about dinner out with family members, all of whom are on your payroll? Well, maybe we should stop short of that. However, in Chapter 10, we show you how to take full advantage of this deduction without overstepping.

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CHAPTER 11: Calculating Tax Withholding and Estimated Taxes

Withholding and estimated tax payments are the dirty little secrets to making today's pay-as-you-go tax system work. Departments of revenue at all levels of government expect individuals and businesses to pay taxes on the money they earn as they earn it. If you don't pay enough early enough, you get slapped with a penalty. Pay too much too soon, and you're essentially giving the government a free loan. In this chapter – the second to last in this guide – we lead you through the process of estimating your tax liability more precisely to avoid both of those undesirable scenarios.

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CHAPTER 12: Protecting Your Business Against Theft, Embezzlement, and Fraud

Here, in the 12th and final chapter of the Guide, you'll learn about the people who are trying to rip you off, the clever scams they try, and techniques you can put in place to keep yourself from becoming easy prey, and how all of this relates to legally reducing your tax liabilities.

Here at SWC, we are eager to share this Small Business Guide to Legally Reducing Your Tax Burden and start you on the rewarding path of keeping more of the money you earn and beating the tax authorities at their own game.

Tax Planning

Let's talk about tax planning. As the old saying goes, "Failing to plan is planning to fail," and this is especially true when you are trying to reduce your tax burden legally.

Consider for a moment the first time you drove a car? If you were doing it right, you spent far more time looking where you were going than where you came from. You don't drive forward staring in the rearview mirror. Unfortunately, that's how most tax "specialists" are geared. They spend so much time looking back at last year's finances that they rarely advise their clients to look forward.



They can tell you all about what you earned and spent last year and how much you owe in taxes as a result, but they rarely think to tell you what you should do *today* to save on taxes *next* year. Even the few who do tell their clients *what* to do rarely tell them when or *how* to do it.

Taking a proactive, forward-looking approach with tax planning can simplify next year's taxes and save you a considerable amount of money, especially if you're a small-business owner. Tax planning provides small-business owners with two valuable benefits:

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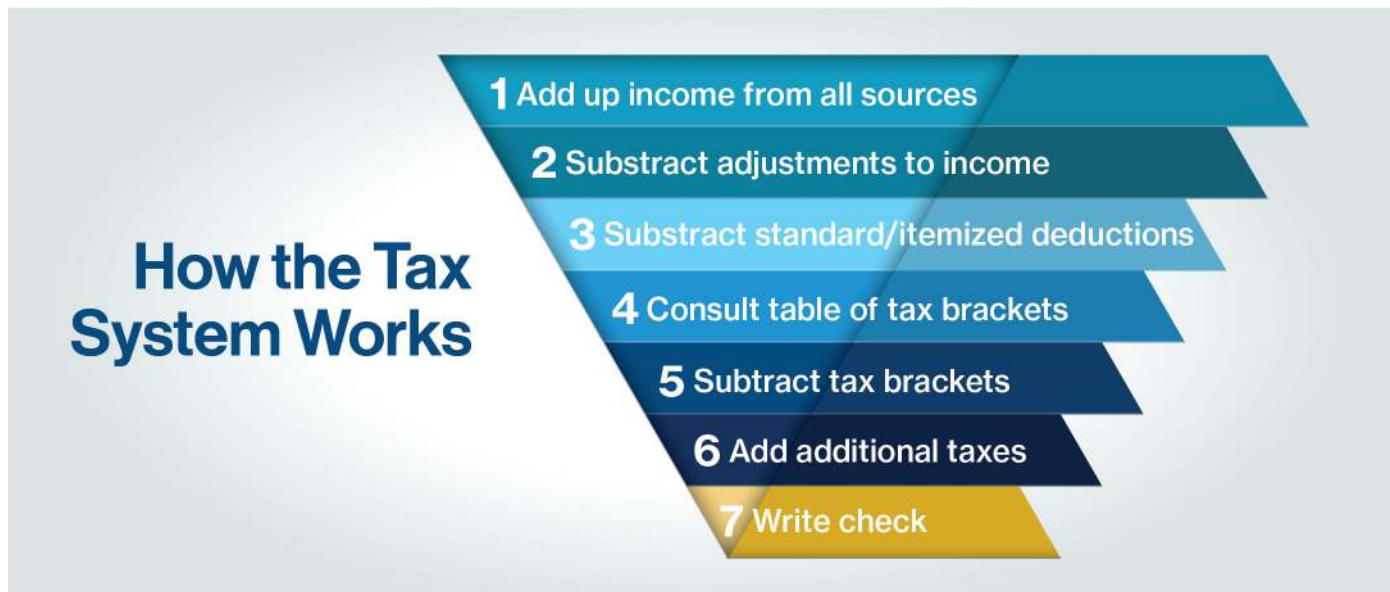
Benefit No. 1: First, tax planning is a key component in your financial protection. As a small to medium size business owner, you have two ways to increase your net profits: *financial offense* (earning more) and *financial defense* (spending less). For most small-business owners, taxes are the biggest expense, so a big part of playing *financial defense* involves reducing the tax burden. And you do that through savvy tax planning.

Benefit No. 2: Second, participating in tax planning almost always ensures results. You can spend a huge amount of time, effort, and money promoting your business with no guarantee of achieving positive results. In contrast, every tax-savings initiative you implement guarantees a return on your investment. But those guaranteed results start with *planning*. For example, you can't deduct medical expenses paid out of a medical expense reimbursement plan if you haven't set up such a plan ahead of time.

To get this series started, indulge us for a moment as we cover how the tax system works here in the United States of America.

Understanding How the Tax System Works

A general knowledge about how the tax system works lays the foundation for understanding specific tax-savings approaches we present later on in this booklet. Here's a graphic demonstrating how the tax system works:



1. Add your income from all sources to calculate “total income.”
2. Subtract “adjustments to income” available to all taxpayers, regardless of whether you itemize, such as certain education expenses and contributions to health savings accounts (HSAs).
3. Subtract your standard deduction or total itemized deductions, whichever amount is greater.
4. Consult the table of tax brackets to determine your actual tax.
 - Note that portions of your income are taxed at different rates; for example, in 2020

continued

if you're married filing jointly, you pay 10 percent on the first \$19,400 of income, 12 percent on the next \$59,549, 22 percent on the next \$89,449, and so on. The maximum percentage you pay is your *marginal tax rate*. The average percentage is your *effective tax rate*.

5. Subtract any available tax credits, such as the child and dependent care credit.
6. Add any extra taxes such as self-employment tax or net investment income tax.
7. Claim your tax refunds or write your checks (if you owe taxes) to the federal, state, and local tax authorities.

Step 1: Calculate your total income



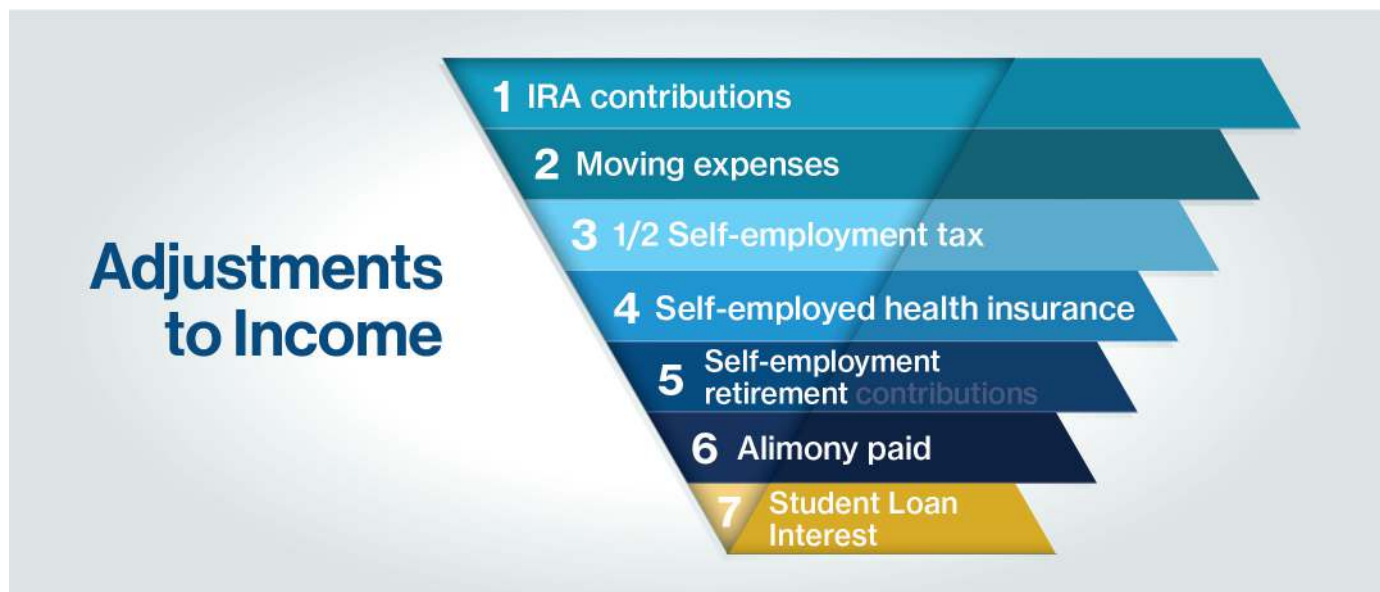
As you may have guessed, the process starts with *income*, which includes everything that the Internal Revenue Service (IRS) is interested in, including:

- Earned income from wages, salaries, bonuses, and commissions
- Profits and losses from your own business
- Interest and dividends from bank accounts, stocks, bonds, and mutual funds
- Capital gains from sales of property
- Income from pensions, IRAs, and annuities
- Alimony received
- Gambling winnings

As it turns out, even illegal income is taxable. The IRS doesn't really care all that much how you earn the income. The government just wants its share. In most cases, if you're operating an illegal business, you're able to deduct many of the same expenses as if you were running a lawful business. Take bookies for example – they can deduct the cost of a mobile phone used to accept wagers. If however, the expenses fall under the notion of being “contrary to public policy” – and most businesses involving illegal drugs, like a marijuana business, even if it's legal in the state in which you're operating the business, it is federally illegal – you're prohibited from deducting expenses related to that business.

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Step 2: Subtract your adjustments to income



Next, you subtract “adjustments to income,” which are considered special deductions, listed on the first page of Form 1040 (officially, the “U.S. Individual Income Tax Return”) that you can take whether you itemize deductions or not. These include:

- One-half of self-employment tax
- Self-employed health insurance
- Contributions to an IRA account
- Student loan interest up to \$2,500
- Moving expenses (for active duty military personnel only starting in 2018)
- Alimony payments (for agreements entered into before January 1, 2019)

Total income minus adjustments to income equals “adjusted gross income” or AGI. These are also called “above the line” deductions, because you take them “above” the line that separates total income from AGI.

Step 3: Subtract your standard or itemized deductions

After you’ve calculated your adjusted gross income, it’s time to take your standard deduction or itemized deductions, whichever is more. For 2020, the standard deduction amounts are \$12,400 for singles, \$18,650 for heads of households, \$24,800 for married couples filing jointly, and \$12,200 for married individuals filing separately. *(Note: Approximately 90 percent of taxpayers claim the standard deduction.)*

If your total itemized deductions exceed the standard deduction for which you qualify, itemizing will save you money. Unfortunately, you need to crunch the numbers to find out, and you may do all that extra work only to discover that itemizing isn’t the best option.

continued



To find out whether itemizing will reduce your tax bill, total the following:

- Medical expenses, to the extent they top 7.5 percent of your AGI
- State and local income, sales, and property taxes paid (up to a total of \$10,000 per year)
- Foreign taxes paid
- Mortgage interest on up to \$1 million for loans closed before December 15, 2017, or \$750,000 for loans closed after that date
- Casualty and theft losses incurred as a result of a federally declared disaster, to the extent they exceed 10 percent of your adjusted gross income
- Charitable contributions

As you would expect, tax deductions reduce your taxable income. If you're in the 12 percent bracket, an extra dollar of deductions cuts your tax by 12 cents on the dollar. If you're in the 35 percent bracket, that same extra dollar of deductions cuts your tax by 35 cents on the dollar.

Step 4: Consult the table of tax brackets

After subtracting deductions from your adjusted gross income (AGI), you're left with your "taxable income," which determines the rate(s) at which your income is taxed.

Suppose you're single, and your taxable income is \$100,000. Here's how your taxes on that amount would be calculated:

- $\$9,875 \times 0.10 = \987.50
- $\$30,249 \times 0.12 = \$3,629.88$
- $\$45,399 \times 0.22 = \$9,987.78$
- $\$14,474 \times 0.24 = \$3,473.76$
- TOTAL TAX = \$18,078.92

So, your effective tax rate is $\$18,078.92 / \$100,000 = 18.08$ percent

Tax Brackets 2020

RATE	SINGLE	JOINT
10%	0	0
12%	9,876	9,876
22%	40,126	40,126
24%	85,526	85,526
33%	163,301	163,301
35%	207,351	207,351
37%	518,401	518,401

continued

Step 5: Subtract your tax credits



Finally, you subtract available tax credits. These are dollar-for-dollar tax reductions that you're allowed to take advantage of regardless of your tax bracket. For example, if you have \$2,500 total in tax credits, your tax bill is reduced by that amount:

$$\$18,078.92 - \$2,500 = \$15,578.92$$

Despite what you may have heard, there's no secret to using tax credits, other than knowing what's available to you. While dozens of tax credits are available, they tend to fall into five main categories:

- Family credits, such as the Child Tax Credit and Dependent Care Credit
- Education credits, such as the American Opportunity Credit and Lifetime Learning Credit
- Foreign tax credits for taxes paid to foreign countries
- General business credits for all sorts of business expenses, such as research and development, hiring employees from disadvantaged groups, and pension plan startup expenses
- Real estate credits, such as the low-income housing credit and renovation credit

These credits can be quite substantial. For example, the child tax credit is \$2,000 per child (up to age 17), with the threshold for phasing it out at \$200,000 for single filers and \$400,000 for joint filers.

Step 6: Add any extra taxes

Almost done! We've taken care of income taxes, but you may be on the hook for other taxes, as well, such as the following:

- **Self-employment tax**, which is what self-employed people pay in place of Social Security and Medicare taxes.
- **A 3.8 percent net investment income tax** on investment income, which the Patient Protection and Affordable Healthcare Act introduced in 2013. This tax hits single taxpayers

continued

earning more than \$200,000 and joint filers earning more than \$250,000. For purposes of this rule, “investment income” includes interest, dividends, capital gains, rental income, royalties, and annuity distributions.

- **The alternative minimum tax (AMT)** for people deemed by the government to be paying too little income tax after accounting for all their deductions and credits.
- **The so-called nanny tax** to cover Social Security and Medicare taxes for any household employees being paid over a certain minimum amount.

The bottom line here is that “tax brackets” aren’t as simple as they might appear. Your *actual* tax rate may be higher than the tax rate based solely on your adjusted gross income.

So that’s how the system works. (Pretty simple, right?)

Leveraging the Power of Tax Planning to Game the System

Knowing how the system works opens opportunities for reducing your tax burden, but to take advantage of these opportunities, you must plan ahead and perform certain tasks during the tax year. And that’s where a [tax and financial planning firm](#) like SWC can help.

Waiting until it’s time to prepare your taxes is often too late. Here are a few tax-reduction approaches that require planning ahead and taking action throughout the tax year:

- **Incorporate your business or change its business structure.** For example, with an S Corporation, you can get money out of the business in two forms – as wage income (subject to Social Security taxes), and as distributions (not subject to Social Security taxes). Properly planning for type of income will reduce the amount you pay in self-employment tax.
- **Pay yourself** in part with tax-free fringe benefits, including medical coverage, health savings account, and a retirement plan.
- **Set up a medical expense reimbursement plan** through an eligible business, so you can pay all medical expenses for you and your family with untaxed dollars.
- **Hire relatives to work for you**, thereby reducing your income by the amount you pay them, all while shifting your tax burden to a lower tax bracket.
- **Set up regular contributions to a tax-deferred retirement account.** You can contribute to these accounts up to the tax year’s filing deadline, but many people don’t have anything set aside at the end of the year to make a substantial contribution.
- **Set up a health savings account (HSA)** and fund it.

