BUSINESS TAX DEDUCTIONS MADE QUICK & EASY
WHAT YOU MUST KNOW TO WIN THE IRS GAME!
Written by a TAX ATTORNEY for SELF-EMPLOYED, INDEPENDENT CONTRACTORS AND SMALL BUSINESS OWNERS IN THE US

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PART ONE. WHO SHOULD READ THIS E-BOOK?

You may call yourself a Freelancer, Business Owner, Independent Contractor or The Grand Poobah. As long as you don’t work for someone else, the tax law classifies you as self-employed, and in a business. This book is for you. It’s about saving money on your tax bill and keeping out of IRS trouble.

Congress writes the tax laws and the IRS creates rules and procedures to administer the law. The rules of tax deductibility generally apply to everyone, from zillion dollar corporations to corner stores and home-based consultants. However, this book is written with the one-person, small time operator in mind. The IRS calls you a sole proprietor, or in some cases you are tax treated as a sole proprietor if you are operating a one-person limited liability company (LLC). For a partnership or corporation, the principals of tax deductibility are the same but the procedures and tax forms are different — and more complex.

Solos should understand the basics of tax deductibility. You may hire a tax pro to prepare your tax returns, but you should know enough to make sure they are doing it right. After all, it is your money, and no one else cares more about it than you do.

We’re going to call all of you folks “solos.” As such, you must report your business income and deductions on Schedule C of your annual Form 1040 individual income tax return. This form is where your business deductions are all listed by category, as well as your business income. (to see the most current Schedule C form, go to irs.gov)

WHY SHOULD I KNOW TAX DEDUCTION RULES?

There is an old saying about earning a living: “It’s not how much you make, it’s how much you keep.” Consider Uncle Sam as your business partner. The offer you can’t refuse is the tax on your income. Uncle allows you to claim certain tax deductions.

Your mission is to deduct as much as you can and still keep the Godfather happy. Capiche? Net profits from your work is what is taxed. So, the more deductions you have, the less income tax you will owe come April 15th.
PART TWO. JUST WHAT IS A BUSINESS TAX DEDUCTION?

The good news is that just about any expenditure to produce business income is tax deductible. The bad news is that the tax law doesn’t make it quite that simple. Let’s start with the fundamentals:

Three Tests. The tax “code” (Congress-speak for the tax law) lays down three tests for deductibility of a business expense.

The cost must be:

(a) “ordinary and necessary” for the particular business, and
(b) not “extravagant” under the circumstances, and
(c) not “personal” but primarily for the business

Yes, these tests are vague, giving rise to gray areas — which tax savvy folks love to exploit, and the IRS loves to squelch. A myriad of tax code provisions and IRS rulings spell out detailed rules for business deductions, which is the reason for this e-book. (One set of rules is for vehicle expenses and is so important that it merits its own e-book, on MileCatcher.com’s site, “Mileage Deductions Made Quick & Easy.” Absolutely free.

I’ll cover business deduction specifics in the rest of the book, and the dangers of not following the tax rules. First, I wanted you to get the deduction ABCs in mind. But, before we venture on, there is something else you need to know:

Tax Deduction No-Nos. There are expenses that you can never deduct: bribes and kick-backs, governmental penalties and fines, political contributions, social club dues, income tax payments and a few other items deemed by Congress as “against public policy.”

Money spent in a reasonable manner with an expectation of bringing in business revenue is usually a deductible business expense.
PART THREE. DOES A DEDUCTION REALLY SAVE ME MUCH MONEY?

Heck yes. Just how much, the value of a deduction, depends on your position in America’s “progressive” or “graduated” tax ladder — the higher your income, the higher your so called “tax bracket.” A Flat Tax, which has been often proposed, would be much simpler, but that’s not what we have.

Seven Tax Brackets. Today’s federal income tax rates are divided into seven brackets, ranging from 10% to 25% to 39.6%. So, it only makes sense that deductions save you money but more deductions can get you into a lower tax bracket.

