Tax Basics for Business: Selected Topics

Presented to the DC Bar Pro Bono Center

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Topics We Will Cover*

- Tax Years
- Accounting Methods
- Deductible Business Expenses v. Capital Expenditures
- Home Office Rules
- Automobile Rules
- Documentation
- Employees v. Independent Contractors
- Additional Resources

*Many of the topics covered in this presentation concern accounting matters. We highly recommend engaging an accountant to set up your business’s books and recordkeeping procedures, and to assist in preparing tax returns. This presentation does not cover state and local income tax rules. Those often conform to federal rules but not always.
Tax Years

- A tax year is an accounting period for which a business reports its taxable income and expenses.
- Taxpayers must operate using a consistent tax year, and must prepare and maintain books in conformity with that tax year.

Types of tax years

- Calendar – January 1 – December 31. This is the most common tax year.
- Fiscal – twelve consecutive months ending on the last day of any month except December 31.
- 52-53 Week Tax Year – ends on the same day of the week that is closest to the end of a calendar month (may be used in certain cases).
- Short – a tax year of less than twelve months. A short period tax return may be required when a business entity is not in existence for an entire year or when there is a change to its tax year.
Tax Years

- A business conducted as a sole proprietorship (including a business conducted in the form of a disregarded entity) will have a tax year that corresponds to the individual owner’s tax year, which is almost always the calendar year.

- When a separate entity (not disregarded) conducts a business, the entity will have its own tax year, which may or may not correspond to the tax year of its owner or owners.

- C corporations are permitted to have a tax year unrelated to the tax year of their owners. C corporations establish their tax years when they file their first tax return.
Partnerships and S corporations have required tax years under the Internal Revenue Code.

- Generally, a partnership must conform its tax year to that of the majority of its partners.
- S corporations must generally use the calendar year, a tax year for which it establishes a business purpose, or another tax year permitted under the Internal Revenue Code.
- Under limited circumstances, partnerships and S corporations may elect to use a non-required tax year (a section 444 election).

Once a business adopts a tax year, it must continue to use that tax year unless the business obtains IRS approval to change to a different year or is otherwise allowed to change tax years without permission under established rules.
Accounting Methods

- Accounting method: the method by which a business reports its income and expenses for tax purposes.

- An accounting method is used to determine the year in which an item is taken into income, or an expense is deducted.
  
  - The IRS requires taxpayers to use an accounting method that accurately reflects their income and to consistently follow that accounting method from year to year unless permission is obtained to change to another accounting method.

- The two basic accounting methods are the cash method and the accrual method.
Accounting Methods

- **Cash Method**
  - Income: all items are included in the taxable year in which they are actually or constructively received.
  - Expenses: all deductible expenses are deducted in the taxable year in which payments are made.
  - Generally, C corporations and partnerships with a C corporation partner may not use the cash method of accounting.
    - However, if a C corporation or a partnership with a C corporation partner has average annual gross receipts in a rolling three year period that do not exceed $5,000,000, the cash method may be used.
    - Businesses that are required to maintain inventory accounting for goods must generally use an accrual method subject to certain exceptions.
Accounting Methods

- **Accrual Method**
  - The purpose of an accrual method is to match income and expenses in the correct year.
  - It is harder to manipulate the timing of income and expenses under an accrual method, which is why it is the method generally favored by the IRS and applicable rules.
  - Income: generally, an amount is included in gross income in the tax year in which all events that fix the right to receive the income have occurred and you can determine the amount with reasonable accuracy.
  - Expenses: generally, an expense or obligation to make a payment is deducted or capitalized in the year in which all events have occurred that fix the liability to make a payment and the amount of the liability can be determined with reasonable accuracy.
Deductible Business Expenses v. Capital Expenditures

- Generally, business expenditures are either deductible business expenses in the year paid or incurred (depending on accounting method) or are capitalized and become part of the tax basis for an asset.
- Deductible business expenses are taken in the year paid (cash method) or incurred (accrual method).
- Capital expenditures are generally recovered over time as depreciation (tangible assets), amortization (intangible assets), or applied against proceeds in determining gain or loss on the sale of an asset.
Deductible Business Expenses v. Capital Expenditures

- **Deductible Business Expenses:** business expenses are generally deductible if they are both ordinary and necessary.
  - **Ordinary:** an expense that is common and accepted in your business.
  - **Necessary:** an expense that is helpful and appropriate for your business.
  - For business that sell goods (i.e., that have inventory), business expenses do not include the cost of goods sold (i.e., the capitalized cost of products/raw materials to manufacture products; storage; labor costs; factory overhead).
    - These expenses are assigned to the carrying value of inventory and recovered as an offset to gross receipts based on the number of units of product sold in determining gross profits.
  - Certain expenses may be incurred for business reasons or incurred in conducting business, but are not allowed as deductions for policy reasons.
    - Examples: fines, penalties and bribes.
    - One-half of business meals are not deductible.
Deductible Business Expenses v. Capital Expenditures

- Capital Expenditures: certain expenditures produce a benefit to the taxpayer that continues over a period exceeding one year. These expenditures must generally be “capitalized” and deducted over time.

