# How Any Small Business Owner or Self-Employed Person Can Save Thousands In Taxes: Find Out What The IRS Doesn't Want You To Know! (For Small Business Owners & Self-Employed People Only)

by
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# CHAPTER ONE
# How To Make Sense Out Of Nonsense --
## The Small Business Owner's Guide
## To The Wild & Wacky World of Taxes

Congratulations! You are the proud owner of one of America's greatest treasures: The Small Business. Without question, our country is truly the "Land of Opportunity." And Small Business Owners like yourself are the main reason why.

I use the term "small business" to include home-based businesses (whether full-time or part-time) as well as online businesses (whether full-time or part-time).

Whether you are making a living from the Internet or just getting started to "see what you can do" in your spare time -- you will soon find out that, at least in the eyes of the IRS, you own a small business and must report that business on your tax return.

Also included in this definition of "Small Business Owner" are self-employed people. You may not own a store, rent an office, or have employees. You just do what you do "flying solo", just you and your web site, offering your products and/or services to the world. Again, from a tax standpoint, you too are considered to be a Small Business Owner and no matter how small you may think your business is, your tax situation just became significantly more complicated.

So, congratulations on taking the first step to "going it alone." There are probably as many reasons for starting a Small Business as there are people who have started a Small Business. But undoubtedly the most common reason for starting a Small Business is the most obvious one: To Make Money -- Lots of Money!

Running a Small Business ***successfully*** (and by that, I mean ***profitably***) is a tremendous challenge. There are a multitude of obstacles to making money in your business. And perhaps the most frustrating one that stands in the way of your success is **TAXES**!

We live in a great country, for sure. But our "system" is not without its problems. And one of the greatest problems you face as a Small Business Owners is simply this: *"How can I legally reduce my tax bill?"*

TAXES!! Income Tax, Payroll Tax, Sales Tax, Real Estate Tax, Personal Property Tax, Excise Tax. The seemingly never-ending list of taxes is just that -- A NEVER-ENDING LIST!! IT DOESN'T END!!!

And not only is our tax system "never-ending", it is also incredibly frustrating because of its complexity.

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Just how complicated is The Tax Code? Consider this: Way back in 1913, when federal income taxes first began, the entire Tax Code occupied a mere half-inch thick book. The first federal income tax return was a simple two-page form with four pages of instructions.

Now what do we have? -- a literal monster! Today the Tax Code takes two four-inch thick volumes to print, along with well over a million lines of "regulations" that officially explain and interpret what the Code means. Then when you add all the relevant tax-related Court decisions that apply the Code -- well, now we're talking about 25 feet of library shelves! (Thank God for CD-ROM technology -- all these books can now fit on a single disk!)

With all these tax regulations, what's the average taxpayer to do? I realize just how intimidating the Tax Code can be to the Small Business owner like yourself. I've tried to write this report in "every day" language -- no accountant's "techno-babble." My intent here is to help you make sense of one of modern civilizations most "non-sensical", complicated and mind-boggling documents -- the U.S. Internal Revenue Code (a.k.a. "The Tax Code").

As a Small Business Owner, here's the first thing you must realize:

**Given the same amount of profit,**
**not all businesses pay the same amount of taxes!!**

Think about that for a moment. It's probably something that you've always wondered about, maybe were even a bit suspicious about. Well, if you always thought that some people pay less tax than you (even though they make the same amount of income), YOU ARE ABSOLUTELY CORRECT!

Why is that?

Is it fair? (Maybe, maybe not!)

Is it "right"? (Hmmm. . .That's a tough one to answer!)

Is it legal? Ah, now we're getting somewhere.

**YES, IT IS ABSOLUTELY LEGAL**
**FOR ONE BUSINESS OWNER TO PAY LESS TAX**
**THAN ANOTHER BUSINESS OWNER,**
**EVEN THOUGH BOTH HAVE THE SAME INCOME!!!**

Any why does this happen, you ask? I'm going to answer this question by telling you about the easiest (and perhaps the most overlooked) tax-reduction strategy on the books.

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***Many Small Business Owners are paying way too much tax, simply because they own the "wrong" type of business!!!***

Now what do I mean by the "wrong type" of business?

I'm not talking about "type" in the sense of whether you own a Carpet Cleaning Business vs. a Pet Store. I don't mean what kind of industry your business is. I don't mean whether you are a manufacturer, a wholesaler, a retailer, or a service business.

Very simply, I'm talking about whether your business is a ***Sole Proprietorship***, a ***Partnership***, a ***"C" Corporation***, an ***"S" Corporation***, or a ***Limited Liability Company (LLC)***.

There are several "types" of business ownership, from a legal entity standpoint. And you have got to "get this right", or you will pay literally thousands of dollars more in taxes than you should. The simple fact is, there are significant differences in the amount of taxes that each of these business "types" usually pay.

