Now here are a few tax concerns.

FIRST

<u>Earlier I said that the IRS doesn't recognize LLC's. Here's what I meant.</u>

When you file your taxes at the end of the year, you can file a sole proprietorship on a Schedule C, a C Corporation on a Form 1120, an S Corporation on a Form 1120S or a partnership on a Form 1065. There is no tax form for an LLC. LLC's have to elect to be filed as either a C corporation or a partnership and if they elect to be taxed as a corporation they can make another election to be taxed as an S Corp. (There are reasons for choosing those entities but that decision can often wait but should be discussed with your tax person). Of course, the IRS has forms and procedures for each of these steps and lots of bureaucracy to help gum up the works.

So, what if you don't want to be a corporation or a partnership. Then you **disregar**d (that's a fancy word that means don't do anything) the election (election is an important word in the IRS lexicon) and you are considered by the IRS to be a **disregarded entity**, which I think sounds a bit insulting, but you simply file your business taxes on a Schedule C just as any other sole proprietor would.

So that's a lot to consider but here's the good news. Most people starting out will file their taxes on a Schedule C and Schedule C's are the easiest tax form there is.

As success comes, you'll need to change your business entity and your taxes will be a bit more complicated, but that's a nice problem to have.

Determining the proper entity is beyond the scope of this article but I hope it is something that you someday have to think about as it usually (but not necessarily) results from business growth.

When you're ready to change, we can help. Changing to a different entity can be as easy as filing a form. For right now, let's make sure you're in business and making money.

SECOND

<u>The second tax thing is allowable deductions before and after your business starts. Business deductions are just that, expenses you are allowed to deduct only if you are in business.</u>

But what if you're not in business yet? You've decided to start a business, you're incurring expenses but you're still in the building stage.   There is no business activity yet.   You've not had any business or maybe haven't even tried to get business yet. You may have incurred some or all of the following: qualification expenses, start-up expenses and organizational expenses. Here is a very short summary of a fairly complicated topic.

First you need to understand that qualification expenses are not deductible business expenses. You spent $20,000 on an auto mechanic certificate and now want to start your own business. That is a qualification expense and is not deductible as a business expense.. You went to school to become a CPA and now want to open an accounting firm. The school expenses are qualification expenses and are not deductible as business expenses. (Note that some education expenses may be deductible after your business starts if they 'maintain or improve skills needed in your business).

The startup and organizational expenses are limited but, in most cases, you can deduct up to $5000 in startup expenses before your business opens. You can also deduct up to $5000 in organizational costs before your business opens. Amounts over that have to be amortized over 15 years.

Startup and organizational expenses are claimed on the tax return filed in the year the business starts. You want to try and limit these by timing as many of your necessary purchases as possible to the period after you are actually in business.

If you have depreciable items, those purchases that you expect to use for more than one year, they would typically be expensed starting after your business is in operation using normal depreciation rules.

Note that these rules also apply to rental properties. Generally, your residential rental doesn't rise to the level of an active business until the property is rented or actively seeking renters.

THIRD

<u>The third tax item that comes up and is often a surprise to new business people is the self-employment tax.</u>

As an employee, income taxes are a pay-as-you-go phenomenon. Generally, it's transparent to the employee as a bit over 6.5% of wages are withheld from each paycheck and sent to appropriate Federal, state and local taxing agencies.

A similar amount is paid by the employer. These payroll taxes are known as FICA deductions and the employee has no control over them. They are based on earnings. Employers have to withhold these amounts and are supposed to make quarterly payments to tax authorities throughout the year.

The employee can also have other payments for life insurance, health care, retirement, etc withheld from their paycheck but they have control of such items and are much more aware of them. The employee can also set up additional withholding for payment of income tax at end of year and also has control of those payments.

As a self-employed person, you are responsible for paying self-employment taxes on any earnings either throughout the year in estimated tax payments or at tax filing time.

If no estimated taxes are paid throughout the year, then the self-employed will have to pay self-employment taxes (which are analogous to payroll taxes) at the end of the year.   Self-employment taxes are paid in addition to income taxes and the combination of the two can be quite a shock to new business owners.

<u>The Importance of Bookkeeping</u>

I can't talk about this enough. ALL successful businesses that want to remain that way must have a good bookkeeping system which is used for at least the following purposes.

- Budgeting – how much have I made at this point, am I keeping up with projections, will I be bringing in enough to make payments, taxes, wages, etc. as they come do, can I purchase that piece of equipment (which might increase my productivity and help me make more money in less time).
- Planning – you need good numbers to make your plans. A good up-to-date system helps you plan for future purchases, match current cash flow with expenses, determine advertising. effectiveness, comparison to other similar businesses, etc. In the initial stages of new businesses, cash flow, or the lack of it, is probably the biggest indicator of future success.
- Reports to regulatory agencies, such as income tax, sales and use tax, payroll tax, etc. are a constant business requirement that you have to keep up with. A good set of books will also be important if and when it comes time to sell your business and you want to demonstrate profitability.
- Loans – most businesses need loans at some point in their life cycle to finance growth, equipment purchases, moves, acquisitions, etc. All loan providers will ask for financial reports, usually for at least the last 2 years. This means you'll need to have a system that can provide adequate financials at any given time for any given period.
- Another big concern for those that sell on the internet is multi-jurisdiction taxation. Your records may have to be good enough to show where sales were made and if taxes for those locations were paid. This can be extremely difficult.
- If you are serious about running a business for profit, and minimizing your tax bill, a robust bookkeeping system is an absolute necessity.