Next up in this guide on how to reduce your tax burden legally, Chapter 2 – how to “audit proof” your tax return.

Audit-Proofing Your Tax Return

Here in Chapter 2, we're going to allay fears you may have of being audited by the Internal Revenue Service (IRS).

While failing to plan ahead for taxes (the subject of Chapter 1) is probably the No. 1 mistake small business owners make, letting the threat of an IRS audit discourage you from claiming certain deductions or credits is a close second. Here at SWC, we encourage clients to claim every legally allowable deduction and credit. Failure to do so leaves money on the table – our clients' money – and that's something we just can't tolerate. The fact is your chances of being audited are slim.

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However, we encourage you to assume you *will* be audited. What?

On its surface, that advice may strike you as a contradiction, but it's really not. Assuming you will be audited simply calls for documenting all income and expenses, so in the event your business is audited, you have the documentation needed to prove your case. In other words, respect the IRS, but don't fear it. Today's historically low audit rates make it pay to be aggressive in claiming deductions and credits, but there is no excuse for careless accounting and record-keeping.

Afraid to Raise Red Flags?

As a taxpayer, chances are good that, at some time, you chose not to claim a deduction or did not claim the maximum you're allowed because you were afraid "it would raise a red flag." The fact is, audit rates are so low, most legitimate deductions simply aren't likely to raise any red flags. Audit rates hit an all-time high in 1972 at one for every 44 returns the IRS received. But lately they've dropped to historic lows. According to the IRS, for 2019, the overall audit rate was just one in every 220 returns, or 0.45 percent of all returns.

Roughly half of those hinged on one issue – the Earned Income Tax Credit for low-income working families. The rest of the audits focused mainly on returns filed by small businesses – especially sole proprietorships and businesses that have plenty of opportunities to hide income. Examples? Single location restaurants and laundromats. (*The IRS publishes a whole series of [audit guides](#) you can download from its web site that tell you exactly what they're looking for. Each guide focuses on a specific industry or type of business, such as "Child Care Provider," "New Vehicle Dealership," and "Cash Intensive Businesses."*)

Just changing your business's legal structure can dramatically change your odds of getting audited. For example, in 2015, the IRS audited 2.31 percent of Schedule C businesses reporting gross income topping \$100,000. Yet for that same year, they audited just 0.2 percent of partnerships and S corporations, regardless of how much they earned. That suggests you can cut your odds of being audited by more than 80 percent just by choosing a different legal structure for your business, which happens to be the topic of Chapter 3 of this guide.

Putting Tax Penalties in Perspective

So, what if you do get audited. What then? Well, if you properly documented your legitimate deductions, you have little to fear. In fact, 35 percent of audits result in refunds or no change either way.

And what if you lose? You will get what the IRS calls a "deficiency notice" – a bill for unpaid taxes plus interest from the time the taxes should have been paid. If you disagree with the auditor, you can appeal the deficiency notice to the IRS. If you don't like the result you get there, you can appeal to the U.S. Tax Court. There's even a "small claims" division for disputes under \$50,000.

Are you worried about getting in real trouble, as in criminal prosecution? Don't be. For fiscal year 2019, the IRS initiated only 2,797 criminal investigations. That's an almost unimaginably tiny fraction of the 240 million returns they collect in a year. Out of those investigations, they achieved 1,735 convictions (IRS investigators don't actually prosecute; they turn that job over to the Department of Justice.) Ninety one percent (or 1,583) of those prosecutions resulted in convictions leading to sentencing (the Feds don't take you to court unless they're pretty sure they can win).

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In the end, the average U.S. small business owner really has nothing to fear from the IRS Criminal Investigations unit. As far as most of us are concerned, the IRS is just the government's collection agency, nothing scarier. You've got to do something pretty outrageous to be the target of one of those 2,797 investigations.

Make Your Case

You can avoid accuracy-related penalties if you have a “reasonable” basis for taking a tax position on your return. A tax position is a reason why you acted as you did regarding something related to your taxes. For example, the reason why you decided not to file a return, the reason you believe certain income you received is tax-exempt, or the reason you chose to shift income from one jurisdiction to another.

Generally, a tax position has more than one chance in three of being accepted by the IRS. You can work with your [tax planning firm](#) to file Form 8275 or 8275-R to disclose positions at the time you file your tax return, but the general consensus among tax experts is against filing them. Why volunteer information that can attract unwanted attention? That would be like calling in an airstrike on your own position.

Instead, note your position when you're completing your tax return, so if you are audited, you can state your position on issues that may be in a gray area.

Document Your Income, Deductions, and Credits

The best defense against an audit is detailed documentation of all income and expenses. We recommend using accounting software for both your business and personal finances, assigning every penny coming in or going out to an income or expense category, and being sure you have documentation for every item in every category that impacts your taxes, including the following:

- **Income:** W-2s, 1099s, and income not reported on W-2s or 1099s. If you are audited, you might have to provide documentation on every single deposit that made its way into your bank accounts. Audit-proof yourself by properly recording all deposits in your accounting software or personal ledgers.
- **Deductible expenses:** Receipts, invoices, check registers (hand-written or electronic), and credit card statements for all expenses that may be deductible, including:
 - Business/professional expenses
 - Mortgage interest
 - Property taxes
 - State and local taxes
 - Health insurance premiums

Pro Tip: Assuming you use accounting software to categorize every income and expense item, you can generate reports that provide you with a complete checklist of the documentation needed for each category of income and expense. This will help ensure that you have all the documentation needed to prepare your taxes and to audit-proof your return. You can then move confidently forward, claiming every deduction and credit for which you qualify, knowing that you can back up each one with documented proof.

continued

- Health Savings Account (HSA) or Flexible Spending Account (FSA) contributions
- Medical expenses
- Childcare expenses
- Education expenses
- Costs of any energy-saving home improvements
- Charitable donations
- Vehicle records for business use of a vehicle you own
- Home office expenses

Take Every Advantage You Can Get

Here at Stees, Walker & Company, LLP we recommend that you take a strong position to claiming deductions and credits. Don't fear that the IRS will bully you into paying more than your fair share in taxes. For further guidance on what is allowed, please read "[Understanding Small-Business Tax Deductions](#)," which is available on the SWC blog.

As a small-business owner, you already have one of the best legal tax shelters available – a business. We can show you how to leverage the power of your business to reduce your taxable income. The first step is to choose a tax-friendly legal structure for your business, which is the topic of Chapter 3 – “Selecting a Business Entity.”

Selecting a Business Entity

Get ready because we're about to describe the five ways you can choose to organize your small business, and then provide guidance on how to choose the best business entity for your business in the current environment.

Here's a common scenario to get us started. You set up a limited liability company (LLC) or S corporation for your small business, and now you are all set in terms of protecting your personal assets from lawsuits and minimizing your tax burden, right?

Not so fast.



One of the most expensive mistakes small-business owners make is choosing the wrong *business entity* – the legal/financial structure within which the business operates.

Most business owners start as sole proprietors. Then, as they grow, they establish an LLC to help protect their personal assets from any lawsuits filed against the business. Many of these same business owners make the common mistake of assuming that an LLC allows them to file their

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taxes as a corporation and use that filing status to save on taxes. The fact is that an LLC is a legal entity, *not* a tax entity. Operating a sole proprietorship as an LLC won't save you any money in taxes.

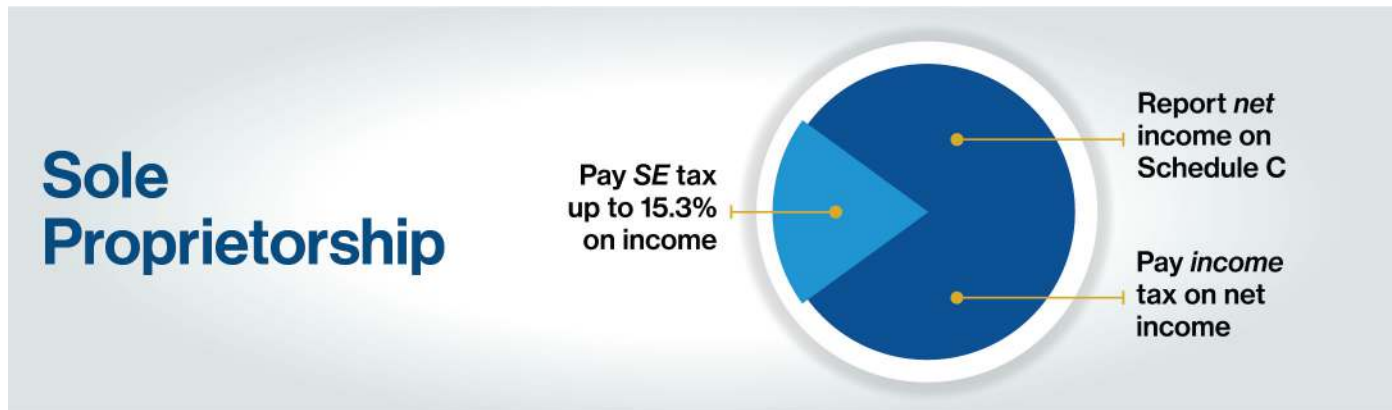
You want a business entity (or more than one business entity) that not only provides legal protection, but also maximizes your tax savings.

Knowing Your Business Entity Options

When choosing a business entity, you have the following five options (only the first four are tax entities):

- A **sole proprietorship** is a business you operate yourself – in your own name or a trade name – with no partners or formal entity. You report income and expenses on your personal return (Schedule C) and pay income and self-employment tax on your profits. This option is okay for startups and small businesses with no employees, operating in industries with little legal liability. However, it is the most expensive in terms of taxes.
- A **partnership** is an association of two or more partners. General partners run the business and remain liable for partnership debts. Limited partners invest capital, but don't actively manage the business and aren't liable for debts. The partnership files an informational return and passes income and expenses through to partners. General partner distributions are taxed as "ordinary" income and subject to self-employment tax; limited partnership distributions are taxed as "passive" income not subject to self-employment tax.
- A **C corporation** is a separate legal "person" organized under state law. Your liability for business debts is generally limited to your investment in the corporation. The corporation files its own return, pays tax on profits, and chooses whether or not to pay dividends. Your salary is subject to income and employment tax; dividends are taxed at preferential rates and not subject to self-employment tax. This business entity is generally best for owners who need limited liability and want the broadest range of tax benefits. However, the administrative costs and complexities are also the highest.
- An **S corporation** is a business that elects not to pay tax itself. Instead, it pays salaries to any employees (who are responsible for paying taxes on that income), and it passes any profits to shareholders – a situation in which the shareholder is responsible for payment of the individual taxes. An S corporation is generally best for businesses whose owners are active in the business and don't need to accumulate capital in the business to cover expenses for day-to-day operations.
- A **limited liability company (LLC)** or limited liability partnership (LLP) is an association of one or more "members" organized under state law. Your liability for business debts is limited to your investment in the company; in fact, LLCs may offer the strongest legal protection against the loss of any personal assets in the event someone files a lawsuit against the business. However, an LLC is *not* a distinct entity for tax purposes. LLC's are considered "disregarded entities," which means they take on the tax characteristics of the tax entity that the members choose for it to be. Single-member LLCs are taxed as sole proprietorships, unless the owner elects to have it taxed as a corporation. Multi-member LLCs can choose to be taxed as partnerships or corporations. Many small businesses operate as an LLC (for legal purposes) and a partnership or S corporation (for tax purposes).

continued



We can't make you an expert in business entities – at least not in a single chapter like this one – but we do want to walk through one popular choice to illustrate how important this question can be.

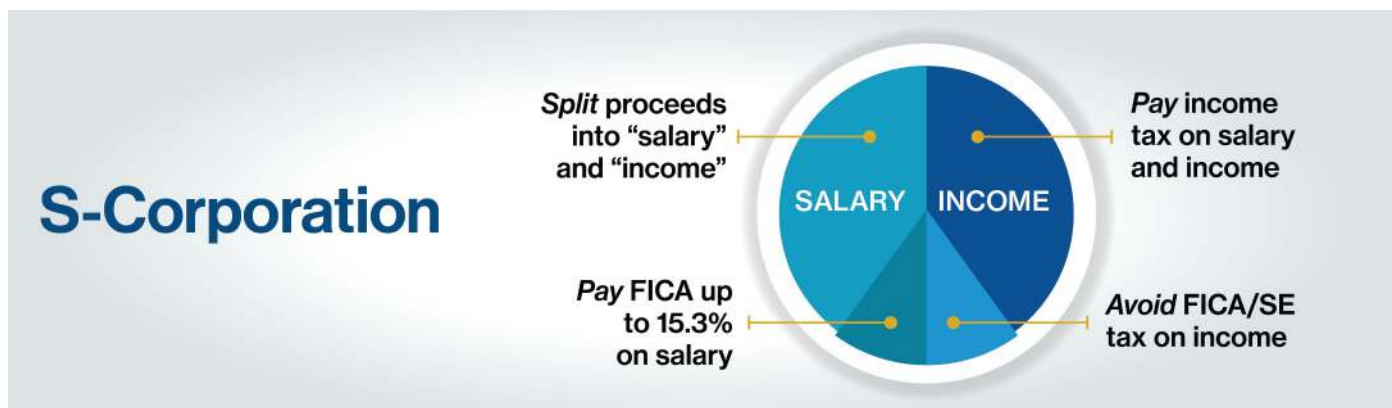
If you operate your business as a sole proprietorship, or a single-member LLC taxed as a sole proprietorship, you may pay as much or more in self-employment tax than you do in income tax. One way to reduce your self-employment tax is to set up an S corporation and file your tax return as an S corporation instead of as a sole proprietor.

If you're taxed as a sole proprietor, you'll report your net income on Schedule C. You'll pay income tax at whatever your personal tax rate is, along with self-employment tax of 15.3 percent on your first \$137,700 of "net self-employment income" and 2.9 percent (Medicare tax) on anything above that. You're also subject to a 0.9 percent Medicare surtax on anything above \$200,000 if you're single, \$250,000 if you're married filing jointly, or \$125,000 if you're married filing separately.

Suppose your profit at the end of the year is \$80,000. You'll pay income tax on that amount at your regular rate, whatever that is.

You'll also owe about \$12,240 in self-employment tax (15.3 percent of \$80,000). On the other hand, if you had earned that \$80,000 working a regular job, you would pay only half that amount – \$6,120. Your employer would pay the other half. As a sole proprietor, you do get to deduct half of your self-employment tax from your income, which takes a little of the sting out of self-employment tax. In this example, that would drop your taxable income from \$80,000 to \$72,000.

To reduce your self-employment tax significantly more, you can structure your business as an



continued

S corporation and take half the profit from that business as salary (subject to self-employment tax) and the other half in distributions (not subject to self-employment tax). You're required to pay self-employment tax on the salary but not on the distributions, so with an S corporation, instead of paying self-employment tax on \$80,000, you pay that 15.3 percent on only \$40,000, slashing your self-employment tax in half. Instead of paying \$12,240, you pay \$6,120.

As you'll see below, it's like giving yourself a tax credit of \$6,120!

Now, suppose you invest \$6,000 of that \$6,120 in a tax-deferred individual retirement account (IRA). That drops your taxable income from \$80,000 to \$74,000 for an additional savings.

Note that you must pay yourself a "reasonable compensation" from the S corporation – whatever amount you would have to pay an employee to do the work for you. If you pay yourself nothing, or merely a token amount, and take the remaining profit out of the business as a distribution, you're going to increase your chances of being audited. If you are audited, the IRS may recharacterize up to 100 percent of your income as salary and hit you with some very hefty taxes, interest, and penalties.

So, don't get greedy!

According to IRS data, the average S corporation pays out about 40 percent of its profits in salary and 60 percent in distributions. We can help you calculate a "reasonable compensation" for your business.

What's the Catch?

The big drawback of using an S corporation to reduce your self-employment tax is that it also reduces the declared wages on which your future Social Security payments will be based, meaning your future Social Security payments could be cut in half.