  - Types of costs that must be capitalized:
    - Business start-up costs, including organizational expenses – costs of getting started in business before you actually begin business operations. An election may be made to expense the first $5,000 of such expenditures and amortize any remaining expenditures over 180 months.
    - Purchase of assets used in the business such as land, buildings, machinery, furniture, vehicles, patents, licenses and franchise rights.
    - Improvements – generally, major expenditures such as new electric wiring, a new roof or floor, new plumbing, etc. Improvements must be capitalized if they result in a betterment to the property, restore the property or adapt it to a new or different use.
      - Repairs and maintenance of a business asset may be deducted as business expenses if they keep the asset in normal efficient operating condition.
Deductible Business Expenses v. Capital Expenditures

- Capital Expenditures
- Capital expenditures are recovered through deductions for depreciation (tangible assets, such as a piece of machinery) or amortization (intangible assets, such as a license).
  - In order to depreciate an asset, it must*:
    - be owned by the business
    - be used in the business
    - have a determinable useful life
    - be expected to last more than one year.

*The remainder of the outline will refer to depreciation of tangible assets. There are roughly similar rules for amortization of intangible assets.
Deductible Business Expenses v. Capital Expenditures

- Capital Expenditures
- Depreciation
  - Depreciation begins when the property is “placed in service” for use in the business.
  - Depreciation ends when the asset’s capitalized cost or other basis has been fully recovered or when the property has been retired from service or sold.
  - Certain conventions standardize when during a tax year an asset is treated as placed in service.
Deductible Business Expenses v. Capital Expenditures

- **Capital Expenditures**
  - Calculating depreciation deductions can be complicated.
  - To determine the amount of a depreciation deduction, you must determine:
    - the depreciation system (generally, the Modified Accelerated Cost Recovery System known as “MACRS”),
    - property class (determines the number of years over which an asset is depreciated and permissible depreciation methods),
    - placed in service date,
    - basis in the property,
    - placed in service convention (e.g., mid-year), and
    - depreciation method (e.g., straight line or accelerated).
Deductible Business Expenses v. Capital Expenditures

- Capital Expenditures
  - Depreciation lives run from 3 to 39 years depending on the asset (e.g. a piece of machinery or a building).
  - Depreciation methods can be accelerated or straight line.
  - Depreciation convention determines when an asset is deemed to be placed in service.
    - For example, under the mid-year convention, one-half a full year’s depreciation is allowed for the year in which an asset is placed in service regardless of the actual in service date.
    - Also, one-half a full year’s depreciation is allowed for the year of sale.
  - IRS Publication 946 provides tables to help business owners determine how to classify their property, which depreciation method to use, and the percentages to use to determine the deduction.
Deductible Business Expenses v. Capital Expenditures

- Simplified depreciation example
- Asset: Computer
  - Cost – $2,000
  - Placed in Service Date – January 2016
  - Useful Life – 5 years
  - Mid-year convention
  - Depreciation Method – Straight Line

If the computer is sold in 2018, accumulated depreciation is $800 so the adjusted tax basis for the computer is $1,200. If the sale price is more than $1,200 there will be a gain. If the sale price is less than $1,200 there will be a loss.

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation Calculation</th>
<th>Depreciation Deduction</th>
<th>Accumulated Depreciation</th>
<th>Adjusted tax basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>½ ($2,000/5)</td>
<td>$200</td>
<td>$200</td>
<td>$1,800</td>
</tr>
<tr>
<td>2017</td>
<td>$2,000/5</td>
<td>$400</td>
<td>$600</td>
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</tr>
<tr>
<td>2018</td>
<td>Computer sold</td>
<td>$200</td>
<td>$800</td>
<td>$1,200</td>
</tr>
</tbody>
</table>
Deductible Business Expenses v. Capital Expenditures

- Electing the Section 179 Deduction (an exception to depreciation)
  - A section 179 deduction allows recovery of all or part of the cost of certain qualifying property by deducting the cost of an asset in the year it is placed in service instead of recovering the cost by taking depreciation deductions.
  - This election essentially allows you to treat a capital expenditure as a deductible business expense.
  - Qualifying property must be acquired by purchase.
Deductible Business Expenses v. Capital Expenses

