

**Welcome To  
Wayne M. Davies'**

# **Tax Reduction Toolkit**

## **FEATURING:**

**29 Little-Known Legal Loopholes  
That Will Reduce Your Taxes By Thousands  
(For Small Business Owners & Self-Employed People)**

## **ALSO INCLUDES EXTRA BONUSES:**

**Tax Consulting Certificates Worth \$445**

**9 Biggest Mistakes Taxpayers Make  
And How To Avoid Them**

**How To Audit-Proof Your Income Tax Return Forever!**

**The Complete Financial Check-Up System**

**The Science of Getting Rich**

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While all attempts have been made to verify information provided in this publication, neither the Author nor the Publisher assumes any responsibility for errors, inaccuracies or omissions. Any slights of people or organizations are unintentional.

Neither the Publisher nor the Author are rendering tax, legal, accounting, or other professional advice. Tax strategies and techniques depend on an individual's facts and circumstances; accordingly, the information presented in this book must be correlated with the individual's tax situation to establish applicability. Moreover, because of the complexity of the tax laws, the constant changes resulting from new developments, and the necessity of determining appropriateness to a particular taxpayer or business entity, it is important that professional advice be sought before implementing the tax ideas presented in this book.

## About The Author

Wayne M. Davies is a Tax Professional & Business Consultant serving Small Business Owners and Self-Employed People in all 50 states. For the past 18 years, Wayne has helped hundreds of small business owners to reduce their taxes by thousands of dollars.

Wayne prepares hundreds of tax returns every year, so he writes this eBook from the trenches of the tax world, not an ivory tower. His business clients include sole proprietorships, partnerships, LLC's, and corporations of all sizes, from the "mom and pop shop" to multi-million dollar operations. In addition to income tax preparation (both business and personal), Wayne provides full-service accounting and payroll services to his business clients.

To serve his clients better, Wayne operates two web sites:

<http://www.YouSaveOnTaxes.com> -- visit this site to subscribe to Wayne's free online small business / self-employed tax newsletter, "Make Your Life Less Taxing", and you'll automatically receive a free report, "How To Instantly Double Your Deductions (and slash your taxes to the bone)"

<http://www.MagneticMarketing.biz> -- visit this site to receive a free report, "How To Get More Customers In A Month Than You Now Get All Year!"

Wayne is the author of 3 tax-slashing ebooks for small biz owners and the self-employed:

The Tax Reduction Toolkit

<http://www.TaxReductionToolkit.com>

Incorporation Tax Secrets Revealed

<http://www.IncorporationTaxSecrets.com>

How To Incorporate Yourself For Free

<http://www.HowToIncorporateForFree.com>

These ebooks are available separately, or as a 3-volume set:

The Small Business Tax Reduction Guide

<http://www.SmallBusinessTaxReductionGuide.com>

You can join Wayne's affiliate program and earn 50% commission by recommending these ebooks to your family, friends and business colleagues or via your website:

<http://www.YouSaveOnTaxes.com/ap-utg.html>

**Wayne M. Davies'**  
**Tax Reduction Toolkit**

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**Wayne M. Davies'**  
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**PART ONE**

**Valuable Certificates Worth \$445**

Income taxes are incredibly complicated. I've done my best to simplify them for you in this Toolkit.

Maybe you'll read this Toolkit and say to yourself, "Oh, yeah. I understand this stuff! It makes perfect sense." And you'll know exactly what to do to implement the many tax-saving strategies presented here.

Maybe you are a "do-it-yourself-er" and so you pride yourself on being able to figure things out on your own, including your own income tax returns.

But there's also a good chance that you'll read my Toolkit and say, "Hmmm. I think I get it. But I sure would like to ask a question or two for clarification, to make sure I understand how to apply a specific tax reduction strategy to my particular situation."

That is the purpose of these certificates. To enable you to contact me with your questions, and to allow you the opportunity to send me up to 4 recent income tax returns for my review.

Don't let these certificates just sit here! Use them, and use them right away! Thousands of dollars in real tax savings could be waiting for you if you do.

Sincerely,  
Wayne M. Davies  
[www.YouSaveOnTaxes.com](http://www.YouSaveOnTaxes.com)

**IMPORTANT  
PREPARATORY  
INFORMATION  
AND  
VALUABLE CERTIFICATES**

**PLEASE READ THIS  
INFORMATION  
FIRST**

**FREE BONUSES**

**FREE BONUSES**

**OVER \$400 OF BONUSES**

**FREE BONUSES**

**FREE BONUSES**

**The following pages provide over \$400 of FREE BONUSES, including four (4) Income Tax Return Critique Certificates and one (1) Telephone Consultation Certificate, entitling you to direct assistance with your implementation of the many tax-reduction strategies presented in this Tax Reduction Toolkit.**

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\$75 Value

\$75 Value

**FREE Income Tax Return  
Critique Certificate**

**This Certificate Entitles Bearer To Submit One  
Business or Personal Income Tax Return  
For Review By Wayne M. Davies**

Business Returns: Form 1065, Form 1120 or Form 1120S

Personal Return: Form 1040 -- (including Schedule C and all related forms used by Sole Proprietorship.)

Bearer must submit all relevant forms, schedules and attachments.

Wayne M. Davies may also request additional supporting documentation used in preparation of the income tax return, such as Forms W-2, Form 1099's, etc.

**How to use your Income Tax Return Critique Certificate:**

1. Send Certificate and Materials (income tax return, plus any relevant forms, schedules and attachments) to: Wayne M. Davies Inc., 4660 W. Jefferson Blvd. #220, Fort Wayne, IN 46804
2. Allow a minimum of 4 weeks for Mr. Davies' response during the months of May - December. Allow a minimum of 8 weeks for Mr. Davies' response during Tax Season (January - April). Do not telephone. Critique given by mail only.
3. Submitted materials will not be returned. Please send a copy that Wayne can keep.

Name \_\_\_\_\_

Address \_\_\_\_\_

City, State, Zip \_\_\_\_\_

Phone \_\_\_\_\_ Fax \_\_\_\_\_

Email \_\_\_\_\_ Website \_\_\_\_\_

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Address \_\_\_\_\_

City, State, Zip \_\_\_\_\_

Phone \_\_\_\_\_ Fax \_\_\_\_\_

Email \_\_\_\_\_ Website \_\_\_\_\_

\$145 Value

\$145 Value

**FREE Tax-Reduction  
Telephone Consultation Certificate**

**This Certificate Entitles You To One 60 Minute  
Telephone Consultation With Wayne M. Davies  
Tax Reduction Specialist**

**How to use your Tax-Reduction Telephone Consultation Certificate:**

1. This phone consultation is designed for use in conjunction with the preceding Income Tax Return Critique Certificates. After signing this certificate, be sure to send this Telephone Consultation Certificate to Wayne along with your income tax returns.
2. After receiving your income tax returns and this certificate, Wayne will contact you to schedule the phone consultation.

**Signature:** \_\_\_\_\_ **Date:** \_\_\_\_\_

**Wayne M. Davies'**  
**Tax Reduction Toolkit**

**PART TWO**

**29 Little-Known Legal Loopholes  
That Will Reduce Your Taxes:  
For Small Business Owners &  
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## INTRODUCTION

### Taxman

by George Harrison

1966

Let me tell you how it will be  
There's one for you, nineteen for me  
'Cause I'm the taxman, yeah, I'm the taxman

Should five per cent appear too small  
Be thankful I don't take it all  
'Cause I'm the taxman, yeah I'm the taxman

If you drive a car, I'll tax the street,  
If you try to sit, I'll tax your seat.  
If you get too cold I'll tax the heat,  
If you take a walk, I'll tax your feet.

Don't ask me what I want it for  
If you don't want to pay some more  
'Cause I'm the taxman, yeah, I'm the taxman

Now my advice for those who die  
Declare the pennies on your eyes  
'Cause I'm the taxman, yeah, I'm the taxman  
And you're working for no one but me.

Written 40 years ago, but it could have been yesterday.

Do you ever feel like "you're working for no one but" the taxman? Believe me, you're not alone.

Each year economists do a calculation to determine "Tax Freedom Day" -- a way to graphically depict that we spend nearly 30% of our income on taxes. In 2009, Tax Freedom Day was April 13. That means that from January 1 through April 12, all the money you made went to taxes. Finally, on April 13, you now get to keep what you make for the rest of the year! Unbelievable, isn't it?

Since state and local taxes vary considerably, check the chart on the following website to find out Tax Freedom Day for your particular state:

<http://www.taxfoundation.org/taxfreedomday/>

**How long did you have to work this year to pay your taxes?  
Find your state in this chart!**

**In 2009, did you know that April 13 was National Tax Freedom Day?  
(But since state/local taxes vary so much, each state has its own Tax Freedom Day, too!)**

	<b>Tax Freedom Day</b>	<b>Rank</b>
United States	April 13	
Connecticut	May 03	1
New York	April 29	2
New Jersey	April 25	3
Massachusetts	April 24	4
Wyoming	April 24	5
Maine	April 23	6
Rhode Island	April 23	7
Washington	April 20	8
California	April 20	9
Wisconsin	April 19	10
Minnesota	April 18	11
Vermont	April 18	12
Nevada	April 18	13
Colorado	April 18	14
Maryland	April 17	15
Illinois	April 17	16
Virginia	April 16	17
New Mexico	April 15	18
Florida	April 15	19
Michigan	April 15	20
Arizona	April 15	21
Texas	April 14	22
Hawaii	April 14	23
Ohio	April 14	24
Utah	April 14	25
Georgia	April 13	26
Nebraska	April 13	27
Kansas	April 13	28
Indiana	April 13	29
Pennsylvania	April 13	30
North Carolina	April 12	31
Oregon	April 12	32
Arkansas	April 12	33
New Hampshire	April 11	34
Kentucky	April 11	35
Delaware	April 11	36
Missouri	April 10	37
West Virginia	April 09	38
South Carolina	April 09	39
Iowa	April 09	40
Montana	April 09	41
Idaho	April 09	42
Louisiana	April 08	43
Oklahoma	April 07	44
North Dakota	April 07	45
Mississippi	April 07	46
South Dakota	April 07	47
Tennessee	April 06	48
Alabama	April 04	49
Alaska	April 02	50
District of Columbia	April 30	

Source: Tax Foundation, 2006  
<http://www.TaxFoundation.org>

Tax Freedom Day is the day when Americans will finally have earned enough money to pay off their total tax bill for the year. All income that's officially called income by the government is counted, and everything the government considers a tax is counted. Taxes at all levels of government are included, whether levied by Uncle Sam or state and local governments.

Tax Freedom Day gives Americans an easy way to gauge the overall tax take, a task that can be quite daunting due to the multiplicity of taxes at each level of government, especially the "hidden taxes" and fees that are often buried in the cost of living. In effect, Tax Freedom Day provides taxpayers with a "tax barometer" that measures the total tax burden over time and by state. The result is a nationwide Tax Freedom Day and a separate Tax Freedom Day for each state.

Yes, as a nation, we Americans spend 29% of our total income on taxes. That's not a misprint. I did say 29% -- more than any other category of spending.

Consumer Spending: How Do You Spend Your Hard-Earned Dollars?	
Taxes	29.3%
Housing	17.8%
Medical Care	14.2%
Food	8.5%
Transportation	8.5%
Recreation	6.0%
Clothing	3.6%
Savings	0.5%
Other Miscellaneous	11.6%
TOTAL	<hr/> 100.0%

So there you have it. If you think you are being "nailed" by the government, you are absolutely right. You spend more on taxes than any other category of consumer spending. In fact, *you spend more on taxes than on food and housing combined.* (Run the numbers: Food-8.5% + Housing-17.8% = 26.3% vs. Taxes-29.3%)

Maybe you already knew "intuitively" that your Tax Bill is outrageously high. If not, the picture I've just painted should thoroughly convince you that you pay too much tax, period.

Again, the 29% is a national average. The percentage in your state may actually be more (or less) than that. Here's another chart to help you see what's going on in your neck of the woods:

**Days Spent Working To Pay Taxes = This is the number of days you spent working just to pay your taxes. In other words, out of 365 days, this is how many days you spent working for the government!** Remember, "you're working for no one but me."

**Total Tax Burden As A Percentage of Income = This is what percentage of your income you spent on taxes (federal, state & local)**

(NOTE: The charts presented above and below are based on 2005 data. For more current data visit: <http://www.taxfoundation.org/taxfreedomday/>)

	Rank	Days Spent Working To Pay Taxes	Total Tax Burden As a Percentage of Income
United States		103	29.3%
Alabama	49	94	25.7
Alaska	50	92	25.0
Arizona	21	105	28.6
Arkansas	33	102	27.8
California	9	110	29.9
Colorado	14	108	29.3
Connecticut	1	123	33.5
Delaware	36	101	27.5
Florida	19	105	28.6
Georgia	26	103	28.2
Hawaii	23	104	28.4
Idaho	42	99	26.9
Illinois	16	107	29.2
Indiana	29	103	28.1
Iowa	40	99	27.0
Kansas	28	103	28.1
Kentucky	35	101	27.5
Louisiana	43	98	26.8
Maine	6	113	30.8
Maryland	15	107	29.3
Massachusetts	4	114	31.1
Michigan	20	105	28.6
Minnesota	11	108	29.6
Mississippi	46	97	26.4
Missouri	37	100	27.2
Montana	41	99	27.0
Nebraska	27	103	28.2
Nevada	13	108	29.4
New Hampshire	34	101	27.7
New Jersey	3	115	31.4
New Mexico	18	105	28.7
New York	2	119	32.6
North Carolina	31	102	27.8
North Dakota	45	97	26.4
Ohio	24	104	28.4
Oklahoma	44	97	26.5
Oregon	32	102	27.8
Pennsylvania	30	103	28.0
Rhode Island	7	113	30.7
South Carolina	39	99	27.0
South Dakota	47	97	26.3
Tennessee	48	96	26.1
Texas	22	104	28.4
Utah	25	104	28.2
Vermont	12	108	29.5
Virginia	17	106	29.0
Washington	8	110	30.1
West Virginia	38	99	27.1
Wisconsin	10	109	29.8
Wyoming	5	114	31.1
District of Columbia		120	32.8%

Source: Tax Foundation 2006  
<http://www.TaxFoundation.org>

To put it simply, the purpose of this book is to change these numbers.

If you are tired of paying so much tax to the government year after year, this book is for you. You'll find perfectly legal loopholes that can reduce your taxes by thousands of dollars, year after year.

In addition, you also received certificates worth hundreds of dollars, that if used, can ensure that you put these tax saving strategies to work.

Let get started!

## **LEGAL LOOPHOLE #1: The Easiest Way To Immediately Reduce Your Business Tax By Thousands**

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.

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, and lots of it.

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 does not end.

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

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. That's why I wrote this book -- to help people like you discover the best ways to legally lower your tax bill.

The first "legal loophole" is simply this:

**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.

***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*.

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.

I certainly don't want to waste your time going into all the legal "ins and outs", pros and cons regarding how your business should be structured legally. But the simple fact is, there are significant differences in the amount of taxes that each of these business "types" usually pay.

And there are probably some very compelling reasons why you picked the type of business structure you currently have. Maybe you have received "legal counsel" on this matter, and your attorney has told the "best way to go" from a legal standpoint.

Here's the deal. I'm going to shoot straight from the hip here.

**If your business is NOT an "S" Corporation,  
you are possibly paying more tax than you have to.**

If your business is a Sole Proprietorship, a "C" Corporation, a Partnership, or a Limited Liability Company, chances are pretty good that you are paying too much tax. Switching to an "S" Corporation may reduce your taxes by literally thousands of dollars each and every year.

The next several sections explain why.

## **LEGAL LOOPHOLE #2: Save a Bundle by "*Making The Switch*" (Part I)**

If your business is a Sole Proprietorship, please read this next section carefully. *This is probably the most important information about taxes you will ever read.*

### **IMPORTANT NOTE:**

No matter what type of business you own, please read this section. If you are a Partner in a Partnership, do not skip this section. If you are a LLC Member in a LLC (Limited Liability Company), do not skip this section. If you are a shareholder in a "C" or "S" Corporation, do not skip this section. It is absolutely critical that you understand the concepts explained in this section, no matter what type of business you own. In other words, this section is not just for Sole Proprietors. You'll see what I'm talking about after reading this section and the sections that follow.

