

Tax Tips

For Small Business

Summer 2007



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The Tax Consequences of Loaning Money to Your Business

Don't forget the interest

Often business owners infuse their business with additional cash. How you structure this capital investment has a direct effect on the tax consequences. In addition, the type of entity you have created for your business also affects the tax consequences.

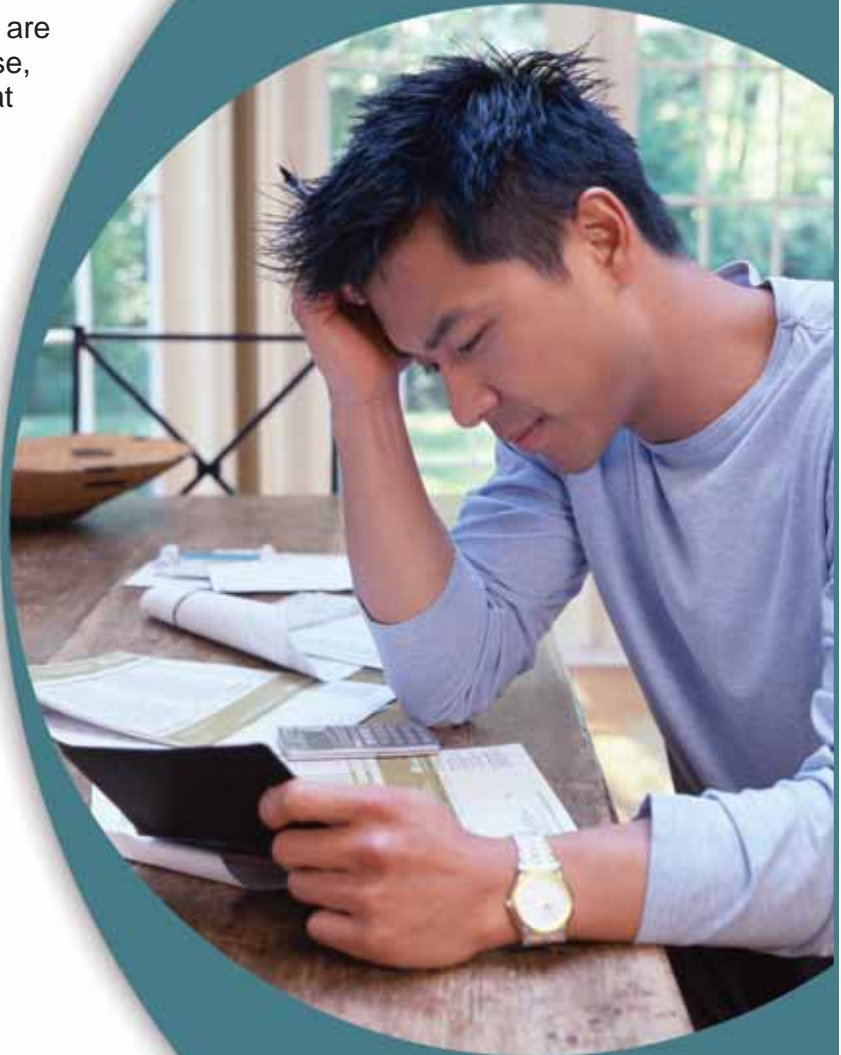
If you have loaned money to your business, you are required to charge interest on the loan; otherwise, interest will be imputed to you. This means that interest will be computed on the outstanding loan balance at the current rates and each payment will be considered to include interest. While you are required to report the interest as income on your personal return, your business is permitted a deduction for the interest paid.

When you make a loan to your business, it's important to charge an adequate rate of interest and document the loan with a stated repayment schedule. Failure to do so may cause the IRS to reclassify a loan as a contribution to capital. This could have unintended consequences. You will not recover a loan that is reclassified as a contribution to capital unless you withdraw money from your business. If your business is incorporated, generally this distribution must be made in the form of taxable wages or a taxable dividend. Repayments on a loan are not taxable to the extent of the principal.

Business Tax Credits That Save You Money

**Claiming a credit can actually save you
more tax dollars than taking a deduction**

Are you missing out on any valuable tax credits? Tax credits reduce your tax liability dollar for dollar. Plus, you can carry any excess dollars forward to future years. Some of the credits you may be entitled to include:



- **Employer Social Security Credit.** Food and beverage establishments are allowed a business credit for an amount equal to the social security tax paid on any tips received by employees that bring their earnings above the minimum wage amount.
- **Disabled Access Credit.** If you incurred expenses to provide handicap access to your business establishment, you are allowed a credit of 50% of the expenses you incur of at least \$250 and not more than \$10,250. This means you may be allowed a credit of as much as \$5,000.
- **Investment Credit.** This credit has two separate parts. The business energy credit is for property you place in service during the year, including solar, geothermal, microturbine, and qualified fuel cell property. The rehabilitation credit is allowed for expenses you incur to rehabilitate certain buildings. Taxpayer-owners and lessees may qualify for the rehabilitation credit.
- **Work Opportunity Credit.** The work opportunity credit provides you an incentive for hiring individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. Such individuals may include qualified veterans, taxpayers who are receiving certain public assistance, and qualified ex-felons. The work opportunity credit expires for any amount paid to an employee who begins work for the employer after December 31, 2007.
- **Research Credit.** This credit is designed to encourage businesses to increase the amount they spend on research and experimental activities. This credit is not available for otherwise qualified research expenses paid or incurred after December 31, 2007.
- **Alcohol Fuels Credit.** This credit applies to alcohol you sold or used as a fuel. Alcohol for this purpose includes ethanol and methanol. It does not include alcohol produced from petroleum, natural gas, coal, or peat; nor does it include alcohol of less than 150 proof.



