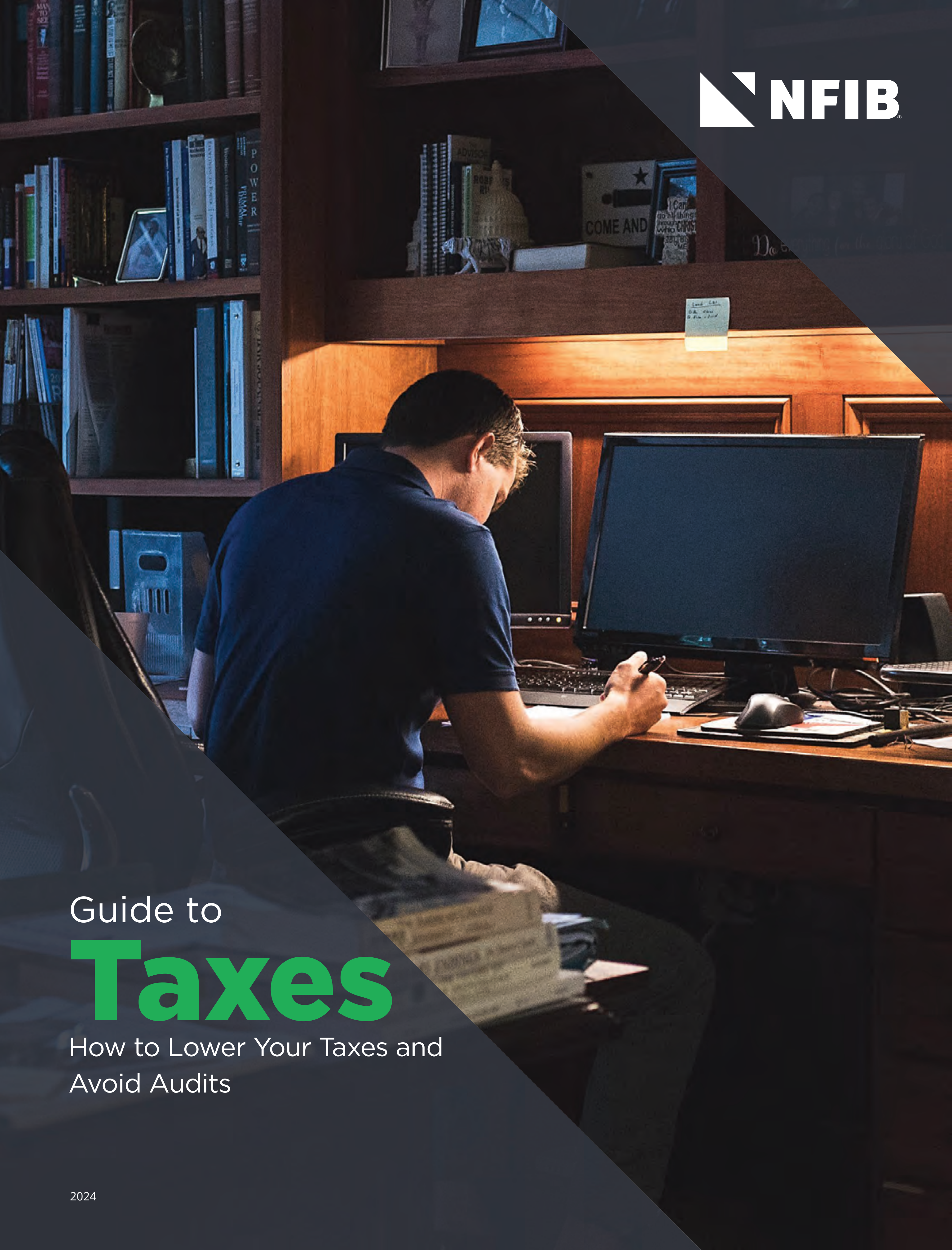
NFIB




Guide to

# Taxes

## How to Lower Your Taxes and Avoid Audits

2024

## About The NFIB Guide to Taxes

Welcome to our exclusive series of publications written to provide practical solutions to the challenges faced by small business owners. The NFIB Guide to Taxes has been compiled to assist you in dealing with a system that is both costly and complex.

This Guide addresses three important areas related to owning a small or independent business: the Alternative Minimum Tax (or AMT), common deductions employed by small businesses, and information on how to avoid an audit.

## About NFIB

The National Federation of Independent Business is the nation's leading small business association, with offices in Washington, D.C., and all 50 states. NFIB's powerful network of grassroots activists sends their views directly to state and federal lawmakers through our unique member-only ballot, thus playing a critical role in supporting America's free enterprise system.

# NFIB Guide to
# Taxes

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA), the most comprehensive tax reform in the past three decades. TCJA simplified the tax system for many taxpayers and included many favorable tax cuts to small and independent businesses. The changes are too exhaustive to list in detail, but here are a few of the most notable small business provisions.

## DEDUCTIONS

Individual income tax rates were slashed across the board, with the highest marginal tax rate decreasing from 39.6% to 37%. The top corporate tax rate was cut from 35% to 21%.

The standard deduction nearly doubled, increasing from $12,700 to $24,000 for married couples, and from $6,350 to $12,000 for individuals. This simplifies the filing process for many taxpayers, who will now take the standard deduction instead of itemizing.

## AMT

The Alternative Minimum Tax (AMT) exemption and phaseout thresholds increased and are indexed for inflation. The corporate AMT was eliminated entirely. This means fewer middle-income taxpayers will be hit with the AMT.

## ESTATE TAX

For the estate tax, TCJA roughly doubled the exemptions; it is now $11.2 million/individual and $22.4 million/couple. It is also indexed. (And, it expires after 2025.)

## EXPENSING

Expensing rules were greatly expanded, allowing businesses to deduct up to 100% of the cost of capital assets in the year of purchase.

# Common Deductions Used by Small Business

Some of the more straightforward business expenses include telephone, utilities, office rent, salaries, legal and accounting expenses, professional services, dues, bank fees, interest on business debt, and subscriptions to business publications. More deductions are described on the following pages.

## DEDUCTION REQUIREMENTS

As a general principal, in order for business operating expenses to be deductible, they must be:

- Ordinary and necessary
- A current expense
- Directly related to your business, and
- Reasonable in amount (an amount is reasonable unless there are more economical alternatives).