The key to overcoming this drawback is to invest the amount you save in self-employment tax toward your retirement. If you invest that money wisely, you have the potential of generating your own retirement payouts that are more than what you would receive in the form of Social Security payments.

Another drawback involves the hassle of creating and maintaining partnership or corporation status. With an S corporation, for example, you're required to set up a board of directors, file annual reports, conduct shareholder meetings, keep records of your meeting minutes, and jump through other hoops to maintain your corporate status. You can outsource this busywork to a lawyer or legal service, but that adds to the costs.

In addition, paying yourself a salary from the S corporation requires that you do payroll, complete with calculating withholdings from your payroll checks. We can help with that, but again, it's an added cost.

S-Corp FICA		Proprietorship SE	
SALARY	\$40,000	INCOME	\$80,000
FICA	\$6,120*	SE TAX	\$12,240
NET	\$73,880	NET	\$67,760

*S-Corp Saves \$6,120

continued

Can't I Just File as an LLC?

No. An LLC is a legal entity, not a tax entity. If you operate as a single-member LLC that is not also a partnership, S corporation, or C corporation, the default tax entity is sole-proprietor. If you're operating as a single-member LLC and you're reporting your business profit on Schedule C, your business is being taxed as a sole proprietorship, which has three major disadvantages:

- Reporting business profits as a sole proprietor is the most expensive way to file your taxes, even if you operate the business as an LLC.
- As a sole proprietor, if your business earns more than \$100,000 in gross income, you're five times more likely to be audited by the IRS, regardless of whether you operate the business as an LLC.
- As a sole proprietor, you're responsible for paying self-employment taxes on 100 percent of your business profits. Operating as an LLC provides no tax benefit in this area.

The takeaway here is that no single business entity is best for every small-business and every small-business owner. You may be better off operating your business as a partnership, an S corporation, or a C corporation, and that can change as your business grows. Or the best option may be a combination of business entities; for example, an LLC operating as an S corporation.

Here at SWC, we can help you identify the most beneficial business entity(ies) for your business. The Tax Cuts and Jobs Act of 2017 makes this choice of business entity even more important by providing a new deduction for "qualified business income," which just happens to be the subject of Chapter 4.

Deducting a Percentage of Your Qualified Business Income

The 2017 Tax Cuts and Jobs Act (TCJA) lowered the top tax rate on C corporation income from 35 percent to 21 percent. This is considerably lower than the top rate of 37 percent on pass-through income from sole proprietorships, partnerships, and S corporations.

Cutting taxes for C corporations without also cutting taxes for small businesses, would probably have caused a stir with small-business owners justifiably exclaiming, “No fair!” To balance the scales, the TCJA allows small-business owners to deduct up to 20 percent of their qualified business income (QBI) from their taxable income for the year, calculated on an activity-by-activity basis.

continued



This is a major change for most small-business owners, but it may leave you wondering what QBI is, how this change is likely to impact your taxes, and what the heck “calculated on an activity by activity basis” means? In this chapter, the fourth in our *Small Business Guide to Reducing Your Tax Burden Legally*, we bring you up to speed on the QBI deduction.

Understanding the Different Income Type

The tax code has always distinguished different types of income and taxed them differently. TCJA created an entirely new type of business income, called qualified business income (QBI), and taxes it in a unique way. In this section, we define and compare the different types of income, including QBI.

Ordinary income

Ordinary income is what you earn from your work or your business. If you draw pension or IRA income, that’s ordinary income too. Here are a few key points about ordinary income:

- Ordinary income is taxed at ordinary income tax rates.
- Any salary you earn from your small business is ordinary income.
- If your small business is a sole proprietorship, your entire net profit from the business is taxed as ordinary income. (*You can change your business entity from sole proprietor to S corporation to reduce the amount taxed as ordinary income. See Chapter 3 in this series to find out more about business entities.*)
- You pay taxes on net income. So, for instance, if you file as married, you earn a salary from a job, and should your spouse lose money in a business, your spouse’s business loss reduces your net income (subject to tax) as a married couple.

Investment income

Investment income is money you earn from your investment portfolio, and different types of investment income are taxed at different rates:

- Interest income is taxed at ordinary income tax rates.
- Qualified corporate dividends are taxed at special rates up to 20 percent.
- Long-term capital gains (for profits from assets held more than a year) are taxed at 0, 15, and 20 percent depending on your total income.
- Short-term capital gains on most assets (held for up to one year) are taxed at ordinary income tax rates.
- If your adjusted gross income (AGI) exceeds \$200,000 for single filers or \$250,000 for joint filers, your investment income is subject to another 3.8 percent “net investment income tax.”

So, here’s the deal... if you have capital losses in a fiscal year, you are allowed to subtract those losses from your capital gains (*profit from the sale of property or an investment*). And you can subtract up to \$3,000 of net capital losses against your ordinary income. But here’s something you need to know: if your net capital loss is greater than \$3,000, you must carry the remainder forward to future years. So, to at least to that extent, investment income is curtailed off into a silo of its own.

continued

By the time the Berlin Wall fell, taxpayers had figured a way around that curtain. They discovered that borrowed money could be used to increase their basis in investments like equipment leasing, oil and gas, real estate, and write off huge paper losses that were significantly in excess of what they had actually invested. They used those losses to offset their ordinary income from salaries and businesses, as well as investment income from their investment portfolios. That was great for taxpayers, of course, especially with marginal rates hitting 70 percent, but it wasn't so good for the U.S. Treasury, so, in 1986, Congress created a new category called *passive income* to classify income from activities in which the taxpayer doesn't "materially participate."

Passive income

The 1986 rules specified that you can write off passive losses against passive income, but not generally against ordinary income or investment income. Congress did provide for two special allowances for real estate income. The first allows for up to \$25,000 of rental property losses, but *that* phases out starting at \$100,000 of AGI. The second allows "real estate professionals" who qualify under special rules to deduct passive real estate losses against ordinary income.

However, for the most part, the 1986 rules placed passive income and losses into a third silo.

Qualified business income (QBI)

With TCJA, Congress created a fourth "silo," called qualified business income. QBI includes net business income from sole proprietorships, partnerships, and S corporations, but not C corporations.

It also includes pass-through income from real estate investment trusts, publicly traded partnerships, and qualified agricultural co-ops. But it doesn't include guaranteed payments or W2 wages you draw from your business. It also doesn't include investment income – most taxable dividends other than REITs, or co-ops, investment interest income, short-term or long-term capital gains, commodity or foreign currency gains, etc.



QBI Deduction Limits

TCJA's new QBI deduction comes with three important limitations, as described in the following sections.

Limitation #1

If your 2020 taxable income – *after* adjustments to income and itemized deductions – is more than \$163,300 (\$326,600 for joint filers) your QBI deduction for each activity is limited to the greater of the following:

- 50 percent of the W-2 wages timely paid on behalf of that activity, *or*
- 25 percent of the W-2 wages plus 2.5 percent of the initial cost – immediately after acquisition – of all tangible property placed in service on behalf of that activity. (Tangible property includes real estate, equipment and machinery, vehicles, or robots that replace your employees.) You can count the initial cost of the property toward this amount for 10 years.

continued

Example: Suppose you own 20 percent of an S corporation that pays \$500,000 in W-2 wages and has \$200,000 of property in service. Your QBI is the greater of \$50,000 (50 percent of your 20 percent share of \$500,000 in wages) or \$26,000 (25 percent of your 20 percent share of \$500,000 in wages plus 2.5 percent of your 20 percent share of the \$200,000 in depreciable property).

This may mean that careful planning is required to maximize your deduction if your taxable income before subtracting QBI is enough to phase out the deduction.

Limitation #2

If your QBI comes from a “specified service business” (medicine, law, accounting, actuarial science, financial services, consulting, performing arts, athletics, or any business that relies on the “reputation or skill of one or more employees”), your deduction for that activity phases out as your taxable income rises from \$163,300 to \$213,300 (for single filers) or from \$326,600 to \$426,600 (for joint filers).

This may mean that careful planning is required to define “specified service income activities” and segregate them from non-service activities to make the most of the opportunity. (In January 2019, the IRS issued final regulations offering more guidance in this area.)

Limitation #3

The overall QBI deduction is limited to 20 percent of your taxable income in any particular year. The 2017 Tax Cuts and Jobs Act (TCJA) makes no provision for carrying over any unused deduction. However, if your QBI for the year is below zero, you can carry the loss forward to the next taxable year.

Maximizing Your QBI Deduction

The new rules suggest several ways to maximize the new benefit. And honestly, the more time tax lawyers and accountants spend looking over these rules, the more ideas they’ll come up with. When critics of the tax bill say it will encourage “gaming the system,” *this* is the provision they’re talking about.

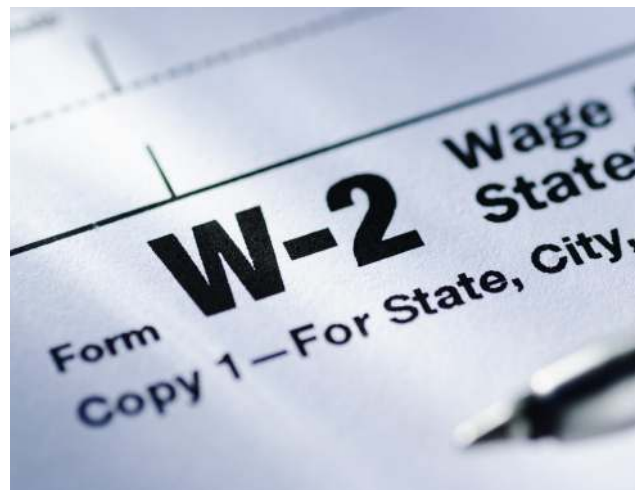
Let the games begin.

Create W2 income

If you currently operate a non-service business as a sole proprietor or partner, you have few or no W2 employees, and your taxable income is above the threshold, consider establishing an S corporation and paying yourself a W2 wage to create a base for taking advantage of the deduction.

“Cracking and packing”

Consider “cracking and packing” approaches to avoid the \$160,700/\$321,400 limits on specified service income.



continued

For example, if your primary business activity is a specified personal service, consider ancillary activities – such as marketing or management – a separate activity. You'll still lose out on the deduction for that primary service activity, but you'll preserve the deduction for the ancillary activities that don't fall under the service business definition. (*The IRS has issued proposed regulations stating that a specified service business includes any trade or business that provides 80 percent or more of its property or services to a specified service business, as long as the two businesses share 50 percent or more common ownership.*)

If a business earns less than 10 percent of its income from specified service activity, it won't be considered a specified service business for purposes of these new rules.

Segregate real estate

If you own real estate for your business to occupy, consider separating that real estate into a separate entity and paying it the highest reasonable rent to qualify for the deduction.

Contractors to employees

If your business uses independent contractors, consider making them W2 employees to maximize the W2 base for calculating the QBI deduction. (Of course, if those contractors are *also* paying attention to the law, they may prefer to *keep* their independent contractor status!)

Final Notes on QBI

We realize this is going to sound self-serving but maximizing your QBI deduction isn't "do-it-yourself" tax planning. Just because you can buy a tool to do something yourself (instead of hiring a professional) doesn't mean you should. If you go to Amazon and search for "orthopedic bone saw," you can find them for under twenty bucks. (Take a look. Seriously, it's terrifying!) But, just because you can buy the saw doesn't mean you should be performing orthopedic surgeries.

Want to read something humorous? below is something that was actually included in the *Conference Report for the Taxpayer Refund and Relief Act of 1999*:

“It is not anticipated that individuals will need to keep additional records due to the provision. It should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this decision.”

Wow! Do you think members of congress actually believed that at the time? Or is it just something they told themselves to feel better about unleashing new uncertainty into the system? How do you think they felt in January 2019, when the IRS issued 278 pages of regulations interpreting the new provision?

To take full advantage of the QBI deduction without running into future problems with the IRS, we urge you to obtain guidance from a qualified tax professional – if not us, then someone else.

To save even more on taxes, consider investing the money you save on taxes into one or more retirement accounts for additional tax savings. In Chapter 5, "Leveraging the Tax Savings Power of Retirement Accounts," we show you how.

Leveraging the Tax Savings Power of Retirement Accounts

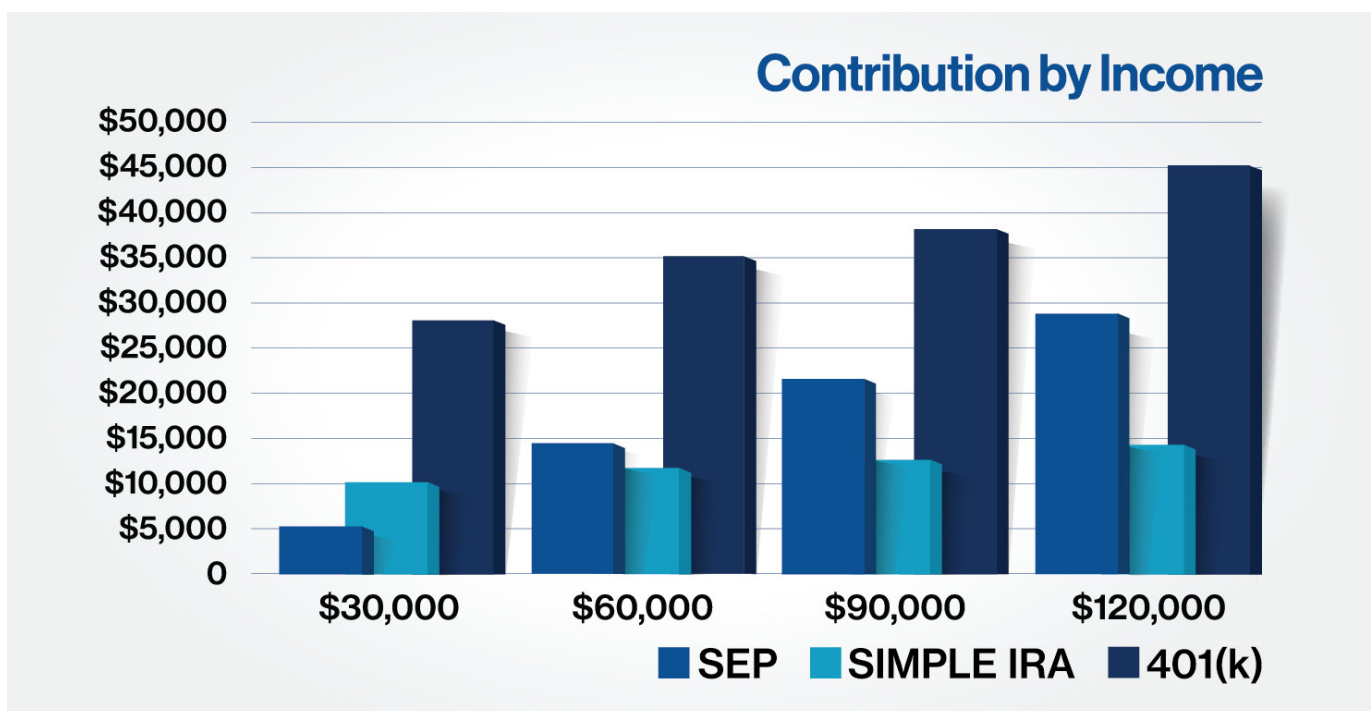
Some of the most powerful tools for cutting taxes are *tax-deferred retirement accounts*, which enable you to invest money tax-free now, then pay taxes on it when you withdraw it in your retirement years. As a small-business owner, you can take advantage of several different types of tax-deferred retirement accounts, including individual retirement accounts (IRA), a simplified employee pension (SEP), a Savings Incentive Match Plan for Employees (SIMPLE) IRA, 401(k), Defined Benefit Plans, and even the option of a hybrid plan. Roth IRAs and permanent life insurance plans are two more tools that can benefit you when planning for retirement.

continued



Many people have one or more retirement *accounts*, which is great, but few have a retirement *plan* – a highly specific approach for using retirement accounts to maximize their tax savings and achieve their retirement goals. Without a properly crafted retirement plan in place, mistakes are more likely, such as choosing an account type with a contribution limit that’s too low, exposing yourself to high taxes when you retire, or paying too much in account/plan management fees.