The reason that Sole Proprietors pay more tax than "S" Corporations is because of something known as "Self-Employment Tax." As a Sole Proprietor, you report your business profit on your Personal Income Tax Return via Schedule C (Profit or Loss From Business). Your business profit is added to any other income reported on your personal tax return (from W-2 wages, interest and dividends, or whatever), and is then subject to regular income tax.

But the Sole Proprietor not only pays income tax on his/her business profit. The business profit is also subject to "Self-Employment Tax", which is also reported on the Sole Proprietor's personal tax return via Schedule SE (Self-Employment Tax).

This Self-Employment Tax is the equivalent of the Social Security Tax and Medicare Tax (also known as "Payroll Taxes") that employees and employers pay on wages. The combined total of Social Security Tax on wages is 12.4% (the employee pays 6.2% and the employer pays 6.2%). The combined total of Medicare Tax on wages is 2.9% (the employee pays 1.45% and the employer pays 1.45%). Altogether, then, a total of 15.3% of employee wages is paid to the government for Payroll Taxes (Social Security and Medicare taxes).

So, if you are an employee, you pay half and your employer pays half. I'm not here to debate whether an employee ever really gets his/her "money's worth" out of that 7.65%, *but at least the employee only has to pay half of the 15.3%.*

**The Sole Proprietor, on the other hand, has to pay the entire 15.3%.**

*For purposes of the Self-Employment Tax, the Sole Proprietor is, in effect, treated as **BOTH the employer and the employee.** I'm sorry to give you the bad news, but that's just the way the system works.*

(To be technically correct, the way Schedule SE works, the Sole Proprietor does get a very small "break" on the 15.3% Self-Employment Tax. For purposes of this discussion -- I don't really want to get "too technical", let's say that the Sole Proprietor ends up paying about 15% Self-Employment Tax on his/her business profit.)

So let's look at an example of a Sole Proprietor's Self-Employment Tax. Let's assume that your business profit, as reported on Schedule C, is \$50,000.

Schedule C Profit	\$50,000
Self-Employment Tax Rate	x 15% (generally speaking)
Self-Employment Tax	\$7,500

Now, let's assume that this same business is an "S" Corporation rather than a Sole Proprietorship. The business has the same \$50,000 profit, which is reported on the corporation's income tax return (Form 1120S).

Here's how the "S" Corporation owner ends up paying less tax than the Sole Proprietor.

Let's also assume that the "S" Corporation is run very similarly to the Sole Proprietorship. It's a typical "one-person show." The owner does most, if not all of the work.

So, since the business is a Corporation, not a Sole Proprietorship, the business must pay the owner as an employee. In other words, at least some of the \$50,000 profit must be paid to the Owner/Employee as wages.

Let's assume, then, that the Fair Market Value of the Owner/Employee's services rendered to the business is about \$35,000. In other words, if the "S" Corporation owner went out and hired someone else to do the work, the "S" Corp would have to pay someone \$35,000 in wages to do the same work that the owner usually does.

***Now here's where the tax savings comes in --  
PAY ATTENTION TO THIS NEXT SECTION!***

Only the \$35,000 in Owner/Shareholder wages would be subject to the 15.3% Payroll Tax.

Of the \$50,000 "S" Corporation business profit, only \$35,000 is subject to Payroll Taxes. ***The other \$15,000 in profit legally avoids Payroll Tax.*** If the business is run as a Sole Proprietorship, the entire \$50,000 is subject to Self-Employment Tax (the equivalent of Payroll Taxes).

**TAKE A LOOK:**

"S" Corporation Wages	\$35,000
Payroll Tax Rate	x 15%
Payroll Tax	\$5,250

Now, let's compare the two scenarios:

SOLE PROPRIETORSHIP	Self-Employment Tax	\$7,500
"S" CORPORATION	Payroll Tax	<u>\$5,250</u>
TAX SAVINGS FOR THE "S" CORPORATION		\$2,250

By simply running your business as "S" Corporation rather than a Sole Proprietorship, you can save \$2,250 in taxes. And assuming that you have this kind of profit year after year, you would save \$11,250 over 5 years and \$22,500 over 10 years.

PLEASE NOTE, that this tax savings is NOT a savings in INCOME tax. It is a savings in Payroll Tax (paid by the corporation) vs. Self-Employment Tax (paid by the Sole Proprietorship).

All other things being equal, there is no savings in INCOME TAX in the above scenario. Assuming \$50,000 of business profit, the Sole Proprietor and the "S" Corporation Owner/Employee would pay the same amount of income tax, (again, assuming all other things being equal).

So, if you are currently running your business as a Sole Proprietorship, there are some substantial tax savings waiting for you SIMPLY BY FORMING AN "S" CORPORATION.

**WHAT IF YOU ARE NOT A SOLE PROPRIETOR? That's OK! There are STILL substantial tax savings waiting for you . . . .**

If you are a **Partner in a Partnership**, make sure you go on to the next section and read LEGAL LOOPHOLE #3 very carefully.

If you are a **LLC Member in a LLC**, make sure you go on to LEGAL LOOPHOLE #4 and read that section very carefully.

And if you are a **Shareholder in a "C" or "S" Corporation**, make sure you go on to ready LEGAL LOOPHOLE #5 & 6 and read those sections very carefully.

## **LEGAL LOOPHOLE #3: Save a Bundle by "*Making The Switch*" (Part II)**

If your business is structured as a Partnership, there are probably some big tax breaks awaiting you simply by switching over to an "S" Corporation format.

And the reason for this is the same reason given in LEGAL LOOPHOLE #2 -- the "S" Corporation Owner/Employee can pay less in Payroll Taxes than a Partner pays in Self-Employment Taxes.

If you are a Partner in a Partnership but skipped over LEGAL LOOPHOLE #2 because you thought, "Oh, this section is for Sole Proprietorships, not Partnerships", **PLEASE GO BACK AND READ LEGAL LOOPHOLE #2.**

As a Partnership, you report your partnership business on Form 1065. But this Form 1065 is really just for information purposes. The Partnership usually doesn't pay its own income taxes. Why? Because the Partnership also has to prepare a Schedule K-1 for each Partner, which reports your share of the Partnership's income (or loss). You then take the K-1 information and transfer it to your personal tax return. If your business has a profit, then you pay income tax on that profit via your personal income tax return.

Now, here's the key. Not only do you have to pay income tax on that K-1 profit, you also have to pay Self-Employment tax on that profit. And just like a Sole Proprietor, you have to pay the entire 15.3% Self-Employment Tax on your share of the business profit.

If you switch from a Partnership to an "S" Corporation, you can pay yourself as an employee with some of the business profit, and legally avoid Payroll Taxes on the rest.

Again, this is all explained in great detail in the previous section, LEGAL LOOPHOLE #2. The point is simply this -- for Self-Employment Tax purposes, the Partner in a Partnership is treated exactly like the Sole Proprietor. You can legally reduce your Self-Employment Taxes by switching to an "S" Corporation. Assuming the same scenario as described in LEGAL LOOPHOLE #2, you can save thousands of dollars every year.

## **LEGAL LOOPHOLE #4: Save a Bundle by "*Making The Switch*" (Part III)**

If your business is structured as an LLC, there are probably some big tax breaks awaiting you simply by switching over to an "S" Corporation format.

And the reason for this is the same reason given in LEGAL LOOPHOLE #2 -- the "S" Corporation Owner/Employee can pay less in Payroll Taxes than a LLC Member pays in Self-Employment Taxes.

If you are an LLC Member but skipped over LEGAL LOOPHOLE #2 because you thought, "Oh, this section is for Sole Proprietorships, not LLC's", **PLEASE GO BACK AND READ LEGAL LOOPHOLE #2.**

As an LLC, you can report your LLC business on Form 1065 (if your business is a multi-member LLC) or Schedule C (if your business is a single-member LLC). For multi-member LLC's, this Form 1065 is really just for information purposes. The LLC usually doesn't pay it's own income taxes. Why? Because the LLC also has to prepare a Schedule K-1 for each LLC Member, which reports your share of the LLC's income (or loss). You then take the K-1 information and transfer it to your personal tax return. If your business has a profit, then you pay income tax on that profit via your personal income tax return.

Now, here's the key. Not only do you have to pay income tax on that K-1 profit, you also have to pay Self-Employment tax on that profit. And just like a Sole Proprietor, you have to pay the entire 15.3% Self-Employment Tax on your share of the business profit.

If you switch from an LLC to an "S" Corporation, you can pay yourself as an employee with some of the business profit, and legally avoid Payroll Taxes on the rest.

Again, this is all explained in great detail in the previous section, LEGAL LOOPHOLE #2. The point is simply this -- for Self-Employment Tax purposes, the LLC Member in an LLC is treated exactly like the Sole Proprietor. You can legally reduce your Self-Employment Taxes by switching to an "S" Corporation. Assuming the same scenario as described in LEGAL LOOPHOLE #2, you can save literally thousands of dollars every year.

NOTE: Another option for the LLC is to file Form 8832, which enables the LLC to be treated like any entity for tax purposes. For more information on this strategy, check out Wayne's second tax ebook for small business owners, "Incorporation Tax Secrets Revealed" at <http://www.YouSaveOnTaxes.com/incorp>.

## **LEGAL LOOPHOLE #5: Remove The Fear of Audit by "*Making The Switch*"**

Have you ever been audited by the IRS? Do you know anyone who has been audited by the IRS? There are plenty of "horror stories" out there about IRS auditors swooping down and wreaking havoc on the lives of innocent small business owners.

Believe me, if you've never been audited, you definitely want to keep it that way. Audits are no fun, even if your books are in good shape and you run a "clean" operation.

Have you ever wondered how the IRS goes about choosing which tax returns to audit? You are about to find out. Here's a chart that pretty much tells us who is at greatest risk of audit:

<b>Type of Business</b>	<b>Percentage of Returns Audited</b>
Sole Proprietorships	
Sales:	
< 25,000	2.63
25,000-99,000	1.13
>100,000	1.36
"S" Corporations	0.42
"C" Corporations	
Assets:	
< 250,000	0.22
250,000 – 1,000,000	0.73
1M – 5M	2.06
Partnerships/LLCs	0.27

The numbers are very clear: Sole Proprietorships get audited much more than any other type of business (except for large "C" Corporations). Why is that? Because self-employed people are the main reason the U.S. has such a large "underground economy", in which millions of dollars of income go unreported every year.

So the IRS has put the most likely "suspects" at the top of its hit list. You are a Sole Proprietor if you own a business that is unincorporated, i.e. you are not a "C" Corporation or "S" Corporation, nor are you a Partnership or Limited Liability Company (LLC).

The easiest way to know if you are a Sole Proprietorship is to answer this question: Do you report your business on your personal tax return (Form 1040) via Schedule C? If so, you are a Sole Proprietorship, and you are much more likely to get audited than a Corporation, a Partnership, or a Limited Liability Company. This is just a fact of life.

We've already discussed the tax benefits of "making the switch" from a Sole Proprietorship to a Corporation, especially the "S" Corporation. Now here's another obvious benefit: by being a Corporation, you will dramatically reduce the likelihood of being audited.

The IRS is much more suspicious of Sole Proprietors than Corporations. So it spends more resources going after small business owners who file a Schedule C on their personal tax returns. And Schedule C, as you may already know, tells the IRS all about your business in great detail -- your business income, plus a detailed list of every expense category.

Furthermore, many Sole Proprietors operate their business out of their home office, necessitating another special form known as Form 8829, Expenses for Business Use of Your Home. Well, guess what? Filing Form 8829 also increases the chances for an audit, simply because there's been so much abuse in the area of claiming the Home Office Deduction.

By forming an "S" Corporation, here's what happens:

1. You remove the Schedule C from your personal tax return

2. Instead, your business files a Form 1120S to report its income and expenses. "S" Corporations who file Form 1120S have a much lower audit rate than Sole Proprietors who File Schedule C, as the above chart demonstrates.

3. Since you are running an "S" Corporation, you will receive a Form W-2 for wages earned and a Schedule K-1 for your share of the corporation's profit. Now your personal return is much less likely to get audited. There is no Schedule C, with all its juicy details. Instead, you have a W-2 and a K-1. The W-2 just tells the IRS how much your wages are. The K-1 tells the IRS that you own an "S" Corporation, but typically there is only ONE number that is transferred from the K-1 to the Form 1040. All the details of your business are "buried" on the Form 1120S. There is no business income or business expense detail on your Form 1040.

4. If you do have a Home Office, you can still deduct those Home Office Expenses on your Form 1120S, but without having to file Form 8829. So you have removed another "audit flag" from your personal tax return and reported that information on the corporations tax return, where it is much less likely to be scrutinized, because there is no special IRS form for an "S" Corporation to list Home Office expenses.

5. As a Sole Proprietor, you are supposed to receive a Form 1099-MISC from any individual or business who paid you at least \$600 in a calendar year for services rendered. This is known as "non-employee compensation" and is reported in Box 7 of Form 1099-MISC. These 1099's are also sent to the IRS, where they are put into the IRS computer and matched up against your Schedule C income. If you don't report this 1099 income, the IRS will know immediately and come knocking on your door.

Once you become an "S" Corporation, you will no longer receive any Forms 1099-MISC. Why? Because the law says that only Sole Proprietors are supposed to get a Form 1099-MISC. Generally, corporations are excluded from the 1099 rules. So, again, just by being an "S" Corporation, you have taken your business out from under the IRS microscope!

6. The IRS loves to audit Sole Proprietors for two main reasons: First, Sole Proprietors are notorious for under-reporting their income. And second, because Sole Proprietors are notorious for over-stating their expenses, especially in the areas of travel, entertainment, and vehicle expenses. Because you are a Corporation, with a much lower audit rate, chances are pretty good that these typical "audit flags" will receive much less scrutiny.

So there you have it. By switching from a Sole Proprietorship to a Corporation, you will not only save thousands in taxes, but you will also greatly reduce the risk of audit.

It's hard to assign a dollar value to something like "reducing the risk of an audit". But if you've ever been audited before (or know someone who has), you know what a hassle it can be. Many hours spent tracking down receipts and records. Many hours spent fretting and worrying.

Removing this fear and aggravation could well be worth **more** to you than the tax savings!

**IMPORTANT NOTE:**

If you've read this far, you realize I'm a big fan of the "S" Corporation. For many Small Business Owners and Self-Employed People, it's the way to go.

Whether or not **you** should form an "S" Corporation, however, depends on several factors: the cost, the additional paperwork, the potential tax savings, your income level, legal and estate planning considerations, among others.

Forming an "S" Corporation is something you should investigate thoroughly before "making the switch".

And this is one of the main reasons why I've included the tax consulting coupons in Part One of the Toolkit. Send me your last couple years' worth of income tax returns and I can tell you the tax consequences of forming an "S" Corporation. During our 60-minute phone consultation, we can discuss the pros and cons of incorporating *for your particular situation*.

Yes, many Sole Proprietors are much better off tax-wise by forming an "S" Corporation. But that does **not** mean that *every* Sole Proprietor should automatically form an "S" Corporation without first doing some serious research and/or consulting with a tax professional experienced in the area of "Choice of Entity".

Please do not misunderstand me here. I am not advocating a "once size fits all" approach to the Choice of Entity issue.

The "S" Corporation may be best for you. And it may not.

For a more thorough discussion of the various factors that should be considered when deciding which entity type is best for you, see "Incorporation Tax Secrets Revealed" at <http://www.YouSaveOnTaxes.com/incorp>

## **LEGAL LOOPHOLE #6: Once Is Enough! (Don't Let Them Do It To You Twice)**

### **How To Avoid Double Taxation of Corporate Profits By Forming An "S" Corporation**

If you own a "C" Corporation, pay attention to this section. One of the first things you should realize is that by owning a "C" corporation, you have become a "victim" of one of the greatest "government scams" of all time. What am I talking about? Something known as "Double Taxation of Corporate Profits".

Also, if you own a Sole Proprietorship, Partnership, or Limited Liability Company, pay attention to this section. I've already explained one great reason why you should switch to an "S" Corporation (to reduce Payroll Taxes). Now, this section will explain why, assuming you are going to incorporate your business, you should consider forming an "S" Corporation rather than a "C" Corporation.

Here's how it works. Let's say you own a "C" Corporation that makes \$10,000 profit in a given year. The "C" Corporation must then report that \$10,000 profit on its corporate income tax return (Form 1120) and pay corporate income tax on that \$10,000 profit. "C" Corporations pay 15% federal income tax on the first \$50,000 of profits, so the federal income tax on this \$10,000 would be \$1,500. (There may be state corporate income tax as well, but for sake of simplicity, let's leave that factor out of this discussion for now.)

