



# Playing with Taxes!

*Creating a Professional Practice*





# Agenda

- *What we will cover today...*
  - *Motivation for understanding impact of taxes*
  - *Reporting requirements for the Sole Proprietor*
  - *Tax benefits which may be leveraged by the entrepreneur*
  - *What records an entrepreneur must maintain and present to a tax professional*
- *What we will NOT cover today...*
  - *How to complete your own tax return*



# Why Should I Care?

- *Urban myth: “My accountant handles my taxes.”*
- *Urban truth: The IRS holds the individual legally responsible, not his/her accountant, for tax burden*
- *Reducing tax expenses to the legal minimum is paramount to building wealth*
- *“Everything’s cheaper if you can get a deduction. Cha cha cha!” – Sandy Botkin, Esq.*



# Effect of 35% tax on \$1 doubling annually

■ Before tax ■ Post-35% tax

Taxes significantly reduce long-term wealth accrual through compounding





# The Bottom Line

- *Entrepreneurs are taxed on net business income, not gross revenue*
- *Personal expenses, when **converted into legitimate business expenses**, reduce net business income*
- *Reduced net business income = lower tax liability*
- *Less tax expense for same gross business revenues = **higher standard of living***



# Tax Impact to Sole Proprietor



Employee	Sole Proprietor
Taxed on salary	Taxed on <i>net earnings</i> (income - expenses) of business
Employer pre-pays 7.65% for FICA tax, employee has 7.65% withheld on pay stub	Pays FICA tax as Self-employment tax (15.3% of 92.35% of net earnings)
Files form 1040	Files form 1040 + Schedule C
FICA and income taxes withheld automatically every pay period	FICA and income taxes must be estimated for the year and <u>paid quarterly</u>

Form **1040** Department of the Treasury—Internal Revenue Service  
**U.S. Individual Income Tax Return**

**SCHEDULE C**  
**(Form 1040)**

Department of the Treasury  
 Internal Revenue Service (99)

**Profit or Loss From Business**

(Sole Proprietorship)

Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

Attach to Form 1040, 1040NR, or 1041.

See Instructions for Schedule C (Form 1040).



# Self-Employment Tax

- *FICA ("Federal Insurance Contributions Act") taxes*

- *Social Security = 12.4%*

- *Maximum tax = \$12,090*

- *Medicare = 2.9%*



- *Employer and employee each pay half (7.65%)*

- *SE-tax applied to 92.35% of net business income*





# Self-Employment Tax (2)

- *SE tax applied to 92.35% of net earnings is...*
  - *15.3% if net earnings < \$97,500*
  - *Otherwise, \$12,090 + 2.9% (max Social Security tax)*
- *Adjusted Gross Income (AGI)*
  - *All income sources (wages, interest, capital gains, etc.) adjusted downward by specific deductions, not including standard or itemized deductions*
  - *AGI is reduced by 50% of SE-tax (lowers income tax)*







# Estimated Tax Payments

- Paid quarterly (April 15, June 15, September 15, January 15<sup>\*\*</sup>) in lieu of payroll withholding by employer
- May submit last payment if filing/paying by end of January
- Each installment to be 25% of total estimated tax due at year-end
- To avoid penalty, total tax estimated payments must total
  - 90% of tax bill for current year, OR
  - 100% of tax bill for previous year (110% if AGI > \$150,000)





# Estimated Tax Payments (2)

Payments are calculated from year-end estimates of the following...

*Income from all sources (employment, business, investments, etc.)*

*- Business expenses (include big-ticket items planned)*

*- Retirement/tax-sheltered investments*

*- Personal (Schedule A) deductions*

*Taxable income: look up in simple table* →

*Estimated tax bill for year* ←

*- Estimated withholding for year*

*Estimated business tax to be paid over 4 quarters*

*(From IRS form 1040-ES):*

## Schedule X—Use if your 2007 filing status is **Single**

If line 5 is:	But not over—	The tax is:	of the amount over—
Over—			
\$0	\$7,825	10%	\$0
7,825	31,850	\$782.50 + 15%	7,825
31,850	77,100	4,386.25 + 25%	31,850
77,100	160,850	15,698.75 + 28%	77,100
160,850	349,700	39,148.75 + 33%	160,850
349,700		101,469.25 + 35%	349,700

## Schedule Y-1—Use if your 2007 filing status is **Married filing jointly or Qualifying widow(er)**

If line 5 is:	But not over—	The tax is:	of the amount over—
Over—			
\$0	\$15,650	10%	\$0
15,650	63,700	\$1,565.00 + 15%	15,650
63,700	128,500	8,772.50 + 25%	63,700
128,500	195,850	24,972.50 + 28%	128,500
195,850	349,700	43,830.50 + 33%	195,850
349,700		94,601.00 + 35%	349,700





What's in all of

this for ME?