## SMALL BUSINESS DEDUCTION

The new Section 199A, or the Small Business Deduction, allows small businesses that are organized as pass-throughs to deduct up to 20% of their qualified business income from an S-Corporation, LLC, sole proprietorship, or partnership. This amount cannot exceed 20% of a taxpayer's total income, excluding capital gains. This deduction is available for tax years beginning after December 31, 2017 and ending before January 1, 2026.

C corporations are not eligible for this deduction; however, C corporations benefit in other ways under the TCJA because the corporate tax rate was consolidated from 35% to 21%.

## QUALIFIED TRADE OR BUSINESS

Owners of all pass-through businesses are eligible, regardless of industry, unless they earn $157,500 in qualified business income for an individual, or $315,000 in qualified taxable income for married couples filing jointly for tax year 2018. For tax year 2019, these thresholds will increase to $160,700 for an individual and $321,400 for married couples filing jointly. The qualified business income deduction may be limited for taxpayers above these thresholds. If the total income of the qualified business owner is greater than $207,500/$415,000 (individual/joint), then the deduction is capped at the greater of: 50% of W-2 wages of the business or 25% of W-2 wages of the business, plus 2.5% of unadjusted basis of qualified property immediately after acquisition. This limitation is phased in if total income is between $157,500/$315,000 (individual/joint) and $207,500/$415,000 (individual/joint) for tax year 2018.

## SPECIFIC SERVICES TRADE OR BUSINESS

The small business deduction is limited for “specified services” either trades or businesses. These “specified services” include health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of employees or owners. However, income from architecture or engineering may still qualify for the deduction. An exclusion for a specified service trade or business phases in above the initial $157,500/$315,000 (individual/joint) thresholds. For taxpayers with qualified business income above the thresholds listed above, $157,500/$315,000 (individual/joint) for tax year 2018, additional considerations come into play. One such consideration is if the business is a "specified service trade or business". The deduction phases out completely for owners of such trades or businesses who earn more than $207,500 for an individual or $415,000 for married couples filing jointly in qualified taxable income for tax year 2018. For tax year 2019, these phase-out amounts increase to $210,700 for an individual and $421,400 for married couples filing jointly.

## TRAVEL

Generally, all expenses incurred during business travel are deductible as ordinary and necessary business expenses. The type of expense you can deduct depends on the facts and your circumstances. Oftentimes, deductible business travel expenses will include the cost of airline tickets, taxi fares, baggage, shipping, rental car, overnight lodging, and other selected expenses.

In addition, you can deduct the travel expenses of an employee, partner, or customer who travels with you as long as it is for a bona fide business purpose, and the travel expenses are otherwise deductible.

### TABLE 1-1. TRAVEL EXPENSES YOU CAN DEDUCT (FROM IRS PUBLICATION 463)

This chart summarizes expenses you can deduct when you travel away from home for business purposes.

| IF you have expenses for... | THEN you can deduct the cost of... |
|---|---|
| Transportation | Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. Special luxury rules may apply if you travel by ship. |
| Taxi, commuter bus, and airport limousine | Fares for these and other types of transportation that take you between:<br>1) The airport or station and your hotel.<br>2) The hotel and the work location of your customers or clients, your business meeting place or your temporary work location. |
| Baggage and shipping | Sending baggage and sample or display material between your regular and temporary work locations. |
| Car | Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses. |
| Lodging and meals | Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See Meals for additional rules and limits. |
| Cleaning | Dry cleaning and laundry. |
| Telephone | Business calls while on your business trip. This includes business communication by fax machine or other communication devices. |
| Tips | Tips you pay for any expenses in this chart. |
| Other | Similar, ordinary and necessary expenses, such as transportation to or from a business meal, public stenographer’s fees, computer rental fees, and operating and maintaining a house trailer. |

You should use a log, diary, notebook, or any other written record to keep track of your travel expenses. When you combine personal travel with business, the expenses must be pro-rated between the two, with the exception that the full cost of the roundtrip airfare is a tax-deductible business expense if the trip is primarily a business trip. If the trip is primarily personal, then the travel expenses are not deductible unless they are business-related expenses. The amount of time during the trip spent on business activities compared to personal activities is a major factor in determining if the trip is primarily business or personal.

*NOTE: If you have one expense that includes the costs of meals, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge.*

## MEALS

Normally, meals are limited to 50 percent of the cost. Meals can be deducted if the taxpayer or an employee of the taxpayer is present and the food or beverages are not considered "extravagant". The meals may be provided to a current or potential business customer, client, consultant, or similar business contact.

You can calculate your meals expense using either of the following methods:

**Actual cost:** Use the exact amount and take 50 percent. Keep your receipts. (Note: If provided during or at an entertainment activity, the food and beverages must be purchased separately from the entertainment, or the cost of the food or beverages must be stated separately from the cost of the entertainment on one or more bills, invoices, or receipts).

**Standard meal allowance:** This is a set federal rate that can be used by self-employed individuals. Consult the IRS Publication 1542 for your local standard rate on meals and incidental expenses (M&IE) under the Per Diem Rate Tables (www.irs.gov/publications/p1542).

## CAPITAL ASSETS

Business property that you reasonably expect to last for more than one year is a capital asset. This typically includes items such as office furniture, computer equipment, vehicles, books, and medical, dental, or other specialized equipment. It is very wise to properly account for all capital assets.

There are two basic ways you can deduct capital assets:

**By Depreciating**
Property can be depreciated if:

• You own it.

• You use it in your business.

• It has a useful life (the length of time that a depreciable asset is expected to be useable) that extends beyond the year it is placed in service (the year you start using it).

• The useful life is determinable (wears out, decays, becomes obsolete), and

• It is not used and disposed in the same year. When an asset depreciates, you can deduct some of the cost each year over the asset's useful life. For example, under a straight-line depreciation method, a $1,000 capital asset with a 10-year service life would allow the taxpayer to take $100 (10%) of depreciation deductions per year for ten years. The most common method for depreciating assets placed in service after 1986 is the Modified Accelerated Cost Recovery System. To learn more about MACRS, consult IRS Publication 946 (www.irs.gov/publicationsp946).

**By Expensing**
**Depreciation – section 179:**
Through section 179, a business owner may expense the cost of qualifying purchases and deduct it the year the item is placed in service. TCJA increased the maximum deduction from $500,000 to $1 million. It also increased the phase-out threshold from $2 million to $2.5 million. For tax years after 2018, these amounts will be adjusted for inflation.