So the "C" Corporation pays the \$1,500 federal income tax.

Now, let's say the "C" Corporation's shareholders (that would be you) want to withdraw that \$10,000 profit out of the business. After all, isn't that why the shareholders formed the corporation in the first place -- to make a profit, and to reap the rewards of that profit?

So the corporation pays the \$10,000 profit to the shareholders, which is known as a "dividend". *Now here's where the "government scam" comes into play.*

Didn't the corporation already pay federal income tax on that \$10,000 profit. Yes. Well, now that the corporation has distributed that \$10,000 dividend to the shareholders, *the shareholders must report that same \$10,000 as taxable income on their personal tax returns.*

So that same \$10,000 gets taxed twice. Once on the corporation's income tax return, and a second time on the individual shareholders' personal tax returns.

Let's say the shareholders' are in the 25% federal tax bracket. That means the shareholders will pay \$2,500 in federal income tax on the \$10,000 dividend. ***This is in addition to the \$1,500 of corporate income tax already paid by the corporation.*** Altogether, that \$10,000 of corporate profit resulted in \$4,000 in total federal income tax: \$1,500 corporate plus \$2,500 personal.

Another way to look at it: **The \$10,000 profit was taxed at a total federal rate of 40% -- 15% corporate tax plus 25% personal tax.** Now, if state taxes are factored in, ***it is very likely that corporate profits are taxed at the rate of nearly 50%!***

Think about that: nearly one-half of your business profit is turned over to Uncle Sam. Now you can see why I am so determined to recommend strategies that reduce my clients' tax burden. With tax rates this high, sometimes it does seem like we are facing a "government scam".

Now, how do you legally avoid this scam of "Double Taxation of Corporate Profits"?

Here's how: By forming an "S" Corporation.

Why should you form an "S" Corporation? Here's why:

When you form a corporation, for tax purposes the IRS automatically assumes that you want to be treated as a regular "C" Corporation, which is subject to the regular rules of corporate taxation as described above. The "C" Corporation is a "stand-alone" taxable entity, and must report and pay tax on its profit as a separate legal tax-paying "person."

But if you want to avoid double taxation of corporate profits, the corporation files a special form (Form 2553) with the IRS declaring that it wants to be recognized as an "S" Corporation. The tax code treats an "S" Corporation differently than a "C" Corporation. The "S" Corporation is still a corporation from a legal standpoint, **but from a tax standpoint, the "S" Corporation usually does not have any income tax liability.**

Now the "S" Corporation still files a corporate income tax return (Form 1120S instead of Form 1120), but the "S" Corporation profits (or losses) are reported on this tax return for "information purposes only." Via a special form called a Schedule K-1, **the "S" Corporation profits (or losses) get transferred from the corporation's tax return to the personal income tax returns of the shareholders.** ***The result is that any corporate profit is only taxed ONCE -- on the personal income tax returns of the individual shareholders.***

What does this mean? In the above example, the total federal income tax would be reduced by 15%. The corporation would not pay the 15% federal income tax on Form

1120. Instead, the corporate profit of \$10,000 would result in *zero* corporate income tax. The only income tax paid on this \$10,000 would be the 25% personal income tax reported on the shareholder's personal tax returns. ***Instead of paying tax twice, the corporate profits are subject to tax only once.***

Now here's some critical information about how to become an "S" Corporation. There are specific requirements to becoming an "S" Corporation. These requirements are listed in detail in the Instructions for Form 2553. Generally speaking, the corporation will probably meet these requirements if all of the following are true:

1. The corporation is a domestic corporation.
2. The corporation has no more than 100 shareholders.
3. The corporation's only shareholders are individuals, estates, certain trusts, or tax-exempt organizations. (If the corporation has a shareholder who is either an estate, trust or a tax-exempt organization, *consult a tax professional*.)
4. The corporation has no non-resident alien shareholders.
5. The corporation has only one class of stock.
6. The corporation is not one of the following ineligible corporations: certain types of banks, thrift institutions, insurance companies, a "possessions corporation", or a "domestic international sales corporation". (If the corporation falls under one of these categories, *consult a tax professional*.)
7. The corporation has a regular "calendar year", i.e. the corporation's "tax year" ends on December 31. (If the corporation has a "fiscal year", i.e. a tax year ending on a date other than December 31, *consult a tax professional*.)
8. Each shareholder consents to the "S" Corporation election.

If your corporation meets the above requirements, great! Now you are ready to file **Form 2553, Election by a Small Business Corporation (Under section 1362 of the Internal Revenue Code)**.

Like many business tax forms, Form 2553 "looks" worse than it really is. Everything on Page 1 and Page 2 must be completed. Page 3, however, can be disregarded totally by most corporations -- read the fine print to see whether you should complete Page 3.

The most important thing to understand about filing this form is knowing **WHEN TO FILE FORM 2553**. Please read the instructions very carefully, especially the section entitled, **When To Make the Election**. Unfortunately, these "due date" instructions are written in typically confusing government-type language. I'll be the first to admit that this is the hardest part of the whole "S" Corporation process. But it is oh-so-critical that this be done right, or your corporation might not qualify for "S" Corporation status, even if everything else is OK.

**WARNING! If Form 2553 is not filed by the appropriate due date, the election to be treated as an "S" Corporation will be rejected by the IRS. The result:**

**your corporation will not qualify for "S" Corporation status and the corporation will have to file the regular "C" Corporation tax return and be subject to regular corporate income taxes and the dreaded "Double Taxation of Corporate Profits" discussed earlier.**

*If the instructions regarding the due date for Form 2553 are not clear to you, please consult a tax professional before filing Form 2553.*

Here's an overview of the "due date" instructions for Form 2553:

**If you want "S" Corporation status to take effect for the corporation's first tax year:**

1. File Form 2553 within 2 months and 15 days of the beginning of the first tax year. A corporation's first "tax year" begins on the date that the corporation: a) has shareholders b) acquires assets or c) begins doing business (whichever is the first to occur). Often this means that the corporation's first tax year begins on the incorporation date.

EXAMPLE #1: XYZ Corporation begins its first taxable year on June 1, 2009 (the date of incorporation). To be an "S" Corporation beginning with its first taxable year (2009), XYZ Corporation must file Form 2553 no later than August 15, 2009.

**If you want "S" Corporation status to take effect for a tax year OTHER THAN the corporation's first tax year:**

1. File Form 2553 within 2 months and 15 days of the current tax year and "S" Corporation status will take effect for the current tax year.

2. If you want "S" Corporation status to take effect January 1 of the following tax year, file Form 2553 at any time during the previous tax year.

**What if you missed either of the "2 month and 15 day" deadlines as explained above?**

Do not despair! There are special rules that may allow the corporation to still qualify for "S" Corporation status even though the Form 2553 was not filed on time. There are specific conditions that must be met which are beyond the scope of this book.

If you missed either of the "2 month and 15 day" deadlines, *consult a tax professional.*

**In conclusion:**

Well, are you still with me? Like I said before, these Form 2553 "due date" instructions are both confusing and critical. Do not hesitate to contact a tax professional to make sure your corporation submits Form 2553 on time. Being an "S" Corporation can result in significant tax savings -- don't miss out on these tax savings because you filed Form 2553 late!

## LEGAL LOOPHOLE #7: Don't Pay Yourself Too Much!

Now that I've explained why the "S" Corporation is often the best type of business to own from a tax-saving standpoint, let's talk a little more about this issue of "compensation."

Many times a new business will go through the following sequence of events:

A business is started, usually as a sole proprietorship or "informal" partnership. After a year or two of at least "break-even" or even mildly profitable success, the business decides to incorporate. During this initial period before incorporation, the business did not have to worry about "payroll". Sole proprietorships and partnerships simply distribute the profits to the owners; technically, these distributions of profit are not "wages" or "salary" to the owners. And there are no payroll tax returns or W-2's to file (unless, of course, the business had any non-owner employees).

After incorporation, however, things are different. Now, if a shareholder performs services for the corporation, the corporation must pay the shareholder as an employee (and in a small, "one-person" or family-run business, it is very likely that all shareholders are actively involved in the day-to-day operation of the business, providing services to the corporation that must be compensated with wages or salary).

So even if there are no "non-shareholder" employees, a corporation with just one shareholder also has just one employee -- the sole shareholder is both owner and employee of the corporation. *And having just one employee (even if it is the shareholder-employee) results in the necessity of filing all federal, state and local payroll tax returns.*

At the federal level, this means filing the following payroll tax returns: Form 941 (quarterly), Form 940 (annually), Form W-2 (annually), and Form W-3 (annually). In addition, federal payroll tax payments are usually due each month via Form 8109 or via the electronic federal tax payment system (EFTPS).

At the state and local level, this means filing any number of additional payroll tax returns, depending on what state the corporation is in. In Indiana, for example, having just one employee means filing Form WH-1 (monthly or quarterly), Form UC-1 (quarterly), and state copies of Form W-2 (annually) and Form WH-3 (annually).

So an Indiana corporation with just one shareholder-employee faces a literal "mountain of payroll-related paperwork". Altogether, **being an employer in Indiana with just one employee results in the filing of some 37 payroll tax returns during the course of one year.** Amazing but true!

Of course, knowing which payroll tax returns to file and when to file them is no small matter. Some are due monthly, some quarterly, some annually. *If you are confused about payroll tax returns, please consult a tax professional!* You do not want to "get behind" in this area. Many small businesses fail simply because of the failure to file payroll tax returns and/or the failure to pay payroll taxes.

Another area of confusion for many corporation owners has to do with how much compensation to pay the shareholder-employee(s). It is common for corporation owners to assume that ALL profit should be distributed to the shareholder-employee(s) as salary or wages, regardless of what services were done by the shareholder-employee. In the case of a "C" Corporation, this strategy is often viewed as "appropriate" because it ensures that no profit will be left in the company, subject to double taxation. And there very well may be situations when this is the "best" approach.

But with an "S" Corporation, it may be appropriate to pay salary/wages to the shareholder-employee(s) which are less than the available profit. Here's an example to illustrate this concept:

XYZ Corp has profit of \$60,000 in a given tax year (before shareholder-employee salary/wages are deducted). XYZ has one shareholder-employee who owns 100% of the stock. This shareholder-employee also works full-time for the corporation, providing services which have a fair market value of \$40,000. By paying the shareholder-employee \$40,000 of salary/wages instead of \$60,000 (the available profit), the corporation and the shareholder-employee save about \$3,060 in Social Security and Medicare taxes (\$20,000 x 15.3%).

**THINK ABOUT THIS FOR A MOMENT.** Here's an incredibly simple-to-understand and easy-to-implement tax-saving strategy. Just by paying yourself \$40,000 wages instead of \$60,000 wages, you save yourself about \$3,000 bucks.

The key concept here is: What is the "fair market value" (FMV) of the shareholder-employee's services? It is critical that the corporation pay "reasonable compensation" for any employee's services, including services provided by the shareholder-employee(s). In the above example, if the shareholder-employee provided services that could have been obtained in the public labor market for \$40,000, then that is what the corporation should pay the shareholder-employee. In other words, if the corporation could have hired someone other than the shareholder-employee to do the same job for \$40,000, then \$40,000 can be documented as "reasonable compensation." Why pay more than FMV for an employee's services?

In other words, just because the corporation has \$60,000 in profit does NOT necessarily mean that the corporation has to pay out the entire \$60,000 as wages to the shareholder/employee. If the shareholder/employee's work is not worth \$60,000, then it is foolish to pay the entire \$60,000 as wages.

Now, you may be wondering, "What about the other \$20,000 of profit? How do I pay myself the rest of the profit?" Good question! The answer is simply this: The \$20,000 remaining profit can be paid to the shareholder/employee as a "profit distribution", sometimes referred to as a "dividend". The corporation just pays the \$20,000 to the shareholder whenever the corporation deems it appropriate to do so. This \$20,000 of "profit distribution" is NOT treated as a "paycheck" -- this \$20,000 is not wages or salary or a bonus for work done as an employee. Rather, it is simply the payment of profit to the corporation's owner, sometimes called a "dividend payment." And because it is a "dividend payment" and not a "paycheck", there are no payroll taxes withheld from the dividend payment -- no Social Security tax, no Medicare tax, no federal unemployment tax, no state unemployment tax.

If you are the owner of an "S" Corporation who happens to also work for the "S" Corporation as an employee, think of yourself as wearing two "hats" -- one hat is labeled "Shareholder", the other hat is labeled "Employee." When you put on your Employee Hat, you get paid wages (or salary) for the services you perform, based on the Fair Market Value of the work you did, just like you'd pay any other employee in a true arm's length business transaction.

When you put on your Shareholder Hat, you get paid Dividends for being the owner of the business who is entitled to receive his/her share of the corporation's profits. These dividend payments are NOT payments for services rendered, but rather are your reward for starting the business, investing capital in the business, and assuming the risk of owning the business.

Another common question you may have is, "Well, how does all this get reported on my personal income tax return?"

With an "S" Corporation, the \$40,000 salary/wages will be reported on the shareholder's personal income tax return via the Form W-2. The corporation will then have a profit of \$20,000 which will also be reported as income on the shareholder's personal income tax return via the Schedule K-1. So whether the corporation pays salary/wages of \$40,000 or \$60,000 will have no effect on the shareholder's personal income tax liability. But by reporting only \$40,000 of wages instead of \$60,000, the corporation and the shareholder will realize a substantial savings in payroll taxes.

This area of shareholder-employee "reasonable compensation" is critical. The corporation should not pay "too much" salary/wages and end up paying too much payroll tax. On the other hand, the corporation must be careful to **not** "under-pay" the shareholder-employee. If the shareholder-employee performs services to the corporation, this should result in payment of reasonable compensation. To not pay the shareholder-employee any salary/wages will likely raise a "red flag" with the IRS. And paying the shareholder-employee less than FMV for services rendered is also likely to draw attention from the IRS. Do not fail to pay close attention to this area.

So I must end this section with a strong **WARNING:**

**IF YOU PERFORM "EMPLOYEE-TYPE WORK" FOR THE CORPORATION,  
DO NOT THINK YOU CAN GET AWAY WITH PAYING YOURSELF ZERO  
WAGES AND ALL DIVIDENDS.**

This "trick" has been tried and does not work. The IRS will look closely at the tax return of an "S" Corporation that reports zero wages to its officers and/or shareholders. In a small, family-run "S" Corporation, the shareholders, officers and employees are often the same people. In fact, if you convert a Sole Proprietorship to an "S" Corporation (which I think is a great idea and will save you thousands of dollars in taxes), it is very likely that there is just ONE person who is sole shareholder, the only officer, and the one and only employee.

Assuming the Corporation is profitable, this one shareholder/employee must be paid something *as an employee*. To pay no wages and all dividends is a big mistake! A few unscrupulous "S" Corporation owners have tried to get away with it, and were caught red-handed. The IRS simply said, "Since the owner also performed work for the corporation as an employee, some of those dividends must be re-classified as wages, and the appropriate payroll taxes must be paid on those wages."

So the whole point behind this Legal Loophole #6 is NOT to get away with paying no payroll taxes. Rather, the point here is it legally reduce the amount of payroll taxes you pay, conceivably by thousands of dollars each year.

## **LEGAL LOOPHOLE #8: Deduct Your Losses *NOW* (Not LATER!)**

IMPORTANT NOTE: Legal Loophole #8 is yet another reason why many small business owners prefer the "S" Corporation over the "C" Corporation. The following comments regarding deductibility of "S" Corporation losses will usually apply to Partnership losses and LLC losses, too.

Many small businesses lose money during their early years. This is a fact of life. I wish this were not the case, but it is. So let's just be honest about it. You may be able to generate a profit right from the start, and if so, congratulations!

But for those businesses that are not profitable, there is some consolation: corporations are allowed to deduct losses against income, thereby saving taxes. But when a corporation gets to deduct those losses, and how a corporation gets to deduct those losses depends on what type of corporation you own.

From a "loss deduction" standpoint, the tax code treats "C" Corporations and "S" Corporations very differently. "C" Corporations, which are treated as stand-alone taxable entities, can only deduct one year's loss against another year's profit. This is known as the "carryback" or "carryforward" rule of loss deduction. Usually, a net operating loss may be "carried back" 2 years or "carried forward" 20 years. If you have a loss in your first year, there are no previous years to "carryback" the loss, so you can only "carryforward" the loss to the first year when you have a profit. Assuming you eventually have a profit in a future year, the loss will eventually be deductible, resulting in a tax benefit. But you have to wait until you have a profit to deduct the loss.