Example, a $1,000 deduction may mean a $150 tax savings to Jesse, an environmental consultant in the 15% bracket, but almost a $400 federal tax savings to Carrie, a concert promoter. And, it could be even more valuable when factoring in any state income taxes and the Self Employment tax, which are covered next.

Most States Tax Income Too:

So far, we have only been talking about Uncle Sam’s cut. Forty-three states also tax business income, with the average rate about 6%. And, if you live in a sky high tax town like the Big Apple, you will have the dubious honor of paying New York State and New York City income taxes. In this case each deduction could shave as much as 50% off your income tax bill! (FYI, my home is in the Sunshine State with no state income tax).

Don’t Forget the Self-Employment Tax. In addition to taxing your net profits, solos face a federal “self-employment” or SE tax for short. This tax for Social Security and Medicare, often comes as a shock to newbies going from wage-earners into self-employment. The SE tax adds a hefty 15.3% on top of your business’ income tax on net profits. So, deductions become even more valuable as they cut the SE tax, as well as your income tax.
PART FOUR. IS IT AN OPERATING EXPENSE DEDUCTION OR A DEPRECIATION DEDUCTION?

There are two major sets of rules for deducting business expenses:

1. Rules for everyday business operating expenses. Rent, office supplies, postage, insurance, training, utility bills, etc. Generally, operating expenses are called “current” expenses and are for things used up in a year or less.

2. Rules for depreciation expenses for business used assets. Most of these things are termed tangible property — vehicles, furniture, machinery, equipment — and a few are intangible items like copyrights and patents. Depreciation expenses are often called “write-offs.”

Anything that Congress has deemed to have a useful life (tax law jargon) longer than one year. This deduction is called a “depreciation expense” and it must be taken, or spread out over a number of future years. The exact number of years depends on its useful (tax) life set forth in the tax code. The period depends on the asset’s category — ranging from as little as three years for certain machinery to thirty-nine years for buildings.

The categories and useful life periods in the tax law are arbitrary, without relationship to the actual life expectancies of the asset. No one has ever said that the tax law makes sense.

*Depreciation deductions and ordinary business operating deductions have the same effect — reducing your tax bite — but under different tax code rules.*
PART FIVE. WHAT ARE THE BIGGEST DEDUCTIONS FOR MOST SOLOS?

According to the IRS, the largest tax deductions (including depreciation write-offs) for small business/independent contractor/self-employeds are:

**1. Operating Expenses.** Operating expenses are covered in detail in Part 6 below.

**2. Transportation.** Vehicles and other modes of getting around can provide large tax deductions. Using your owned or leased vehicle (other than for commuting to work) can be a biggie. This is covered in our e Book, “Mileage Deductions Made Quick & Easy”. For now, just know that there are two ways to deduct vehicle expenses: business mile driven or actual expenses.

**3. Workers.** A solo may not always be a one man band, so you may need hired help at some stage. Your workers will be tax-classified as either employees or independent contractors. Know the difference.

- **Employees.** A payroll is the greatest expense for some small businesses. Not only wages paid, but for any benefits provided, such as health insurance or retirement accounts. And, there is the employer’s share of federal and state payroll and unemployment taxes. There is also extra tax reporting and accounting duties.

- **Independent Contractors.** Hiring independent contractors instead of employees saves the added costs of payroll taxes and other employee expenses. Your only tax obligation is to issue an annual tax form (1099) to the contractor and to the government showing the amount paid. (No form is necessary if the amount paid is less than $600 for the year).

⚠️ The IRS is on the lookout for businesses that claim their workers are independent contractors when they are legally employees. If you aren’t clear on the difference check Tax Savvy for Small Business (Nolo) and the IRS website, irs.gov. This is vital stuff to know if and when you hire help.

**4. Insurance.** Businesses, particularly those providing services, may have big
insurance expenses. Worker’s Compensation, liability, health, vehicles and most other risks can be covered. Insurance can be very costly, but necessary, and deductible.