This is not an all-inclusive list of the available credits. Credits are also available for low-income housing, renewable electricity production, and for wages paid to Native Americans who work within a reservation.



Substantiating Business Expenses

Don't forget to save those receipts

One of the most important things a business owner can do is to keep good records throughout the year. If the IRS examines your tax return, any expenses you failed to document could be disallowed. Keeping receipts, credit card statements, bank statements, and cancelled checks is a must. Set aside a spot in your office for expenses and sort through them periodically. Group similar expenses together and total them. Good record-keeping will give you a better idea of the types of expenses you are incurring and what your bottom line will be. An added benefit is that, when it comes time to file your tax return, you'll be more prepared.

Do You Have a Real Business?

Beware of hobby rules

Expenses connected with your business activities may be tax deductible or limited to the rules for hobby expenses. The limit on hobby losses applies to individuals, partnerships, estates, trusts, and S corporations. The limit does not apply to corporations that are not S corporations. In determining whether you are carrying on an activity for profit, you should consider all the facts. No one factor alone is decisive. Among the factors to consider are whether:

- You conduct the activity in a business-like manner.
- The time and effort you put into the activity indicates your intention to make it profitable.
- You depend on income from the activity for your livelihood.
- Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type of business).
- You change your methods of operation in an attempt to improve profitability.
- You or your advisors have the knowledge needed to carry on the activity as a successful business.
- You were successful in making a profit in similar activities in the past.
- The activity makes a profit in some years (and how much of a profit it makes).
- You can expect to make a future profit from the appreciation of the assets used in the activity.

Acquiring Business Assets

Do you have a taxable sale, or a tax-free exchange?

The most common way of obtaining business assets is by purchase. Other times, you acquire assets by trading in old or outdated equipment for new equipment. The nature of the transaction dictates whether you have a taxable sale or a tax-deferred like-kind exchange. If you sell an

QUIK TIPS

1 As a self-employed taxpayer, you may deduct 100 percent of your health insurance premiums as an adjustment to income. If you are a shareholder in an S corporation or a partner in a partnership, health insurance premiums paid on your behalf are included in your income. You are allowed a deduction for the premiums as an adjustment to income.

2 Expenses related to the business use of your personal telephone, cellular phone, and internet connection may be deducted as business expenses.

3 For 2007, the standard mileage rate for the cost of operating your car, van, pickup, or panel truck increases to 48.5 cents a mile for all business miles.

4 Generally, you can deduct only 50 percent of your business-related meal expenses while traveling away from your tax home for business purposes. Also, you can usually deduct only 50 percent of certain reimbursements you make to your employees for meal expenses they incur while traveling away from home on business. You can deduct a higher percentage if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. These limits apply to workers who are under certain federal regulations. The percentage increases to 75 percent for 2007.

5 Are you a household employer? You might be if you have hired a housekeeper or a dependent care provider who provided services in your home. If you have a household employee, you may be required to withhold social security, Medicare, and federal income taxes from their wages. You also may be required to pay federal unemployment tax.

6 Are you planning to set up a retirement plan for yourself and your employees? A SIMPLE plan must be established by October 1, 2007. A SEP must be established by the due date of your return, plus extensions. You can make employer contributions up to the due date of your return, including extensions.





asset and use the proceeds to acquire a new asset, generally the transaction is considered a taxable sale. If the proceeds from the sale are under your control, a sale has occurred and you will pay tax on any recognized gain.

If you trade in old equipment for new equipment, the transaction is treated as a like-kind exchange because you are transferring your property in exchange for replacement property. The dealer will adjust the purchase price by an amount that is allowed as the trade-in value and you'll pay any difference in cash or financing. The like-kind exchange rules are mandatory. In other words, your transaction is treated as an exchange rather than a sale. The cost of the new asset that you are allowed to depreciate is equal to the remaining basis of your old asset plus any additional amounts you pay. In turn, you are not required to report the transaction as a taxable sale. Keep in mind, however, that any cash you receive on the deal is taxable.

Combining Business With Pleasure

How much of a trip's cost is really deductible?

Our lives keep getting busier and sometimes it's hard to find the time to take a vacation, even a short one. Many people find it convenient to combine a business trip with a few days off for rest and relaxation.

Generally, expenses you pay for a business trip are either fully or partially deductible on your tax return. Deductible expenses include costs for meals, lodging, and travel, including airfare and car rental. Although you cannot deduct meals and lodging expenses on days that are not devoted to business, the IRS may allow a deduction for the entire cost of the airfare. You can deduct the cost of the plane ticket as long as the purpose of the trip is primarily for business—that is, more days are spent working than relaxing.

Do I Owe Self-Employment Tax?

Don't get caught short at the end of the year

If you are self-employed as an independent business owner or partner, you are responsible for paying your own income tax and social security (FICA) tax on the profit you make. Your contribution to social security is called self-employment tax. This tax is not withheld and deposited regularly like an employee's FICA. Instead, it is computed at the end of the year and is added to the income tax liability on your Form 1040. Self-employment tax is treated as part of your income tax and must be taken into account in figuring your estimated tax. If you have a net profit of \$400 or more at the end of the year, you are subject to self-employment tax at the rate of 15.3%.

Self-employment tax is due on income from any trade or business activity in which you participate on a regular and continuous basis. For instance, if you regularly rent personal property to your business or to your employer, such as a vehicle, tools, or other equipment, the profit you earn is self-employment income and subject to self-employment tax. There are exceptions, however. For example, if you own real estate and rent it to your corporation, the income you collect is not subject to self-employment tax.