For example, depending on your income and the type of retirement account, your contribution limit varies considerably. If you earn \$90,000, for example, you can contribute \$16,200 to a SIMPLE IRA, or \$22,500 to a simplified employee pension (SEP), or \$42,000 to a 401(k). (Note: That’s before any catch-up contributions you can start making at the age of 50.) In some cases, plans can be combined to create even greater contribution potential.



But contribution limits aren’t the only thing you need to know. Which plan gives you the best combination of contribution limit, flexibility, liquidity, and cost? In addition, you need to consider that the decisions you make now can have long-term implications, possibly even limiting your future choices.

At SWC, we’re not here to make you a subject matter expert on retirement accounts. But we *can* help you decide if the account(s) you have are the right fit for you and your business and provide some guidance on how to use retirement accounts most effectively in the context of an overarching retirement plan.

We’ll assume for the purposes of this chapter in our booklet on reducing your tax burden legally that you’ve already decided you want to contribute more to your retirement than the \$6k you can contribute each year toward a traditional IRA. We’ll also limit the information we provide, at least over the first part of this chapter, to tax-deferred accounts, which involve claiming a deduction for

continued

your contributions now and then paying taxes on the money you withdraw during retirement.

Note: Toward the end of this chapter, we address other financial vehicles that may be advantageous to you in retirement, including Roth IRAs and permanent life insurance. But first, let's cover the SEP (simplified employee pension).

Understanding the Simplified Employee Pension (SEP)

The Simplified Employee Pension (SEP), which was authorized by Congress and is monitored by the IRS, is the easiest plan to set up.



The SEP is essentially a turbocharged IRA, and the rules governing it are pretty straightforward:

- If you're self-employed, you can contribute up to 25 percent of your *net self-employment income*.
- If your business is incorporated and you're salaried, you can contribute 25 percent of your salary (aka, your *covered compensation*).
- The maximum contribution for any one employee in 2020 is \$57,000.
- If you have employees, you must contribute for them also – generally the same percentage for your employees as you contribute for yourself. Note that if your income is much higher than your employees, you can use an “integrated” formula to make additional contributions for higher income earners.
- The money goes directly into regular IRA accounts you set up for your employees and yourself. No annual administration or paperwork is required.
- SEP assets accumulate tax-deferred over time. You'll pay tax on them at ordinary income rates when you withdraw them when you're in retirement. Penalties apply for early withdrawals (before age 59½) and for failing to take required minimum distributions (beginning at age 70½).

The Simplified Employee Pension is easy to adopt, easy to maintain, and flexible. If no money is available to contribute, you simply do not contribute. Keep in mind however that the contribution is limited to a percentage of your covered compensation. For example, if you set up an S corporation to limit your self-employment tax (as explained in Chapter 3 of this booklet – *Selecting a Business Entity*), you'll also limit your SEP contribution because it's based on that lower salary amount.

continued

Understanding the SIMPLE IRA

The next step up the retirement plan ladder is the SIMPLE IRA. If you've ever wondered what SIMPLE stands for, here it is: **S**avings **I**ncentive **M**atch **P**LAN for **E**mployees. See, wasn't that simple?



The SIMPLE IRA is a "supercharged" IRA that allows you to contribute more than the traditional IRA's \$6,000/year limit. Here are the rules for a SIMPLE IRA:

- You and your employees can defer and deduct 100 percent of your income up to \$13,500.
- If you're 50 or older you can make an extra \$3,000 "catch up" contribution per year.
- You must match everyone's deferral or make profit-sharing contributions. One option is to match employee contributions dollar-for-dollar up to 3 percent of their pay; you can reduce that 3 percent to as low as 1 percent for every two out of five years. The other option is to contribute 2 percent of each employee's wages (up to \$280,000), regardless of whether they choose to contribute.
- The money goes straight into employee Individual Retirement Accounts. While you're allowed to designate a single financial institution to hold the money, if you choose you can allow your employees to choose where to hold their accounts.
- SIMPLE plans have no annual administration fee or set-up charge. Since you're simply establishing special IRAs for your employees, you're thought of as having established a qualified plan trust to hold the assets as you would with a 401(k) or defined benefit plan.
- SIMPLE assets accumulate tax-deferred over time. That means you'll pay tax at ordinary income rates when you withdraw funds in retirement. Penalties apply for any early withdrawals (before age 59 1/2) and for failing to take required minimum distributions (beginning at age 70 1/2).

The SIMPLE IRA may be best for part-time or hobby businesses earning less than \$54,000 per year, because the flat \$13,500 contribution is higher than the 25 percent SEP contribution for incomes up to \$54,000. And it may be best for lower-paid employees. The maximum contribution is below the \$19,500 limit for a 401(k), but you have to stop to consider how many of your employees will actually contribute that maximum amount anyway.

continued

Understanding the 401(k)

Moving on, the next step up the retirement plan ladder is the 401(k).



Most people think of 401(k)s as retirement plans for bigger businesses, but you can set up a 401(k) for any size business. You can even set up what’s called a “solo” or “individual” 401(k) just for yourself.

If you’re unfamiliar with the history of the 401(k), it’s rather fascinating. As described in Helaine Olen’s national best seller, *Pound Foolish: Exposing the Dark Side of the Personal Finance Industry*, in the early 1970s, a group of high-earning executives from The Eastman Kodak Company approached members of Congress to allow a part of their salary to be invested in the stock market and thus be exempt from income taxes. According to Olen, this eventually resulted in section 401(k) being inserted in the then-current taxation regulations that allowed what the Kodak executives had lobbied for to be done.

As a result, the 401(k) – which refers to subsection 401(k) of the Internal Revenue Code – is a true “qualified” plan. This means you’ll set up a trust, adopt a written plan agreement, and choose a trustee. And here’s the great thing to know: the 401(k) lets you contribute far more money, and it is far more flexible than either the SEP or the SIMPLE. Here’s how it works:

- You and your employees can “defer” and deduct 100 percent of your income up to \$19,500 for 2020. If you’re 50 or older, you can make an extra \$6,000 “catch up” contribution.
- You can choose to match contributions or make profit-sharing contributions up to 25% percent of everyone’s pay. (If you operate as an S corporation, you can contribute up to 25 percent of your salary, but not any pass-through distributions you receive.) That’s the same percentage you can save in your SEP – on top of the \$19,500 deferral.
- The maximum contribution for 2020 is \$57,000 per person, plus any “catch up” contributions.
- You can offer yourself and your employees, loans, hardship withdrawals, and all the benefits large corporations offer their employees.
- You can use cross-testing to skew profit-sharing contributions to favored employees.

continued

For example, age-weighted plans allow you to allocate more to older employees; integrated and super-integrate” plans allow you to allocate more to higher-earning employees (on the theory that they receive little to no benefit from Social Security for their income above the Social Security wage base); and rate group plans allow you to divide employees into groups (such as administrators, managers,, and sales team members) and make different contributions for each group.

- 401(k) assets accumulate tax-deferred over time. That means you’ll pay tax at ordinary income rates when you withdraw them in retirement. Penalties apply for any early withdrawals (before age 59 1/2) and for failing to take required minimum distributions (beginning at age 70 1/2).

What’s the downside to the 401(k)? Well, 401(k)s are true “qualified” plans, which means more administration is required than simplified employee pensions (SEPs) or SIMPLE IRAs. As a result, you’ll have to file IRS Form 5500 (the Annual Report/Report of Employee benefit Plan form) reporting contributions and assets every year. Also, there are important anti-discrimination and other rules to keep you from shorting your employees while you pad your own account.

Another big downside of 401(k)s is that the U.S. Department of Labor recently targeted hidden fees in 401(k)s and mandated that retirement account sales reps follow a fiduciary standard, not the less stringent suitability standard. As a result, many financial services companies are leaving the 401(k) market. By one estimate, the mandated change will impact nearly \$3 trillion of retirement assets and \$19 billion of revenue in the financial services industry. If you control your business’s 401(k), this change can impact you, too, possibly drawing increased scrutiny from the Department of Labor.

However, if the 401(k) really *does* make sense for you and your business, these three alternatives might make the administration of the plan somewhat easier:

- A “SIMPLE” 401(k) avoids nondiscrimination and top-heavy rules in exchange for guaranteed employer contributions. You and your employees can defer 25 percent of covered compensation up to the SIMPLE plan contribution limits. Your business must contribute 2 percent of covered compensation or match contributions up to 3 percent of covered compensation. This works if you want a true 401(k), but you’re afraid your employees won’t contribute enough to let *you* make meaningful deferrals. You can also convert an existing 401(k) to a SIMPLE 401(k).
- A “Safe Harbor” 401(k) avoids nondiscrimination (but not top-heavy) rules in exchange for bigger employee contributions. You and your employees can defer up to the regular 401(k) limit. You can either: 1) contribute 3 percent of covered compensation; or 2) match contributions dollar-for-dollar up to 3 percent of covered compensation and fifty-cents-on-the-dollar for contributions between 3 percent and 5 percent of covered compensation. You can even make extra profit-sharing contributions on top of the required contributions.
- If you operate your business entirely on your own with no employees other than your spouse, you can establish an “individual” 401(k) with much less red tape.

continued

Understanding the Defined Benefit Plan

Now, if you really want to contribute more than the \$57,000 limit for SEPs or 401(k)s, consider a defined benefit plan. This is your mother’s retirement plan – the traditional “pension plan” that so many U.S. employers have stopped offering because they simply can’t afford to maintain it anymore. However, it can still be a great choice for older, highly compensated business owners with few employees. For instance:

Defined Benefit Contributions		
Age	Regular DB	412(i)
45	\$80,278	\$164,970
55	\$211,448	\$395,634
60	\$236,910	\$450,112

Projections based on retirement at age 62 with \$165,000 annual pretax income.

- Defined benefit plans let you guarantee up to \$230,000 in annual income (2020 limit).
- You can contribute and deduct as much as you need to finance that benefit. You’ll calculate those contributions according to your age, your desired retirement age, your current income, and various actuarial factors that your [tax planning and financial services advisory firm](#) can help you with.

The biggest challenge with the defined benefit plan is the required annual contributions. That means, if your business doesn’t have the money, you still have to pay. However, you can combine a defined benefit plan with a 401(k) or SEP to give yourself a little more flexibility. Suppose you could contribute up to \$100,000 to a defined benefit plan, but you’re not certain that you can commit to that much every year. In that case, you might be smart to set up a defined benefit plan with a \$50,000 contribution, then pair it with 401(k) for another \$50,000. If business is slow in a particular year, you can choose to skip the 401(k) that year.

Using Other Account Types in Your Retirement Plan

Now that we’ve covered the menu of traditional employer-sponsored retirement plans, let’s cover a potentially reasonable complication . Do you even need or want a traditional plan, or would you be better off with an alternative, perhaps even giving up the current tax break?

All of the plans we covered so far assume that you’re better off taking a tax deduction for contributions now, letting the assets grow tax-free over time, and then paying tax on withdrawals at ordinary income rates when you need them for retirement.

That’s a great approach if your tax rate is higher now than it will be in retirement. It puts more of your money to work for you right now, and you benefit later by paying less tax on withdrawals.

But that traditional pattern doesn’t always hold true. Say you’re young, just starting your career, and your income is low (and so is your tax rate). Maybe you’re repositioning yourself from one career or business to another, and your income is currently low. Maybe you think that tax rates in general will rise. (Today’s top marginal rate may seem high at 37 percent, but that’s actually low by historical standards.) Sometimes, contributing to a traditional retirement plan creates a ticking tax time bomb and actually *costs* you money over the long run.

You have two additional tools at your disposal when you’re planning for retirement – Roth IRAs and permanent life insurance policies.

continued

Using Roth IRAs to Your Advantage

Roth IRAs turn the traditional defer-now-pay-later arrangement on its head. You invest after-tax dollars now and withdraw them later, generally tax-free, as long as they've aged at least five years.

Tax-free income sounds great, right? Well, contributions are limited to \$6,000 per year (\$7,000 if you're 50 or older), and you cannot contribute at all if your income is over \$139,000 (single filers) or \$206,000 (joint filers). If your income is above those limits, you can still fund a Roth by contributing the maximum to a nondeductible traditional IRA, then immediately converting it to a Roth.

If your business sponsors a 401(k), you can choose to designate your salary deferrals up to \$19,500 as Roth deferrals. You won't receive any deduction today, but your future withdrawals will be tax-free. (Any employer contributions will continue to be treated as deductible now and taxable later.)

If you have a simplified employee pension (SEP), you can create a backdoor "Roth SEP" by making a deductible SEP contribution, then immediately converting it to a Roth. Roth conversions are a subject for another day; we just want you to be aware that the possibility exists. (Note: You can do the same with a Savings Incentive Match Plan for Employees (SIMPLE), but you have to wait at least two years from the time you contribute the money to convert it to a Roth.)

Leveraging the Power of Permanent Life Insurance Policies

Permanent life insurance policies that have a cash value can offer several significant tax breaks for supplemental retirement savings. You don't get to claim a deduction for the premiums you pay into the contract, but the policy's cash value grows tax deferred. And you can take cash from your policy tax-free by withdrawing your original premiums and then borrowing against remaining cash values. You'll pay (nondeductible) interest on your loan but earn it back on your cash value. Many insurers offer "wash loan" provisions that let you borrow against your policy with little or no out-of-pocket costs.

Insurers offer three main types of cash-value policies with three different investment profiles to suit different investors. The key is finding a policy that matches your investment temperament:

- "Whole life" resembles a bank CD in a tax-advantaged wrapper, with required annual premiums and strong guarantees. Remember when we said the defined benefit pension was your father's pension plan? Well, this is your mother's life insurance.
- "Universal life" generally resembles a bond fund in a tax-advantaged wrapper, with flexible premiums but weaker guarantees. Some insurers also offer "indexed universal life," which lets you profit from equity markets but gives you a guaranteed return even when those markets are down.
- "Variable life" lets you invest cash values in a series of "subaccounts" resembling mutual funds in a tax-deferred wrapper. You can choose "variable whole life" with required premiums and stronger guarantees, or "variable universal life" contracts with flexible premiums and weaker guarantees.

Note: These advantages aren't completely unlimited. If you place too much cash into the policy in the first seven (7) years, it's considered a "modified endowment contract" and all withdrawals are taxed as ordinary income until you exhaust your inside buildup.

continued

Again, we're not trying to make you an expert on retirement accounts and other financial tools for minimizing your taxes and maximizing your return at retirement. Our objective is to open your eyes to the wide variety of accounts and other options so that you have a general idea of what's possible when you discuss retirement with your accountant or financial planner. We also want to keep you from falling into the common trap of assuming that deferring today's income is always best.

Regardless of whether you already have one or more retirement accounts, we urge you to meet with your accountant or financial planner to develop a retirement plan and discuss what you already have in place (if anything). Making a few adjustments could save you money now while ensuring a more secure and comfortable future.

Next, in Chapter 6, we continue this series by explaining how you can reduce your taxes by paying wages to family members who work for your business. And then maybe they can start saving for retirement, too!

Hiring Your Kids to Cut Taxes

Do you ever get the feeling that your kids are taking you to the cleaners? We're not talking about the cost of necessities such as daycare, living space, food, school supplies, and clothing. It's those discretionary expenses, like cell phone service, sports leagues, music lessons, games and entertainment, outings with friends, and car and driving expenses.



Do you ever get the feeling that your kids are taking you to the cleaners? We're not talking about the cost of necessities such as daycare, living space, food, school supplies, and clothing. It's those discretionary expenses, like cell phone service, sports leagues, music lessons, games and entertainment, outings with friends, and car and driving expenses.

If you're paying for all that, you're doing so with after-tax dollars. And you should be putting the brakes on that habit immediately if not sooner.

continued

As a small-business owner, you're allowed to hire your family members (including children, grandchildren, parents, siblings, nieces, nephews) to work for your business, pay them a fair and reasonable wage, and then have *them* pay for their own bells and whistles. In addition, they can sock away some of that money to use later for college or to buy a car, pay for their own lavish wedding, start a business or support the start-up costs associated with starting a family, retire, pay for college or whatever else they decide to do when they're ready to do it.