Here's a quick overview of each of these business entity types:

## SOLE PROPRIETORSHIP

If your business is not a partnership, corporation, or LLC, then by default you are a Sole Proprietorship. From both a legal and tax standpoint, there is no distinction between you and the business, so you have unlimited liability. You report the business on your personal income tax return (Form 1040) via a special form called Schedule C. Numerous other forms may also be required on your personal return, depending on the complexity of your business and the nature of its operations.

## PARTNERSHIP

A Partnership is an agreement between two or more persons to carry on a business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business. A Partnership must file an annual income tax return to the IRS (Form 1065) to report the income, deductions, gains, losses, etc., from its operations, but the Partnership does not pay income tax. Instead, it "passes through" any profits or losses to its partners via a form called Schedule K-1. Each partner includes his or her share of the Partnership's income and expenses (as reported on the K-1) on his or her personal tax return.

## CORPORATION

For tax purposes, there are two main types of corporations: the "C" Corporation and the "S" Corporation. When you form a Corporation according to the laws of your particular state, the IRS automatically assumes you are a "C" Corporation for tax purposes. To become an "S" Corporation, you have to apply for "S" Corporation status via a special application (Form 2553), which the IRS will accept if you meet the criteria to become an "S" Corporation. From a tax standpoint, there are significant differences between a "C" Corp and an "S" Corp.

**C Corporation.** The profit of a "C" Corporation is taxed TWICE(!!) -- once to the Corporation and a second time to the shareholders when distributed as dividends. (This is the dreaded "double taxation of corporate profits"). However, shareholders cannot deduct any losses of the Corporation. The "C" Corporation files Form 1120 to report its income and expenses to the IRS.

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**S Corporation.** If your business qualifies, it can avoid double taxation by becoming an "S" Corporation. An S corporation generally is exempt from federal income tax, but still must file an income tax return called Form 1120S. The income or loss of the S corporation is transferred from the Corporation to the individual shareholder's personal income tax returns via Schedule K-1, which the Corporation must give to each shareholder.

## LIMITED LIABILITY COMPANY (LLC)

This is the newest kind of legal entity. It is a cross between a Corporation and a Partnership. From a legal standpoint, the LLC is much like a Corporation, offering limited liability to the owners (which are called "members"). From a tax standpoint, the LLC is taxed like a Partnership (if there is more than one member) or a Sole Proprietorship (if there is only one member). Like a Partnership, the LLC files Form 1065 and gives a K-1 to each member, so that the LLC's profit or loss is transferred to the personal income tax return of the members.

So here's a recap of what we've covered so far:

| TYPE OF BUSINESS | Income Tax Return |
| --- | --- |
| SOLE PROPRIETOR | Form 1040, Sch C |
| PARTNERSHIP | Form 1065 |
| "C" CORP | Form 1120 |
| "S" CORP | Form 1120S |
| LLC | Form 1065 |

Three things bear repeating. (Like a teacher from "The Old School", I like to use repetition to emphasize what's most important!)

### IMPORTANT POINT #1: Beware the Dreaded Double Taxation of Corporate Profits

Yes, I *did* say that the "C" Corporation pays income tax on its profit *not* once, but *twice*. Did you understand what that means? This is an incredibly important part of our beloved Tax Code. If you want to enjoy the legal benefits of incorporation (and there are many), then you must come to grips with this issue -- how are you going to legally avoid the possibility of paying both corporate income tax and personal income tax on your business profit?

There are several perfectly legal strategies available to the Small Business Owner to avoid the dreaded double taxation of corporate profits. For many, forming an "S" Corporation is the best option. If you are giving serious thought to forming a Corporation, you should also give serious consideration to applying for "S" Corporation status with the IRS.

Whether or not ***you*** should apply for "S" Corporation status is a complicated issue that should be discussed with a competent Tax Professional.

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### IMPORTANT POINT #2: Forms, Forms and More Forms!

Please note that regardless of what entity type you own, each entity has its own long list of business income tax forms that must be filed.

Even the simple one-person Sole Proprietorship has a much more complicated tax return than the W2-type employee. And if you decide to incorporate your business or form a Partnership or LLC, well, things just got even more complicated. All 4 entity types (Sole Proprietorship, Partnership, LLC, or Corporation) require special income tax forms unique to each type of entity.

Perhaps you've been comfortable preparing your own tax returns when you were an employee. Now that you own a business (even a one-person Sole Proprietorship), the consensus among experienced business advisors is simply this -- *when it comes to preparing your business tax returns, don't try this at home!*

If you think personal income tax returns are mind-numbing, you ain't seen nothin' yet!

So, be sure to hook up with an experienced Tax Professional who can help you through this incredibly complex maze of paperwork.

### IMPORTANT POINT #3: Strive to Understand the Basics

Having said that, there are some basic concepts you need to master, depending on which entity type you own.