5. **Capital Assets.** These are the depreciation “write-off” costs (see Part 4 above). Computers, cell phones, printers, furniture, vehicles, etc. Unlike operating expenses, capital expenses are depreciated over multiple years. Tax Break Exception. You can choose tax code section 179 and deduct the costs of certain assets totally in the year of purchase and placed in service. (See Part 8 below for details).

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**PART SIX. WHAT CAN I DEDUCT FOR BUSINESS OPERATING EXPENSES?**

Day to day costs of doing business are fully deductible in the year of the outlay. These are tax-termed “operating expenses.”

**Top Business Operating Deductions**

- Rent — real estate and equipment
- Workers — employees and independent contractors
- Home office (see Part below)
- Professional fees — accounting, legal & other.
- Business start-up costs — limit of $5,000 for first year, with balance taken in future years.
- Supplies — things normally used up within the year
- Interest — paid on loans or credit on goods and services
- Bad debts — for goods provided, but not for your services
- Advertising & Promotion — if a clear business connection
- Licenses and permits — necessary to go into or stay in business
- Vehicles — see below, and our free E-Book, Mileage Deductions Made Quick & Easy (milecatcher.com)
- Research & Development — too tricky to cover here but go to irs.gov if you think you might qualify.
• Business insurance — worker’s compensation, malpractice, liability, overhead, employee’s health and other. Vehicle insurance is covered in the next chapter.

The tax code lays down some specific rules for certain expenses to keep us from going overboard.

**Not deductible operating costs:**
1. Asset purchases (discussed several places above and below)
2. Federal and state income taxes
3. Clothing (unless it qualifies as a uniform)
4. Commuting to work
5. Business gifts (over $25)
6. Charitable contributions (but you can take them on your personal tax return schedule)
7. Government fines and penalties
8. Political contributions and lobbying
9. Personal expenses unrelated to any business purposes
10. Owner draws (you are taxed on the businesses net profits)
PART SEVEN. WHAT ABOUT DEDUCTING MY CAR FOR BUSINESS?

Deducting Vehicle Expenses. This deduction is so important that it is given its own (free) e-book, “Mileage Deductions Made Quick & Easy” on our site, milecatcher.com. The takeaway is that you must track your business mileage to justify this deduction. The MileCatcher app is a tool that will nail down this big tax saver.

PART EIGHT. WHAT ARE THE BEST WAYS TO DEDUCT BUSINESS ASSETS?

Business-used equipment, vehicles, furnishings, machinery and buildings are tax-termed “capital assets.” This category is for things with a useful life of more than one year. (Recall the distinction that all operating expenses are for things used up in year or less).

The tax law specifies just how long the deduction period can be for that category of an asset. For instance, most vehicles have tax code useful life of five years, and office furniture, seven years (a complete listing of the depreciation periods allowed by law is at the IRS website, irs.gov).

FASTER WAYS TO DEDUCT ASSETS.

There are two ways of getting an asset expense deduction without waiting for years. Here they are:

1. **Expensing Assets Instead of Depreciating.** To stimulate business spending and simplify recordkeeping, Congress allows two major exceptions to the long term depreciation rules:
   - **$500 purchases.** You don’t have to depreciate items that cost less than $500 each, but can deduct them in the year of purchase. This is known as the “de minimus safe harbor” rule. This election, taken on your tax return, eliminates the need for tracking depreciation deductions for under $500 items. It can’t be used for a few things like land, inventory.
   - **Section 179 - Over $500 asset purchases.** Thankfully, you won’t find another Internal Revenue Code section listed by number in this book, but this one is too juicy not to mention. If your capital asset qualifies, you can — but don’t have to — deduct the entire cost in
one year. Section 179 is commonly called “first year expensing.” The annual limit is a generous $500,000. You can also mix and match, by taking part of the cost as a 179 deduction and the balance as a regular long term depreciation. This is a decision that you, or your tax preparer, can make when it comes time to file your tax return.