NOTE: The following comments regarding "S" Corporation deductibility of losses also apply generally to Partnerships and LLC's that are taxed like a partnership.

With an "S" Corporation, there is a different set of rules altogether. Generally speaking, an "S" Corporation does not pay income tax on net profit from business activity. Instead, "S" Corporations "pass through" profits and losses to the shareholders, who report those profits and losses on their personal tax returns.

So, if your "S" Corporation has a loss in the first year, the shareholders can report that loss on their personal tax returns, using that loss to offset other income and thereby reducing their personal income tax in the year of the "S" Corporation loss. There is no waiting until the "S" Corporation has a profit.

This deductibility of "S" Corporation losses on shareholder tax returns can be a major benefit of choosing "S" Corporation status. Consider the following example.

Mr. Taxpayer forms an XYZ Corporation as an "S" Corporation on January 1st. Mr. Taxpayer owns 100% of the stock of XYZ Corporation. The corporation suffers a \$5,000 loss in its first year. Mr. Taxpayer's wife, Mrs. Taxpayer, works a regular full-time job and earns salary of \$95,000 as reported on her W-2. Mr. & Mrs. Taxpayer are in the 25% federal tax bracket. Mr. Taxpayer is allowed to report the \$5,000 loss on his personal tax return; therefore the \$5,000 "S" Corp loss offsets a portion of Mrs. Taxpayer's income, resulting in a federal tax savings of \$1,250 ( $\$5,000 \times 25\%$ ). Assuming Mr. and Mrs. Taxpayer also pay state income tax of 5%, they will realize an additional savings of \$250 ( $\$5,000 \times 5\%$ ).

So, because Mr. Taxpayer formed an "S" Corporation, he saves a total of \$1,500 in federal, state and county income taxes.

Compare this to what would have happened if XYZ Corporation been a "C" Corporation. First of all, Mr. and Mrs. Taxpayer would have paid \$1,500 more income tax in Year One of the corporation. The \$5,000 loss would have been "carried forward" to Year Two, when it could have been deducted against the first \$5,000 of profit earned in that year. If there was a loss in Year Two, the Year One loss and the Year Two loss would have been "carried forward" to Year Three and so on, until the corporation made a profit.

Which would you rather do -- save taxes now or save taxes later? In most cases, it is usually better to reduce taxes now, especially when you consider the time value of money.

## **LEGAL LOOPHOLE #9: How To Pay Yourself First! (And Get The Government To Chip In!!)**

IMPORTANT NOTE: The SIMPLE Plan described below is available to virtually all types of business entities: Corporations (both "C" and "S"), Partnerships, LLC's, and Sole Proprietorships. So from a "business entity" standpoint, there is no good reason *not* to have a SIMPLE Plan!

Every now and then, Congress and the President pass legislation that is actually beneficial to taxpayers, including small business owners like yourself. The Small Business Job Protection Act of 1996, which became law August 20, 1996, created a simplified retirement plan for small businesses. This new type of retirement plan was available on January 1, 1997 and is called the "Savings Incentive Match Plan for Employees" -- or the SIMPLE Plan. And believe it or not, compared to other types of employer-sponsored retirement plans, the "SIMPLE Plan" is truly *simple*! It is simple to understand, simple to implement, and simple to maintain.

As a small business owner, you may already have employees. If you don't currently have employees, you probably will have to consider hiring employees if you want your business to grow.

**If you are the corporation's only employee (or if you are a Sole Proprietor, Partner, or LLC member), or if your only other employees are family members, the SIMPLE Plan is still a great tax-saving strategy. Even with just one employee (YOU!), you can take advantage of the benefits of saving for retirement and paying less taxes at the same time.**

Having employees means offering benefits to obtain and retain those employees. Today, an attractive retirement plan can play a big role in recruiting and keeping valued employees. But many small business owners may not be able to offer a plan like the popular 401(k) plan, given its high administrative and recordkeeping costs. Simply put, a 401(k) plan is expensive, costing hundreds or even thousands of dollars each year *just for administrative tasks* which are typically handled by a "third-party" retirement plan administrator.

This is where the new SIMPLE Plan comes to your rescue. It is the ideal low-cost, low-maintenance alternative to the 401(k) plan. The SIMPLE Plan offers many 401(k) plan-like features (such as employee tax-deductible contributions and employer matching contributions) at a much lower cost. Under the SIMPLE Plan, employees make tax-deductible contributions to a SIMPLE IRA maintained by the employer. The employer also makes matching contributions to this same SIMPLE IRA account. Here's how the SIMPLE Plan works:

### **Eligibility Requirements for Employers**

You can offer a SIMPLE Plan if you:

1. Employ 100 or fewer employees
2. Do not concurrently maintain any other employer-sponsored retirement plan

### **Eligibility Requirements for Employees**

Your employees are eligible to participate if they:

1. Earned at least \$5,000 in any two preceding years, and
2. Expect to earn at least \$5,000 during the current year.

*Important Note:* You can make the employee eligibility requirements *less* restrictive or even eliminate them entirely. So, you can reduce the \$5,000 compensation requirement to any amount you wish, or not have any compensation requirement at all. This offers you much flexibility. For example, if you want to exclude part-time employees from participation, you would keep the \$5,000 requirement. If you want to include as many employees as possible, even those that make only a few hundred dollars a year, than you would eliminate the compensation requirement completely.

### **Employee Contributions**

If younger than 50, eligible employees can contribute up to \$11,500 of his or her compensation to the SIMPLE-IRA in 2009 and 2010. If age 50 or older, the maximum contribution is \$14,000 in 2009 and 2010. The employee's contribution is tax-deductible, just like a 401(k) plan or a "traditional" IRA.

These employee contributions can only be made via payroll deduction. The employer must submit the employee's payroll deductions to the SIMPLE-IRA account no later than 30 days after the end of the month in which the contribution was deducted from compensation.

## Employer Matching Contributions

The employer is required to make contributions to each participant's SIMPLE-IRA. Each year, the employer may select one of the following two methods:

1. A dollar-for-dollar match of participating employee contributions, up to 3% of compensation. This match can be decreased to as low as 1% for two years out of five.

Each of the following examples assume the employer chooses to match up to 3% of each participating employee's compensation:

Example #1: Employee A makes \$10,000 and contributes 10% (\$1,000) to his SIMPLE-IRA. The employer is required to contribute 3% of the employee's compensation, or \$300.

Example #2: Employee B makes \$10,000 and contributes 60% (\$6,000) to her SIMPLE-IRA. The employer is required to contribute 3% of the employee's compensation, or \$300.

Example #3: Employee C makes \$10,000 and contributes 1% (\$100) to his SIMPLE-IRA. The employer is required to contribute 1% of the employee's compensation, or \$100.

Example #4: Employee D makes \$10,000 and chooses not to participate, contributing zero to her SIMPLE-IRA. The employer's matching contribution is therefore zero.

The critical factor here: Only those employees who participate by making their own contributions will receive the employer match. If an employee chooses not to contribute to his/her SIMPLE-IRA, then the employee receives no employer match.

2. A flat 2% contribution of all eligible employee's compensation.

The critical factor here: All eligible employees receive the 2% employer contribution, including any employees who did not participate by making their own contributions.

## **Benefits for Employees (including Corporate Shareholder-Employees, Partnership Partners, LLC Members & Sole Proprietors)**

1. All contributions are tax-deductible. This reduces your current income tax bill.
2. The employee's maximum annual contribution is \$11,500 (or \$14,000 if 50 or older) in 2009 and 2010 -- which is significantly more than the annual limit of \$5,000 for a "traditional" IRA or a Roth IRA (\$6,000 for those 50 or older).
3. Like 401(k) and IRA accounts, all contributions and earnings grow tax deferred until withdrawn. Earnings can compound faster than they would in a comparable taxable investment because they're not being eroded each year by taxes.
4. Contributions are made automatically via payroll deduction. This is probably the most convenient way to save money for retirement. The employee never "sees" the money - it goes right into the SIMPLE-IRA account. What an easy way to save!
5. Both employee and employer contributions are immediately 100% vested.
6. The employer contributions are mandatory. Employees are rewarded with a great tax-free benefit!
7. The employer contributions provide an extra incentive for the employee to participate. If the employer is using the "matching" method to determine the employer's contribution, the employee *must* contribute in order to receive the employer contribution.
8. Virtually all employees will be able to participate, regardless of income level, because many SIMPLE Plan sponsors (such as mutual fund companies) will accept monthly employee contributions of as little as \$25.

## **Benefits for Employers**

1. You are providing a tremendous fringe benefit to your employees. This will help you to attract and retain quality employees.
2. All employer contributions are tax-deductible.
3. You are not "locked in" to only one employer contribution method. There is flexibility here -- you may choose the contribution method that best suits your needs, and you may change the contribution method each year. Under the "matching" method, you

even have the option of reducing the match to as low as 1% for any two years out of a five-year period.

4. If you use the "matching" method of employer contribution, only participating employees receive a match. If no employees participate, you are not required to make a matching contribution!
5. The administrative responsibilities are very minimal. There are no burdensome discrimination tests (which do exist for 401(k) plans and other types of employer-sponsored retirement plans). And there are no complicated IRS annual reports, which are required for 401(k) plans and pension plans.
6. The administrative cost is practically zero. Many SIMPLE Plan sponsors (such as mutual fund companies) charge a minimal "set-up" fee of as little as \$100. Plan sponsors rarely charge the employer any further ongoing annual fees. Employees are typically charged a nominal annual SIMPLE-IRA trustee fee of \$15 or \$20.
7. By providing a retirement plan to your employees, you are encouraging your employees to share the responsibility of funding their own retirement. It is hard for many people to save *any* money at all -- having some "help" from their employer may be the only retirement planning help your employees ever receive.

The SIMPLE Plan provides numerous benefits for both the employer and employee. Whether you are a one-person business or a small business with up to 100 employees, the SIMPLE Plan offers many nice perks.

## **How To Establish A SIMPLE Plan**

There are some specific requirements regarding the implementation of a SIMPLE Plan which are beyond the scope of this book. Be sure to consult a tax or investment professional to make sure you follow these rules properly. Setting up a SIMPLE Plan is not difficult or time-consuming, but a few forms must be completed, including Form 5304-SIMPLE.

A SIMPLE Plan is both a "tax vehicle" and an "investment vehicle." The employer sends in the money (both employee and employer contributions) to each employee's SIMPLE-IRA account. There are many investment options available for a SIMPLE-IRA, so you must consult with an financial institution which offers SIMPLE-IRA accounts.

## **LEGAL LOOPHOLE #10: Paying Yourself First Just Got Better!**

News flash!! News flash!! Believe it or not, the government recently changed the rules regarding SIMPLE Plans. From 1997 through 2000, the maximum employee contribution was \$6,000 per year. In 2001, the maximum employee contribution was \$6,500 per year. (And don't forget, for purposes of the SIMPLE Plan, an "employee" includes Sole Proprietors, Partners, and LLC Members, plus Corporation Shareholders who also work as an employee for the Corporation they own.)

Starting in 2002, the maximum amount that each employee can contribute to a SIMPLE Plan per year has been increased as follows:

<b><u>YEAR</u></b>	<b><u>BASE AMOUNT</u></b>	<b><u>Catch-up AMOUNT (age 50 or older)</u></b>
2002	\$7,000	\$500
2003	\$8,000	\$1,000
2004	\$9,000	\$1,500
2005	\$10,000	\$2,000
2006	\$10,000	\$2,500
2007	\$10,500	\$2,500
2008	\$10,500	\$2,500
2009	\$11,500	\$2,500
2010	\$11,500	\$2,500

Notice the column labeled "Catch-up Amount"? If you are 50 or older, this is an additional amount that you can contribute, on top of the Base Amount.

If you operate a profitable business and are looking for a way to both reduce your taxes NOW and put aside substantial amounts of money for LATER, this is a fantastic opportunity for the Small Business Owner.

By 2009, the SIMPLE Plan limits of \$11,500 and \$14,000 are comparable to the amounts that employees of large companies have been able to put into other more expensive retirement plans such as 401(k)s and 403(b)s. Finally, the government has done something good (for a change) for the Small Business Owner. TAKE ADVANTAGE OF IT!

If your business is just starting out, or you've been struggling lately just to break even, perhaps you're not in a position yet to save this kind of money for retirement. But at least now you are aware of what you CAN do for yourself once your business becomes profitable and you can afford to PAY YOURSELF FIRST!

Think about this: How many bills do you pay each month? How many OTHER people get your money. Too many to count? Probably. You deserve to PAY YOURSELF something each year -- something that continues to grow until you are ready to retire. Only you can START SAVING TODAY!

## LEGAL LOOPHOLE #11: How To Deduct All Your Medical Expenses

IMPORTANT NOTE: The Medical Reimbursement Plan (MRP) described below works best for "C" Corporations and Sole Proprietorships. "S" Corporations, Partnerships, and LLC's can also have a MRP, but the tax benefits are not as great.

One of the most misunderstood aspects of tax law concerns the deductibility of medical expenses. Many people may have a "vague idea" that medical expenses are deductible on their personal income tax returns, but over the years I have become acutely aware that most people are just plain "clueless" about this.

Yes, medical expenses are *potentially* deductible on your personal income tax return, provided you meet **both** of the following two conditions:

1. You itemize deductions on Schedule A.

So if you take the standard deduction, forget about deducting any medical expenses. And remember, it is only advantageous to itemize deductions if your total itemized deductions exceed your standard deduction.

2. Your medical deductions exceed 7.5% of your Adjusted Gross Income (AGI)

Adjusted Gross Income is simply your gross income less any "adjustments" like a deductible IRA contribution. As an example, let's say your AGI is \$50,000. Multiply \$50,000 times 7.5% to get the "magic number" of \$3,750. You can deduct medical expenses only to the extent that your medical expenses exceed \$3,750! In other words, your first \$3,750 of medical expenses are NOT deductible. If you have \$4,000 of medical expenses, the first \$3,750 ( $\$50,000 \times 7.5\%$ ) are non-deductible; only \$250 are deductible.

So you can see how tough it is to deduct medical expenses on your personal income tax return. The large majority of taxpayers are not eligible to take this deduction, and now that you understand how the rule works, it is easy to understand why.

Of course, many people are covered by an employer-sponsored health insurance plan, and often these plans provide excellent coverage at affordable group rates. So employees of large companies may not have to worry too much about medical expenses. There may be a deductible and co-insurance payments, so out-of-pocket medical costs may only be a few hundred dollars per year. And if a more major medical problem occurs, like a serious illness or accident, often a very high percentage (say 80% or 90%) of the employee's medical cost is covered.

But what about the small business owner like yourself. Now that you have formed your own business, you may not have an employer-sponsored health insurance plan to rely

on. Small business owners frequently must purchase health insurance on their own, and often must pay much higher insurance premiums than a large company gets on a group plan. And an individually purchased plan may not provide the same level of benefits -- resulting in higher deductibles, higher co-payments, and more out-of-pocket expenditures.

Well, there is a way for the small business owner to save taxes by deducting 100% of his/her medical expenses, including health insurance premiums. This strategy is known as a "Medical Reimbursement Plan" (MRP). The MRP utilizes IRS Code Section 105, which allows small business owners to deduct 100% of their insurance premiums and out-of-pocket medical expenses not covered by insurance.

Let's use the above example: You have \$4,000 of medical expenses. Assuming you have \$50,000 of AGI and are able itemize deductions on your personal income tax return, only \$250 of these medical expenses are deductible. If you are in the 15% federal income tax bracket, this will reduce your taxes by only \$38 ( $\$250 \times 15\%$ ).

Instead, your business establishes a Section 105 Medical Reimbursement Plan. Let's also assume that you are the business' only employee. So now you simply submit documentation of your medical expenses to your business (which is really just you!), and the business reimburses you the \$4,000. Now the full \$4,000 of medical expenses is fully deductible by the business as a legitimate business expense. Assuming the business is in the 15% tax bracket, this results in an income tax savings of \$600 rather than only \$38!

To make this arrangement even better, there are payroll tax savings as well. These reimbursed medical expenses (in the above example -- \$4,000) are not considered taxable compensation (i.e. wages or salary) to the shareholder/employee. Had this \$4,000 been paid to the shareholder/employee as wages/salary, the business and the employee would have paid of total of 15.3% in social security/medicare payroll taxes (7.65% paid by the business plus 7.65% paid the employee). So, \$612 in payroll taxes was saved by paying this \$4,000 as a tax-free fringe benefit rather than as taxable compensation.