Even better, you won't have to pay income tax or self-employment tax on the wages you pay them, and chances are good, in the case of your children, that neither will they. Also, when you hire your own children to work for you, the wages you pay them are exempt from FICA (Social Security and Medicaid) withholdings and federal unemployment (FUTA) tax unless your business is incorporated. Some restrictions apply, of course, but this tax loophole is perfectly legal and something that all small-business owners with children should consider.

So, How Does This Work?

Here's how it works: You hire your child and the business pays them. Their first \$12,400 of earned income is taxed at zero. That's because \$12,400 is the standard deduction for a single taxpayer, even if you claim them as your dependent. Their next \$9,876 of taxable income is taxed at just 10 percent.

Here are the basic rules:

- Your child must be at least seven years old.
- You must have a written contract with your child stipulating the work to be done and how wages will be calculated and paid.
- You have to pay a "reasonable" wage for the work they do – technically what you'd pay any non-related person for the same work, with an adjustment made for the child's age and experience. So, if your 14-year-old cleans the pools for your rental properties, pay her what a pool service would charge. If your 17-year-old helps keep your books, pay him a bit less than a freelance bookkeeper might charge. If your teenager helps you keep up on the latest technologies, pay her about the same as you would pay an IT person.
- To audit-proof your return, create a job description and keep a timesheet. However, nothing in the tax code requires that anyone you hire actually does the work you hired that person to do. The IRS doesn't care if you want to pay people for doing nothing. However, as a parent, you probably want to require that your child perform a reasonable amount of work for the money. Taking on responsibilities at a young age isn't a bad benefit of this approach.
- Pay by check or electronic transfer (not cash), so you can document the payment.
- You must deposit payments into an account in the child's name, but it doesn't have to be their pizza-and-party fund. It can be a Roth IRA for decades of tax-free growth, a Section 529 college savings plan, or a custodial account that you control until they turn 21. Now, you can't use money in a custodial account for your obligations of parental support, but private and parochial school, extracurricular activities, video games, and phone plans aren't obligations of parental support.
- You must issue your child a W-2 at the end of the year.

continued

Recognizing the Benefits

Let's say your teenage son wants to spend two weeks at tennis camp. You can earn the enrollment fee yourself, pay tax on it, and pay for his camp enrollment and commissary fees with after-tax dollars. Or you can pay him to work in your business, deposit the payment in his custodial account, and then, as custodian, write the check to the tennis camp yourself. In a sense, hiring your son and putting him to work allows you deduct his tennis camp costs as a business expense.

Pro Tip: If you hire one of your children to work in an unincorporated business (a business that does not possess a separate legal identity from its owner – commonly referred to as a Schedule C or Self-proprietor business), you don't have to withhold for Social Security until the child turns 18. So, as you can see, this truly is tax-free money. You'll still have to deal with paperwork, like issuing a Wage and Tax Statement (W-2) at the end of your business' fiscal year. And you still must ensure that they report their income on their own tax return (if the income is enough to require them to file a tax return themselves). But as you can see, this is painless when you consider the money

Finally, hiring your children to work for you might teach them a thing or two about the value of a dollar and how to manage their money. To further that effort, you might even consider starting a family investment club – something that helps your children learn how to make investment decisions, resulting in an education that will pay enormous dividends for the rest of their lives.

Now that you're not supplementing your children's lavish lifestyles, you can shift your focus to more important things, such as health insurance for you and your family. Up next is Chapter 7 – "Improving Your Medical Benefits While Cutting Your Taxes." We don't have a secret formula for eliminating the cost of health insurance, but we will suggest ways to get more for your money and get Uncle Sam to offset the costs.

Improving Your Medical Benefits While Cutting Your Taxes

The Affordable Care Act (ACA), dubbed “Obamacare,” made health care much *less* affordable for many small-business owners. It led to higher health insurance premiums, while doing little to nothing to rein in the spiraling costs of doctor visits, diagnostic tests, pharmaceuticals, and hospital care.



As a result, many small-business owners have dropped their healthcare coverage, which is not something we recommend. That’s because a single unforeseen individual or family illness could stick you with a bill that could drive you into bankruptcy. What we do recommend is that you make healthcare more affordable for yourself and your family by taking full advantage of every tax break available for healthcare expenses.

You are probably already aware that if you pay for your own health insurance, you’re allowed to deduct it as an adjustment to income. You’re probably also aware that if you itemize your deductions, you’re allowed to deduct unreimbursed dental and medical that exceed 7.5 percent of your

continued

adjusted gross income. However, most of us don't spend that much on healthcare, and since the standard deduction nearly doubled with the passing of the Tax Cut and Jobs Act of 2017, many of us don't itemize. As a result, we end up losing a lot of money in otherwise legitimate deductions.

Here's an idea. What if there was a way to write off medical bills as business expenses? Actually, there are three ways:

- Medical Expense Reimbursement Plan (MERP)
- Health Savings Account (HSA)
- Flexible Spending Account (FSA)

In any event, in this chapter we cover each of the three ways to legally write off medical bills as business expenses, starting with the use of an MERP (medical expense reimbursement plan).

Medical Expense Reimbursement Plan (MERP)

The first thing to know about a MERP (also known as a 105 plan) is that it's an *employee* benefit plan. That means it requires an employee:

- If your business is taxed as a sole proprietorship, you're considered self-employed. You can't establish the plan for yourself. However, if you're married, you can hire your spouse.
- If your business is taxed as a partnership, you're also considered self-employed. Again, you can't establish the plan for yourself. However, you can still hire your spouse so long as he or she owns less than 5 percent of the business.
- If your business is taxed as an S corporation, both you and your spouse are considered self-employed. This means you'll need another source of income, not taxed as an S corporation, to establish the plan. (Alternatively, you can establish a health savings account, covered later in this chapter, to give yourself most of the same benefit as the 105 plan.)
- If your business is taxed as a C corporation, you qualify as your own employee, so you can simply hire yourself.

If you're married, and you choose to hire your spouse, you don't even have to pay him or her a salary. You can compensate them in the form of benefits only, which avoids the hassle of filing payroll returns. The main requirement here is that the benefits you pay have to be "reasonable compensation" for the service they perform. If your spouse works an hour a month filing invoices for you, you'll probably have a hard time convincing an auditor that that's "reasonable" for \$4,000 worth of LASIK surgery!

TIP: Take a big-picture approach to healthcare costs. While a high-deductible healthcare plan costs less and makes you eligible to contribute to a health savings account (HSA) and pay out-of-pocket costs out of that account tax-free, a low-deductible plan that covers more expenses may be more cost-effective for your family depending on your situation. Here at SWC, we can help you evaluate different plans and choose a plan that's best for your overall finances.

Owner Eligibility

Business Entity	How to Qualify
Sole Proprietor	Hire Spouse
Partnership	Hire Spouse (if <5% owner)
S-Corporation	>2% Shareholders ineligible
C-Corporation	Hire Self

continued

Eligible Expenses with a MERP

Once the MERP is in place, you can reimburse your employee for any medical expense they incur for themselves, their spouse, and their dependents, including the following:

- Any kind of health insurance, including major medical, long-term care (up to specific Internal Revenue Service limits), Medicare premiums, and even Medigap coverage.
- All copays, deductibles, “co-insurance,” and other amounts insurance doesn’t pay.
- All prescription medications.
- Expenses for dental care, vision care, and chiropractic care that traditional insurance might not cover.
- Some big-ticket expenses such as orthodontist care (braces for children), fertility treatments, and special schools for learning-disabled children. Let’s say your physician diagnoses your 8-year-old son with ADHD, and prescribes *tai kwon do* lessons. Guess what – those lessons are now tax-deductible!
- Over-the-counter medications and supplies, so long as they’re prescribed by a physician.

One big advantage of the medical expense reimbursement plan is that it works with any insurance policy. You don’t have to purchase special coverage. You can use a MERP with insurance you buy on an exchange or on your own. If your spouse receives coverage from their employer, you can even set up a MERP in your business to cover any out-of-pocket expenses your spouse’s insurance doesn’t cover.

Say for instance that you’re a sole proprietor with three children and you’ve hired your spouse to work for your business. The MERP lets you reimburse your employee/husband for all dental and medical expenses he incurs for himself, his spouse (which brings you into the plan), and his dependents – your kids.

This includes all the eligible expenses listed below:



Eligible Expenses

- Major medical, LTC, Medicare “Medigap” Insurance
- Co-pays, deductibles, prescriptions
- Dental, vision and chiropractic
- Braces, LASIK, fertility, special schools
- OTC medications (by prescription)

The best part is, this is money you’d spend anyway, regardless of whether you’d claim it as a deduction. You’ll spend your money on contact lenses or your kids’ braces whether it’s deductible or not. The MERP simply allows you to move it from someplace on your return where you certainly can’t deduct all of it (and probably can’t deduct *any* of it), to a place where you can.

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Setting Up and Using a MERP

Setting up a *medical expense reimbursement plan* (MERP) starts with a written document – a plan, if you will, which we here at SWC can draft for you.

If you've hired your spouse, you'll need to be able to verify that they qualify as a bona fide "employee." That means you need to direct the work they perform for the business, the same as you would direct the work that any other employee performs.

Here's one important requirement that the IRS *will* pay attention to in the unlikely event you're audited – you *must* run the payments through the business. You can't just pay medical bills out of the family personal account, total them up at the end of the year, and throw them on the business return.

This means you have two choices:

- Pay healthcare providers directly out of the business account. If your business account has a debit card or you have a business credit card, you can use it to charge medical expenses directly to the business.
- Reimburse your employees (from the business account) for expenses they pay out of their personal funds. For example, suppose your husband picks up a prescription. He can use his own money, and you can reimburse him from the business account.



The Paperwork

Excludible Employees:

- Written plan document
- Benefits = "reasonable compensation"
- Document payments
- Certification

If you've simply hired your spouse in order to write off your own family's medical expenses, you generally don't need a third-party administrator (TPA), but you will need a TPA if you're reimbursing non-family employees (to avoid violating medical privacy rules).

No pre-funding is required. You don't have to open a special bank or investment account, as you do with a health savings account or flexible spending account. You don't have to decide up front how much to contribute to the plan, as you must do with flexible spending accounts, and there's no "use it or lose it" rule. The MERP is really just an accounting device that lets you recharacterize your family medical bills as a business expense.

The MERP doesn't just help you save *income* tax. It also helps you save *self-employment* tax. Remember, when you work for yourself, you pay a self-employment tax in place of the Social Security and Medicare taxes that you and your employer would share on your salary. That self-employment tax is based on your "net self-employment earnings." Using a MERP, all medical expenses reduce your self-employment income, so you're not paying self-employment tax on that money.

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Determining Employee Eligibility

Here's the not so good news. If you have non-family employees, you must include them. To be sure, you can exclude employees under age 25 who work less than 35 hours per week and less than nine months per year, or who have worked for you less than three years. You can also exclude employees covered by a collective bargaining agreement that includes health benefits. Regardless, having non-family employees may make it prohibitively expensive to reimburse everyone as generously as you'd cover your own family.



Employee Eligibility

Excludible Employees:

- Under age 25
- Less than 35 hours/week
- Less than 9 months/year
- Less than 3 years service

Other Possible

Excludible Employees:

- Controlled group rules
- Affiliated groups

One final formality: The Affordable Care Act imposed a pesky excise tax requirement on MERPs called the “Patient Centered Outcomes Research Trust Fund Fee,” or PCORI fee. For plan in the years ending after September 30, 2019 and before October 1, 2020, that amount is \$2.54 per person, which gets reported on IRS Form 720, and is due by July 31, 2021.

Next up among the three ways to legally write off medical bills as business expenses is the health savings account (HSA).

Health Savings Accounts (HSAs)

If a medical expense reimbursement plan isn't appropriate – either because you don't have a spouse to hire or you have non-family employees you would have to cover – consider establishing a health savings account (HSA). These arrangements combine a high-deductible health plan with a tax-free savings account to cover unreimbursed costs.

To qualify, you'll need to be covered by a high-deductible health plan (HDHP). For 2020, this means the deductible is at least \$1,400 for single coverage or \$2,800 for family coverage. Neither you nor your spouse can be covered by a “non-high deductible health plan” or by Medicare. The plan can't cover any expense, other than certain preventive care benefits, until you satisfy the annual deductible. You're not eligible if you're covered by a separate plan or rider offering prescription drug benefits before the minimum annual deductible is satisfied.

Once you've established your eligibility, you can open a deductible health savings account at your bank to cover out-of-pocket expenses (those not covered by your insurance). For 2020, you can contribute up to \$3,550 if you have individual coverage or \$7,100 if you have family coverage. (If you're 55 or older, you can contribute an extra \$1,000 per year.)

HSAs are easy to open. Most banks, brokerage firms, and insurance companies offer them, and many will issue you a debit card, so you can charge medical expenses directly to the account.

continued



Health Savings Account

High deductible health plan

- \$1,400+ deductible (individual coverage)
- \$2,800+ deductible (family coverage)

Health savings account

- Contribute and deduct up to \$3,550/\$7,100
- Tax-free withdraws for qualified expenses

Generally, you're prohibited from using funds in your HSA to pay health insurance premiums. These funds are for paying out-of-pocket (OOP) costs. You can use your HSA to pay health insurance premiums *only* if you are collecting federal or state unemployment benefits or you have Consolidated Omnibus Budget Reconciliation Act (COBRA) continuation coverage through a former employer.

Withdrawals are tax-free so long as you use them for "qualified medical costs." Withdrawals *not* used for qualified medical costs are subject to regular income tax plus a 20 percent penalty. When you reach the age of 65, withdrawals are no longer subject to the 20 percent penalty, but they're still subject to regular income tax.

After your passing, your HSA account goes to your specified beneficiary. And if your beneficiary is your own spouse, they are allowed to treat it as an HSA of their own. And if they choose not to, your beneficiary will pay ordinary tax on the account proceeds (but not the 20 percent penalty).

The health savings account (HSA) isn't quite as powerful or flexible as the medical expense reimbursement plan (MERP). You have specific dollar limits on what you can contribute to the account, which might not cover all your out-of-pocket costs. And there's no self-employment tax advantage as there is with a MERP. However, an HSA can still help cut your overall healthcare costs by allowing you to deduct those costs.

Finally, your third option for legally writing off medical bills as business expenses is the flexible spending account.

Flexible Spending Accounts (FSA)

Flexible spending accounts (FSAs) are available to those that work for an employer that offers this benefit, which is another way of saying these plans are not available to those classified as being self-employed.

Flexible spending accounts let you set aside pre-tax dollars (up to \$2,750) for a variety of nontaxable benefits, including medical expense reimbursement, and disability and health insurance. FSA plan contributions avoid federal income and self-employment tax. Your employer deducts plan contributions from your paycheck and deposits them into your account until you claim your reimbursements. Your employer can also match your contributions up to \$2,750 but is not required to do so.

Once the money is in the account, you can use it for most medical expenses except

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nonprescription drugs and supplies, long-term care coverage, and associated expenses.

When you enroll, you must choose how much to contribute each pay period. You generally can't change your contribution amount in the middle of the plan year unless there's a change in your family status. Eligible changes include marriage or divorce; birth, adoption, or death of a child; spousal employment; change in a dependent's student status; and the like.

You can claim your full year's reimbursement as soon as you incur qualifying expenses, whether you've fully funded your account for that amount or not.

Historically, FSA rules have required you to use your account balance by the end of the year or forfeit it. However, employers can provide a grace period of up to two and a half months after the end of the year to use the money, or they can allow employees to carry over up to \$500 to the following year.

Now that you have Uncle Sam covering a larger portion of your healthcare costs, consider another tax savings tactic to get him to cover a portion of your home office expenses.

Up next, Chapter 8 – “Maximizing Your Home Office Deduction.”

Maximizing Your Home Office Deduction

If you're self-employed or run a small business out of your home, you can reduce your income tax bill by claiming a *home office* deduction. This deduction enables you to subtract from your income a portion of expenses attributable to the area of your home that you use for business.



For example, if you run a pet grooming business out of 20 percent of your home and use that other 80 percent as living space, under the right circumstances, you may be able to deduct 20 percent of your mortgage interest, property taxes, homeowner's insurance, homeowner association fees, and utilities (such as electricity, gas, water, sewer, and trash). You might even be able to deduct depreciation on that portion of your home.