HOT TIP: You don’t actually have to spend a dime to get the 179 deduction for the year of purchase! Just get extended credit terms or charge it and pay for the asset in future years. You must take possession of the asset and start using it before year end.

NO-NOS FOR 179 EXPENSING

There are restrictions on 179 immediate write-offs. The main ones are:

1. If the item is susceptible to personal use, like a computer or vehicle, you must use the item at least 50% of the time for business.
2. It cannot be used for a building (real estate never qualifies for 179).
3. An intangible asset (like a patent, copyright or trademark) doesn’t qualify.
4. You must not have bought it from a relative or inherited it or.
5. It can’t be received it as a gift; you must have paid for it.
6. You must use the item in your business for at least as many years as it would have taken to claim depreciation expenses.
7. If you use the 179 property for both business and personal things, you must reduce the amount of the deduction by any percentage for personal use. Example: 60% business use of a computer and 40% personal use would reduce a $1,000 section 179 deduction to $600. (See my book, “Tax Savvy for Small Business” (Nolo) or irs.gov for more 179 rules and details)

HOT TIP: Fast write-offs may not be the wisest moves. Too many asset deductions in one year—the $500 purchases, 179 and bonus depreciation—may deprive you of deductions in future years. All of these “fast” routes are elective — you don’t have to take them. If your business is growing and expected to have higher profits in the years to come, you should take...
regular depreciation deductions. You don’t have to decide until tax filing time when you can run the numbers. Tax software makes this fairly easy.

**BONUS DEPRECIATION**

Yet another way to get a bigger tax break for asset purchases is a 50% first year bonus depreciation deduction. For instance, if you decide to take a long term depreciation deduction, which entitled you to $1,200 for the first year, you can claim a $600 bonus for that year. Then you can deduct the rest of the price over the normal multi-year depreciation period.

**LISTED PROPERTY RESTRICTION**

Congress calls certain business used assets “listed property” and has special rules for deducting them. We’re talking things with a high potential for personal use — cars, planes, boats, computers, cameras and anything else that might be utilized beyond pure business. The IRS suspects that you are going to be driving your business car, a Porsche 911, for weekend outings and using the business laptop to surf the web.

**HOT TIP:** Meet the listed property rules with a simple logbook or business diary or calendar. Show dates, times and business purpose usage of the listed property. If you don’t have this record, you risk losing the deduction if the IRS comes knocking. Exception: You don’t have to keep records if the listed property is strictly used for business — such as desk top computer at your office, or a delivery van.
PART NINE: CAN I TAKE A BUSINESS DEDUCTION FOR MY HOME?

Technology — computers and the internet — has revolutionized working from home in the 21st century. Millions of us, sans make-up or razors, no longer make the dreaded workday commute. I for one, don’t miss it at all.

A business expense, no matter where incurred—including while home— is deductible. The so-called home office deduction goes further, allowing a tax deduction for some of the costs of owning or renting your home. We’ll explain how this works later, but first let’s see if you are entitled to the home office deduction.

Three Tests. To qualify as home office, three requirements must be met:

1. The home is your principal place of business. If you have a fixed business location elsewhere — an office or store — and just bring work home, then you may fail this test. However, if you meet customers or clients at home, or use your home for management or administrative activities but most of your work is outside, you may qualify. (For more info, see Tax Savvy for Small Business (Nolo) or IRS Publication 587, Business Use of Your Home).

2. The office must be a separately identifiable space in your home used just for business. This can rule out your man cave or the dining room table. But, it’s okay if a portion of the room is clearly devoted to business. For instance, a desk, chair and file cabinet in a corner of your living room should work.

HOT TIP: While claiming a home office was once an audit hot button, it is now so common that it no longer raises eyebrows at the IRS. So, don’t be afraid to take the home office deduction if you qualify.