If you're a Sole Proprietor, please note that all the required business income tax forms are filed as part of your personal income tax return.

If you're an "S" Corporation, a Partnership, or an LLC, please note that you must file a separate business income tax return, but technically the business doesn't really pay any income tax! (Didn't I tell you things would get a little wacky here!)

Yup, that's taxes for ya! The "S" Corporation files Form 1120S; the Partnership and LLC file Form 1065. If you look on these forms, the heading says "income tax return." **But the "S" Corporation, Partnership and LLC do not actually pay any income tax!**

In effect, this so-called "income tax return" (Form 1120S or Form 1065) is really just an information return, giving the IRS the information about the business' income and expenses.

These three entities then give the business' owners a Schedule K-1, which reports each owners' share of the business' profit or loss. The owner then reports this K-1

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information on his/her personal income tax return (Form 1040), where the income is taxes or the loss is deducted.

Still with me?  Great.

Are you sure you didn't nod off there amidst all that technical tax-talk? Super!

Congratulations on making it through this little lesson on Taxation 101. Don't worry if it didn't all make complete sense.  I'm convinced that our beloved politicians (the ones who make up these crazy tax laws) are doing their best to keep us all confused.

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# CHAPTER TWO
# How To Pass Any IRS Audit With Flying Colors

Or: "My Recent Close Encounter of the IRS-Kind"

Congress recently passed legislation that is supposed to result in a more "sensitive" Internal Revenue Service. You know, not such a lean, mean, tax-collecting machine.

I DON'T THINK SO! Here's why.

A few months ago, one of my clients (let's call him Mr. Jones) got one of those IRS "love letters" requesting more information about his return, and the IRS wanted to meet with Mr. Jones in person to discuss the situation (not a good sign!)

Mr. Jones (a local small business owner) was required to show up at the local IRS office with all his records. The IRS was questioning the legitimacy of several business deductions -- and so the IRS was doing what it is allowed by law to do -- demand that the taxpayer prove that those deductions were valid.

[By the way, most IRS audits are done these days by mail. Humans are rarely involved in these so-called "correspondence audits."

Those big IRS computers can check and cross-check all kinds of information that should be reported on your tax return. And if something doesn't show up on the return that is easily tracked by the IRS computers, then the computer just spits out a not-so-friendly "discrepancy notice", which you can respond to via mail.]

Turns out that Mr. Jones lost the audit and ended up owing the IRS a significant amount of money -- the additional tax, plus penalty and interest for late payment of that tax. Why did Mr. Jones' lose the audit? Mr. Jones made two "classic" taxpayer mistakes:

MISTAKE #1: "NO RECEIPT, NO DEDUCTION"

Mr. Jones lost several deductions simply because he didn't have the proper documentation to prove the deductions.

What do I mean by "documentation"?

Well, if the IRS requires you to substantiate a deduction on your tax return, you must be able to provide written proof that the deduction really happened. The easiest way to prove a deduction is to hang on to:

a) The receipt or invoice, and

b) Proof of payment, which can be a canceled check, cash
receipt, or credit card statement.

Mr. Jones reported numerous deductions for which he simply didn't have the documentation. No receipts, no canceled checks, no nothing. Turns out that Mr. Jones was one of those "cash guys". Do you know what I mean by a "cash guy"? Maybe you know what kind of guy I'm talking about -- He never wrote a check in his life, just carried a wad of cash around in his pocket. He paid for everything with cash, and never kept any of his receipts.

Every year he would just sit down with his wife and "remember" how much he spent on different things. No way to prove any of this, of course. He just had a "feel" for how much cash he had spent, and he had run his business for so many years that he just "knew" how much it cost to purchase certain things.

Well, this is the kind of taxpayer that the IRS loves! It really is true -- if you can't prove that you paid for something (with receipts, invoices, canceled checks, etc.), then you run the risk of losing that deduction in the event of an audit.

One of the most common questions I am asked by clients is this: "I know I paid for something, but I don't have a receipt. Should I still report the deduction?"

My response is usually this: "You only need a receipt if you get audited!"

Think about that for a minute! At first, many clients don't know if I am joking or not.

Well, I do make that comment with my tongue planted firmly in cheek, but there really is a lot of truth to it. If you don't have the documentation to prove a deduction, you can still report the deduction (if you want), because you only have to prove the deduction if you get audited.

But if you do get audited, knowing that there are undocumented deductions on the return, be prepared to lose the deduction!

And here's the second major mistake that Mr. Jones made:

MISTAKE #2: BOGUS DEDUCTIONS!

It turns out that Mr. Jones wasn't completely honest with me about some of his deductions. He reported deductions that simply were not real deductions. Here's one example:

Mr. Jones owned several rental houses. These rental houses, of course, required maintenance and repair work. Many times Mr. Jones would do the work himself rather than pay someone else to do the work.

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