Of course, the higher your medical expenses, the higher your tax savings. And don't forget that the MRP can reimburse you for both health insurance premiums and out-of-pocket medical expenses not covered by insurance.

To create the MRP requires some careful planning and formal paperwork. Here's an overview of what to do.

### **STEP ONE: Formal adoption of the Medical Reimbursement Plan**

The business must formally adopt a Section 105 Medical Reimbursement Plan, subject to the non-discrimination rules and regulations established by the Department of Labor. This means that you must offer the MRP to all employees who meet eligibility requirements, including any non-family employees.

A word of caution is in order here: If you have non-family employees who meet the eligibility requirements, you may not want to establish the MRP. It may be too expensive to pay all eligible employee medical expenses.

The most common situation for effective utilization of the MRP is a "one-person" corporation or a family-owned corporation in which all employees are family members. The most common example is a corporation which is 100% owned by one person, and that one person is the only employee of the corporation. Another good example would be a corporation with just a few family-member shareholders, and the only employees are the shareholders and immediate family-members of the shareholders. Then the corporation's liability to reimburse employee medical expenses is limited to the family members who own the corporation.

Another common scenario for the MRP to work well involves a Sole Proprietorship in which one spouse is the Owner of the business and the other spouse is an employee of the business.

This concept of "limited exposure" is critical because the MRP must comply with the non-discrimination rules and regulations of the Department of Labor. You, the employer, must establish the eligibility requirements that your employees must meet to participate in the plan. The following list of "eligibility requirements" show the *maximum* requirement allowed:

1. Hours -- Any employee working at least 25 hours/week must be included in the plan
2. Seasonal Employees -- Any employee that works at least seven months/year must be included in the plan
3. Age -- any employee over age 25 must be included in the plan
4. Current Employees -- Any current employee who has worked for you more than 36 months must be included in the plan
5. New Employee -- Any future employee who completes 36 months of service for you must be included in the plan.

A few comments about the about list of eligibility requirements:

◆ You may select any of these requirements up to the maximum allowed, but you are also permitted to select a lower requirement for participation. For example, if you choose to exclude employees based upon the number of hours worked, you may choose to exclude employees who do not complete 20 hours of work per week, even though the maximum exclusion is 25 hours per week. This would exclude any employee who works less than 20 hours/week, and would include any employee that works at least 20 hours/week.

- ◆ The ability to select a lower requirement applies to any of the regulations for participation in the MRP.
- ◆ Any of the regulations listed above may exclude an employee from participating in the MRP.
- ◆ IMPORTANT: If you choose not to select any eligibility requirements, all employees will be eligible for participation.

So, if you have non-family employees and you want to limit your reimbursement exposure, study these eligibility requirements closely. It may be possible to still hire non-family employees and legally exclude them from the MRP, provided you follow these MRP "setup" rules carefully. For example, you could utilize the 25 hour/week requirement to legally exclude all part-time employees. Maybe your business can be run with non-family employees only working part-time (25 hours/week or less). The only full-time employees (more than 25 hours/week) would be family-member employees.

This step of "formal adoption" of the MRP is critical. Plan documents must be created that meet the above-mentioned "non-discrimination rules and regulations" established by the Department of Labor. Do not treat this step lightly. If you think that your business is a candidate for a MRP, *please consult a tax professional*.

### **STEP TWO: Implementation of the Medical Reimbursement Plan**

Here's where common sense and good record-keeping come in to play. If this is a *real* Medical Reimbursement Plan, then the employee must submit *real* proof to the business of the employee's *real* medical expenses, and the business must *really* reimburse the employee for those expenses. In other words, the employee must provide receipts for the expenses and the business must then pay the employee for the expenses with a check from the business checking account.

It is critical that these simple paperwork procedures be followed. Do not treat the reimbursement procedure "casually."

## LEGAL LOOPHOLE #12: Keep It "All In The Family"

**IMPORTANT NOTE:** Legal Loophole #12 can apply to all types of business entities: Corporations (both "C" and "S"), Partnerships, LLC's, and Sole Proprietorships.

Yes, it is perfectly legal to put your child "on the payroll." This is a great tax-saving strategy for many family-owned and family-operated small businesses.

First things first, however. Be careful to pay close attention to the following guidelines:

1. The child must actually perform the work for which he/she is paid.
2. The compensation must be "reasonable."
3. The work done by the child must be necessary for the business. In other words, if your child did not do the work for which they were paid, the business would have had to hire someone else to do it.

These guidelines are merely common sense. Simply put, your child must be treated like any other "real" bona fide employee.

Now, here's why this strategy can save you significant tax dollars:

1. A child who can be claimed as a dependent on your personal tax return is still entitled to claim a standard deduction on his/her own personal tax return. For 2009, the standard deduction for a dependent child can be as much as \$5,700.

So, a child employed by his parent's business could earn up to \$5,700 of wages *tax-free!*

2. The child's wage expense is a legitimate business expense, fully deductible on the parent's business tax return.

The end result: Within the family, up to \$5,700 has been paid by the business to the child. The business deducts the wage expense, thereby reducing the business' profit. The child receives a W-2 and reports the wages on his/her personal tax return, but if the wage amount is \$5,700 or less, the child will pay no income tax on this earned income.

Should the child receive more than \$5,700 of wages, there is still significant tax savings. The first \$5,700 is tax-free income. All wages above \$5,700 will be taxed at the child's income tax rate (probably 10% for federal tax purposes), which is likely to be much lower than the parent's income tax rate. For example, if the parent is in the 28% tax bracket, the family unit has saved 18% (28% - 10%) of the wage amount over \$5,700.

3. If the child is age 17 or younger and your business is a Sole Proprietorship, a single-member LLC, or a husband-wife partnership, here's another great tax benefit to hiring your child: the child's wages are not subject to Social Security and Medicare taxes.

This is another great loophole that can put thousands in your pocket every year.

Have *real* businesses actually implemented this strategy successfully? You bet! Here's a "real life" example, taken from actual Tax Court records:

*The Facts:*

The taxpayers owned a mobile-home park and hired their three children, aged 7, 11, and 12 to work there. The children cleaned the grounds, did landscaping work, maintained the swimming pool, answered phones, and did minor repair work. The taxpayers deducted \$17,000 of wages paid to the children over a three-year period. But the IRS objected and the case went to trial.

*Court's Decision:*

Over \$15,000 of wage deductions were approved. Most of the deductions that were disallowed were attributable to the 7-year old. But even \$1,200 of his earnings were approved by the Court.

So, this strategy has been effectively used, in spite attempts by the IRS to disallow such child employee wages. If you have children who can perform tasks essential to the operation of your business, give this strategy serious consideration.

## **LEGAL LOOPHOLE #13: "Depreciation?" -- FORGET ABOUT IT!**

**IMPORTANT NOTE:** Legal Loophole #13 can apply to all types of business entities: Corporations (both "C" and "S"), Partnerships, LLC's, and Sole Proprietorships.

Depreciation expense is one of the most complex and convoluted areas of tax law. Over the years, lawmakers have seemingly gone out of their way to unnecessarily complicate a very routine business practice: how to deduct the cost of business property.

(And if you don't mind me saying so, depreciation tax laws are just another example of why I'm convinced that politicians must be sniffing glue whenever they create new tax laws.)

For the typical small business owner, the concept of depreciation can seem very foreign at first. (Have you ever looked at these depreciation rules? I mean, we are talking about some really wacky stuff. When I say that depreciation is a "foreign" concept for the average small business owner to grasp, I mean *really* foreign -- like you might as well be reading Greek.)

Many other expenses, like telephone expense, utilities expense, office supplies, salary and wages, are simply deductible in the year in which the expense was incurred. If you pay for something business-related, you normally get to deduct that cost immediately.

One of the major exceptions to the above-mentioned "general rule" concerns "depreciable property," which is defined as property which meets the following basic requirements:

- ◆ The property must be used in business or held to produce income.
- ◆ The property must have a determinable useful life longer than one year.
- ◆ The property must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

The most common types of depreciable property for small business owners include office furniture, office equipment, machinery, vehicles, and buildings.

Now here's where things start to get complicated. If you buy a piece of property for use in your business, like a computer or a printer, this item is not treated like office supplies or the electric bill. Just because you paid for it in 2010 (or any other year) doesn't mean you get to deduct the purchase price in 2010. Instead, you have to deduct the purchase price over a certain number of years, depending on what "asset class" the item belongs to. It could be 3 years, 5 years, 7 years, 10 years, 15 years, 20 years, and for real estate, as much as 27.5 years or 39 years. The tax law has "classified" just about every

conceivable type of depreciable property into so many categories that it boggles the mind. (Believe me, I've had to look at these categories so many times, my mind has truly been "boggled.")

And there is a literal boatload of obscure rules regarding different ways to calculate what percentage of the purchase price gets deducted each year over the 3-year period or 5-year period, or whatever time period applies. There are several "acceptable" methods, each with their own peculiarly stupid rules and exceptions to rules. It's quite a system!

But enough of my droning on and on about these insane depreciation rules. For most small business owners there is a way out of this mess. Fortunately, the "powers that be" had enough sense to pass legislation that provides a significant "exception" to all these depreciation rules. This "exception" is known as the "Section 179 Deduction" and if you apply the provisions of Section 179, you will probably be able to fully deduct most, if not all, of your business equipment costs in the year of purchase, rather than having to wait any number of years to write off the cost.

Of course, there are rules regarding *what types* of property can and cannot be deducted under Section 179, and there are also rules regarding *how much* property can be deducted under Section 179. Do not despair. I'll give you the most important features of Section 179 that most likely apply to you, the small business owner.

### **What Types of Property Can Be Deducted Under Section 179?**

Generally, tangible personal property can be 100% deducted in the year of purchase rather than depreciated over several years. "Tangible personal property" includes many commonly purchased items for use in a small business: office equipment (including computers, monitors, printers, scanners), office furniture, machinery, and tools.

The major category of property that *cannot* be deducted under Section 179 is real property, including buildings and their structural components.

### **How Much Property Can Be Deducted Under Section 179?**

Over the past few years, the maximum amount of the Section 179 deduction has gradually increased to \$24,000 in Year 2002. Then, in 2003, things got even better -- due to legislation passed in May 2003, the maximum skyrocketed up to \$100,000. This is a great way for small business owners to finally forget about depreciation and get a much bigger tax break right away -- in the year of purchase -- instead of waiting 5 or 7 years to get the tax benefits of equipment purchases.

The Tax Code had been increasingly generous to Small Business Owners over the past few years – note how the total cost of deductible Section 179 property has increased:

<u>Tax Year</u>	<u>Maximum Amount Deductible</u>
2000	\$20,000
2001 -- 2002	\$24,000
2003	\$100,000
2004	\$102,000
2005	\$105,000
2006	\$108,000
2007	\$125,000
2008	\$250,000
2009	\$250,000
2010	\$134,000

At first glance, the Section 179 deduction looks simple and straightforward. And for many small businesses, it is. But like most areas of tax laws, there are exceptions. What would a "good" tax rule be without a few "good" exceptions to the rule!

There are several exceptions to the Section 179 rule. Here are the two most important ones to keep in mind:

### **Exception #1: The Investment Limit**

The Investment Limit is \$800,000 for 2009 and \$530,000 for 2010. If you purchase more than \$800,000 of Section 179 property in 2009, then the amount of your Section 179 deduction is reduced as follows:

For each dollar of Section 179 property purchased over \$800,000, reduce the maximum amount deductible by one dollar.

Example. In 2009, XYZ Corp purchased equipment costing \$825,000. Because this cost is \$25,000 more than \$800,000, XYZ must reduce its maximum deductible amount of \$250,000 by \$25,000. The maximum Section 179 deduction for XYZ Corp in 2009 would be \$225,000 rather than \$250,000.

**IMPORTANT POINT:** Most small businesses are unlikely to purchase over \$800,000 of equipment in a single year, so chances are you do not need to worry about this "Investment Limit."

### **Exception #2: The Taxable Income Limit**

The total Section 179 deduction is limited to the business' profit for the year. So if your 2009 profit is at least \$250,000, you can deduct up to \$250,000 of Section 179 property. If your profit is \$10,000, you can deduct up to \$10,000 of Section 179 property, and so on. If you just "broke even" or had a loss, you cannot take the Section 179 deduction.

Any cost that is not deductible in one tax year because of this "taxable income limit" can be carried over to the next tax year.

For some new businesses, this "taxable income limit" may apply. It is not uncommon for a new business to lose money in its early years, or to just break even. If that's the case, you may have to depreciate property until your business becomes profitable (sorry about that!).

### **Other Important Rules Regarding Section 179**

There are some other critical rules governing the Section 179 deduction which are beyond the scope of this book. The primary purpose of this chapter is to provide an introductory overview of the concept, not delve into all the details. Many small businesses qualify for the Section 179 deduction for all their business property. If your business purchased equipment, please consult a tax professional to make sure you qualify for the Section 179 deduction.

And by taking advantage of this deduction, you gain two main benefits:

1. You avoid the complicated task of tracking depreciation;
2. You get to fully deduct the purchase price of property immediately. Why deduct something over several years when you can deduct it all right away?

## LEGAL LOOPHOLE #14: How To Deduct Your Vacations!

**IMPORTANT NOTE:** Legal Loophole #14 can apply to all types of business entities: Corporations (both "C" and "S"), Partnerships, LLC's, and Sole Proprietorships.

Over the years, tax law changes have made it increasingly difficult to deduct travel-related expenses. But there are still several legitimate deductions you can take for travel, so make sure you take advantage of the following items.

### Travel Expenses for Business Trips

The key to deducting travel expenses is this: *What is the primary purpose of the trip?* If the *primary* purpose is a business one, then you can deduct the cost of traveling to and from your destination, even if you stay a few extra days to enjoy pleasure-related activities. If the primary purpose is business-related, you can also deduct travel expenses even if you take a "side trip" for pleasure during the visit .

Here's an example: You travel to Chicago on Monday for a 5-day business conference which concludes on Saturday morning. After the conference is over, you decide to stay in Chicago for a couple more nights to enjoy the sights. Your travel expenses between home and Chicago are fully deductible (if you traveled by plane, the air fare is deductible; if you rented a car, the cost of the rental car plus gasoline; if you drove your own car, then you could take a mileage deduction or the actual cost of gasoline, depending on your particular situation). From Monday through Saturday morning, you can deduct the cost of your lodging, local transportation and 50% of meals and business-related entertainment. After the conference is over, (from Saturday afternoon through your departure on Monday), the lodging, local transportation, meals and entertainment expenses are not deductible because that part of your trip was not business related.

### What About Mixing Business With Pleasure?

Again, the key factor is *the primary purpose* of the trip. If you take a trip *primarily* for pleasure (like the traditional "family vacation"), then the cost of traveling to and from your destination is not deductible. This is the case even if you happen to engage in some business activity during the trip. But be aware that on a trip taken primarily for pleasure, you may incur some isolated business-related expenses that can be deducted.

Here's another example: You take a one-week vacation to Chicago. During the trip, you meet a customer (who happens to live there) for lunch. You can still deduct 50% of the meal, as long as business discussion occurred during the meal. Also deductible would be tax, tips, and parking-lot fees, as well as local transportation costs to get to the restaurant.

## **Plan Your Trips Accordingly!**

With these rules in mind, make travel plans accordingly. When you go to another city on business, check out the possibility of staying a few extra days to "play", especially if this is an area that you would likely travel to for vacation anyway. As long as the main purpose of the trip is business-related, you can enjoy considerable tax savings while enjoying a good time!

## LEGAL LOOPHOLE #15: How To Turn Taxable Income Into Tax-Free Income!

IMPORTANT NOTE: Legal Loophole #15 is available to owners of any type of business. In fact, you do not even have to own a business to implement this strategy -- but it is the best technique I know of to legally avoid income tax, so I could not resist including it in this ebook.

There is a perfectly legal way to turn taxable income into tax-free income! Honest! Technically, you do not even have to own a small business to implement this strategy. The vast majority of average, middle-class taxpayers can do this.

IRA's have been around for years. Many Americans have taken advantage of the "Traditional" tax-deductible IRA, which has been a great way to both save taxes and save for retirement.

Recently, a new type of IRA was created -- it's called the "Roth IRA". This Roth IRA is how you can legally turn taxable income into tax-free income, and save literally thousands of dollars.