Hey, it's only fair. Other businesses get to deduct the cost of maintaining a building or renting office space, so you should get a tax break for the portion of your home you use for conducting business.

Unfortunately, many small-business owners don't claim this deduction

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because they fear that doing so will raise red flags and increase their odds of becoming a target for a dreaded tax audit. Others avoid claiming it because they're afraid that the calculations or record-keeping would be too complicated. However, the calculations and record-keeping are straightforward, and there's no evidence that claiming the home office deduction increases your odds of being audited. Besides, as long as you're honest about the business use of your home, and you have records to back up the expenses you claim, even if you do get audited, you have nothing to fear.

In addition to being able to claim the home office expense, if you are using your home office as the base for business auto mileage, it is a good idea to establish your home office as your "tax home." This supports your claim for auto expenses any time you travel from your home office to another business location.

Deciding Whether Your Office Space Qualifies

To qualify for a home office deduction, a portion of your home must be used in *one* of the following ways:

1. Exclusively and regularly as your principle place of business
2. Exclusively and regularly as a place where you meet and deal with your customers in the normal course of your business
3. A separate structure that's not attached to your home and is used exclusively and regularly in connection with your business
4. On a regular basis, the space is used for storage of inventory or product samples used in your business for selling products at retail or wholesale (note: this usage does not have to be exclusive)
5. For rental use
6. As a daycare facility

Let's translate this into plain English:

- In #1 above, *principle place of business* means that you have no other fixed location where you conduct substantial administrative or management activities of your business. In other words, if you have an outside office where you conduct most of your business and you're bringing work home with you, you do not qualify for this deduction. There is, however, an exclusion to this for an administrative office required by your employer, which is not discussed in detail here. For more info on this, feel free to contact us here at SWC.
- In #1, #2, and #3 above, "exclusively" means you can't use the same space for personal and business purposes. The example the Internal Revenue Service (IRS) gives is that if you're an attorney and use the den of your home to write legal briefs and for personal purposes, your home doesn't qualify for the home office deduction. On the other hand, if you're a freelance commercial artist and use a room of your home as your studio, that room qualifies for the home office deduction.

Pro Tip: You may be able to use expenses associated with a home office to reduce self-employment income and taxable income from your business — but not below zero. If your home office expenses for a particular year are more than your net income from your business, you may be able to carry forward the loss to future years.

continued

- In #1, #2, and #3 above, “regularly” generally means at least 10 to 12 hours per week.
- In #4, #5, and #6, note that the word “exclusively” is omitted. For example, if you’re running a daycare facility out of your home, and you use your kitchen, dining room, living room, and den during the day as your business space, you can deduct the expenses related to those areas. You just need to calculate the percentage of time that space is used for business.
- Your home office doesn’t have to be an entire room. You can use part of a room so long as it meets the requirements. And in the case of storing inventory, it does not have to meet the “exclusive” requirement –you can store your inventory in your garage and claim a portion of that space!

Assuming the space you use for business qualifies for the home office deduction, you can start deducting expenses. If your business is taxed as a sole proprietorship, you’ll use Form 8829 – *Expenses for Business Use of Your Home*. If your business is taxed as a corporation, you’re not allowed to take the home office deduction, but you can have the corporation reimburse you for home office expenses and then deduct the expense through the corporation’s tax return. If your business is taxed as a partnership, you can deduct home office expenses as unreimbursed partnership expenses.

Choosing a Method

The IRS provides two methods for calculating the home office deduction – the *regular method* and the *simplified option*. A third method enables you to lease space to your business for up to 14 days per year tax-free and deduct the rent as a business expense. The following sections explain these three options.

The Regular Method

With the regular method, you calculate the percentage of your home used as a business. For example, if your home is 2,400 square feet, and your office is 15-by-12 (180 square feet), the percentage of your home used for business is 180 divided by 2,400, which equals 0.075 or 7.5 percent of your home.



If the rooms of your home are all roughly the same size, you can calculate the percentage by dividing the number of rooms you use for business by the total number of rooms. For example, if your home has 10 rooms all about equal in size and you use one of them for business, 1 divided by 10 equals 10 percent.

If you’re running a daycare from your home and use space both for living and business purposes, multiply the percentage space you use for business by the percentage of time it’s used for business. For example, suppose your home is 2,500 square feet, and you use half of it

continued

during the course of the business day, but the business day is only 10 hours five days a week. The percentage of your home space used for business is 50 percent, but the percentage time that space is used is 50 hours divided by 168 hours in a week, which equals about 0.30 or 30 percent. Multiply 0.50 by 0.30, and you get 0.15, which is 15 percent.

The next step is to use that percentage to calculate indirect expenses – expenses related to the entire home, as opposed to expenses related only to your office space. For example, if your electricity bill was \$4,000 for the year, multiply the percentage of your home by \$4,000 to determine your deduction. If your office space is 7.5 percent of your home, your deduction for electricity would be \$4,000 times 0.075 = \$300. Repeat that calculation for all expenses that apply to your entire home, including the following:

- Homeowner's insurance
- Mortgage interest
- Property taxes
- Homeowner's association fees
- Cleaning services
- Maintenance, repairs, or improvements for the entire home (such as a new roof or siding, furnace or air conditioning maintenance or replacement, a security system, and so on)
- Utilities (gas, electric, water, sewer, trash)
- Depreciation of the home, which is the only complicated calculation. Start with your basis in the home (what you paid for it plus the cost of any improvements), subtract the cost of the land, and divide by 39 (the number of years over which the property will be depreciated). The first year you place the office in service, instead of dividing by 39, you multiply by a percentage specified in a table provided on the instructions for filling out form 8829. For example, if you first started using the home for business in June, you'd multiply the basis of your home by 0.01391, which is 1.391 percent.

The final step is to add in any *direct expenses* – 100 percent of any expense related exclusively to the office space. For example, if you replace the carpet in the office or have the office painted, you can deduct the entire expense. (You're not allowed to deduct expenses for the parts of your home not used for business, for example, lawn care or painting a room not used for business.)

The Simplified Option

With the simplified option, you claim a flat rate of \$5 per square foot for up to 300 square feet of qualifying home office space (regardless of what percentage it occupies in your home and regardless of your actual expenses). If you itemize, you can deduct mortgage interest and property tax on Schedule A (Form 1040 – Itemized Deductions). You lose the depreciation

Note: When you use the regular method, you claim depreciation as a home office expense; when you sell your home, the sale may result in a capital gain due to depreciation recapture, and you will be responsible for paying taxes on that gain. For example, if over the course of 15 years, you claimed \$10,000 in depreciation for your home office and you sell the home for a profit of more than \$10,000, that amount is treated as a taxable gain even if your total profit on the sale of the home is less than the allowable \$250,000 tax-free residential sale exclusion.

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deduction, but when you sell your home, you won't be subject to depreciation recapture for the years you use this method.

The simplified option is easier than the traditional method, but you're likely to end up with less of a deduction. The only way to know is to run the numbers and calculate the deduction both ways.

The Renting Your Home Approach

Another way to use your home as a business deduction is to have your business rent your home for up to 14 days per year and deduct the rent as a business expense, assuming the business has a separate and distinct corporate identity. In other words, this method is an option if your business is organized as a C corporation or S corporation, but it is *not* an option if your business is structured as a sole proprietorship or single-member limited liability company (LLC).

If you use this method, note the following:

- You must charge a fair market rental rate for your home, which you can determine by checking rental rates for similar properties in your area.
- You must document business use of your residence, which you can do by keeping a record of shareholder meetings, business planning meetings, budgeting meetings, staff meetings, or other business on the dates the property was used.
- The corporation must file a Form 1099-MISC to report the income, and you must report the rental income on Schedule E (Supplemental Income and Loss), Form 1040, but you can then zero out the rental income by reporting "other deductions."

An Additional Perk

Claiming the home office deduction can also boost your car and truck deductions by minimizing or even eliminating nondeductible commuting miles for your business. For example, suppose you're a real estate agent with a desk at your broker's office. If you don't have a home office, your trip from home to the office is a nondeductible commute. However, if you have a home office, and you start your workday in that office, your "commute" is your trip to the home office, and your trip from home to your desk at the broker is a deductible trip from one business location to another.

We refer to this as the "doorknob touch rule." When you touch the doorknob of the first location you work at during a day, the business mileage from that point becomes deductible. Therefore, if you touch the door knob of the home office first, perform work there and then leave to the brokers office, for example, mileage to the brokers office and any other business locations then becomes deductible, including the mileage to return to the home office at the end of the day.

As discussed earlier, it is important to establish your home office as your "tax home" for the purposes of qualifying auto expenses.

Speaking of deducting car and truck expenses, that just happens to be the topic of the next chapter – "Deducting Qualifying Car and Truck Expenses."



Deducting Qualifying Car and Truck Expenses

Did you know that if you have a motor vehicle and a business, you may have a tax deduction coming your way? It's true. In many cases, you can deduct from your business profits the cost of buying, driving, and maintaining that vehicle. And if you use it exclusively or almost exclusively for work, you may be able to get the government to pay a good chunk of the expenses related to that vehicle (in the form of money you save on taxes).



That's only fair. Every penny you put into driving to deliver product or perform a service for your customers is a penny out of *your* business profits!

In this chapter, we cover how it may be possible to claim a deduction on a qualifying car, truck and related expenses.

continued

Two Ways to Claim Vehicle Expenses

In these United States, the Internal Revenue Code provides for two different ways to claim vehicle expenses:

- Actual expenses:** You claim the business use percentage (BUP) of all expenses related to a vehicle, including fuel cost, auto insurance, lease payments (or loan interest and depreciation), personal property tax, repairs/maintenance (oil changes, tires, etc.), and car washes. For example, suppose you use a vehicle 75 percent for business and 25 percent for personal use, and your total vehicle expenses are \$8,000 for the year. Your deduction would be $\$8,000 \times 0.75 = \$6,000$.
- Standard mileage:** You multiply the number of miles you drove the vehicle for business by the standard per-mile rate, which is 57.5 cents for the year 2020. For example, if you put 8,000 business miles on a vehicle $8,000 \times 57.5 = \$4,600$. Using this method, you can also deduct the business use percentage of vehicle registration fees and taxes, vehicle loan interest, and tolls and parking fees. (**Note:** You cannot use the standard mileage method if you use five or more vehicles in your business, or you use your vehicle for hire; for example, taxi, Lyft, Uber, etc.)

Many small-business owners choose the standard mileage option because it's so straightforward in terms of calculations and record-keeping. All you need is your odometer meter reading at the beginning and end of the year and a log of the number of miles you drove for business (which you should keep regardless of the method you use to calculate your deduction). You don't need a receipt for every time you fuel up or take your vehicle in for an oil change.

However, using the easy method could cost you money. Every year, the American Automobile Association (AAA or more commonly "Triple A") conducts in-depth research into vehicle operating costs. If you're choosing to take the standard deduction for a vehicle that costs more than 57.5 cents/mile, could be losing money by not claiming your actual expenses.

Step 1: Keep Detailed Records

The most difficult aspect of claiming actual expenses is that you must keep detailed records, not only of all your expenses but also of all your business trips. Here's a list of the records you need to keep:

- Odometer reading at the beginning and end of the year, so you can calculate the total number of miles the vehicle was driven each year.
- A record of every business trip, including the mileage driven, the date, the departure and destination points, and the names and relationships of the parties (for example, customers or partners).
- Fuel receipts

AAA Driving Costs Survey (2019)

Vehicle	Cents / Mile
Small Sedan	47.4
Medium Sedan	57.6
Large Sedan	69.4
Medium 4WD SUV	68.4
Minivan	66.9

Figures assume 15,000 miles/year

continued

- Maintenance and repair receipts (including oil and tires)
- Registration form showing vehicle registration fees and taxes
- Records of vehicle loan or lease payments
- Cost of the vehicle and year placed in service (to calculate depreciation)
- Car wash/detailing receipts
- Invoice or other record of vehicle insurance payments
- Receipts of any tolls, parking fees, or garage rental fees paid

Step 2: Calculate Your Business Use Percentage

The next step to calculating your vehicle deduction based on actual expenses involves calculating your business use percentage (BUP) for your vehicle. The Internal Revenue Service (IRS) allows you to divide your trips into three categories:

- Business
- Commuting
- Personal

Ordinary personal and commuting trips are nondeductible. Trips from your home to your first business stop, and trips from your very last business stop to your home are considered *personal* (unless, of course, your home is your principle place of business). (Note that trips around town to the post office, copy center, bank, and other stops along the way where you perform no business-related service yourself do not qualify as “business.”) In short, personal and commuting miles don’t count as business miles.

And in case you’re wondering, yes, you can deduct the cost of branding your vehicle with your company name and logo.

Next, the IRS gives you these four (4) ways to track what qualifies as “business” miles:

- 1. The Brute Force method:** Here, you record every business mile you drive for the fiscal year. You then divide your business mileage by your total mileage for the year. (If you use more than one vehicle for business, this is the method you have to use.)
- 2. The 90-days method:** With this method, you record your business miles for a typical 90-day period. Next, divide that amount by your total mileage for that period to calculate BUP, then use that percentage for the entire year.
- 3. The First Week method:** With the first week method, you record your business miles for the first week each month. You then divide that by your total miles for that period and use it for the entire month.
- 4. The Simplified method:** Here, you record your starting and ending mileage for a 90-day period. Record your personal and commuting miles for that period and assume all the rest of your miles are for business. Calculate your BUP and use it for the entire year.

Another *in case you’re wondering...* yes – travel between temporary business stops *is* deductible.

continued

For example, if you leave home, make four business stops, meet a business prospect for lunch, then drive home, your mileage between your first stop and the restaurant is deductible. Also, if you have a regular business stop, one that you make at least eight to 10 times in a six-month period and that you expect to last less than a year, you can count those as business miles. And if your home is your principal place of business, then all business trips are deductible.

Step 3: Calculate Your Vehicle Deduction

After you've calculated your BUP (business use percentage), you have two ways to calculate your vehicle deduction based on actual expenses:

1. Total all expenses for your vehicle:
 - Depreciation and interest (if you purchased your vehicle)
 - Lease payments (if you've leased your vehicle)
 - Insurance
 - Gasoline, oil, and car washes
 - Tires, maintenance, and repairs
 - License and registration fees
 - Personal property tax payments
 - Parking and tolls
2. Multiply the total by the vehicles BUP.
3. Repeat Steps 1 and 2 if you have more than one vehicle you use for business.

Compare Methods

Which approach saves the most? There's one way to find out – try them both and see for yourself. Generally, if you log a lot of business miles, the standard mileage method is likely to save you the most money – especially if your vehicle expenses are relatively low. For example, you drive a vehicle that's been paid off and requires little in maintenance and repairs. If you're a real road warrior and log 25,000 or more business miles per year, you'll almost certainly come out ahead with the standard mileage method, regardless of the vehicle you drive.



What if you've been using the standard mileage method because it's easier, or because your tax preparer told you it was all the same, and you discover you ought to be taking actual expenses. What now? You *can* switch from the standard mileage to the actual expense method *if* you own your car – but not if you lease.

Unfortunately, the reverse isn't true. You can't switch from actual expenses to the mileage allowance.

Another deduction that small-business owners tend to underutilize is the deduction for qualifying meals and entertainment. Suppose you and your life partner, who also happens to be your business partner, discuss business over lunch – that's deductible. Office holiday parties, annual picnics, office retreats, team lunches – all deductible. Next, see Chapter 10 to find out how to qualify for these deductions and reduce your tax bill without overstepping your bounds.

Deducting the Costs of Qualifying Meals, Entertainment, and Gifts

As a small-business owner, you know that you can easily rack up a considerable amount in expenses over the course of the year dining with and entertaining clients, colleagues, and partners. Then there's hosting "free" seminars or presentations for prospective clients. And feeding your employees (for example, *donuts and coffee for a morning meeting or pizza and soft drinks for a team that's working overtime on a project*). You may even have additional expenses related to gifts presented to customers and vendors to show your appreciation for their business and efforts on your behalf.

continued



All this is money *leaving* the business and not going into *your* pocket, so it should be deductible, right? Yes, it is, but just how deductible it is depends on the context in which that money is spent and who received the benefit.