# Benefits to the Sole Proprietor

- Lower net business income = Lower taxes!
  - FICA taxes: “off the top”
  - Lower Adjusted Gross Income (AGI)
    - Less income subject to federal & state income tax
    - Potentially lower tax bracket (% taxed)
  - TVM advantage: quarterly vs. biweekly
  - Adjust estimated payments based on forecasting





# “*☆ Ordinary and Necessary*” Expenses

- Advertising
- Automobile related to business



- Actual expenses, OR
- Standard rate per mile (2007):
  - \$0.485 for business
  - \$0.14 for charitable
  - \$0.20 for medical or moving



- Capital expenses: Depreciation/  
Section 179

- *Under \$100,000*, items may be deducted in their entirety

- Computer, appointment book, cell phone/PDA, iPod, stereo equipment, etc.

- Insurance\*\*

- Interest

- Legal/professional services



# “*Ordinary and Necessary*” Expenses (2)

- Office expenses
- Rent/lease of property/equipment
- Utilities, repairs, maintenance
- Taxes, licenses
- Travel
- Meals and entertainment (50%)
- Gifts for clients
  - \$25 per client per year
  - Better to entertain (think “season tickets”)
- Benefits for employees
- Wages/allowances
- Health insurance premiums
- Reimbursement plan
- “Other” expenses
- Professional development, continuing education courses, business seminars, conventions, books/periodicals, professional association dues...



# Retirement Deductions



- *Individual Retirement Arrangement (IRA)*

- *Limit of \$4,000/year (\$5,000 over 50)*
- *May not be fully deductible*

- *Group 401(k) (for employees only)*

- *Limit of \$15,500/year (\$20,500 over 50)*

- *Roth IRA*

- *Limit of \$4,000/year (\$5,000 over 50)*
- *May contribute if AGI < \$114,000/\$166,000 (single/married jointly)*
- *Contributions made with post-tax dollars*
- *Withdrawals (after retirement) are tax-free*

- *For the self-employed...*

- *Simplified Employee Pension (SEP)*

- *Limit of \$45,000/year (\$50,000 over 50) up to 20% of net business income\*\**

- *Individual 401(k)*

- *Limit of \$45,000/year (\$50,000 over 50) up to 20% of net business income\*\**
- *Access to funds via tax-free loans up to \$50,000 or 1/2 of account balance*
- *Typically more flexible vehicle*



# Example: Home-based business deductions



Category	Total expense	Deductible portion	Total deduction
Auto	12,000	75%	9,000
Cell phone	1,500	90%	1,350
Utilities	2,400	10%	240
Mortgage interest	15,000	10%	1,500
Travel	8,000	100%	8,000
Meals, entertainment	2,400	50%	1,200
Family health insurance	10,000	100%	10,000
Total business expenses	51,300		31,290





# Example: Home-based business deductions (2)



	Employee	Entrepreneur
Gross Income	100,000	100,000
"Overlapping" business expenses	-	31,290
Net income	100,000	68,710
FICA tax	7,650	9,708
FICA tax deduction	-	4,854
Retirement deduction	15,500	13,742
Adjusted Gross Income	84,500	50,114
Schedule A mortgage interest	15,000	13,500
Schedule A charitable	5,000	5,000
Taxable income	25% bracket 64,500	15% bracket 31,614
Estimated Federal income tax	12,549	4,351
Federal income + FICA tax	20,199	14,059



## Example: Home-based business deductions (3)

- *Summary of Entrepreneur's advantages:*
  - *Lower income tax bracket (15% instead of 25%)*
  - *Tax savings of **\$6,140** annually (\$512 monthly)*
  - *Utilize income gained early in year for big-ticket expenses later in year (auto, travel, insurance)*





Great! Now how do I take  
advantage of all of this?