HOT TIP: If you store inventory, products or business records, that space counts as a home office too. If you have an outbuilding, like a converted garage, just for your business, then you should have no problem meeting this test.
3. If you have passed the first two tests, then the home office still must be regularly and exclusively used for business. Just using the office every April 14th to do your taxes doesn't look very regular. Exclusive means the space or room can't be used for anything other than business. Take the bed out of the spare room - unless you operate some kind of business that requires a bed. Hmm.

💰 HOT TIP: Keep a simple diary or calendar showing how often the office is used, even if just for a few minutes at a time.

Are You a Home Owner or Renter?

- For Owners, the home office deduction is called a depreciation expense. The amount of depreciation each year depends on IRS tables. Usually, 1/39 of the value of the home (minus the value of the land on which it sits) can be deducted for depreciation each year. Example. Zane’s home is valued at $300,000 when he started his graphic design business in a spare room and storing equipment and supplies in another room, comprising 2 out of the 6 rooms of Zane’s home. The local tax assessor valued the lot at $50,000, and the structure at $250,000. Zane’s full year home office depreciation deduction is 1/39 of $250,000 = $6,410, multiplied by 2/6 of the home used for business = $2,137. This is the home office depreciation deduction for every year the home is used a full twelve months for business.

- For Renters, the home office deduction is a percentage (based on the number of rooms or square footage of the used as a home office) of the annual rent. Example. Zooey’s apartment rent is $12,000 per year. She uses one of its four rooms exclusively for her medical technology consulting practice. Zooey’s home office deduction is 1/4 multiplied by $12,000 equals $3,000 assuming a full twelve months for business.

Two Ways to Figure the Home Office Space. The home office space is based on either (a) the square footage of the business portion of the home, or (b) the number of rooms in the home dedicated to business. For example, a home with 2,000 square feet and a home office of 500 square feet would yield a 25% expense deduction. The rooms must be roughly the same size.
• **Indirect Home Office expenses.** Besides the home office depreciation or rent deduction, you can partially deduct most other home expenses. Indirect home office expenses for utilities, maintenance, insurance, real estate taxes, condo fees, pest control, alarm systems, etc, are deductible. Like the home office depreciation or rent deduction, the indirect expense deduction is equal to the proportion of the home used for business, such as 25% in the example above.

**HOT TIP:** Another benefit of a home office is that all trips from home for business are deductible. Otherwise, driving to an office or regular place of work is a commuting expense, and never deductible.

**Simplified Method of Home Office Deduction.**

There is an alternative, but very limited, home office deduction method. The IRS allows a deduction of $5 per square foot of home office space, up to $1,500 annually. The home office still must meet the three tests above. There is no further deduction for any of the other indirect expenses above.

**In the year of the sale of your home, all past depreciation deductions for the home office may become “recaptured”, that is, taxable. There is no free tax lunch. Your tax preparer or software like Turbotax can track and tell you how much the tax bite will be.**

**A home office deduction can’t be claimed if your business operation loses money or taking the deduction would cause a loss.**
PART TEN. WHAT IS THE DEAL ON DEDUCTING TRAVEL, MEALS & ENTERTAINMENT?

Here is an opportunity to combine business and pleasure and have the tax man foot a big part of the bill. Go to San Francisco for a convention and on your free time catch a Giants game, ride the cable car to Fisherman’s Wharf and take a trip to Alcatraz. You’ll have to pick up the tab for the Giants tickets and the nightlife, but the airfare and hotel and convention related business expenses are fully deductible.

The primary purpose of the trip must be business related, with fun and games secondary.

As with most good things, there can’t be too much, so the IRS Grinch has rules and limits on travel deductions. Here are the major ones:

1. **U.S. Travel.** The tax law allows a business travel deduction if the trip was far enough away from home to require a stay overnight. As long as it is ordinary and necessary and primarily for your business — a trade show, prospecting or servicing customers, clients or investors, training and similar things — living expenses on the road are fully deductible. (Main limitation: meals. Eating out is only 50% deductible. Details below)

2. **Transportation Distinction.** The tax code distinguishes travel from transportation. Any kind of business transport — planes, trains, boats — qualifies 100%. Ditto with lodging, tips, laundry, etc. But, not for commuting — getting to and from your regular workplace. If you drive your own vehicle, the costs can be deducted too, as explained in our e-book, “Mileage Deductions Made Quick & Easy” at milecatcher.com. Did I mention that the book is free?