In this chapter – No. 10 of 12 in our *Small Business Guide to Reducing Your Tax Burden Legally series* – we break down business deductions for meals, entertainment, and gifts, to ensure that you’re taking full advantage of what the government allows, taking care to not do something that may prompt the government to question any of your deductions.

Deducting the Cost of Meals Out

If you’re in a business such as management consulting, marketing services, insurance, or personal finances, you likely spend considerable time meeting with clients over lunch, coffee, or drinks. In other businesses, you may meet with partners or colleagues to discuss plans for business ventures or projects you’re currently working on together. As long as meals you pay for under either of those scenarios are for a legitimate business purpose – with existing clients, new business prospects, and business colleagues such as vendors you work with – they’re deductible.

Costs for business meals (food and beverage) are generally deductible up to 50 percent, but expenses must meet the following conditions:

- Business meals must be “ordinary and necessary”
- The meal must not be “lavish or extravagant”
- An owner or employee of the business must be present at the meal
- If the meal is part of an entertainment event, only the cost of the meal is deductible

Since the United States government (*i.e.*, the *Internal Revenue Service*) assumes you have to eat – whether it’s home or out with a business client – you may not deduct the entire cost of the meal. But they are willing to meet you halfway – literally. This deduction includes costs for the following:

- Food and drinks
- Taxes
- Tips (believe it or not – including for valet parking)

In case you’re wondering, you generally can’t deduct the cost of meals you eat with your spouse unless you’re traveling together for business. However, the cost of a spouse or other “closely connected” person can be included if your guest brings *their* spouse.

While documenting expenses sounds like a stressful practice, you’ll be glad to know that you do not need to keep and record receipts for expenses under \$75. However, you will need to record five pieces of information related to those expenses:

- Date of the expense
- Location of where the expense occurred
- Cost/receipt
- Purpose of the meal/meeting

continued

- Names/occupations/positions of people attending the meeting/meal

Also, you can deduct off-premises meals you pay for as part of required business meetings. For example, if you take your employees out to lunch to discuss an upcoming project.

Entertaining at Home

If you entertain at home and discuss business during such occurrences, you may be able to deduct those meals, too. At the end of the day, there's no requirement that you must eat *out* to deduct the cost of a business meal. With that in mind, don't forget to deduct the costs of eating with and entertaining guests at home for business purposes. If you have up to 12 guests, you'd use the same rules as if you were eating out. If you have more than 12 guests in your home, you can deduct "reasonable" costs, but only if your primary purpose of your in-home gathering is business.



Hosting Promotional Seminars and Presentations

If you host promotional seminars or presentations to market your products or services, don't make the common mistake of claiming those events as meal and entertainment expenses. These are marketing expenses and are 100 percent deductible. For example, if you're an attorney hosting a seminar on estate planning at a boutique hotel, you can write off the entire bill.

Note: You used to be able to deduct entertainment expenses for items such as sporting events, movie theatre tickets, and musical concerts, if they took place directly before or after substantial discussions directly related to the focus of your business. Back in the day, you could deduct the face value of tickets to events, food and drinks, parking, taxes, and even allowable tips.

That is, you *could*, meaning now you *can't*. The Tax Cuts and Jobs Act of 2017 eliminated that deduction.

Other 100% Deductible Meal Expenses

The costs for hosting promotional seminars and presentations aren't the only 100 percent deductible meal expenses. Other meal expenses that fall in this category include the following:

- Business holiday parties and company picnics
- Office snacks provided for employees
- "Working lunches" and other meals – for example, to reward employees for working late or on weekends for the employer's benefit
- Meals included as part of a contractor's compensation

Deducting the Cost of Business Gifts

Curious about business gifts? Gifts for *business associates* (a person or entity that performs

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certain functions or activities that is for the benefit of your business) are deductible up to \$25 per person annually, *if* you can show a business purpose for the expense or business-related benefit to be gained by your business. This includes your family and friends if they qualify as genuine clients, prospects, or referral sources. (Married couples count as one person for this rule – meaning, you can’t deduct \$25 for each.) Finally, keep these other gifting rules in mind:

- When presenting a gift to a group of recipients, such as the staff of an office, you can deduct \$25 for each member of the group.
- Promotional items such as branded pens and mugs with a value up to \$4 each, are deductible as advertising expenses and don’t count against the \$25 per person annual limit for business gifts.
- Gifts are nontaxable to the recipient.

As a small-business owner, you’re responsible for tracking your income and tax-deductible expenses, including expenses for meals, entertainment, and gifts, along with all the tax-deductible expenses covered in the previous chapter. You then have the added obligation each quarter of estimating your income, expenses, and net profit and calculating what you owe in estimated taxes to federal, state, and local governments.

Many small-business owners like you approach the end of each quarter with dread for just those reasons. To make the process easier to manage and less dreadful, see Chapter 11 – “Calculating Tax Withholding and Estimated Taxes.”

Calculating Tax Withholding and Estimated Taxes

Nobody looks forward to paying taxes, but it's less painful when tax withholdings are calculated by an employer and automatically withheld from your pay. Much easier than crunching the numbers ourselves and then paying the government out of our savings. Somehow, the latter process feels like we're working for Uncle Sam, and that's not a pleasant feeling.

Here in the United States, ours is a *pay-as-you-go* tax system, meaning we taxpayers are expected and required to pay taxes on our income as we earn it – instead of paying it all at once at the end of the year. Employees have taxes automatically withheld from their paychecks by their employers, which satisfies the taxing authority's requirement.

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In contrast, if you're a small-business owner, you face the onerous task of calculating your income and expenses, *estimating* the amount of tax owed on that amount, and cutting checks (or making electronic payments) for the amounts due to state and federal entities. These include the Franchise Tax Board here in California, and/or the Internal Revenue Service (IRS). And, you're required to repeat this process four times a year, to pay your businesses quarterly estimated federal, state, and local taxes.

No one wants to get stuck with a huge tax bill (and penalties) at the end of the year. Nor do we want to overpay, which is essentially giving the government a free loan while leaving ourselves and our business with less of the money we earned. As small-business owners ourselves, we at SWC feel your pain, so in this chapter of our *Small Business Guide to Reducing Your Tax Burden Legally* – the 11th in our 12-chapter guide – we lead you through the process of estimating your taxes, hopefully making it a little less painful. But first, we need cover a few preliminary topics.

Understanding Tax Withholdings and Estimated Taxes

According to the IRS, “Taxes must be paid as you earn or receive income during the year, either through withholding or estimated tax payments.” *Withholdings* are taxes an employer collects on behalf of the taxing authorities and sends to them on behalf of the employee. *Estimated taxes* are generally those paid quarterly based on a business entity's expected business income.

Taxpayers are required to pay estimated taxes in the following situations:

- The amount of income tax withheld from your salary or pension is not enough.
- You receive additional income such as interest, dividends, alimony, self-employment income, capital gains (for example, from selling stock for a profit), prizes, and awards from which taxes have not been withheld.
- You are in business for yourself, in which case the estimated taxes you pay cover not only the income tax you owe but also self-employment tax and alternative minimum tax (if applicable).
- If you don't pay enough tax through withholding and estimated tax payments, you may be charged interest, calculated weekly, on what you should have paid. You also may be charged interest if your estimated tax payments are late, even if you are due a refund when you file your tax return.
- To avoid having to pay interest, you must deposit a certain minimum amount by the end of the year:
 - If your 2019 Adjusted Gross Income (AGI) was \$150,000 or less, you'll need to withhold 100 percent of your 2019 tax or 90 percent of your 2020 tax.
 - If your 2019 AGI was more than \$150,000, you'll need to withhold 110 percent of your 2019 tax or 90 percent of your 2020 tax.

Estimated taxes are the alternative for small-business owners. With the estimated tax approach, you estimate your total bill, divide the estimate by four, and send quarterly payments to the IRS. As with withholding payments, you owe specific percentages by deadlines set by the taxing authorities. And if you miss any of the deadlines, you'll owe interest on what you should have paid.

continued

For 2020, estimated tax due dates are:

- 22.5 percent by April 15
- 45 percent by June 15
- 67.5 percent by September 15
- 90 percent by January 15

Whether you're an employee or self-employed, we encourage you to review your withholding and estimates whenever your tax picture changes, such as in the following cases:

- You get married or divorced
- You have a baby (or adopt)
- You or your spouse takes a new job
- You or your spouse gets a raise
- You buy or sell a house
- You sell *appreciated property* (real, personal, or intangible assets having a fair market value greater than their original cost)

If you're an employee, you can change your withholding by submitting an updated Form [W-4](#) to your employer. If you're self-employed, you'd use Form [1040-ES](#) to calculate and pay quarterly estimated taxes. You may also find the following IRS publications useful:

- [IRS Publication 505: Tax Withholding and Estimated Tax](#)
- [IRS Publication 919: How Do I Adjust My Tax Withholding? \(PDF File\)](#)

Who Must Pay Estimated Tax

The bar is low for determining who's required to pay quarterly estimated taxes. That said, you're required to pay estimated tax if you meet any of the following conditions:

- An individual who's a sole proprietor, partner, or S corporation shareholder and expects to owe \$1,000 or more in federal tax upon filing the annual federal tax return.
- A corporation that expects to owe \$500 or more in federal tax upon filing the annual federal tax return.
- An individual who owed taxes in the prior year may be required to pay estimated tax for the current year.

If you're unsure whether you're required to pay estimated tax, ask us using the [Contact information](#) on our website, or if you're one of those do-it-yourselfers, see [Form 1040-ES, Estimated Tax for Individuals](#) or [Form 1120-W, Estimated Tax for Corporations](#).

Tip: If you operate your business as a corporation, you can draw income through the year in the form of loans, then convert the loans into income (and withhold the resulting tax) in a single lump sum at the end of the year.

continued

Who Doesn't Have to Pay Estimated Tax

You don't have to pay estimated tax for the current year if you meet **all three** of the following conditions:

1. You had no tax liability for the prior year, meaning your total tax was zero or you didn't have to file an income tax return for the prior year.
2. You were a U.S. citizen or resident for the whole year.
3. Your prior tax year covered a 12-month period.

If you're an employee receiving salaries and wages, you can avoid paying estimated tax by asking your employer to withhold more tax from your earnings. You make such a request by filing a new [Form W-4](#) with your employer. Form W-4 has a line on which you can specify the additional amount you want your employer to withhold.

If you receive a paycheck, you can use the IRS's [Tax Withholding Estimator](#) to be sure you have the right amount of tax withheld from your paycheck.

How to Calculate Your Estimated Tax

In the following sections, we present a nine-step process for calculating your estimated tax for any given quarter of the year, assuming you're a small-business owner (and not an employee).

Step 1: Estimate your annual business income.

The easy way to estimate your annual business income is to look at last year's income, then compare your total business income from last year at this time to your total business income so far this year and make a reasonable projection about this year's income.

For example, suppose you're nearing the end of the second quarter.

- Your business pulled in \$150,000 last year, \$70,000 of which was earned by the end of the second quarter.
- This year, you've already earned \$80,000 by the end of the second quarter, so you're pretty sure you're going to earn more than last year, probably at least \$10,000 to \$20,000 more.

You decide to play it safe and estimate high, so you project that your business will pull in \$170,000 this year.

Step 2: Estimate your annual business expenses.

Repeat Step 1, but this time, look at your total business's *expenses* from last year, then compare your total business expenses from last year at this time to your total business expenses so far this year, and make a reasonable projection about this year's expenses.

For example, suppose:

- You had \$30,000 in business expenses all of last year, \$17,000 of which you spent by the end of the second quarter.
- This year, you've spent \$20,000 to cover the first and second quarter's business expenses, which is \$3,000 more than you spent during the first half of last year, so you project that you'll probably spend at least \$3,000 to \$6,000 more than last year.

You decide that \$6,000 is probably more accurate, so you expect to spend \$36,000 by the end of this year.

continued

Step 3: Estimate your taxable business income (and ultimately your total income).

You project that your business will pull in \$170,000 this year and spend \$36,000 to cover business expenses, so, $\$170,000 - \$36,000 = \$134,000$, which is your projected business income for the year. (Note: This is where you stop to calculate self-employment tax, which is Step 5 below.)

Now, subtract \$12,200 (your standard deduction for a single taxpayer).

If you and your spouse own and run the business together and are filing jointly, subtract \$24,400.

Assuming you take the standard deduction for a single taxpayer, that knocks your business income down to $\$134,000 - \$12,200 = \$121,800$.

If you itemize deductions, this is when you would estimate all of your itemized deductions and reduce your taxable income by that amount. For the sake of ease, we are using the standard deduction for examples.

Assuming your business income is all your income for the year, that \$121,800 is a good ballpark estimate of your adjusted gross income (AGI).

Once you have resolved what your business income is, it would now be time to add in all other taxable income such as wages, interest, dividends, etc. For the sake of this example, we are assuming that your business is all of your income.

Step 4: Calculate your projected total income tax for the year.

Calculate the tax due on your total business income based on the current year's tax tables. For example, for single taxpayers, 2020 tax rates are as follows:

- 10 percent on the first \$9,875
- 12 percent on income ranging from \$9,876 to \$40,125
- 22 percent on income ranging from \$40,126 to \$85,525
- 24 percent on income ranging from \$85,526 to \$163,300

To continue our example, the federal tax on \$121,800 would look like this:

- 10 percent of \$9,875 = $0.10 \times \$9,875 = \98.75
- 12 percent of $\$40,125 - \$9,875 = 0.12 \times \$30,250 = \$3,630$
- 22 percent of $\$85,525 - \$40,125 = 0.22 \times \$45,400 = \$9,988$
- 24 percent of $\$121,800 - \$85,525 = 0.24 \times \$36,275 = \$8,706$

So, the total tax would be $\$98.75 + \$3,630 + \$9,988 + \$8,706 = \$22,422.75$

Step 5: Calculate your self-employment tax.

To calculate self-employment tax, multiply *total business income* (before subtracting for your standard deduction) by 92.35 percent, then multiply the result by 15.3 percent, which is the total of Social Security tax (12.4 percent) and Medicare (2.9 percent).

- In our example, $92.35 \text{ percent} \times \$134,000 = \$123,749$, and $\$123,749 \times 0.153 = \$18,933.60$.

continued

Step 6: Calculate your total federal tax.

Add your income tax and self-employment tax together to determine your total estimated tax for the year.

- In our example, the total projected annual tax would be $\$22,422.75 + \$18,933.60 = \$41,356.35$.
- Step 7: Subtract the federal tax you paid so far.
- Subtract any quarterly estimated federal tax payments you already made this year and any refund from last year's taxes you applied to this year's federal taxes from the total in Step 6. For example:
 - If you applied \$1,000 in refund from last year's taxes and paid \$8,000 in first quarter estimated taxes, that's \$9,000.
 - In our example, the total projected federal tax remaining for the year would be $\$41,356.35 - \$9,000 = \$32,356.35$.

Step 8: Calculate your remaining quarterly payments.

Next, divide the result in Step 7 by the number of remaining quarterly payments to estimate the amount of each of the remaining payments. In our example, this is the second quarter, so including the second quarter payment, we're looking at three remaining payment periods, so divide the total from Step 7 by three: $\$32,356.35 \div 3 = \$10,785.45$.

Step 9: Calculate your state and local taxes.

Finally, repeat Steps 1-8 to calculate your state and local taxes. The only variation in the process is the tax rate(s) you use in Step 4 and the fact that you skip Step 5 because you won't owe self-employment tax at the state and local levels.

Paying Estimated Taxes on Time

To avoid penalties, you must pay your estimated taxes on or before specific due dates. For estimated tax purposes, the year is divided into four payment periods, which are typically as follows:

- 1st Quarter – April 15
- 2nd Quarter – June 15
- 3rd Quarter – September 15
- 4th Quarter – January 15

Easy? Not necessarily. We are here at SWC to help you with these calculations!

Next, in Chapter 12, we tell you about the people who are trying to rip you off, the clever scams they try, techniques you can put in place to keep yourself from becoming easy prey, and how all of that relates to the focus of this guide – Reducing Your Tax Burden Legally.