**Depreciation – bonus depreciation:**
The new 100 percent depreciation deduction allows businesses to write off most depreciable business assets in the year they are placed in service by the business. The 100 percent depreciation deduction generally applies to depreciable business assets with a recovery period of 20 years or less and certain other

property. Machinery, equipment, computers, appliances, and furniture generally qualify. The deduction is retroactive, applying to qualifying property acquired and placed in service after September 27, 2017. The 100% allowance generally decreases by 20% per year in taxable years beginning after 2022 and expires January 1, 2027.

The property must be:

• Tangible personal property such as machinery, office equipment, or livestock; or qualified improvements to non-residential buildings (modifications to the interior of a building are generally eligible).

• Acquired for business use.

• Acquired by purchase.

• Put into service after Sept. 27, 2017 and before Jan. 1, 2023.

• Must not be land or certain excepted property.

The 100% expensing deduction under TCJA is temporary. For property purchased in 2023, the expensing deduction is set to drop to 80%. And it is set to drop again for property purchased in 2024 to 60%. Unless Congress revisits the issue, the expensing deduction will continue to decrease by another 20% each year, until 2027 when the expensing deduction will be phased out entirely.

There are many rules that limit a Section 179 deduction. Consult IRS Publication 946, mentioned earlier, to learn more details about Section 179 expensing. In certain cases, you may be better off taking regular depreciation. This is best resolved by conferring with a professional who understands your tax needs and the depreciation tax rules. In any event, be sure to keep records on the date of purchase, date you started using the property, and all costs associated with the purchase (like freight and setup).

**De Minimis Safe Harbor**
Small-business owners have another option for deducting the cost of purchased assets through a De Minimis Safe Harbor. Schedule C businesses, rentals, farms, and farm rentals may elect to deduct items that cost less than $2,500 instead of depreciating over time. These regulations are in addition to the other depreciation and expensing rules, and small-business owners may be eligible for both the De Minimis Safe Harbor deductions and normal depreciation and expensing deductions.

**NFIB Federal Public Policy Victory**
For years Congress would change the expensing limit from year-to-year. Prior to enactment of the 2017 tax reform, the expensing limit was $500,000; however, the new tax code raises the expensing limit to $1 million dollars, and the rate is thereafter indexed (i.e., tied to inflation), which means this is a permanent tax benefit for small business. Further, with the new tax law NFIB scored a significant victory for small business in expanding the list of property subject to Section 179 expensing to include improvements to commercial real estate.

**Special Disaster Depreciation Rules:**
Losses resulting from a Presidentially declared disaster may be claimed as a qualified disaster loss. For more information, consult IRS Publication 547 (www.irs.gov/pub/irs-pdf/p547.pdf).

**Catch-up Depreciation**
IRS regulations allow a "catch up" election for unclaimed depreciation and amortization. If you didn't claim depreciation in prior years on a depreciable asset, or you claimed more or less than the allowable depreciation on a depreciable asset, you may be able to take advantage of this "catch up" election without amending past business or personal returns.

## INVENTORIES

If you make or buy goods to sell, you can deduct the cost of goods sold from your gross receipts on Schedule C. However, to determine these costs, you must value your inventory at the beginning and end of each tax year. Opening inventory will usually be identical to the closing inventory of the year before. You must explain any difference in a schedule attached to your return. The following methods, described below, are those generally available for valuing inventory:

1) Cost

2) Lower of cost OR market

3) Retail

For more information on inventories, consult IRS Publication 538 (www.irs.gov/publications/p538/).

| TABLE 1-2. TYPES OF EXPENSES (HOME OFFICE DEDUCTION) | | |
|---|---|---|
| Expense | Description | Deductibility |
| Direct | Expenses only for the business part of your home.<br><br>**Examples:** Painting or repairs in the area used for business. | Deductible in full.*<br><br>**Exception:** May be partially deductible in a daycare facility. |
| Indirect | Expenses for keeping up and running your entire home.<br><br>**Examples:** Insurance, utilities, and general repairs. | Deductible based on the percentage of your home used for business.* |
| Unrelated | Expenses only for the parts of your home not used for business.<br><br>**Examples:** Lawn care or painting a room not used for business. | Not deductible. |

## HOME OFFICE

If you work out of your home, consult with your tax advisor to determine whether a home-office deduction makes sense for you.

To claim expenses for business use of your home, you must show that you use your home office exclusively and regularly as your principal place of business.

**1) Exclusive:** The office must be used for no purpose other than your business. Two exceptions to this are if you are storing inventory or using a room to provide daycare.

**2) Principal place of business:** This is where you conduct administrative or management activities, exclusively and regularly, for your business.

If you have another office somewhere else, you may be able to deduct the cost of a home office as well, if, for instance, you meet with clients at your home office. Employees must also be using the home office for the convenience of their employer.

**Allowable Deductions:** Home office expenses that are eligible for deduction include all normal office expenses plus interest, taxes, insurance, and depreciation (you must claim the depreciation) on the portion of your home used exclusively for business. You can deduct business-related telephone charges, such as long distance charges, made from your home number, as well as business equipment and supplies.

Eligibility is based on the percentage of your home used for business and whether the expenses are direct, indirect, or unrelated.

**Limits to Home Office Deduction:** If your gross income from the business use of your home equals or exceeds your total business expenses (including depreciation), you can deduct all your business expenses related to the use of your home.

If the business does not have enough profit to absorb the home-office deduction, you can deduct the excess from income earned on a 9-to-5 job, if you still have one, or from your spouse's income, if you file a joint return. Or, you may carry the excess expenses to the following year. In addition, there are limits to deductions a shareholder may take for home-office expenses when receiving rent from the shareholder's "C" or "S" corporation.

**Business Percentage:** Allocation of home-office expenses is generally made on the basis of the ratio of square footage used exclusively for business to total square footage of the residence. You must also prove that the part of your home you use as your home office — which can be just a portion of a room as opposed to an entire room — is used only for business. Take photographs of your home office. But, having personal items captured in the picture may cause you to lose your claim that it is solely used for business. The home office determination is important for maximizing your business travel expenses. If your home office is your residence, then travel away from the home office can be business travel. This reduces the non-deductible commuting costs since your residence and tax home (home office) are the same place.

## SIMPLIFIED HOME OFFICE DEDUCTION

In 2013, the IRS created a new simplified home office deduction. Taxpayers may claim it on a year-by-year basis. The simplified deduction sets the allowable deduction for home office expense at $5 per square foot for a maximum yearly deduction of $1,500. This simplified deduction avoids the need to calculate the ratio of square footage used for business to total square footage. However, the standard home office deduction is still available and there may be situations where it is more advantageous to use it.