3. **Foreign Travel.** Travel out of the U.S. is deductible. However, if the time abroad exceeds seven days, the rules are more stringent. The IRS is on the lookout for those deducting a two-week trip to Gay Paree. Your deduction is reduced by as much as 75% if you don’t spend more than half of your time strictly on business. And, no deduction at all if you spend less than 51% on business. Lesson: Keep notes of your business activities in case the IRS ever asks.

4. **Meals.** Dining away from home is only 50% deductible. Congress reasons that you
would still have to eat, traveling or not. (But, see below for the per diem meal deduction that may get you out of this limitation."

5. Entertainment: 50% Deductible Rule. Congress recognizes that wining and dining of prospects, customers, clients and employees helps businesses to prosper. The IRS has okayed tickets for sporting events, concerts, hunting, fishing and about any other kind of fun that is legal. And, the expense can’t be extravagant under your particular circumstances. For example, a $3,000 Super Bowl ticket for a law firm’s client might pass muster, but not for your shoe shine stand customer. You get the picture.

- **50% Limit.** Entertainment expenses are okay but with a few exceptions — only 50% of the costs are deductible. **Exceptions:** Employee parties, transportation to the entertainment or general public events are 100% deductible.

- **Two Tax Tests.** To be deductible, the entertainment must be:
  
  (1) Both *appropriate and accepted* in your particular business, and

  (2) Either *directly related, or somehow associated*, with your business.

**HOT TIP:** Make sure some business is discussed before, during or after the entertainment. Keep notes with dates, names and places of entertainment, and a general description of the business discussed.

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**TWO WAYS TO DEDUCT TRAVEL & MEAL EXPENSES**

The tax law allows you to choose either the actual expense method (tracking every penny spent) or the per diem expense method. How much you can take under per diem (day) is listed in IRS Publication 1542 Per Diem Rates based on the geographical location of your travel. The amounts for per diem lodging are revised annually and range from as little as $99 per day to over $350. The IRS knows that hotels are pricier in Aspen than Omaha. The meal per diem rate ranges from $46 to $71. Compare the two methods and take the most beneficial at tax time. Duh.

Caution: Sole proprietors can use the per diem method for meals but not for lodging. Don’t ask me why, it’s the law.
PART ELEVEN. HOW MUCH RECORDKEEPING IS REALLY NECESSARY?

Keeping books and records is the Achilles Heel of the small time operator. It is the least fun thing about being in business. Recordkeeping eats up valuable time, and no one I know enjoys it. But it comes with the territory. I can hear you groaning. Get over it.

Never forget that tracking your outlays for business adds to the bottom line, every bit as much as your revenue stream. And, the IRS is on the lookout for record keeping slackers.

HOW TO KEEP RECORDS.

Unless you have only a handful of expenses per month, start organising your expenses in the expense categories, for example “advertising”, “commissions”, “insurance”, “legal and professional”, “supplies”, “repairs and maintenance”, “travel”, “meals”, “entertainment”, “wages”, “utilities.” The expense categories tie in with your tax reporting requirements shown on Schedule C of your tax return.

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HOT TIP: Try a dedicated, free expense tracking apps like Expensify, Receipt Burner or Expenditure to complement MileCatcher for automatic mileage logging. Good dedicated expense apps connects your credit card and bank accounts for quick expense tracking. You will spend less time on administration when you have a dedicated, optimized app for each task.

If you want to keep your own books, then export your expenses to an accounting solution. After the initial set up, payees and categories are memorized. When you get past the initial set-up and learning curve, you’ll love the way these programs automate the dreaded recordkeeping process and offer one click expense reports.