Roth IRA contributions are not tax-deductible. Instead, if the following two conditions are met, *withdrawals from the Roth IRA are tax-free:*

1. The Roth IRA owner is age 59 1/2 or older
2. The Roth IRA account has been open for at least five years.

The Roth IRA offers a very rare opportunity to receive TAX-FREE INCOME -- legally!

Remember this: Most Retirement Plan contributions (like employer-sponsored 401k and 403b Plans) and "Traditional" IRA contributions are tax-deductible now, and the growth of those contributions is also "tax-sheltered" while the funds remain in the account. ***But eventually all tax-deductible Retirement Plan contributions and all tax-deductible "Traditional" IRA contributions, as well as the growth of those contributions, will be subject to income tax when the money is withdrawn from the account.***

In other words, Retirement Plans and Traditional IRA's offer the opportunity to **POSTPONE** taxes. Retirement Plans and Traditional IRA's enable you to save taxes --- **BUT THESE TAX SAVINGS ARE TEMPORARY.**

This is the *big difference* between  
 Retirement Plans/Traditional IRA's and Roth IRA's:

Retirement Plans and Traditional IRA's allow you to *temporarily* **POSTPONE** taxes.

The Roth IRA offers the opportunity to *permanently* **AVOID** taxes.

Here's how much *tax-free* income you can potentially earn in a Roth IRA:

**Assumptions:**

Annual contributions:	\$2,000/year x 20 years
Total contributions:	\$40,000
Average annual total return:	10%
Roth IRA account balance after 20 years:	\$126,005
<b>AMOUNT OF TAX-FREE INCOME:</b>	<b>\$ 86,005</b>

This is truly an amazing calculation: If you invest \$2,000 per year for 20 years into a Roth IRA, you will have invested a total of \$40,000. Now if that Roth IRA earns an average of 10% per year, that \$40,000 will grow into \$126,005.

No.	Date	Deposit Amount	Interest Amount	Interest Rate/Yr.	Deposit+ Interest	Balance
1	Jan 1, 2000	2000.00	0.00	0.000	2000.00	2000.00
2	Jan 1, 2001	2000.00	200.00	10.000	2200.00	4200.00
3	Jan 1, 2002	2000.00	420.00	10.000	2420.00	6620.00
4	Jan 1, 2003	2000.00	662.00	10.000	2662.00	9282.00
5	Jan 1, 2004	2000.00	928.20	10.000	2928.20	12210.20
6	Jan 1, 2005	2000.00	1221.02	10.000	3221.02	15431.22
7	Jan 1, 2006	2000.00	1543.12	10.000	3543.12	18974.34
8	Jan 1, 2007	2000.00	1897.43	10.000	3897.43	22871.78
9	Jan 1, 2008	2000.00	2287.18	10.000	4287.18	27158.95
10	Jan 1, 2009	2000.00	2715.90	10.000	4715.90	31874.85
11	Jan 1, 2010	2000.00	3187.48	10.000	5187.48	37062.33
12	Jan 1, 2011	2000.00	3706.23	10.000	5706.23	42768.57
13	Jan 1, 2012	2000.00	4276.86	10.000	6276.86	49045.42
14	Jan 1, 2013	2000.00	4904.54	10.000	6904.54	55949.97
15	Jan 1, 2014	2000.00	5595.00	10.000	7595.00	63544.96
16	Jan 1, 2015	2000.00	6354.50	10.000	8354.50	71899.46
17	Jan 1, 2016	2000.00	7189.95	10.000	9189.95	81089.41
18	Jan 1, 2017	2000.00	8108.94	10.000	10108.94	91198.35
19	Jan 1, 2018	2000.00	9119.83	10.000	11119.83	102318.18
20	Jan 1, 2019	2000.00	10231.82	10.000	12231.82	114550.00
	<b>Jan 1, 2020</b>		11455.00	10.000		<b>126,005.00</b>

Now comes the fun part: **You can withdraw the entire \$126,005 TAX-FREE.**

Remember, you did not deduct the \$2,000 per year of Roth IRA contributions -- these contributions were made with "after-tax dollars."

**But the "growth" of your contributions is \$86,005 -- and this entire \$86,005 is tax-free income.**

Now comes the *really* fun part! Had you put this same \$40,000 into a tax-deductible Retirement Plan or Traditional IRA, you would have saved some taxes each year, and the annual earnings growth would have accumulated tax-postponed for 20 years. But when you withdraw the \$126,005 during retirement, you will receive \$126,005 of taxable income.

But since this \$40,000 has been invested in a Roth IRA, you will end up paying literally thousands of dollars less tax. How much less tax?

Let's assume that you are in the 15% federal income tax bracket:

$$\mathbf{\$86,005 \times 15\% = \$12,901}$$

Assuming you pay 5% in state income tax, you would realize even more tax savings:

$$\mathbf{\$86,005 \times 5\% = \$4,300}$$

**NOTE: Your state and/or local income tax will likely be different than 5%. But I'm including the 5% in this example as a reminder that most folks do have state and local income tax, which should also be factored in to the tax-saving equation.**

**So, for taxpayers in the 15% federal income tax bracket,  
the total federal and state income tax savings equals \$17,201.**

And if you happen to be in a higher federal income tax bracket, the savings are even more significant.

**For taxpayers in the 28% federal income tax bracket,  
the total federal and state income tax savings equals \$28,382.**

Think about it: If you invest \$2,000/year for 20 years in a Roth IRA instead of a Retirement Plan or Traditional IRA, you would end up paying \$28,382 less tax -- during your retirement years! Don't you think that money will come in handy when you are retired?

Of course, understanding the advantages of a Roth IRA takes a "long-term perspective". Many people may prefer to temporarily reduce taxes now (by contributing to tax-deductible Retirement Plans and/or Traditional IRA's) rather than permanently avoid taxes later. That's a personal decision that only you can make -- and it can be a very tough choice.

Other factors can come into play, too. The above examples assume that your federal income tax rate during your working years will remain the same during your retirement years. This may not be the case. For many people, their income is reduced during retirement years and so they find themselves in a lower tax bracket during retirement years.

EXAMPLE: If you make tax-deductible Retirement Plan and/or Traditional IRA contributions while in the 28% federal tax bracket, and then during retirement make taxable withdrawals in the 15% bracket, you will realize a *permanent* tax savings of 13%. So making tax-deductible contributions is not without merit in some situations.

Another situation that can compel one to contribute to an employer-sponsored Retirement Plan: many employers offer a "matching program" that rewards the employee for making tax-deductible contributions. These matching employer contributions can add thousands of dollars to your retirement savings -- money that you would not have received had you not participated in the Retirement Plan. Sure, you have to pay tax on this money when you make withdrawals many years later, but you are paying tax on "free" money -- money literally *given* to you by your employer.

So, there are several viable alternatives to choose from when saving for retirement. Unless you are independently wealthy already, you need to be doing something to save for retirement. Do you really think Social Security will be enough to live on 20 or 30 years from now? And fewer and fewer employers even offer the old-style employer-funded "pension". And if your new business is your sole source of income, you are "on your own" to fund your own retirement. The SIMPLE Plan (discussed in Legal Loophole #8) is a great way to make tax-deductible retirement plan contributions. And the Roth IRA is a great way to make after-tax contributions that can turn into tax-free income.

Sorting out these options *from a tax standpoint* is a challenging task. In addition, you must also make retirement planning decisions *from an investment standpoint*, too. What is a Retirement Plan? What is a Traditional IRA? What is a Roth IRA? Are these primarily **tax-related** accounts or **investment-related** accounts? Obviously, they are ***both*** tax-related ***and*** investment-related.

Once you decide which kind of retirement savings account is best for your ***from a tax standpoint***, you must then decide what kind of ***investment*** to put your contributions into. Now you really have some choices to make. There are literally hundreds of ways to invest your Retirement Plan and/or IRA money.

If you are comfortable making all these decisions on your own, great. But for many people, seeking the advice of a competent tax and investment professional can make a big difference.

## **LEGAL LOOPHOLE #16: How To Turn EVEN MORE Taxable Income Into Tax-Free Income!**

More good news from Washington! Congress and the President passed new laws in 2001 that increase the maximum amount of money that you can contribute to a Roth IRA.

Instead of \$2,000 per person per year, here are the new amounts:

### **HIGHER CONTRIBUTION LIMITS FOR ROTH IRA'S**

<u>YEAR</u>	<u>AMOUNT</u>	<u>50 &amp; Older Catch-up</u>
2002	\$3,000	\$500
2003	\$3,000	\$500
2004	\$3,000	\$500
2005	\$4,000	\$500
2006	\$4,000	\$1,000
2007	\$4,000	\$1,000
2008	\$5,000	\$1,000
2009	\$5,000	\$1,000

So, what does this mean for the Small Business Owner? It means that the amount of tax-free income you can accumulate (as calculated in the previous section) has just been dramatically increased. Within a few years, you will be able to put at least twice as much into a Roth IRA as before.

If you take advantage of these increased Roth IRA contribution limits, the amount of tax-free income you can receive in retirement has just been doubled (at least)! If you start putting \$4,000 (instead of \$2,000) into a Roth IRA for the next 20 years, go back to the number in the previous section and **DOUBLE THEM ALL**. You'll get twice as much tax-free income, and your actual tax savings will be twice as much.

## **LEGAL LOOPHOLE #17: How To Procrastinate Your Way To Tax Savings! (Part I)**

I've always liked that old saying, "Why do it today when you can put it off until tomorrow." When it comes to taxes, truer words were never spoken!!!

I hate taxes. And I hate paying taxes.

Not only do I hate taxes, but I hate having to pay taxes any sooner than necessary. Why pay taxes today when you can put it off until tomorrow.

But sooner or later, if you have taxable income, you are going to have to pay The Man. But at least there are some legal loopholes that allow you to legitimately postpone the payment of your taxes as long as possible, without any extra penalty or interest charges.

Think about it. It's your money. Yes, part of it has to go to the government eventually. But until that time comes, until the official Day of Reckoning is upon you, why not hang on to your hard-earned dollars as long as possible? You get to earn more interest on your money, and you get to use that money for short-term cash flow needs.

Here's a little-known legal loophole that lets you wait all the way until April 15 to pay the final amount of tax due -- it's known as the "Safe Harbor Method". Here's how it works.

Let's say you are doing some tax planning for Year 2010, and you are trying to figure out when to pay your income taxes for Year 2010. Let's further assume that your business is one of the following types: Sole Proprietorship, Partnership, or Limited Liability Company (LLC).

(NOTE: for Corporations, both "S" and "C", see the next section, Legal Loophole #18, for additional tips on how to legally procrastinate the payment of taxes.)

Since you are a Sole Proprietor, Partner, or LLC Member, you probably have to make quarterly estimated income tax payments via Form 1040-ES. And of course, in the government's infinite and wacky wisdom, these "quarterly" payments are due April 15, June 15, September 15, and January 15.

Rather than basing your quarterly income tax payments on projected or actual 2010 income, you can pay your Year 2010 tax based on your Year 2009 tax liability. You just go to your Year 2009 personal tax return, take the amount of federal income tax you paid for the whole year (your TOTAL **annual tax liability**, not the balance due), and divide that amount by four.

What you have just calculated is the *minimum* amount of federal tax you have to pay for Year 2010. It doesn't matter what your actual tax liability ends up being on the Year 2010 income tax return. During 2010, as long as you pay the Year 2009 tax liability amount in 4 equal installments, then you can wait until April 15, 2011 to pay the rest, without any penalty or interest.

This is a great strategy when your income goes up from one year to the next, for at least 2 reasons:

1. You get to keep some of your money until April 15 of the next year, giving you at least 3 1/2 months to earn interest on that money or to use that money for other short-term needs.

2. You don't have to worry about figuring out exactly what your current year tax liability is going to be until after the year is over.

Keep in mind, of course, that this isn't such a great idea if your income decreases significantly from one year to the next. Why? Because then you end up paying in more than you were required (which I just absolutely hate to do!). You'll end up getting a refund, but it just irritates me to no end to let the government have more of my money than I'm legally required to give them.

So, if your income decreases substantially, then you shouldn't use the Safe Harbor Method. You are probably better off calculating your actual tax liability during the year and paying quarterly estimates based on those current year calculations.

NOTE: The "Safe Harbor Method" for Higher Income Taxpayers is a bit different. If your adjusted gross income was more than \$150,000 (\$75,000 if you are married filing a separate return), you must deposit the smaller of 90% of your expected tax for 2010 or 110% of the tax shown on your 2009 return to avoid an estimated tax penalty.

## **LEGAL LOOPHOLE #18: How To Procrastinate Your Way To Tax Savings! (Part II)**

Now here is definitely one of the least-known "Little-Known" Legal Loopholes I know of. Very few people know about this one, believe me.

Also, this loophole only works if you are a Corporation (either "S" Corporation or "C" Corporation). If you are a Sole Proprietorship, Partnership, or LLC taxed like a Sole Proprietorship or Partnership, this loophole just won't work for you. SORRY!! But this is yet another reason to form an "S" Corporation.

Here's how it works:

If you are a Corporation Shareholder/Employee, you can literally wait until the last day of the year to pay your taxes for the whole year. You simply wait until December 31 to create a paycheck for yourself. On this final paycheck, you can deduct your entire federal income tax liability for the year. Then the corporation will eventually pay this income tax withholding amount to the government via Form 8109 (Federal Tax Deposit Coupon) or via the Electronic Federal Tax Payment System (EFTPS).

Usually, small businesses have until the 15th of the next month to deposit employee withholding amounts. So the taxes withheld on December 31 would actually be paid to the IRS by January 15 of the next year.

You may be asking yourself a couple questions right now, such as, "How can I get away with waiting until the last day of the year to pay my taxes? Doesn't the government require me to 'pay-as-you-go'."

The answer to that question is, Yes, our tax payment system does operate on a "pay-as-you-go" basis. And most employees who work for a company must have taxes withheld from every paycheck. Generally, employees cannot wait until the last day of the year to pay their taxes. It just wouldn't work. Their gross wage amount wouldn't be enough to cover the withholdings, anyway.

Likewise, self-employed people (like Sole Proprietors, Partners, and LLC Members) who make quarterly estimated tax payments also have to make equal payments throughout the year. The "Safe Harbor" method discussed in the previous section only avoids penalties and interest if the payments are made in equal amounts.

But as the Corporation's owner, you have much more control over your payroll system and your cash flow situation. So if you are in a position to do so cash flow-wise, you can wait until December 31, prepare one paycheck from which you withhold most (or even all) of your income tax for the year, and then pay it all at once by January 15th.

Here's why this is a perfectly legal loophole: This federal income tax which was withheld from your December 31 paycheck is reported on your Form W-2, which the Corporation will give to you as an employee. Specifically, it is reported on Form W-2 in Box 2, "Federal Income Tax Withheld." ***No matter when the W-2/Box 2 amount was actually withheld from the employee's paycheck, the amount reported in W-2/Box 2 is treated as if it was withheld in equal installments throughout the year.***

Do you see why this can be a great strategy for you to hang on to your money as long as possible? Again, assuming you can afford to wait this long, you can keep control of your money for many months before turning it over to the IRS. You could use the money for short-term operating capital, or just keep it in an interest-bearing account.

## **LEGAL LOOPHOLE #19: How To Legally Avoid Tax On Stock Dividends**

You have probably figured out by now that I'm a big fan of the "S" Corporation. For many Small Business Owners, it is definitely the way to go. You can dramatically reduce your taxes by switching to an "S" Corporation, regardless of what kind of legal entity you currently own.

I'm the first to admit, however, that there are some advantages to legal entities other than the "S" Corporation. If you are a "C" Corporation, here's a great way to legally avoid tax. And believe me, there are very few times in the Tax Code when Uncle Sam lets you AVOID tax. Most legal loopholes are able to help you reduce your tax, minimize your tax, or temporarily postpone your tax. But to AVOID tax -- legally -- just doesn't happen very often in the tax code. Here's one time where it does occur, and it happens to apply to "C" Corporations only.

(For a more complete discussion of the tax advantages of the "C" Corporation, see "Incorporation Tax Secrets Revealed" at <http://www.YouSaveOnTaxes.com/incorp.>)

If your "C" Corporation owns less than 20% of the stock in another U.S. company, and that other company's stock pays dividend income to your "C" Corporation, then your "C" Corporation can avoid tax on 70% of those dividends. Not bad, eh?

The same type of rule also applies to companies in which your "C" Corporation owns 20% or more of the stock. It gets even better, though -- your Corporation gets to avoid tax on 80% of the dividend income from a "20% or more" company.

So if your "C" Corporation owns dividend-paying stock, be sure to take advantage of this legal loophole.