## OUTSIDE OFFICE

An outside office that you rent or own presents many opportunities for tax deductions. Virtually all your outside office expenses are deductible, including rent, utilities, insurance, repairs, improvements, and maintenance. Capital improvements may need to be depreciated over the life of the underlying property. The tangible property regulations discussed above also create new rules regarding what improvements need to be capitalized.

## HEALTH INSURANCE

In most cases, health insurance premiums are deductible for business owners. However, the process for taking the deduction is different depending on how your business is organized.

**“C” Corporations**

“C” corporations can deduct health insurance as an ordinary and necessary business expense. When you form a corporation to own and operate your business, you’ll work as its employee. The corporation can then provide you with health insurance as an employee fringe benefit and deduct the cost as a business expense. Health insurance is a tax-free fringe benefit, so the employee does not need to pay taxes for the amount of this benefit.

**Self-employed (Sole Proprietorships, Partnerships, and Passthrough LLCs)**

If you are self-employed and have a net profit for the year, you may be able to deduct up to 100 percent of the amount paid for medical, dental, and qualified long-term care insurance on behalf of yourself, your spouse, and dependents. In order to qualify for this deduction, you must meet the following two requirements:

You have no other health insurance coverage. You must not be eligible to participate in a health insurance plan maintained by your employer or your spouse’s employer.

You have business income. You can only take a deduction up to the amount of income that the business produces. If you own multiple businesses, you can only use the income from a single business that you designate as the health insurance plan sponsor. You cannot add together the income from multiple businesses to take a larger deduction.

If you meet these two requirements, then the health insurance premiums are deductible regardless of whether you purchase health insurance as an individual or under the name of the business. If you purchase the insurance through a business, then that business will be designated the plan sponsor (and subject to the income limitations described above). However, if you purchase health insurance as an individual, you may designate which business you want to be the plan sponsor at the start of each year. Additionally, owners of multiple businesses can purchase health insurance sponsored by one company and dental insurance sponsored by another and still claim the full deduction. This can help maximize your deductions if no single businesses has enough income to deduct both policies.

It is important to note that this is not a business deduction. The health insurance deduction is a special personal deduction available to self-employed individuals. As a result, you cannot deduct health insurance from self-employment taxes (12.4% for Social Security and the 2.9% Medicare tax).

Additionally, if you qualify for a premium tax credit (premium subsidy), you can only deduct the part of the premium that you pay yourself. Any taxpayer who itemizes deductions and does not claim 100 percent of self-employed health insurance on his or her return (maybe because of the limitation on income) may be able to deduct the premiums if the expenses exceed 10 percent of his or her adjusted gross income.

**"S" Corporations**

Shareholders of an “S” corporation are treated a little differently due to special tax rules. A shareholder who owns more than 2% of an S corporation normally must include the cost of health insurance premiums as taxable income (unlike “C” corporations, which may treat this as a tax-free fringe benefit) and must pay Social Security and Medicare taxes on this amount. Fortunately, “S” corp shareholders are still eligible for a deduction under the

self -employment rules stated above.

More than 2% owners of "S" corporations are treated as self-employed individuals for the purpose of deducting health insurance premiums. The deduction is limited to the amount of wages paid to you by the “S” corp. You can still claim this deduction whether you purchase your policy as an individual or through the business, but the “S” corp must pay the premiums to be able to claim the deduction. Therefore, if you purchase your plan individually, the “S” corp must reimburse you for the premiums.

For tax filing purposes, the amount of premiums must be included in your employee wages. This is not subject to Social Security and Medicare taxes if either (i) you are the sole employee of the “S” corp or (ii) the “S” corp provides health insurance to all non-owner employees as well. The “S” corp then deducts the amount of insurance premiums as employee compensation on its own return. Finally, the more than 2% “S” corp shareholder takes a personal deduction for self-employment health insurance costs.

It is also important to note that the Affordable Care Act (ACA) imposes penalties on “S” corps who offer health plans that fail to comply with certain market reforms. This includes health plans that reimburse employees for the cost of individual health insurance premiums. These penalties do not apply to “S” corporations with only one employee. Currently, the ACA market reform penalties will not be enforced as to “S” corporations under IRS Notice 2015-17, which provides that taxpayers may rely on IRS Notice 2008-1 unless and until additional guidance provides otherwise. Shareholders will want to check each tax year and make sure that Notice 2008-1 still applies.

Also keep in mind that an above the-line deduction is not allowed for any calendar month in which the shareholder is eligible to participate in any subsidized health plan maintained by any other employer of the shareholder or of the spouse of the shareholder.

## OTHER DEDUCTIBLE INSURANCE PREMIUMS

You generally can deduct other premiums you pay for the following kinds of insurance related to your trade or business:

• Insurance that covers fire, storm, theft, accident, or similar losses.

• Credit insurance that covers losses from business bad debts.

• Group hospitalization and medical insurance for employees, including long-term care insurance.

• Accident insurance.

• Liability insurance.

• Malpractice insurance that covers your personal liability for professional negligence resulting in injury or damage to patients or clients.

• Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.

• If a partnership pays workers' compensation premiums for its partners, it generally can deduct them as guaranteed payments to partners. Remember that if an S corporation pays workers' compensation premiums for its 2 percent shareholder-employees, it generally can deduct them, but must also include them in the shareholder's wages.

• Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.

• Overhead insurance that pays for business overhead expenses you have during long periods of disability caused by your injury or sickness.

• Car and other vehicle insurance that covers vehicles used in your business for liability, damages, and other losses. If you operate a vehicle partly for personal use, deduct only the part of the insurance premium that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums.

• Life insurance covering your officers and employees if you are not directly or indirectly a beneficiary under the contract.

• Business interruption insurance that pays for lost profits if your business is shut down due to a fire or other cause.

## AUTOMOBILE EXPENSES

Deductions can be calculated in one of two ways: either by using the IRS standard mileage rate or the actual operating expenses related to your business, whichever is greater.

This deduction is available to you whether you or your business owns or leases the car.

To limit vehicle lease expenses so that they are comparable to expenses for owned vehicles, you may have to reduce your deduction for your lease payment if the value of your leased car is above a certain fair market value. This is designed to prevent taxpayers from avoiding the luxury auto depreciation limits. Consult IRS Publication 463 ( www.irs.gov/publications/p463) for more details.

