

HOW TO PREPARE FOR AN APPOINTMENT IF YOU HAVE A SMALL BUSINESS

Overview

Sole proprietors file a Schedule C with their personal returns to show profit or loss from a small business. This is the single most likely Schedule to trigger an audit.

The first step in successfully and accurately completing this form is to isolate income and expenses from the business apart from other unassociated income and expenses. Ideally there will be a separate account for the business. Not only is this important for accuracy; it will make any subsequent examination by the IRS much easier, and may even deter the IRS from examining personal expenses.

Income

Regardless of the type of business, all services rendered or goods sold should be documented by invoices or receipts. Like any other number on the tax return, you must be able to point to its source. While estimation and guessing may be accepted in a very narrow context, a taxpayer will be met with skepticism from the IRS if the proper “books” are not kept. Disorganization or poor business practices will not be acceptable as an excuse, and the IRS will not hesitate to either attribute income to you or deny expenses to you if records are not kept.

What is critical to understand is the way the law is written. The burden of proof is on the taxpayer in a couple of areas. First of all, if the IRS wants to do a bank deposit analysis, you will have to show each deposit in each of your accounts is not income. Loans, cash advances, refunds and transfers must all be documented and proven to the satisfaction of the IRS, or they will be presumed to be income.

Expenses

The burden of proving deductions is also on the taxpayer. There are two components to each expense. You must first show the expense was incurred through documents such as receipts and invoices. You must then show the expense was ordinary and necessary to the business. This may be simple (buying a pencil) or not so simple (that week in Hawaii).

Frequently taxpayers cannot even get past the first hurdle. They may have a cancelled check from Wal-Mart, for example, but if they failed to keep the receipt exactly identifying the nature of the expense, it may be disallowed.

Yet another problem is that the taxpayer has not sought professional guidance, and has been led to believe certain expenditures are legitimate expenses when they actually are not. Common examples of these are large gifts (gifts are actually limited to \$25 per person per year), charitable contributions (they must be shown on the individual's Schedule A, not Schedule C), bad debts for services (a bad debt may only be deducted when the money has previously been included in income), and life insurance (not deductible at all).

Expenses should be broken down by category and totaled on an annual basis. Ideally, they should be reflected in a cash flow statement, which sets forth an opening balance, the source of income, the destination of expenses and a closing balance. Here are some common categories of expenses:

- 1) Advertising
- 2) Office Supplies – but you must depreciate any permanent equipment you purchase – list them separately from other office supplies, along with the date of purchase and see “capital expenditures,” next.
- 3) Capital expenditures – this is property such as telephones, computers, fax machines, etc. It must be depreciated over time, or an election must be made to take all depreciation in the year of purchase. This is something I will discuss during the appointment.
- 4) Insurance – disability, workers compensation or professional, not life or auto
- 5) Self employed health insurance
- 6) Rent paid – for equipment or for real property
- 7) General Supplies (but not inventory held for sale)
- 8) Professional fees (lawyers, accountants, etc.)
- 9) Travel – do not include your spouse or dependents' expenses unless they are employees.
- 10) Meals and entertainment – be careful here – if entertaining clients, documentation is a must! Meals for travel are acceptable only if you are away from home overnight – lunch on a local trip is not an expense. But for travel an easy way to deal with meals is use the per diem, which is generally around \$40 per day domestically.
- 11) Interest – if you financed any aspect of your business operations, including expenses or inventory, you may deduct the interest. If you have not heeded my advice, however, and used a separate account, it may be impossible to identify business interest from personal interest.
- 12) Continuing education – this is education which helps or improves your business. Two important, non-deductible exceptions are education which leads to a new profession (real estate license school, medical school, law school, etc) and education required to meet the basic requirements of the profession (classes to obtain a teaching credential, for example).
- 13) Books and publications
- 14) Memberships in professional organizations

- 15) Wages – hopefully if you have employees you are using a payroll service – compliance requirements for employers are very complex and time consuming. The payroll service will issue a statement detailing how much tax you paid to various state and federal agencies on behalf of employees. The usual taxes paid by the employer for California employees, based on gross wages, are to a) the IRS for employment taxes (FICA+Medicare+FUTA), b) EDD for unemployment insurance. The employer paid share goes under “Taxes and licenses.(#16)” In addition, income tax, FICA and Medicare payments withheld from the employees’ checks are submitted to the state and federal governments. These amounts are not separately deducted by the employer because they are part of the wages already paid and deducted.
- 16) Taxes and licenses – this may include employment tax, as mentioned above, local (business tax) and possibly sales tax – see #17.
- 17) Sales tax, as a rule, need not be included in the tax return at all. In California, because it is collected on behalf of the State, it is in no way considered income. Some businesses, however, have accounting structures in which it is easier to include sales tax in gross proceeds. In this case, the sales tax is then listed as an expense in this category.
- 18) Telephone – This will include cell phone, voicemail, fax line, DSL and office phone. Here again, problems may occur if there are no separate accounts set up for the business. It is very difficult to justify telephone expenses when they are commingled with personal calls.
- 19) Utilities – this category should be reserved for utility expenses incurred in operating a storefront business. Do not put any utilities here related to the use of a home office. Instead, see the home office checklist by [clicking here](#).

Cost of Goods Sold

Another very common misunderstanding involves what is called the “Cost of Goods Sold,” or COGS. This is the accounting method which must be used by businesses that carry inventory. The rule is that the cost of the inventory and any expenses associated with that inventory may only be deducted when withdrawn for sale.

For example, lets say I sell flashlights. If, on December 31, I take delivery of and pay for \$5000 of flashlights in anticipation of a busy new year, do I have a \$5000 expense for my business No, I do not. The \$5000 I spent has no effect because it represents the cost of goods sold and not an operating expense. The \$5000 will be part of my closing inventory on December 31 and again a part of my opening inventory on January 1.

The cost of goods sold is generally calculated like this:

Opening inventory + goods purchased during the year + incidental expenses (such as shipping and packaging and labor) - the closing inventory.

The result of this calculation is a figure indicating the value of the goods which were sold during the year. The two most common methods to value the inventory are the actual

cost (wholesale), or the lower of cost or market value (sometimes used if the value of inventory declines). After calculation, it is the COGS that is ultimately deducted as an expense.

In summary, an accurate closing inventory must be calculated at the end of each year, otherwise the entire profit and loss position of the business will be inaccurate, and the proper tax liability will not be calculated. Buying inventory, no matter how much you spend, is not a deductible expense. Only what is used is actually an expense.

Multi-Level Marketing and Distribution

Many clients are representatives for MLM businesses. They carry no inventory, but only take orders. These taxpayers do not carry an inventory, so they do not have a cost of goods sold. But they should still be aware many of the MLM companies provide very poor tax guidance.