- Electing the Section 179 Deduction
  - Very generally, property eligible for a section 179 deduction includes:
    - Tangible personal property (i.e., any tangible property that is not real property, such as machinery and equipment, including office equipment).
    - Off-the-shelf computer software – readily available for purchase by the general public, subject to nonexclusive license, that has not been substantially modified.
    - Qualified real property:
      - Qualified leasehold improvement property – improvements to an interior portion of a building that is nonresidential real property.
      - Qualified restaurant property.
      - Qualified retail improvement property – certain improvements to an interior portion of nonresidential real property that is open to the general public and used in the retail business of selling tangible property to the general public.
Deductible Business Expenses v. Capital Expenses

- Electing the Section 179 Deduction
  - Maximum deduction
    - $500,000 per year*
    - The deduction is reduced by the cost of qualified property placed in service in a year in excess of $2,000,000.
  - To make the section 179 election you must complete IRS Form 4562 and file it with the tax return for the year in which an asset is purchased.
  - To make the section 179 election for qualified real property, the tax return must include a statement indicating that you are making a section 179(f) election.
  - The deduction under section 179 cannot exceed the taxable income produced by the business (ignoring the section 179 deduction) (a carryover is allowed for an excess deduction).

*The $500,000 and $2,000,000 amounts are to be inflation indexed (no increase for 2016).
Home Office Rules

- Business owners may be entitled to a “home office” deduction on their income tax return for using a portion of their residence for business purposes.

- That portion must be used exclusively on a regular basis for business purposes and must be the principal place of your business or a place used by customers, clients, or patients in meeting with you in the normal course of your business or profession.
  
  • Exclusive Use – you must use a specific area of your home only for your business. The space does not need to be marked off by a permanent partition, but it cannot be used for both personal and business purposes.
    
    – Exception: storage of inventory or product samples; daycare facilities
  
  • Regular Use – you must use a specific area of your home on a regular basis. Incidental or occasional business use is not regular use.

  • The exclusive and regular use requirements also apply to an employee with the additional requirement that business use of the employee’s home is for the convenience of his or her employer.
Home Office Rules

- Principal Place of Your Business (self-employed persons)
  - The portion of your home used for business purposes must be the principal place of your business.
  - If you conduct business at a location outside of your home and still use your home substantially and regularly to conduct business, you may still qualify for the home office deduction.
    - If you use your home exclusively for administrative or management activities of your business and you have no other fixed location where you conduct substantial administrative or management activities of your business, then your home office will qualify as your principal place of business.
    - Examples of these activities include billing customers and clients, recordkeeping, setting appointments, and writing reports.
  - You may deduct expenses for a separate free-standing structure, such as a studio or garage if you use it regularly and exclusively for your business.
Home Office Rules

- The IRS offers two methods you can use to determine the amount of your home office deduction.
- Under each method, home office expenses are not allowed to create a tax loss (the “no loss” rule).
- Simple Method – this method uses a simple calculation to determine the amount of the deduction and significantly reduces recordkeeping burdens for taxpayers.
  - Deduct $5/ft\(^2\) used for a home office. The allowable square footage of home use for business cannot exceed 300 ft\(^2\).
  - You cannot deduct any actual expenses except for business expenses that are not related to the use of the home.
  - No depreciation deduction.
### Home Office Rules

**Simple Method**
- Home-related itemized deductions may be claimed in full on Schedule A (i.e. mortgage interest, real estate taxes, and casualty losses).
- Under the “no loss” rule, the simplified method deduction cannot exceed gross income from business use of home less other business expenses.
  - Note: if you have more than one place of business, you must determine the part of your gross income from the business use of your home by considering the time spent at each location, the business investment in each location, and any other relevant facts and circumstances.
- Deductions in excess of gross income limitation may not be carried over to future tax years.
- Loss carryover from use of the regular method (see below) in a prior year may not be claimed in tax years using the simplified method.
Home Office Rules

- Regular Method – this method requires taxpayers to determine the portion of overall home expenses allocable to their home office, including mortgage interest, insurance, utilities, repairs, and depreciation.
  
  • The regular method uses the percentage of your home devoted to business use. You must compare the size of the part of your home that you use for business to the size of your whole house using square footage.
  
  • You may then deduct all of your actual home expenses based on that percentage.
  