# Documentation: Income

- *Payments received from clients in private practice*
  - *Session ledger (paper, electronic)*
  - *Client database*
- *Compensation received from contract work*
  - *1099 statements*
  - *W-2/employee income is NOT included in business income*





# Documentation: Expenses

- *When in doubt, document*
  - *Expense ledger (paper, electronic)*
  - *Financial software, e.g. Quicken/Quickbooks*
- *Maintain a tax journal*
  - *Include mileage, actual expenses*
  - *IRS must believe what is recorded, unless convicted of fraud*
- *Keep receipts for at least 6 years*





# Tax Journal

- *Record in timely fashion (within 24 hours of activity)*
- *What to record...*
  - *Who: Name(s) of those involved in the activity*
  - *Where: Location of promotional activity*
  - *Why: Specific business purpose*
  - *When: Date, time*
  - *How much: Cost of activity*
    - *Record 100%, deduct 50% of promotional activity*



Example:

Documentation of

Entertainment

From "Tax Strategies for Business Professionals" by Sandy Botkin

ACTIVITY 1			
GASOLINE AND OIL			
REPAIRS AND MAINTENANCE			
OTHER			
<b>TOTAL</b>			

ENTERTAINMENT			
WHO?			
WHERE?			
WHY?			
BREAKFAST		HOME	OTHER
LUNCH		GOLF/ETC.	
DINNER		COCKTAILS	
<b>TOTAL</b>		<b>TOTAL</b>	<b>TOTAL</b>

WHO? <i>J &amp; S Rock</i>			
WHERE? <i>Palm and Kennedy Center</i>			
WHY? <i>Johnson Referral at Dinner Followed by Theatre</i>			
BREAKFAST		HOME	OTHER
LUNCH		GOLF/ETC.	<i>Theatre 120.00</i>
DINNER	<i>235.00</i>	COCKTAILS	<i>Parking 11.00</i>
<b>TOTAL</b>		<b>TOTAL</b>	<b>TOTAL 381.00</b>

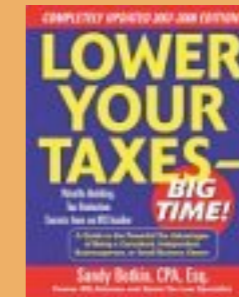
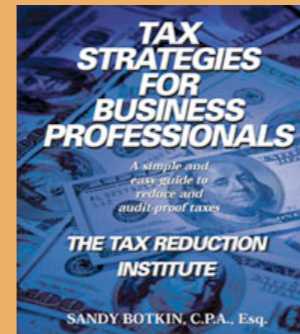
  

WHO?			
WHERE?			
WHY?			
BREAKFAST		HOME	OTHER
LUNCH		GOLF/ETC.	
DINNER		COCKTAILS	



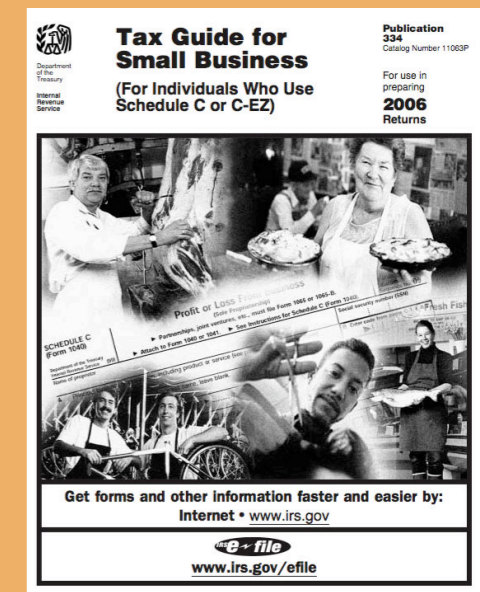
# Resources

- Sandy Botkin, CPA, Esq.
- [www.taxreductioninstitute.com](http://www.taxreductioninstitute.com)



- IRS Publications

- [www.irs.gov/businesses/small/index.html](http://www.irs.gov/businesses/small/index.html)
- [www.irs.gov/businesses/small/article/0,,id=99083,00.html](http://www.irs.gov/businesses/small/article/0,,id=99083,00.html)



....along with a GREAT tax accountant!