Pro Tip: Most states that collect income tax impose the same deadlines as the IRS. To boost your current year's itemized deductions, prepay your fourth quarter estimate this year to claim the deduction on next year's return. If you wait until next year to pay, you'll have to wait until the following year to claim the deduction. When using this approach, keep in mind that there's a \$10,000 annual limit on deducting state and local taxes as itemized deductions.

Protecting Your Business Against Theft, Embezzlement, and Fraud

Today's headlines are filled with stories about small-business fraud, but a vast majority of these stories are about small-businesses *committing* fraud against the government. Most recently, the news media have focused on fraud involving the Paycheck Protection Program (PPP) – the federal government program designed to keep small businesses solvent during the coronavirus pandemic. The PPP provided ample opportunity for con artists and dishonest small-business owners to defraud the government – and you, the taxpayers – of millions of dollars.

continued



What you hear much less about are the far more common crimes *against* small businesses, many of which are committed by trusted employees. These crimes include the following:

- **Theft:** Stealing money or property from the business outright.
- **Embezzlement:** Diverting money or property from the business for the employee's own personal use.
- **Fraud:** Tricking a business into “voluntarily” giving away money or property.

These crimes cut into the profits of any business, but they can be especially devastating to small businesses, and are more difficult and costly for those small businesses to protect against and recover from. In this chapter, we look at the high costs of these workplace crimes (often referred to as *occupational fraud*); suggest ways that small businesses can protect against, detect, and recover from these crimes; and highlight the importance of retaining professional services when necessary.

Recognizing the High Costs of Theft, Embezzlement, and Fraud

The U.S. economy is built on the backs of small-business owners, who collectively account for \$8.5 trillion dollars of the country's \$17 trillion Gross Domestic Product (GDP). Unfortunately, as we all know, money attracts thieves, and small businesses are often the easiest targets.

Criminal schemes targeting small businesses rarely attract public attention and often go undetected for many years. That's no surprise given the fact that crimes targeting small businesses are often inside jobs committed by trusted employees. In fact, employees are stealing more than employers are aware. Recent statistics on employee theft reports that 75 percent of employees have admitted to stealing from their employer once, and 37.5 percent have stolen twice.

To protect their businesses and their own financial health, small business owners must implement comprehensive approaches to protect, detect, and recover in the unfortunate event they fall victim to occupational fraud. Problem is, they seldom take the necessary steps. Limited resources, lack of education in business operations, and limited staff and expertise restrict many business owners from establishing effective control measures. Unfortunately, it is not until after the money goes missing that they appreciate the importance of control measures.

The aftermath of fraud is long-lasting – it affects the owners personally, professionally, emotionally, and financially for years after the fraud occurs. The biggest regret small business owners have is that they hadn't taken preemptive measures. While the effects of fraud are difficult to withstand, realizing that preventive measures could have prevented the loss is especially agonizing.

Small business owners endure the added stress of responding to customers' and employees' inquiries in a delicate manner to avoid legal ramifications or damage to the reputation of the business. The repercussions of fraud cause victims to feel vulnerable, exposed, and apprehensive. These feelings are intensified for business owners as they navigate through unfamiliar territories when deciding how to proceed with fraud charges and legal processes.

Learning to identify the red flags will help you detect occupational fraud and start the investigation

continued

process sooner. Losses will be reduced and small businesses like yours will have a better chance of withstanding the financial impact of the theft.

Increased Risks for Small Businesses

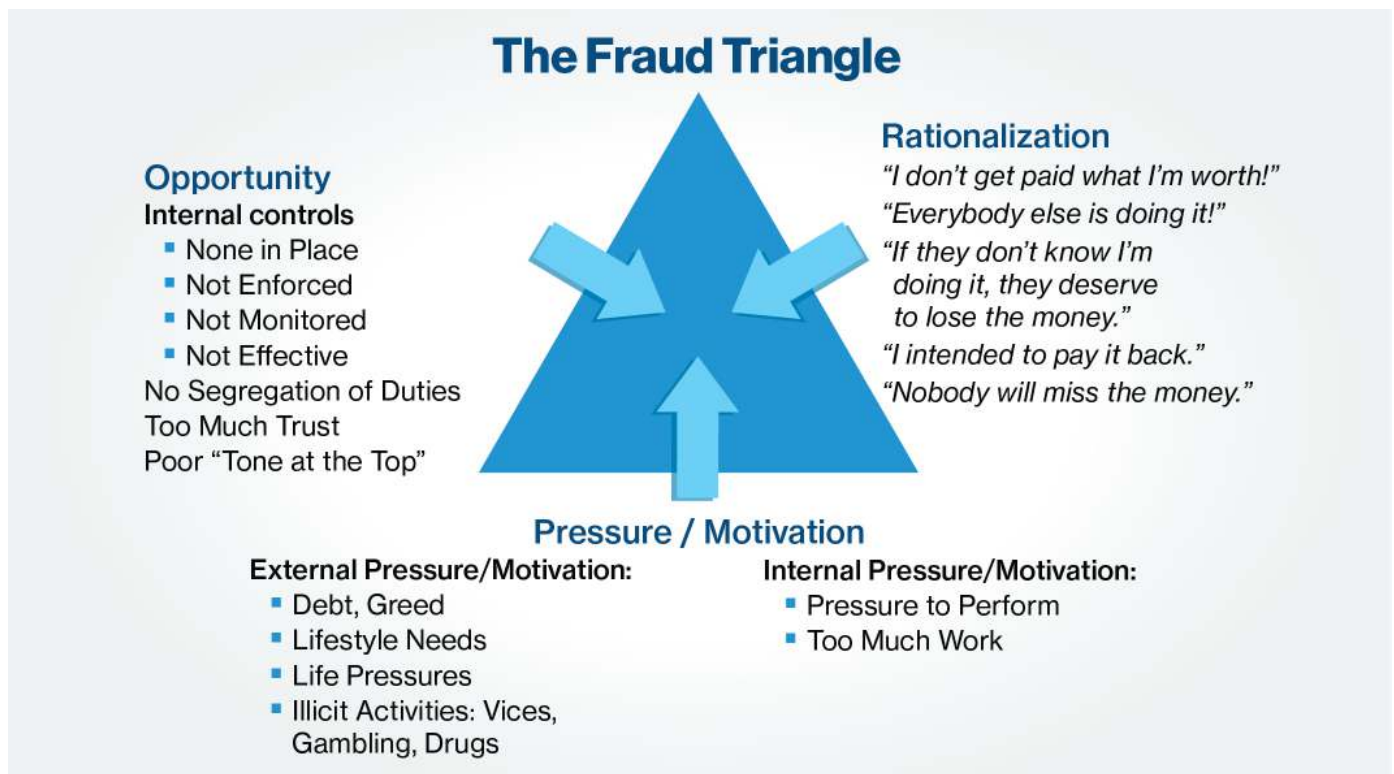
Small businesses are especially vulnerable to theft, embezzlement, and fraud. Why? Well, to be frank, if you own a small business, you're more likely to have limited resources to perform countless duties to keep the company afloat. As profits grow, you can afford to hire employees and delegate some of the tasks, allowing you to focus on higher-level business tasks. However, your drive to succeed, which is an admirable attribute, can regrettably morph into an obsession that causes tunnel vision.

As a result, if you own and operate a small business with fewer than 100 employees, you may find yourself at risk of becoming increasingly susceptible to making mistakes that increase your probability of being defrauded by staff. Common mistakes include:

- Relying too heavily on employees.
- Trusting without verifying.
- Failing to implement internal controls or implementing weak controls.

In the [2018 Report to the Nations](#) (the largest global study on occupational fraud), the Association of Certified Fraud Examiners (ACFE), identified that small businesses with 100 employees or fewer had the highest incident rate of occupational fraud and suffered the greatest monetary loss.

Identifying Risk Factors: The Fraud Triangle



continued

ACFE founder, Donald Cressey, leveraged his experience as a sociologist and a criminologist to develop the fraud triangle theory, which postulates that all fraud is comprised of three critical elements:

- Perceived pressures inside and outside the workplace
- Rationalization
- Opportunity

Keeping these three elements in sight will help you minimize the threat of fraud, especially by employees.

Unfortunately, your suffering as a result of a fraudulent act may not stop just because the fraud has been discovered. A failure to recognize the red flags of fraud is often used as defense maneuver in civil litigations as evidence of your own negligence and failure to perform a duty of care. As a result, Cressey's fraud triangle theory is a launching pad for you to protect you and your business. Knowing your employees, paying attention to red flags, and increasing control measures are the essential first steps.

Perceived Pressures

Many of us would like to think that we would *never* steal from anyone, let alone our employer. In fact, according to ACFE, close to 88 percent of fraudsters have never been charged or convicted of an earlier crime. So, what drives employees to do it? First it begins with their perceived pressures, both inside and outside the workplace. The perceived pressures are commonly financial but can be nonfinancial as well. Nonfinancial pressures include unreasonable deadlines, long hours, and an unreasonably competitive work environment.

Far beyond your reach as a small business owner are the more difficult pressures such as a sick child or parent, a divorce, loss of home, or personal bankruptcy. While these pressures arise outside of the workplace, they do not remain there. They follow employees to work each and every day. By maintaining an open dialogue with employees, you can proactively find solutions to issues that otherwise could lead to resentment, entitlement, or isolation.

Employees who feel they are heard and understood are far less likely to commit fraud against their organization than those who feel they are overlooked or underpaid.

ACFE's Cressey often refers to the perceived pressure as the fraudster's "motive" or incentive to commit the crime. Greed is a motive that cannot be underestimated. When the rewards of stealing outweigh the consequences, fraud – or any crime for that matter – is more likely to occur. Small business owners who are appropriately aware of what is going on in the lives of their employees, will simultaneously reduce the risk of fraud and create a supportive working environment.

Red Flags and Rationale

Since 2008, the ACFE's studies have repeatedly named several behavioral warning signs that are most displayed by workplace fraudsters.

Pro Tip: Have an open-door policy. Be accessible to employees to hear their thoughts and learn more about what is causing their pressures, both inside and outside the workplace.

continued

They include:

- Living beyond means
- Financial difficulties
- Unusually close relations with vendors/clients
- A “wheeler dealer” attitude

One red flag that is less obvious is an employee’s over-dedication to work. Simply stated, if you own a small business, you must question an employee’s unwillingness to take vacations, as well as if the employee is *always* first to arrive and last to leave the office.

Nothing is out of the ordinary about small-business employees working long shifts, especially when the staff is small, but requiring employees to take time off is a strong protective measure for detecting fraud, not to mention avoiding labor violations.

Many frauds schemes are detected by accident when an employee takes a vacation and someone else needs to fill in temporarily. The typical occupational fraud scheme spans 24 months resulting in a median loss of \$150,000. A two-week vacation can cut that timespan and dollar loss significantly.

Accounting and analytical irregularities are also possible indicators of fraud. That’s because small business owners are not always equipped with the skills to figure out whether inventory counts or accounting documents are correct, but an increase in accounting and software changes is a red flag that you should be able to notice.

Red flags can be subtle, but even more difficult to spot is employee rationale for stealing. People can come up with all sorts of clever reasons to justify their unethical or criminal actions. Here are some of the more common reasons employees use to justify stealing from the business:

- The company won’t miss the relatively small amount of money I’m taking.
- Other employees are doing it.
- I just needed the money for [fill in the blank].
- I deserve a lot more money than the company is paying me.
- The loss is insured.

Also, consider having regular meetings to check-in with employees to discuss their concerns or frustrations with their workload, coworkers, or standard operating procedures. Be flexible to adapt and improve processes to increase the morale, fairness, and efficiency of your employees’ workflows.

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Pro Tip: Have a tip-line or tip-box. Employees know their coworkers sometimes better than you, as the business owner, do. Allowing employees to share their concerns anonymously protects their credibility and may give you a deeper understanding of what employees are thinking or doing. The ACFE’s 2018 global study illustrates the most prominent source of early fraud detection in occupational fraud is a tip. In fact, tips are more than twice as likely as an internal audit to reveal fraud.

Opportunity

In my experience, small private businesses either underestimate the importance of internal controls or lack the resources to put such controls in place. *Internal controls* consist of policies and procedures divided into three types:

- **Preventative controls** are implemented to minimize the risk prior to an incident. *Segregation of duties* – for example, assigning deposits to one employee and payables to another – is paramount because it creates a system of checks and balances. Segregation of duties becomes a challenge for businesses with only two or three employees and for businesses that are organized by departments instead of control measures. For example, one employee might handle the entire accounting department, giving that person full access to create fraudulent invoices, alter bank ledgers, or pocket cash.
- **Detective controls** are designed to identify suspicious activities. Examples of detective internal controls are surprise audits and inventory counts.
- **Corrective controls** are policies and procedures put into place in response to weaknesses in the system or specific incidents. An example would be when an employee discovers that his or her drawer is short at the end of their shift. One reason could be theft, but a more likely reason would be the cashier gave the incorrect change at some point. Having a procedure in place allows employees to communicate the error and implement a resolution.

Pro Tip: Make occasional inquiries to vendors to ensure the charges, the contact information, and the invoices are legit. Scan bank accounts, credit card accounts, and payment processors daily to ensure funds coming in and going out are authorized. Conduct a surprise inventory check once a quarter.

Talk with employees and ask them what controls they think are weak. By including them in the discussion, you give them a voice and an opportunity to collaborate on efforts to protect the company and, ultimately, their source of employment.

Responding to Incidents of Occupational Fraud

If you suspect one or more employees of committing occupational fraud, you want to act quickly but intelligently with full knowledge of the possible consequences of any action you decide to take. Accusing or firing an employee – even if you are certain that person is stealing from the business – could compound your problems.

With that in mind, below is one approach to consider when responding to incidents of fraud at your small business.

1. **First, assess the damages.** Undeniably, this might further the emotional trauma of the fraud, but it is imperative. Finding out what was stolen, and the amount stolen, will help to determine how to proceed. Investigate discretely without making changes or revealing what you know.
2. **Don't delay.** Any delay gives the perpetrator time to discover that the crime has been detected and time to hide or destroy evidence. In addition, a delay could result in not being able to take legal action against an individual due to a statute of limitation or not being able to file a claim with an insurance company due to a limitation it has in place.

continued

3. **Follow fraud-related policies.** Every action you take after discovering the criminal activity will be impactful and could have profound legal and financial consequences. As a result, follow your business's established fraud investigation policies, but if no such policies exist, consult with an attorney and/or a fraud investigator before taking any action. Ideally, hire both an attorney who specializes in occupational law and a fraud investigator or forensic accountant (FA) to work in tandem.
4. **Determine predication.** Your fraud investigator or FA will discuss your reasons for being suspicious and help you decide whether they warrant predication (sufficient reason to launch a formal investigation). Determining predication involves reviewing "the circumstances, taken as a whole, that would lead a reasonable, prudent professional to believe fraud has occurred, is occurring, or will occur."
5. **Commence an investigation.** Once predication is proven, the fraud investigator or FA will apply his or her accounting and fraud knowledge to determine the best approach to investigate the fraud and collect evidence. The investigator or FA will begin deploying various investigation tactics to collect testimonial, documentary, and physical evidence and record any personal observations.
6. **Prosecute (or not).** Once the investigation is complete and substantial evidence has been collected, you can decide, with the assistance of legal counsel and law enforcement, how to proceed.

Make no mistake about it – and we do not mean to scare or frighten you – but occupational fraud is rampant, and it poses an existential risk to any small business owner who operates as if they're immune to being taken advantage of by their own employees. As a small business owner, you have an obligation to yourself, your family, and your business to put suitable controls in place to discourage and prevent theft, embezzlement, and fraud. You should also have policies and procedures in place to guide you in the event that such crimes occur, so you can quickly address the problem, mitigate the damage, and strengthen your controls.

SWC can help you put the necessary controls in place and recover in the event that your business falls victim to occupational fraud. We offer a range of services, including rebuilding your books, filing tax amendments to account for the fraud, and claiming any tax deductions related to losses from fraudulent activity to offset those losses. If additional legal or specialized forensic accounting services are necessary, we can refer you to reputable providers.



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