In addition, if a vehicle is used more than 50 percent for business purposes, it may also qualify for standard depreciation or expensing. The amounts of these deductions are also limited by the luxury auto depreciation limits.

**IRS Standard Mileage Rate:**
For 2024, the deductible rate for business-related automobile mileage is 67 cents per mile (up 1.5 cents from 2023)
To calculate this deduction, multiply the rate by the exact business mileage. If you claim accelerated depreciation on a vehicle, then you may not subsequently claim the standard mileage rate when driving that vehicle.

## WHAT YOU CAN'T TAKE A DEDUCTION FOR

Business owners should know that there have been changes in the tax code that can affect the tax liability of both owners and employees. Of relevance here, some deductions are no longer permitted:

• State and local tax deductions are now capped at $10,000 (this includes property tax, income tax, and sales tax).

• The cap on the home mortgage interest deduction was reduced from $1,000,000 to $750,000.

• The interest deduction on home equity lines of credit has been eliminated.

• Deductions for business entertainment expenses were eliminated.

• Deductions for employee moving expenses, dues, and transportation expenses were eliminated. Income exclusion for moving expense reimbursement, bicycle commuting expense, and employee cash and gift awards were eliminated.

• Deductions for alimony payments were eliminated. Miscellaneous deductions up to 2% of Adjusted Gross Income were eliminated. This includes: Appraisal fees for a casualty loss or charitable contribution. Casualty and theft losses from property used in performing services as an employee.

• Credit or debit card convenience fees.

• Fees to collect interest and dividends.

• Hobby expenses.

• Investment fees and expenses. Loss on deposits in an insolvent or bankrupt financial institution. Repayments of income, for example, repayment for overpayment of Social Security benefits.

• Tax advice and preparation fees, including legal fees related to producing or collecting taxable income.

• Unreimbursed employee expenses.

In addition, here are some other nondeductible expenses to be aware of:

• Broker's commissions.

• Campaign expenses, lobbying expenses, or political contributions.

• Check-writing fees.

• Club dues, including any club organized for business, pleasure, recreation, or other social purpose.

• Commuting expenses (the cost of transportation between home and work).

• Fees and licenses, such as car licenses, marriage licenses, and dog tags.

• Fines or penalties, such as parking tickets, settlement amounts, or tax penalties.

• Hobby losses.

• Home repairs, insurance, and rent (but homeowners may still qualify for a home office deduction; see the earlier section).

• Investment-related seminars. Life insurance and personal disability insurance premiums paid by the insured.

• Losses from the sale of your home, furniture, personal car, etc.

• Lost or misplaced cash or property.

• Lunches with co-workers and meals while working late, unless as part of travel.

• Personal legal expenses.

• Personal, living, or family expenses.

• Professional accreditation fees.
• Residential telephone line.
• Travel expenses for another individual.

## BUSINESS BAD DEBT

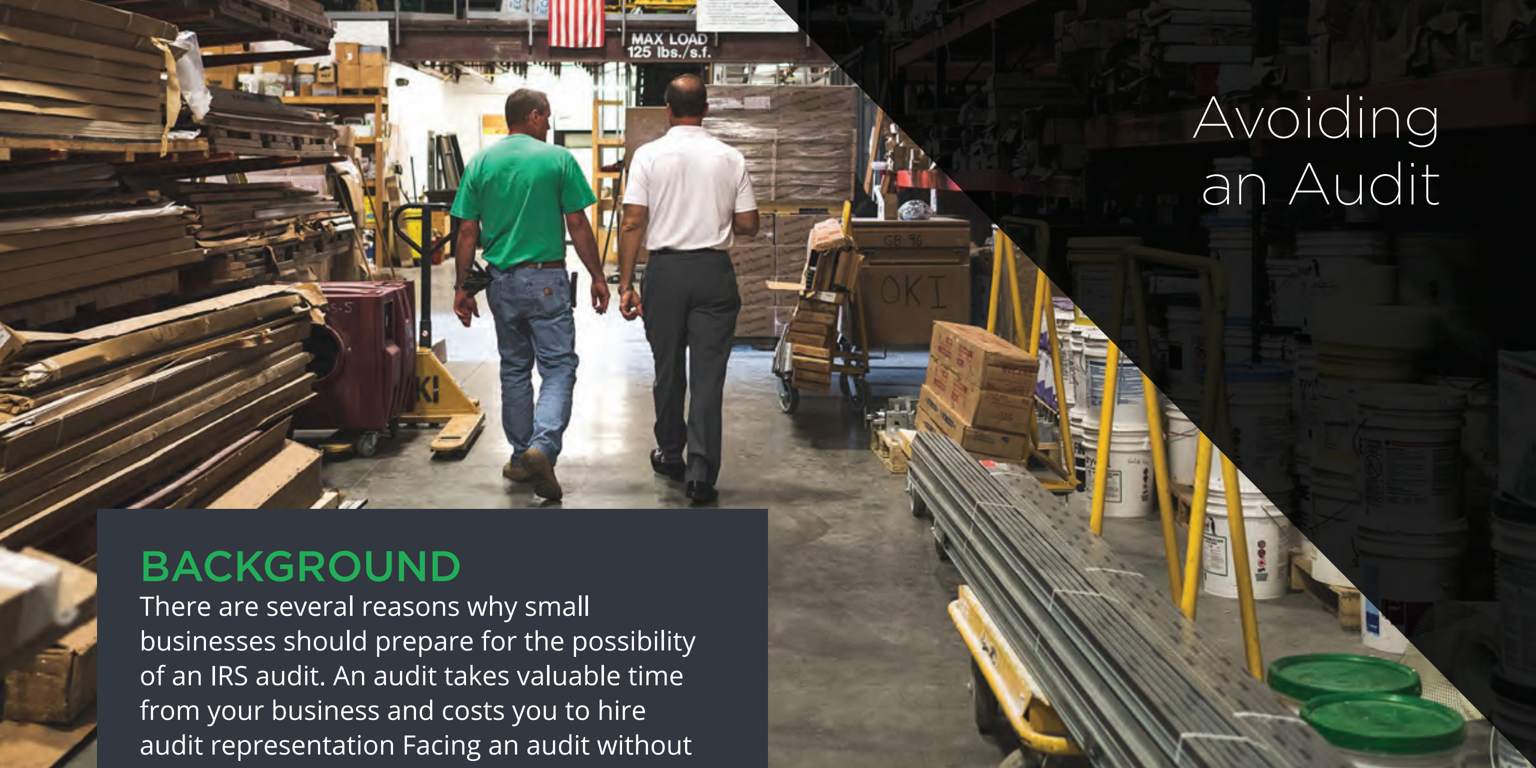
A business bad debt is a loss from a debt created or acquired in your trade or business.