And if you own a "C" Corporation and are thinking about buying stock for your personal account, you should seriously consider having the Corporation purchase the stock.

What if you don't own a "C" Corporation? What if you own an "S" Corporation, Partnership, or LLC taxed like an "S" Corp or Partnership? Sorry, there's no way to avoid tax on the dividends. The dividend income is reported on the tax return of the "S" Corporation, Partnership or LLC, but the business doesn't pay any tax on that dividend income. Instead, the dividend income is reported on each owner's Schedule K-1, and the end result is that this income is reported on the owner's personal income tax return.

So there is no tax advantage to owning stock in the name of an "S" Corporation, Partnership, or LLC taxed like an "S" Corp or Partnership.

## **LEGAL LOOPHOLE #20: What A Difference A "Bracket" Can Make!**

Here is another potential tax advantage of the "C" Corporation over the other 4 business entity types (Sole Proprietorship, "S" Corporation, Partnership, and Limited Liability Company): At certain income levels, the "C" Corporation owner may end up paying less income tax than the owner of these other 4 entities. Why is that? Let me explain.

First, keep in mind that these other 4 business types all pay the same amount of income tax on business profit. Here's why:

### **Sole Proprietorship**

The Sole Proprietor reports business profit directly on his/her personal income tax return via Schedule C. End result: any business profit is subject to the Sole Proprietor's regular personal income tax rate.

### **"S" Corporation**

Even though the "S" Corporation files a separate corporate income tax return (Form 1120S), the "S" Corporation ends up paying no corporate income tax on that Form 1120S. Instead, the "S" Corporation shareholders receive a Schedule K-1 from the corporation which reports each shareholder's proportionate share of the corporation's profit (or loss). The shareholder then reports the K-1 corporate profit on his/her personal income tax return. End result: the corporate profit is subject to the owner's regular personal income tax rate.

### **Partnership**

Same situation as "S" Corporation, except the business return is called a Form 1065. Each Partner receives a Schedule K-1. End result: Partnership profit is subject to the Partner's regular personal income tax rate.

### **Limited Liability Company -- multi-member**

Identical to Partnership. Owners of LLC are treated just like the Partners in a Partnership. (Sometimes LLC "owners" are called "Members".)

### **Limited Liability Company -- single-member**

Identical to Sole Proprietorship. The single-member LLC reports the business as part of his/her personal income tax return via Schedule C.

And what are those personal income tax rates? Here's the personal income tax rates for Tax Year 2009 (assuming that you file Married Filing Jointly):

**PERSONAL INCOME TAX RATES FOR 2009  
(MARRIED FILING JOINTLY)**

<b>TAXABLE INCOME</b>	<b>TAX RATE</b>
0 - 16,700	10%
16,701 - 67,900	15%
67,901 - 137,050	25%
137,051 - 208,850	28%
208,851 - 372,950	33%
372,951 and over	35%

Now, compare the above personal income tax rates to the "C" Corporation income tax rates.

**"C" CORPORATION INCOME TAX RATES FOR 2009**

<b>TAXABLE INCOME</b>	<b>TAX RATE</b>
0 - 50,000	15%
50,001 - 75,000	25%
75,001 - 100,000	34%
100,001 - 335,000	39%
335,001 - 10,000,000	34%
10,000,001 - 15,000,000	35%
15,000,001 - 18,333,333	38%
18,333,334 and over	35%

Now, here comes the punch line.

Let's assume you are married (and filing jointly), and you are the only shareholder of a "C" Corporation which has \$50,000 of profit. The corporation will therefore pay \$7,500 of corporate income tax on that profit (\$50,000 x 15%).

How much income tax would you have to pay on the \$50,000 profit if you were a Sole Proprietorship, "S" Corporation, Partnership, or LLC? That's depends on the amount of taxable income you have from sources other than the business.

For example, let's assume your spouse is employed and has at least \$67,900 of *taxable* income from that job. Now look at the personal income tax table above. See how it works? The first \$67,900 of taxable income is taxed at 2 different rates -- the first \$16,700 is taxed at 10%; the next \$51,200 is taxed at 15%, and then any taxable income above \$67,900 is taxed at 25%. Your wife's \$67,900 of taxable income puts you in the 25% tax bracket, and now ***all additional income above \$67,900 will be taxed at 25%***.

So, if you now add your \$50,000 of business profit (from a Sole Proprietorship, "S" Corporation, Partnership, or LLC) to your wife's \$67,900 of taxable income, ***that entire \$50,000 will be taxed at 25%***. The end result: you pay \$12,500 of personal income tax (as a Sole Proprietor, "S" Corporation, Partnership, or LLC) instead of \$7,500 of corporate income tax. That's a difference of \$5,000. And obviously, that's a big difference!

This subject of "which business entity type is best for me" can get a bit complicated. The above example may or may not be applicable to your situation, and I did not include this example to confuse you. Rather, I'm just trying to point out that at certain levels of income, you may end up paying less income tax as a "C" Corporation compared to the other business types.

Also keep in mind that the above example assumes that the "C" Corporation shareholder did not need (or want) to distribute the \$50,000 as dividends. Instead, the "C" Corporation chose to retain the profits in the business, perhaps to fund expansion or provide operating capital. Had the "C" Corporation made a \$50,000 dividend payment to the shareholder, then that \$50,000 would be taxed again on the shareholder's personal tax return -- and so be subject to the dreaded "Double Taxation of Corporate Profits" discussed in Legal Loophole #6.

## **LEGAL LOOPHOLE #21: How To Pay Less Tax On An "Early Retirement"**

Many Small Business Owners have retirement plan and/or IRA assets that they would like to access during the early years of their business. For example, you might have been an employee for a larger company for many years prior to starting your own business. You've built up quite a nest-egg in that company's retirement plan over the years, and now you've decided to "go it alone."

While your new business is getting started, you may need to access your retirement plan or IRA funds to "make ends meet." Hey, don't feel bad! Many new business owners (and even experienced "veteran" business owners) have cash flow "crunch times", when the business just isn't making enough money to support the owner.

So there sits your retirement plan or IRA. Sure, you hate to dip into the money you were going to reserve for your Golden Years, but sometimes this may be your only option, or at least it may be the best option available to you. Again, don't feel bad -- it happens!

One of the major disadvantages of taking money out of your IRA or retirement plan is simply this: any withdrawals will be subject to income tax. There is no way to avoid this. The money you put into the IRA or retirement plan was not subject to income tax, and all the growth of your contributions has legally avoided income tax while in the account, so when you take money out of the account, the withdrawals are considered taxable income.

A second major disadvantage of an IRA or retirement plan withdrawal has to do with how old you are. If you are younger than 59 1/2 years old, the withdrawal is considered an "early withdrawal" or "premature distribution", and as such it is subject to an additional 10% penalty!

There are several exceptions to the 10% early withdrawal penalty, for both IRA's and retirement plans.

For IRA's, the exceptions include withdrawals made due to death, disability, certain health insurance premiums for the self-employed, higher education expenses, first-time home purchase, certain medical expenses, and an IRS tax levy.

For employer-sponsored retirement plans like a 401k, the exceptions include withdrawals made due to death, disability, retirement after age 55, medical expenses, and an IRS tax levy.

There is another exception to the 10% early withdrawal penalty that applies to both IRA's and retirement plans. It is known as "**The Substantial and Equal Periodic**

**Payment"** exception. Sometimes it is also referred to as the "Annuity Exception" or "Section 72t Withdrawal."

Here's how it works:

You can receive distributions from your traditional IRA or retirement plan that are part of a series of substantially equal payments over your life (or your life expectancy), or over the lives (or the joint life expectancies) of you and your beneficiary, without having to pay the 10% additional tax, even if you receive such distributions before you are age 59 1/2.

You must use an IRS-approved distribution method and you must take at least one distribution annually for this exception to apply. The easiest method to use is generally referred to as the "Life Expectancy Method." This method, when used for this purpose, results in the exact amount required to be distributed, not the minimum amount.

There are two other IRS-approved distribution methods that you can use. They are generally referred to as the "amortization method" and the "annuity factor method." These two methods are not discussed in this book because they are more complex and generally require professional assistance. See IRS Notice 89-25 in Internal Revenue Cumulative Bulletin 1989-1 for more information on these two methods. This notice can be found in many libraries and IRS offices.

Here is the most important thing to understand about this Substantial and Equal Periodic Payment rule:

***The payments under this exception must continue for at least 5 years, or until you reach age 59 1/2, whichever is the longer period.***

So, once you have determined how much you must withdraw each year, those withdrawals must continue for at least 5 years, and perhaps longer than 5 years if you are younger than 54 1/2.

Example: You are 45 years old and want to begin taking withdrawals from your IRA without paying the 10% penalty. You have to take these equal payments until you are 59 1/2 -- which means you have to receive these IRA withdrawals for 14 1/2 years.

Example: You are 58 years old and want to begin taking withdrawals from your former employer's 401k plan without paying the 10% penalty. You have to take these equal payments for 5 years.

If the payments under this exception are changed before the end of the above required periods for any reason other than the death or disability of the IRA owner, he or she will be subject to the 10% additional tax.

If you are looking for a way to take money out of your IRA or retirement account without paying the extra 10% penalty, this is the way to go!

## LEGAL LOOPHOLE #22: How To Save Taxes By "Owning" And "Loaning"

Most small businesses get their operating capital from one primary source -- YOU! As a Small Business Owner, you have probably poured not only your heart and soul into this business, but also a sizable amount of cash -- cash to get things going, pay the bills, and so on.

If you have borrowed money from a bank, you probably had to put the loan in your own name rather than the name of the business. Even more likely is this scenario: if you were unable to come up with the cash from your own resources (savings accounts, retirement plans, credit card advances, etc.), you probably then went to family and friends to get the rest of the operating capital you needed to finance your business.

Now comes the important question: What about all that money you've poured into the business? How is it treated for tax purposes? Do you have to pay that money back? Or can it just "stay in the business" forever?

The answer to these questions depends on what type of legal entity your business happens to be. Here's an overview:

**Sole Proprietorship.** If you are a Sole Proprietor, you can put your own money into the business whenever you want and "pay yourself back" whenever you want. It really doesn't matter. Whatever profit you have (as reported on your personal income tax return via Schedule C) is subject to income tax and self-employment tax, no matter how much of your own money you had to contribute to the business to make it profitable.

**Corporation.** Here's where things get much more interesting. Since the corporation (both the "C" Corporation and the "S" Corporation) is a separate legal entity from the owner(s), it is much more critical that you document all loans between you and the business.

It is a big mistake to just indiscriminately "put money in" by paying business expenses out of your own pocket (which is a common mistake made by many small business owners whose business happens to be a corporation).

If you provide operating capital to the business, it is much better to put the money directly into the corporation's checking account, then pay the bills out of the corporation's checking account.

Each time you "put money in" like this, you should treat this money as a *real* loan between you, the corporation's owner, and the corporation.

What do I mean by a "real" loan? I mean have the business treat this loan just like a loan that you could get at a bank. For example, a real loan has the following characteristics:

1. A written loan document or note agreement.

In other words, put it in writing! Would a bank loan money to your business without putting it in writing? Of course not. The loan agreement simply states the terms of the loan: when the loan is to be repaid, what the interest rate is, etc.

2. An interest rate that reflects current market conditions.

3. A written corporate resolution which authorizes the loan.

4. Collateral for the loan.

If there is no collateral, then the interest rate should reflect that.

5. Evidence that the loan has indeed been repaid.

In other words, treat the transaction as a true "arm's length transaction" between two willing parties.

Now, why is all this paperwork so important? For the simple reason that once you have loaned money to your business, eventually the loan must be repaid. Those repayments are a very critical source of tax savings to you. Once the business starts making a profit and has the cash flow to repay the loan, you can then start paying yourself back what the company owes you. Instead of paying yourself wages, which are taxable income to you, you can pay yourself back the loan, which will be non-taxable.

I've personally seen several situations in which the business owner had loaned the company literally tens of thousands of dollars over the years. Then, the business owner never directs the corporation to pay back the loan! Instead, the business owner pays himself wages or salary with money that could have been classified as loan payments. The result: the business owner needlessly pays income tax and payroll taxes on those wages. Had those wages been treated as loan payments, taxes would have been legally avoided.

## **LEGAL LOOPHOLE #23: How To Save A Bundle Just By Being On Time!**

As a Small Business Owner, you either already have employees or will eventually have employees (assuming your business continues to grow). And even if you are a "one-person band", if you have formed a corporation (or plan to do so soon), then you have at least one employee -- YOU!

Having employees (even just one) means having to make payroll tax payments and file payroll tax returns. There are very strict rules regarding when to make these payroll tax payments. These payroll tax payments are due at the federal, state, and even local level. For purposes of this discussion, I'm going to focus on the federal payroll tax payments.

The most common federal payroll tax is known as the "Form 941 tax". This is a combination of the following 5 types of federal payroll tax:

1. Federal income tax which you, the employer, have withheld from your employee's paycheck
2. Employee's Social Security tax which you, the employer, have withheld from your employee's paycheck
3. Employee's Medicare tax which you, the employer, have withheld from your employee's paycheck
4. The employer's share of Social Security tax. You have to "match" whatever has been withheld from your employee's paycheck.
5. The employer's share of Medicare tax. You have to "match" whatever has been withheld from your employee's paycheck.

So items #1, #2 and #3 come out of the employee's pocket. Items #4 and #5 come out of the employer's pocket. After withholding all these payroll taxes, the employer is required to pay these taxes to the federal government, usually on a monthly basis.

Here's how it works. The IRS determines how frequently you must pay Form 941 tax by adding up all the payroll taxes you have paid over a recent 12 month period. If your total Form 941 tax is less than \$50,000 for that 12 month period, then you have to pay the Form 941 tax every month. If your total Form 941 tax is greater than \$50,000 for that year, then you have to make payments every week.

What happens if you make a late payment of Form 941 tax? The penalties are harsh, as evidenced in the following table:

- 2%** - Payments made 1 to 5 days late.
- 5%** - Payments made 6 to 15 days late.
- 10%** - Payments made 16 or more days late. Also applies to amounts paid within 10 days of the date of the first notice the IRS sent asking for the tax due.
- 15%** - Amounts still unpaid more than 10 days after the date of the first notice the IRS sent asking for the tax due or the day on which you receive notice and demand for immediate payment, whichever is earlier.

On addition to these late payment penalties, the IRS will also add an interest charge based on the actual number of days the payment is made late.

So, it is extremely important that you treat payroll tax payments as a top priority. It is easy for a new (and perhaps struggling) business to overlook payroll taxes. Maybe things are "tight" and you are having a hard time paying your bills. So you "borrow from Peter to pay Paul", so to speak, by taking the amount of withheld payroll taxes from your employee's paychecks to pay other bills, or to just have some money to pay yourself.

The end result -- you now owe Uncle Sam even more than the original payroll tax you withheld, because now a couple months have gone by and an additional 10%, 15%, or 20% of penalty and interest charges have been added to the bill.

I've seen this happen to many small business owners who thought they could ignore their payroll tax payments when things got tough. They seem to think that if they just don't pay Uncle Sam, he will go away. Unfortunately, it doesn't work that way. The IRS will start sending you late payment penalty notices like you wouldn't believe. Month after month they will arrive, while the penalty and interest charge clock continues to tick every day.

Meanwhile, the business owner just continues to ignore these notices -- maybe he's still having trouble making ends meet, and now that the IRS has added literally hundreds or even thousands of dollars in late penalty and interest charges, well, it's now even more difficult to pay the IRS and get caught up.

So don't let this happen to you! Stay on top of your payroll tax situation -- make all required payments on time, and you will save yourself a lot of time, trouble, and your hard-earned money.

## **LEGAL LOOPHOLE #24: How To Save Yourself Time & Money By NOT Going To The Bank!**

Have you ever stopped to consider the value of your time? As a Small Business Owner, your time is perhaps your most valuable asset, is it not? And every day you probably waste time by a) doing things you shouldn't even be doing at all and/or b) doing things in an inefficient manner.

The end result is that you are, in effect, wasting a lot of money by the way you spend your time. Here's a great example of this tendency for the Small Business Owner to waste time -- it has to do with the monthly or weekly payment of federal payroll taxes, particularly the Form 941 payroll tax described in the previous section.