HOT TIP: Keep your accounting solution simple and in the cloud. It will help you when you grow and hire or outsource bookkeeping to manage your books. Check out free, easy solutions like Wave and Zipbook that make their money elsewhere or the more traditional offerings like Freshbooks, Quickbooks Online and Xero.
If you are inclined to do a more formal set of books, read up on the (very boring) topics, “single and double entry” bookkeeping, and “cash and accrual” and “calendar and fiscal year” accounting, in my book, “Tax Savvy for Small Business” (Nolo) and at irs.gov.

HOT TIP: Once your business can afford it, and your time is better spent elsewhere, hire a part-time bookkeeper. And, if you have employees, a payroll tax service is a headache preventer. But, even if you farm out the chores, you should be aware of the basics.

WHAT KIND OF RECORDS DO I HAVE TO KEEP?

The IRS doesn’t mandate any particular method for keeping records, or even the kind of records needed. The only hard and fast rule is that your records must clearly show all income and expenses of your business.

Business records must be kept on a yearly basis and be tied in with your income tax reporting forms. Here’s the most common records for a small timer:

1. **Income statements** — commonly, bank deposits and electronic transfers into a business bank account. The year’s bank statements should match up with the income reported on your tax returns. And, if the bank totals are more than the income reported, be ready to explain why, such as a business loan or another non-taxable source. It’s a good idea to note the source, like the name of the customer or client.

2. **Expense statements** — typically bank and credit card statements from financial institutions. The statements alone are not enough; you must also have supporting documents, primarily invoices and receipts, covered below.

3. **Assets** — for business used equipment and real estate that is depreciated (deducted) over a number of future years, keep a separate record file. Include the original purchase documents, and evidence of any expenditures for improvements. Also, a logbook should be kept showing the business usage of any asset tax termed “listed property” which is discussed in Part Eight above.
4. Receipts — keep bank and credit card statements, canceled checks, receipts and invoices. There are also smartphone apps that scan and track paper receipts. In the event of an IRS audit, you’ll need to print out paper copies.

☞ HOT TIP: Business expenses under $75 do not have to be documented.

5. Calendar — a calendar, business diary or appointment book should be maintained. The dates should tie into your expenditures, especially for things with a higher IRS audit potential, like travel and entertainment.

☞ HOT TIP: Keep separate bank and credit card accounts for your business. This will make the process cleaner and more business-like — and easier at tax time.

HOW LONG SHOULD I KEEP OLD RECORDS?

The answer depends on how long you should be worried about an IRS audit. Here’s what the law says, and then you can make up your mind:

Three IRS Statute of Limitations Periods on Audits. The very minimum record retention period is three years from the date you file a tax return. This is because the IRS must examine a tax return and assess a bill within three years of the filing.

But there are two exceptions to the three year period:

One, if the tax return underreports your tax liability by 25% or more, the period is extended to six years.

Two, in the event of serious tax fraud, the period is unlimited.

Luckily, the IRS seldom looks beyond three years and very rarely beyond six years. When they do it is usually someone who is already in the public eye, so will make headlines in the news. The IRS loves the kind of publicity that instills fear into tax miscreants. Note: Some states allow their tax agencies to go beyond the federal time limits.

What if I don’t file a tax return? There is no limitation on the period of time the IRS
can audit if you never file. The IRS can simply create a tax return for the year you didn’t do it, using estimates of income, 1099s and W-2 forms showing payments to you and giving you the bare minimum in deductions and exemptions. The IRS literally has forever to come after you!

☞ HOT TIP: Be Safe, Not Sorry. I don’t throw anything out for at least six years after filing a tax return. And, I keep asset records for purchases of real estate, equipment and vehicles from the purchase date for six years after disposition of the asset. This might mean keeping records for decades, in the case of real estate. My garage is bulging with boxes of paper. Don’t tell the Fire Department.
PART TWELVE. WHO’S AFRAID OF THE IRS?