Any other worthless debt is a business bad debt only if there is a very close relationship between the debt and your trade or business when the debt becomes worthless. A debt has a very close relationship to your trade or business if your main motive for incurring the debt is a business reason.

## RETIREMENT PLANS

For you to qualify as a participant in a tax-deductible retirement plan funded by your business, you must have earned income each tax year in which you wish to participate. Earned income consists of your share of the business' profits plus W-2 wages paid to you by your business. Earned income does not include S corporation profits. Dollars used to fund your retirement plan are tax-deductible to your business and grow tax-free until you retire.

Retirement plan rules are complicated and penalties for violating these rules can be severe. Using your local credit union, insurance agent, or bank for retirement programs may be adequate for some businesses and a mistake for others. You should secure competent advisors for your retirement plans.




# Avoiding an Audit

## BACKGROUND

There are several reasons why small businesses should prepare for the possibility of an IRS audit. An audit takes valuable time from your business and costs you to hire audit representation Facing an audit without representation is like representing yourself in court. With the IRS experiencing significant personnel turnover, and in the midst of hiring new auditors, you have a good chance of facing a less-experienced auditor. This means your audit may take longer and you may need to address audit issues that an experienced auditor knows are irrelevant. An audit may take months to complete. As a small business owner, you should be prepared for an auditor visit to your place of business even if you have audit representation. Taking the necessary precautions will help alleviate some of the headaches associated with an audit. As Benjamin Franklin once said, “An ounce of prevention is worth a pound of cure.”

## HOW TAXPAYERS ARE SELECTED

Some audits are triggered by a whistle-blower and some are simply random. However, most audits are scheduled because of very high or very low Discriminate Inventory Function (DIF) System scores. This is a number assigned to your return after it is processed. Your DIF score is based on comparing tax returns to other businesses in the same standard industrial code. The more your DIF score is higher or lower than the average, the more you are likely to be the target of an audit. If your DIF scores are average, then you are less likely to be audited.

## THINGS TO CONSIDER WHEN PREPARING YOUR TAX RETURN

You may take certain steps to avoid being a target. Your tax return entries should be accurate and hopefully result in your return having an average DIF number. Your return should reflect that you have taken time to keep good records. Having only a few entries on your return implies you have taken shortcuts. Also, you may want to try to avoid lumping a multitude of costs into the office category rather than listing them as a capital asset.

Consider the following important questions when preparing your tax return:

• Is your cost of goods figure in line with your industry?

• Are vehicles and vehicle expenses appropriate for your business?

• Is compensation realistic, or is it too low or too high?

• Are there expenses for employee health insurance but no payroll?

• If you are an S Corporation shareholder unreasonably low compensation can trigger an audit.

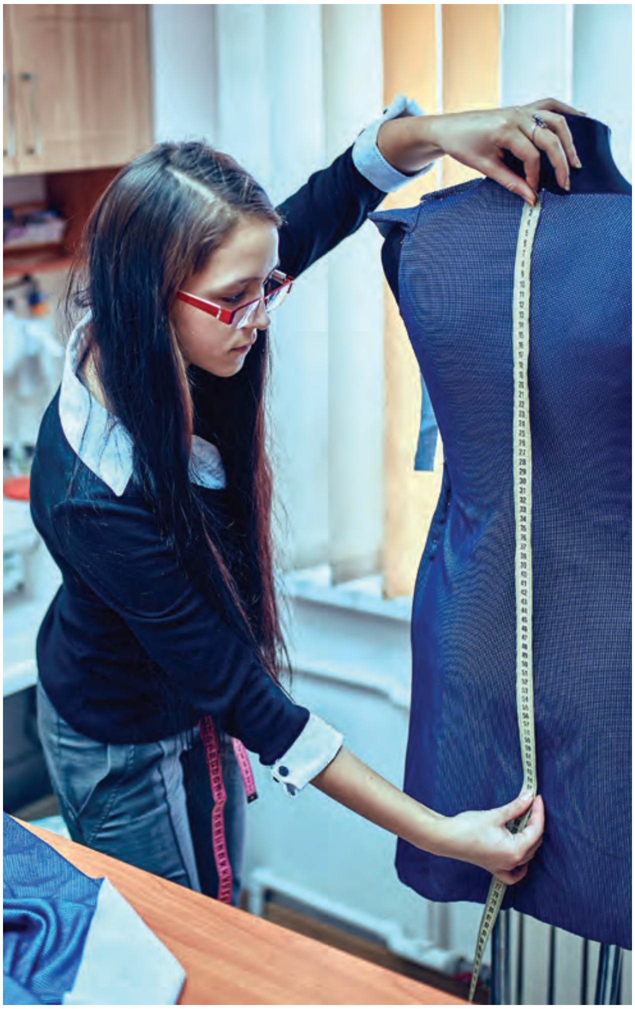
• Should the independent contractors really be W-2 employees?

• If you receive large amounts of cash, have you complied with the IRS Form 8300 reporting rules?

• Are you filing your federal and state tax reports on time? Failure to report or pay on time draws unwanted attention to your business.

• Is your lifestyle (perhaps matched to others in your ZIP code) consistent with your income?

The IRS has been limited in doing financial status audits but still may do so if they have reasonable indication there is a likelihood of unreported income. Auditors can examine credit reports, property tax records, business license applications, credit applications, motor vehicle records, currency transaction reports, and other documents to get a sense of your income.