  • You may be able to carry forward to other tax years an amount for use of the home office that you could not deduct in the current year under the “no loss” rule.
Home Office Rules

- A cautionary note:
  - The IRS allows taxpayers to exclude up to $250,000 of the gain on the sale of a personal residence.
  - If you have taken depreciation deductions for your home office you cannot exclude the part of the gain attributable to the home office use of your home if you later sell the residence that includes your home office. Gain on that part of the sale must be determined separately and must reflect prior depreciation deductions.
Automobile Rules

- If you use your car for business purposes, you ordinarily can deduct car expenses using one of two methods: standard mileage rate or actual car expenses.
  - Standard Mileage Rate
    - 54 cents per mile driven for business purposes, which is the rate for 2016. The IRS sets this rate each year.
    - If you choose to use the standard mileage rate, you must use it in the first year the car is available for use in your business. In later years, you may choose to use the standard mileage rate or the actual expenses method.
    - If you want to use this method for a leased vehicle, you must use it for the entire length of the lease.
Automobile Rules

• Actual Car Expenses
  – Using this method you may deduct various types of expenses that relate to use of your
    automobile: depreciation, licenses, gas, oil, tolls, lease payments, insurance, garage rent,
    parking fees, registration fees, repairs and tires.
  – If you use your car for both business and personal use, you must divide your expenses
    between business and personal use based on the miles driven for each purpose.
  – If you own a car, the cost of your car (allocated to business use) may be recovered
    through depreciation deductions or section 179 deductions (discussed earlier).
  – If you lease a car, generally lease payments (allocated to business use) are deductible in
    place of depreciation.
  – Specific limitations apply to depreciation and lease payments on what are considered
    “luxury vehicles” (Code section 280F “listed property”).
Documentation

- Deductions must be supported by contemporaneous documentation.
  - Examples
    - Business meals: when, with whom, purpose, cost (charge slip or receipt).
    - Other expense items: dated receipts, cancelled checks.
    - Trip logs: dates and mileage.
  - Depreciation
    - Cost, description and placed in service date should be documented.
  - The IRS will generally not allow undocumented expenses even if the amounts claimed and purposes are reasonable.
Employees v. Independent Contractors

- Generally, businesses will hire or contract with other persons to provide services.
- Your tax obligations with respect to payments for these services will differ depending on the nature of your relationship with the service provider and whether that individual is considered your employee or an independent contractor.
- Similarly, if you are working for or providing services to someone else, your and your employer’s tax responsibilities will differ depending on whether you are an independent contractor (self-employed) or an employee.
Employees v. Independent Contractors

- Whether someone is an employee or independent contractor depends on all of the facts and circumstances of the business relationship between the business and the person providing services.
  - Crucial question: To what degree does the business owner have the right to control and direct the work of the person providing services?
  - The more control the business has over an individual’s performance and working conditions, the more likely that individual will be considered an employee.

- The following factors and other relevant facts should be considered as a whole when determining how to classify a service provider.
  - State law treatment of an individual as an employee or an independent contractor is relevant but not dispositive.
Employees v. Independent Contractors

- Key factors in making a status determination:
  - Behavior – does the employer have the right to direct or control how the work results are achieved?
    - Type and degree of instruction – when and where to do the work; what tools and equipment to use; what work must be performed by a specified individual; what order or sequence to follow when performing the work; the level of detail to instructions; working hours and duration.
    - Evaluation systems
      - Measuring the details of how the work is performed v. a system measuring just the end result.
  - Training
    - If the business provides training on how to do the job, this typically indicates that the business wants the job done in a certain way. This is evidence that the individual is an employee.
    - Periodic and on-going training about procedures and methods is stronger evidence of employee.
    - Independent contractors will typically use their own methods to complete the work.
Employees v. Independent Contractors

- Key factors in making a status determination
  - Finances – are the economic aspects of the worker’s job controlled by the payer?
    - Significant investment
      - Typically an independent contractor has a significant investment in the equipment he/she uses in working for someone else.
    - Unreimbursed expenses
      - Employees are more likely to have expenses reimbursed by their employer whereas independent contractors usually have unreimbursed expenses.
    - Opportunity for profit or loss
      - If a service provider has a significant investment in the tools/equipment used and has unreimbursed expenses, there is a higher risk of losing money since expenses may exceed income received for the work. This is evidence of status as an independent contractor.
    - Services available to the market
      - Independent contractors are generally free to seek out business opportunities and have other clients. They may advertise and maintain a business location and have their own firm. Employees, however, typically will work for one employer at a location or locations determined by the employer.
    - Method of payment
      - Employees are generally guaranteed a regular wage amount for a certain period of time (i.e. hourly, weekly, bi-weekly, etc.) and may receive a commission.
      - Independent contractors are usually paid a flat fee for the job sometimes with performance incentives or penalties.
Employees v. Independent Contractors

**Key factors in making a status determination**

- **Relationship**
  - Employee Benefits
    - Generally, benefits such as insurance, retirement plans, paid vacation and sick days are not provided to independent contractors. However, the lack of such benefits does not necessarily mean that the worker is an independent contractor.
  