This is the last chapter in the book, and is placed at the end for a very good reason: If you don’t obey the rules of tax deductions in the foregoing chapters, you will be sorry if the IRS ever picks you for an audit.

The IRS calls them “examinations” not audits. The not so obvious distinction is that an IRS examiner can look beyond your tax return — at your finances beyond what is on your tax return. The IRS will be curious if you claim expenses for a Rolls Royce for your paper route deliveries.

BIG BROTHER IS WATCHING.

The IRS has the right to question any tax filing you ever make — or the IRS can create a filing that you should have made, but didn’t. The IRS goal is to verify that you reported all of your income and substantiate any tax breaks claimed, mainly deductions. So, let’s look at who gets picked by the IRS for audits, and why they were selected.

AUDIT SELECTION.

- DIF score.

The number one way the IRS picks its audit victims is by an electronic method, nick-named the “DIF score.” Just like school, when your test papers were graded, your annual tax return is scored by the IRS computers.

The IRS DIF formula is super-secret, like the fabled recipe for Coca Cola. Tax pros believe the core basis of the DIF is that the more deviation your deductions are from the norm (for your particular business), the greater your DIF score. Graphic designer’s tax returns are compared to other graphic designers, lawyers to other lawyers and so on. There is no one magic number or percentage, applied to all businesses in the DIF scoring process.

If your computer score puts you into to the tier, your tax return is flagged for human scrutiny. An audit team screens out the majority of DIF kick-outs and determines the small number of those making the Final Jeopardy Round. Then, a decision is made by these folks on just how the audit will be done: by mail (easiest), at the IRS office (harder), or at your place of business (hardest).
• **Missing items.**

Another way to get audit attention is when the IRS computer finds a miss-match between its records and your tax return. For instance, when there is a 1099 form filed with the IRS by someone who paid you money, but, the IRS doesn’t see that payment on your return. Perhaps a bank credited you $250 for interest on a savings account and you forgot about it because you never saw the money in your hands. Ordinarily, small things only generate a bill from the IRS, but it might trigger an audit.

• **Other reasons.**

A relatively few audit picks are for special IRS projects targeting cash intensive operations like laundromats, vending machines and bars. Or, the IRS may look at building contractors, bankruptcy lawyers, chiropractors and used car dealers.

A small number of auditees are selected randomly for IRS statistical purposes or from snitches. (For more info on the audit process, see my book, “Stand Up To The IRS” (Nolo))

Note: Audit notices usually come — if at all — 12 to 18 months after you file a tax return.

• **Small Businesses & Audits.**

The IRS audit rates are near an all-time low — less than 1% of all individual tax returns filed. But small business folks shouldn’t take too much comfort in this fact. The IRS has not gone all warm and fuzzy. The audit rate for Sarah the Small Time Operator is about 2.5%, four times higher than for Willie the Wage Slave.

If you are in business for years, chances are that you will be audited, and maybe more than once. Statistics don’t mean anything if the postman drops an IRS audit notice at your door.

• **What is an IRS auditor is looking for?**

The best way to answer this question is to direct you to the preceding chapter, “Recordkeeping & Accounting.” The IRS has borrowed the state of Missouri’s motto: *Show Me* — the Records.

**Words to Live By:** Take all the tax deductions that the law allows, but remember the Boy Scout’s motto: Be Prepared. Keep good records.
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Fred’s tax commentary is utilized by Turbotax and has been licensed by Microsoft. He has given tax programs for CPAs, Enrolled Agents and even the IRS. Fred attended, and provided data to the Senate Finance Committee hearings in 1998 which resulted in a sweeping IRS reform act.

He has been quoted in the New York Times, Wall Street Journal, Time and Money magazines. He has appeared on CBS, NBC, Fox, NPR news features and ABC’s Good Morning America.

Fred is the author of books on taxes, including Stand Up to the IRS and Tax Savvy for Small Business. His website, taxattorneydaily.com features a wealth of tax tips for minimizing taxes and dealing with IRS.

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