## AUDIT HOT BUTTONS

**These are some IRS audit issues for business filers:**

• Reflecting the proper amount of personal auto use

• Claiming a business that is really a hobby

• Claiming personal deductions on business returns

• Claiming spouse travel expenses

• Deducting start-up expenses instead of following amortization rules

• Unreported income

• Proper use of cash versus accrual method of accounting

• Taxpayer not being involved in the business on a regular and continuous basis

• Failing to follow capital asset depreciation rules

• Designating workers as independent contractors when they should be employees

• Claiming family members as employees who may not really be employees

• Improper retirement program funding

• Giving employee fringe benefits when there are no employees or giving employee fringe benefits to an independent contractor

• Lack of adequate record keeping for listed property (autos, phones, certain computers or entertainment facilities)

• Accumulated earnings

• Losses taken but not allowed because of basis limitations

• Losses taken but not allowed because of insufficient business involvement

• Loan applications where the taxpayer states income or assets not consistent with the tax return

## 12 WAYS TO HELP YOU AVOID AN AUDIT

**(1) GROSS RECEIPTS SHOULD AGREE WITH BANK DEPOSITS**: The first area an auditor will test is how your bank deposits compare with your gross receipts. If they do not match up, three issues arise. First, the auditor will assume you simply made a mistake and will gross up your receipts to match the bank deposits. Second, it sets the tone for the remainder of the audit. If the gross income is wrong, what else is wrong? Third, it may give the IRS a reasonable indication there is a likelihood of unreported income and trigger a financial status audit. The auditor may require you to produce the year's bank statements for all accounts. This is a solid reason to use a business checking account and to not use your personal checking account for business.

**(2) DO NOT USE ROUND NUMBERS FOR DEDUCTIONS:** You want to prove that you are keeping precise and accurate records. If you use round numbers, the IRS will think you are estimating your expenses and this will raise a red flag.

**(3) KEEP ORIGINAL RECEIPTS OF EXPENSES:** For large deductions, such as medical bills or charitable donations, it is best to attach copies of receipts, checks, insurance reports, and anything else you have to prove their legitimacy. Keep the original documents in your files. If your tax return is tagged for additional scrutiny, having the documentation attached to your return and readily available in your files could eliminate the need for a larger audit.

**(4) KEEP TAX RECORDS AND CORRESPONDING DOCUMENTS FOR AT LEAST SEVEN YEARS:** The IRS has up to three years to audit your filed return. Therefore, it is important to keep your tax records for at least that long. Additionally, the IRS has six years to come after you if they believe you underreported your gross income by more than 25 percent on a filed return. This is why it is essential to keep your records organized for at least seven years, so that they are easily accessible if necessary. These limits apply only if a return is filed. If a return has never been filed, these time limits do not apply because the statute of limitations does not start running until you file a return. In other words, you are forever open to a tax assessment or audit if you have never filed a return for a particular tax year.

**(5) AVOID HANDWRITING YOUR RETURN:** Do your return by computer or typewriter. The IRS tends to give handwritten returns closer scrutiny. A sloppy return may invite an audit because the examiner has difficulty reading the return.

**(6) LIMIT ITEMIZED DEDUCTIONS:** You are expected to claim every deduction to which you are entitled by law. However, it is a good idea to avoid large amounts of itemized deductions relative to income. Claiming large deductions that exceed your income can put you at risk for an audit. Keeping good records will assist you in the event of an audit. Attaching a note explaining unusual situations may also help to avoid an audit.

**(7) REPORT ALL TAXABLE INCOME:** Do not forget to report cash prizes, bartering, cash payments, alimony, tips, 1099-MISC income, 1099-R, W-2G gambling, capital gains, and anything else that is considered taxable income. IRS computers are getting better at matching what is on your return with what others say they paid you.

**(8) CHECK YOUR MATH:** The IRS automatically corrects some mathematical errors, but that does not mean a return full of math errors will not be red-flagged. If you are filing paper returns, check your math carefully to avoid careless errors that could cost you later.

**(9) KEEP A WRITTEN DIARY OF EXPENSES:** Even though you may have a receipt to document a business expense, it is a good idea to keep a diary notation (or expense report) as a supplement to your receipt. This can help in establishing business travel and entertainment deductions.

For example: Documentation for a business meal should include the following information:

- The amount paid
- The name and location of the restaurant
- The person you entertained
- The person's business relationship with you
- The business discussion related to the entertainment

**(10) KNOW WHEN TO FILE:** Have your return prepared early. Ifyou have a big refund and are unconcerned with audit issues, file early and get your money back. If you have taxes due, and no penalty for underpayment, avoid filing too early. Tax payments made prior to April 15th for the previous year's tax liability are interest-free loans to the IRS.

**(11) AVOID OFFSHORE ACCOUNTS OR CREDIT CARDS:** Many people put money in an offshore account to avoid paying taxes on the interest. The IRS has begun to scrutinize taxpayers with offshore accounts.

**(12) BE CAREFUL WHEN TAKING A HOME OFFICE DEDUCTION:** Be sure to consult with a tax professional to determine whether your home office qualifies for the deduction and the appropriate deduction amount. Have pictures showing your home office. Having personal items in the picture is a good way to defeat your claim that it is solely used for business. This is an item that the auditor may be checking when they visit your business in person.

## WHAT TO DO IF YOU ARE SELECTED FOR AN AUDIT

**(1) OBTAIN AUDIT REPRESENTATION:** Taxpayers are permitted to have audit representation in an audit. Certainly some taxpayers could represent themselves adequately, but they are the exception rather than the rule. You should obtain representation prior to contacting the IRS.

**(2) OBTAIN ADVICE AND REPRESENTATION ONLY FROM LEGITIMATE AND REPUTABLE SOURCES:** Look for credentials such as an Enrolled Agent, a CPA, or a tax attorney who is qualified to practice before the IRS. In addition, consider knowledge and experience. A good professional will provide references.

**(3) DON'T PANIC!** Remember that your proper record-keeping practices will help alleviate the burdens of an audit.

# UNDERSTANDING THE INDIVIDUAL AMT

## BACKGROUND

The Alternative Minimum Tax (AMT) is one of the most complex federal taxes in existence. It was designed to prevent the wealthiest taxpayers from avoiding paying taxes altogether. Under the AMT, taxpayers effectively calculate their taxes under two systems (regular income tax and AMT) and pay the higher of the two liabilities.

Although the AMT originally targeted the highest-income taxpayers, over time more and more middle-income taxpayers were subject to the AMT and, consequently, owed additional taxes. Fortunately, TCJA drastically reduced the number of taxpayers who will be subject to the AMT, with only around 200,000 taxpayers expected to be affected by the AMT between tax years 2018-2025 (for comparison, 5 million taxpayers paid the AMT in 2017). Unfortunately, the changes to the AMT under the TCJA are temporary and will expire in 2025. In the meantime, NFIB continues to advocate for the repeal of the AMT.