  - Permanency of the relationship
    - If there is an expectation that the relationship will continue indefinitely, this is evidence of an employee-employer relationship.
    - If an individual was hired for a specific project or period of time, this is evidence of an independent contractor relationship.
  
  - Services provided are a key aspect of the business
    - If the individual’s services are a key aspect of the business, this leans toward an employee-employer relationship because it is likely that the business has more control and direction over the work.
Employees v. Independent Contractors

- Tax obligations to an employee v. an independent contractor differ considerably.

- Employee
  - Employers withhold certain taxes from the employee’s wages and remit those taxes to the IRS.
    - Withhold income taxes based on the employee’s W-4.
    - Withhold the employee’s share (50%) of social security (FICA) and Medicare (HI) taxes and pay a matching amount.
      - Social security tax (6.2% each) and Medicare tax (1.45% each).
      - The maximum taxable amount of earnings subject to social security tax is capped at $118,500 for 2016.
      - The Medicare tax is not capped. There is an additional Medicare tax of 0.9% for earnings over $200,000 for a single taxpayer or $250,000 for married taxpayers, on which the employer withholds but does not pay a matching portion.
    - Pay federal unemployment tax (FUTA) on wages paid to an employee (this is paid from the employer’s own funds and is not withheld from the employee’s wages)
Employees v. Independent Contractors

- **Employee**
  - Employers must make timely deposits of withheld taxes and their share of payroll taxes to the IRS and state and local authorities, and report taxes withheld.
    - The employer must deposit federal income tax withheld and both the employer and employee portions of the social security and Medicare taxes (Forms 941 and 945).
      - Two deposit schedules: monthly and semi-monthly.
      - Before the beginning of each calendar year, employers must determine which of the two schedules they are required to use.
      - A failure to deposit penalty applies if you fail to make a timely deposit – up to 15%.
    - Deposits for FUTA (Form 940) are required for the quarter within which the tax due exceeds $500.
    - Employers must use electronic funds transfer (EFTPS) to make all federal tax deposits.
    - Generally, employers who withhold federal income tax or social security and Medicare taxes must file Form 941 each quarter.
Employees v. Independent Contractors

- **Independent Contractor**
  - The business recipient of services provided by an independent contractor generally has no obligations to withhold or pay any taxes on payments to independent contractors.
  - The contractor should submit Form W-9 to his or her customer.
  - The business must complete Form 1099-MISC to report payments made to an independent contractor if payments are $600 or more in a calendar year.
  - A copy of Form 1099-MISC must be provided to the independent contractor by January 31 of the year following the payment.
  - A copy of Form 1099-MISC must also be sent to the IRS by February 28 (or March 31 if the business files 1099s electronically).
Employees v. Independent Contractors

- Independent Contractor
  - Independent contractors are subject to the self-employment (SE) tax (15.3%), which consists of the full social security (12.4%) and Medicare taxes (2.9%).
    - Earnings subject to the social security tax are capped at $118,500 for 2016.
    - The 2.9% Medicare tax is not capped.
    - There is an additional Medicare tax of 0.9% for earnings over $200,000 for a single taxpayer or $250,000 for married taxpayers.
  - A self-employed individual gets an income tax deduction for one-half of the 2.9% Medicare tax.
Employees v. Independent Contractors

- Properly classifying individuals who provide services to your business is of the utmost importance.

- Misclassification may expose your business to both tax liability and liability under the Fair Labor Standards Act (FLSA).

  - Liability under the FLSA may include failing to pay overtime, minimum wage violations, family and medical leave, and unemployment insurance.

  - This presentation does not cover the FLSA, but more information can be obtained by visiting the Department of Labor’s website at: https://www.dol.gov/whd/workers/misclassification/
Additional Resources

- The IRS issues a number of publications on a variety of tax topics. These publications are generally user-friendly and easily accessible.

- A list of publications relevant to topics discussed in this presentation are below:
  - Tax Years and Accounting Methods – IRS Publication 538
  - Deductible Business Expenses v. Capital Expenditures – IRS Publication 535 and IRS Publication 946
  - Home Office Rules – IRS Publication 587
  - Automobile Rules – IRS Publication 463
  - Employees v. Independent Contractors – IRS Publication 15 and IRS Publication 15-A
For further information, visit our website at dechert.com. Dechert practices as a limited liability partnership or limited liability company other than in Dublin and Hong Kong.