# CALCULATING THE AMT STEP-BY-STEP INSTRUCTIONS

Every year, taxpayers need to consider whether they will have to pay the AMT. The AMT has evolved into a tax system that is parallel to our regular income tax system. It expands the amount of your income that can be taxed, adding back items that were tax-free (exempt) under the regular tax system and disallowing many deductions and credits. The following steps show how the AMT is calculated.

**STEP ONE:** Add back various tax preference items to your taxable income (see next page for the disallowed deductions). This new amount then becomes your AMT tax base.

**STEP TWO:** The appropriate AMT exemption is subtracted from the AMT tax base, calculated in Step one. The AMT exemption amounts for 2018 are: $109,400 for married individuals filing jointly, and $70,300 for single filers. These exemption amounts are indexed for inflation and will sunset in 2025.

The basic AMT exemption amount begins to phase out at a rate of 25 cents for each dollar of AMT taxable income that exceeds certain threshold amounts. These thresholds are: $1,000,000 for joint returns, and $500,000 for single filers. These thresholds are also indexed for inflation.

**STEP THREE:** After calculating Step Two, if your AMT tax base is less than the exemption amount, you are not subject to the AMT. If you still have an AMT tax base remaining, then you must pay the AMT. In contrast, the top marginal income tax rate under TCJA is 37%.

The AMT tax rate schedule is 26 percent of the first $191,500 ($95,750 for unmarried individuals) of AMT taxable income in excess of any AMT exemption and 28 percent on any additional AMT taxable income.

**If the calculated AMT tax liability is higher than your regular income tax liability, you will pay the AMT tax liability and move on to Step Four.**

*Note: Capital gains and dividend income are still taxed at their normal rate and not at the AMT rates. Today, the capital gains and dividend rate is 20 percent, with an additional 3.8% net investment income tax for high-income taxpayers.*

**STEP FOUR:** The AMT liability can be reduced by the full amount of an individual's personal tax credits. Some of these personal tax credits include:

- Dependent care credit
- Credit for the elderly and disabled
- The HOPE Scholarship credit
- The Lifetime Learning credit
- Adoption tax credit
- Child tax credit
- IRA tax credit
- Credit for electricity

**STEP FIVE:** For future tax years you may be eligible for an AMT tax credit that is calculated as an item to be carried forward to offset regular income tax liabilities. To calculate and report your AMT tax credit, you need to fill out Form 8801, Credit for Prior Year Minimum Tax.

*NOTE: To calculate and report your AMT liability you need to fill out Form 6251, Alternative Minimum Tax — Individuals.*

*You are required to take your AMT liability into account in determining how much estimated tax you pay. If the tax calculated on Form 6251 is higher than that calculated on your regular tax return, you have to pay the higher amount. As always, check with your tax advisor to be certain about your potential AMT liability.*

# Deductions **Not Allowed** Under AMT

**(1) THE STANDARD DEDUCTION**

**(2) MEDICAL EXPENSES:** If you itemize deductions, medical deductions are only allowed to the extent that they exceed 10 percent of adjusted gross income.

**(3) CERTAIN ITEMIZED DEDUCTIONS:** You cannot take itemized deductions for state and local income tax, real estate taxes, general sales taxes and personal property taxes, even though these were deductible on your regular return.

**(4) DEPRECIATION DEDUCTIONS:** These are added back to the extent the deductions taken under accelerated provisions exceed the slower depreciation rules. For property placed in service after 1998, if the 200 percent declining balance method is used for regular tax purposes for 3-, 5-, 7-, or 10-year property, then the 150 percent declining balance method and regular tax depreciation period must be used for AMT purposes.

For all other property placed in service after 1998, no AMT adjustment is required, as AMT and regular tax depreciation are the same. For property placed in service after 1986 and before 1999, similar adjustments must be made.

Adjusting MACRS depreciation deductions (see pg. 8), rather than treating them as Tax Preference Items, may provide taxpayers with some major benefits as they compute AMT in the later years of a property's use.

Generally, no AMT adjustments have to be made to the amount expensed under IRS Code Section 179.

*NOTE: When disposing of depreciated assets, the depreciation rules differ between regular and AMT; you are likely to have a different gain or loss amount to report.*

**(5) TAX-EXEMPT INTEREST:** Taxpayers will have to add back tax-exempt interest, less any related expenses, on specified private activity bonds, which generally are issued after August 7, 1986.

## CERTAIN HOME MORTGAGE INTEREST PAYMENTS MAY BE ALLOWED AS A DEDUCTION

Among the interest deductions that may be claimed against AMT taxable income is qualified housing interest. This is similar to the qualified residence interest deduction that may be claimed against regular tax. Qualified housing interest is interest paid on a loan used to purchase, build or improve a taxpayer's principal residence or other dwelling (i.e., a house, apartment, condominium, or mobile home that is not used on a transient basis). Interest on a refinanced loan is also deductible if the loan does not exceed the balance remaining on the original loan. This eliminates many home equity loans and loans on motor homes, boats, etc., because these dwellings are not qualified dwellings for AMT purposes.

**YOU MAY GET HIT WITH AMT LIABILITY IF YOU HAVE**

• High state and local taxes, including income, property, personal property, and sales taxes.

• A large family.

• A large amount of deductible medical expenses.

• Exercised incentive stock options.

• A large number of personal exemptions.

• A large amount of miscellaneous itemized deductions.

• A large amount of capital gains.

Investors in a tax shelter should be aware that they may have a higher probability of being subject to this tax. Investors in a tax shelter have increased risk of facing the AMT because most tax shelters are structured to maximize the use of tax preference items.

*NOTE: If you have any of these issues on your tax return, or any combination of them, you should consult with your tax advisor to determine whether you have any AMT liability.*

## MINIMIZING YOUR EXPOSURE

**ACCELERATE INCOME**

• Take a prepayment of salary or bonuses.

• Recognize short-term gains on portfolio securities.

• Redeem Series EE U.S. Savings Bonds or certificates of deposit.

• Withdraw money from your IRA or other retirement funds.

• Convert tax-free bonds to higher yielding taxable bonds.

**DEFERRING DISALLOWED AMT DEDUCTIONS**

• Defer making your estimated state income-tax payments until the next year.

• Defer paying your real estate or personal property taxes until the next year.

• Defer any medical expenses if the total doesn't exceed 10 percent of your adjusted gross income.

• Defer payment of any employee business expenses, union dues, job-education, investment, and tax-preparation expenses.

• Spread the exercise of any incentive stock options over a multi-year period to minimize the amount of preference items in any single year.

• Depreciate rather than deduct business furniture and equipment.