Whether you are a monthly or weekly payor of Form 941 payroll taxes, you are required by law to make these payments at a local bank or credit union. If your quarterly Form 941 payroll tax liability exceeds \$2,500, then you cannot mail your Form 941 payment to the IRS. Instead, you have to make your payment at a local bank or credit union, which acts on behalf of the IRS to receive your payment. For years, the only way you could make this payment was to fill out a special form called Form 8109 (which the IRS would send to you in a little yellow coupon booklet), write out a check, and physically take the check and Form 8109 to the bank and make the payment in person.

Many Small Businesses continue to take care of this payment in this manner. Even if you are a monthly Form 941 payor, it could easily take you 30 minutes (or more) to fill out Form 8109, write out the check, drive to the bank, stand in line, make the payment, and drive back to the office. Form 940 tax (another payroll tax known as Federal Unemployment Tax) is another type of tax that the IRS has always required be paid in person at your local bank via Form 8109. This Form 940 tax is due quarterly.

So if you could be making up to 16 trips to the bank to make these Form 941 and Form 940 payments -- taking up at least 8 hours of your time each year. And if you are a weekly payor of Form 941 tax, then we are talking about a lot more time than that -- more like 25 or 30 hours of time each year just going to the bank.

Well, there is an easy way to avoid all these trips to the bank. A few years ago the IRS created a much easier way for Small Businesses to make these payroll tax payments. A system was created known as "EFTPS" -- which stands for Electronic Federal Tax Payment System.

Now you can make all your federal tax payments electronically -- either by phoning an IRS toll-free 800 number or going to an IRS web site -- and save a significant amount of time.

I was skeptical of this system myself at first. The IRS doesn't have the greatest reputation when it comes to technological innovations. (Example: it took several years for some of the "bugs" to be worked out of the IRS "efile" program, which lets taxpayers and tax preparers electronically file income tax returns.) But I've been using the EFTPS system myself for the past couple years, and I must say it has worked very well for me.

I like the phone call method -- I just dial an 800 number, punch in a few numbers, and my payroll taxes are electronically deducted from my bank account. It takes less than 5 minutes to make the phone call. No more filling out Form 8109. No need to cut a check. No more going to the bank and waiting in line.

So if you have employees and are required to make monthly or weekly payroll tax payments, do yourself a favor and check out the EFTPS program. It's a great time-saver, which means it will save you money, too.

To sign up for EFTPS, visit [www.eftps.gov](http://www.eftps.gov) or call 1-866-528-0687.

## **LEGAL LOOPHOLE #25: How To Deduct 100% Of Your Business Meals**

Business Owners have been able to deduct at least a portion of business-related meals for many years. Currently the deduction is limited to 50% of the cost of the meal.

What many Business Owners do not realize, however, is that there are exceptions to the "50% Rule" that allow you to deduct the full cost of your business-related meals. You just have to know how these rules work, so here's an overview:

An employer can usually deduct the cost of furnishing meals to employees (including the owner!) if the expense is an ordinary and necessary business expense. In general, the deduction for furnishing meals is limited to 50% of the costs except under certain conditions:

### ***Deduct 100% of the cost of furnishing meals for:***

1. Meals that qualify as a "de minimis" fringe benefit. This includes all meals provided on the employer's premises for the convenience of the employer if more than 50% of the employees who are furnished meals are furnished meals for the employer's convenience. Prior to 1998, "substantially all" of the meals provided to employees had to be for the employer's convenience. The current rules apply for all tax years so employers may amend any open years.

What is a "de minimis" fringe benefit? It is simply a benefit provided to an employee by an employer that has minimal value. An example of a "de minimis" fringe benefit would be something like occasional personal use of office equipment by the employee. Such "de minimis" fringe benefits (like the cost of furnishing meals to the employee on the employer's premises for the convenience of the employer) are deductible by the employer and tax-free to the employee.

2. Meals where the value is included in the employee's wages.

3. Meals furnished to employees at the site of an employer's restaurant or catering service.

4. Company picnics or holiday parties.

The important thing to realize here is that the value of meals is excluded from an employee's wages when the following requirements are met:

1. Meals must be furnished on the business premises
2. Meals must be furnished for the convenience of the employer

Meals that can be excluded from an employee's wages under the exclusion rules are treated as "de minimis" and are fully deductible by the employer. If more than half the employees that are furnished meals meet the exclusion rules, all meals provided to employees are treated as "de minimis" and are fully deductible by the employer and are excludable to the employee.

A key part of the loophole is the phrase "*for the convenience of the employer*". Just exactly what does this mean? To meet the "employers convenience" rule, meals must be provided to the employee for one of the following reasons:

1. Meals are provided so employees are available for emergency calls during the meal period, and such calls actually occur or can reasonable be expected to occur.
2. Meal periods must be short (30 to 45 minutes) because of the nature of the employer's business and the employee does not have time to eat elsewhere. Short meal periods to allow employees to go home early do not qualify.
3. Because of a lack of eating facilities near the business (or other similar circumstances), employees cannot be expected to secure proper meals within a reasonable meal period.
4. Meals furnished to restaurant or other food service employees during working hours.
5. Meals furnished immediately after working hours that would have been provided during business hours but because of work duties, were not eaten during working hours.

## **LEGAL LOOPHOLE #26: How To Deduct Virtually All Your Mileage**

Business Owners have always been able to deduct expenses related to the use of their vehicles. Obviously, if the business owns the car, and the car is used 100% for business purposes, then all vehicle-related expenses are deductible, including:

1. The cost of the vehicle, as deducted each year via depreciation expense
2. The actual cost of gasoline
3. The actual cost of maintenance, repairs, oil changes, etc.
4. Automobile insurance
5. Vehicle registration and license plate fees
6. Emergency road service membership fees such as AAA Auto Club

But for many Business Owners, it is more common that the business does not own the car. Rather, the Business Owner has purchased a vehicle in his or her own name, but then uses that vehicle for business purposes. The Business Owner can then deduct vehicle-related expenses only to the extent that the car is used for business. So, you must maintain a written log of your business use miles, and at the end of the year you either deduct the appropriate business use percentage of the actual expense listed above, or you deduct an expense equal to the number of business miles times the prevailing mileage rate established by the IRS. For Year 2009, for example, the mileage rate is 55 cents per mile. For 2010, the rate is 50 cents per mile.

For many Business Owners, the Mileage Rate Method provides a higher deduction than the Actual Expense Method. So here's an easy (and perfectly legal) way to substantially increase the number of miles that you drive your car for business purposes.

First, you must realize that "commuting" miles are not counted as business use miles. When you get in your car and drive to your place of business, even when you own the business, this "commute" is considered a non-deductible personal use of your car.

But there's an easy way to "get around" the commuting rule. Simply create an office in your home (and for many Small Business Owners, you probably have already done this). Then, start each day by first "going to work" in your home office.

The tax code says that driving from home to your place of business is a non-deductible commute. But the tax code also says that driving from one business location to another (second) business code is deductible business mileage. So, driving from your

home office to your place of business is no longer a commute. It is driving from one business location to a second business location. This enables you to legally deduct the cost of your "commute" because now it is no longer a commute.

Here's an example of how you can save money by implementing this simple Legal Loophole. Assuming the distance between your home office and your place of business is 15 miles each way, you would get to deduct an additional 7,500 miles per year:

15 miles one-way x 2 trips per day = 30 miles per day  
30 miles per day x 5 trips per week = 150 miles per week  
150 miles per week x 50 weeks per year = 7,500 miles per year

And what is that 7,500 miles worth to you?

$7,500 \text{ miles} \times .50 = \$3,750$  deduction (in Year 2010)

And depending on your tax bracket, what is that deduction of \$3,750 worth to you in actual tax savings? Let's assume you pay about 28% federal income tax and 5% state/local income tax for a total income tax rate of 33% --

$\$3,750 \times 33\% = \$1,238$  in actual tax savings.

So, this simple record-keeping technique could save you over \$1,200 per year. Over the next 10 years, that would be over \$12,000 of extra cash in your pocket!

## LEGAL LOOPHOLE #27 Be It Ever So Deductible, There's No Place Like A Home Office

One of the most under-used and over-looked deductions is the infamous "Home Office" deduction. A few years ago, the IRS got tough on how it interpreted the complex set of rules governing this deduction, and so many deserving Small Business Owners were no longer allowed to take this deduction. And even those who still qualified were "scared off" by the IRS tough stance.

But I have good news for you! A provision in the *Taxpayer Relief Act of 1997* makes it easier for many taxpayers to claim the home office deduction beginning in 1999.

**EDITORIAL COMMENT:** Isn't it ironic how Congress likes to use a word like "relief" and "taxpayer" in the same sentence? Where I come from, that's called a "oxymoron"!

Prior to 1999, the home office deduction was only available to taxpayers who could meet the strict interpretation of the "principal place of business" requirement. Now it is much easier to qualify.

Here's how it works: The area used for business in your home must be used *regularly* and *exclusively*:

1. As the principal place of business (including administrative use); or
  2. As a place to meet or deal with clients/customers in the normal course of the business;
- or
3. In connection with the business if it is a separate structure not attached to the taxpayer's personal residence.

Now, for some definitions of the key terms used above:

**Regular Use:** The area used for business is used on a continuing basis. The occasional or incidental use of the area does not meet the regular use test, even if it is used for no other purpose.

**Exclusive Use:** A specific part of a taxpayer's home is used for business purposes only.

Here's how the deduction is calculated:

1. Determine the **Business Use Percentage** by dividing the area exclusively used for business by the total area of the home.

2. Add up all of the following **Home-Related Expenses** which benefit both the business and personal parts of the home. These expenses involve the upkeep and running of the entire home:

- Mortgage interest
- Real estate taxes
- Homeowner's insurance
- Security system
- Home repairs & maintenance
- Utilities
- Rent
- Depreciation
- Water, sewer, garbage removal, snow plowing

3. Multiply the **Home-Related Expenses** by the **Business Use Percentage**.

The end result is that the typical Small Business Owner who spends time in his Home Office gets a substantial business deduction for expenses that he would have paid for whether or not he used part of his home of business. This is truly one of the best deductions available to the Small Business Owner. Make sure you are taking it!

## LEGAL LOOPHOLE #28

### It Is Better To Give Than To Receive!

Charitable contributions have been deductible by both individuals and businesses for many years. The government has always given a nice tax break to those taxpayers with the means and desire to help others.

But for individuals, here's an important rule to consider: You only get to deduct your personal charitable contributions if you itemize deductions on Form 1040, Schedule A. So if you don't have enough itemized deductions to file Schedule A, then you are out of luck. Your charitable contributions will provide you with no tax benefit whatsoever.

If you happen to own a "C" Corporation, here's a great way to get around that problem:

A "C" Corporation can deduct up to 10% of its taxable income as a business expense. So, if you are not able to deduct your charitable contributions on your personal return, then just make sure you use your business checking account (instead of your personal checking account) to write the checks for your charitable contributions.

Here's another great tax deduction for "C" Corporations involving charitable contributions of property (as opposed to contributions of cash). By property, I mean inventory held for resale and depreciable assets.

The tax code allows a "C" Corporation to donate inventory to charity and deduct *more than the cost of the inventory*. The amount of the deduction is equal to the cost of the inventory item *plus one-half the difference between the cost and the regular sale price (aka "Fair Market Value")*, up to twice the cost of the inventory.

Here's an example of this little-known legal loophole that let's you buy something and then deduct more than what you paid for it:

ABC Corporation buys a product for inventory at a cost of \$500. Normally, ABC Corporation has a 100% markup on the product and so normally sells it for \$1,000. Therefore, the Fair Market Value (FMV) of the inventory is \$1,000.

ABC then donates the property which it bought for \$500. But ABC gets to deduct \$750, because the amount of the contribution (for tax deduction purposes) is \$500 (cost) plus \$250 (one-half of \$500, which is the difference between cost and FMV).

To qualify for this "greater than cost" charitable contribution, the following rules must be met:

- 1) The charity must be a Section 503(c)(3) organization
- 2) The charity must use the donated property solely for the care of the ill, the needy, or infants
- 3) The charity cannot exchange the donated property for money, other property, or services
- 4) The corporation must be given a written statement from the charity that says it will follow rules (2) and (3) above
- 5) If the donated property is subject to the regulations of the Federal Food, Drug, and Cosmetic Act, all such regulations must be satisfied
- 6) Use of the donated property must be related to the purpose or function that gives the charity its exempt status.

## **LEGAL LOOPHOLE #29**

### **When In (Reasonable) Doubt, Deduct It!**

I am the first to admit that this is the most "aggressive" strategy in this book. And one could make a good argument questioning whether this is really even a "legal loophole" at all.

So if you are a person with a more "conservative" approach to taxes, then perhaps this section is not for you. And that's OK.

But if you tend to look at taxes from a more "aggressive" standpoint (and my hunch is that you do, otherwise you wouldn't be reading this right now), then I think you will find my comments here very welcome.

Why do I say, "When in doubt, deduct it" ? For two main reasons:

#### **REASON #1:**

Your chance of being audited is slim. Remember those "audit rates" that were mentioned back in Legal Loophole #5? Here they are again:

<b>Type of Business</b>	<b>Percentage of Returns Audited</b>
Sole Proprietorships	
Sales:	
< 25,000	2.63
25,000-99,000	1.13
>100,000	1.36
"S" Corporations	0.42
"C" Corporations	
Assets:	
< 250,000	0.22
250,000 – 1,000,000	0.73
1M – 5M	2.06
Partnerships/LLCs	0.27

My point back in Legal Loophole #5 was that it makes sense to switch from a Sole Proprietorship to a Corporation because the audit rate for Sole Proprietors is more than double that of most corporations.

Now let's just focus on the audit rates themselves -- assuming your business is a Corporation, Partnership, or LLC, the chance of being audited is **less than 1%!!!**

Think about that for a minute. That's an amazing statistic, and I hope it helps you to realize that the IRS just doesn't have the resources to even "scratch the surface" of looking at business tax returns with any degree of thoroughness. Most returns are processed without any question whatsoever.

And even if you do get audited, so what? What's the worst that could happen to you? Even if you took a questionable deduction that is disallowed by the IRS, all that happens is that the IRS sends you a bill for the amount of tax that you would have owed anyway (had you not taken that questionable deduction), plus interest.

### **REASON #2:**

When it comes to "questionable deductions", the tax code offers a great deal of latitude. How much latitude? Well, consider this simple fact:

Some deductions are specifically allowed in the tax code, i.e. "This particular item is deductible, no doubt about it."

And then there are deductions that are specifically disallowed, ie. "Sorry, but this particular item is NOT deductible, no doubt about it."

But what most taxpayers do not realize (and the IRS is in no hurry to tell you this) is that most deductions are not specifically mentioned anywhere in the tax code.

By that I mean this: Where does it say in the tax code that paper clips used in your office are deductible? Guess what -- IT DOESN'T! How about staples? Same thing -- there isn't really a specific reference to that either.

Then how do we know what is deductible and what isn't? Because the tax code does provide some general rules about what is deductible, and these general rules can be boiled down to the following 2 guidelines.

To be deductible, a business expense must be:

1. "Ordinary"
- and
2. "Necessary"

So, any expense that meets these criteria is deductible. Think about that for a minute.

Here's how the IRS defines these 2 requirements:

By "ordinary", the tax code simply means an expense that is "common and accepted" in your type of business.

By "necessary", the tax code means an expense that is appropriate and helpful for your business. And here's a key concept: An expense does not have to be indispensable to be considered necessary.

With these guidelines in mind, I hope you feel a little more relaxed about the statement, "When in reasonable doubt, deduct it!"

In closing, please remember this simple truth -- every time you do something to reduce your taxes, you just gave yourself a raise!

**Wayne M. Davies'**  
**Tax Reduction Toolkit**

**PART THREE**

**9 Biggest Mistakes Taxpayers  
Make & How To Avoid Them**

**PLUS: Bonus Reports --  
Just How Complicated Can It Be To File  
Business Tax Returns?  
My Failed Jobs Program**

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## **MISTAKE #1**

### **Getting A Big Refund**

I will never forget the day that a tax client named Douglas came into my office to pick up his personal income tax return.

"How's it look?" he asked.

"Well," I said, "It looks like you're getting a refund."

"Great! How much?"

"Oh, it's a big one," I said. "Over \$5,000 dollars."

Douglas couldn't have been happier. He face lit up like a light bulb. He was ecstatic -- he sincerely believed that he had "beat the tax man" by getting such a large refund.

I was not so happy. I couldn't understand his thinking. So I asked Douglas if he really meant to get such a big refund. Douglas was a W-2 employee and so I wondered if maybe his payroll department made a mistake -- maybe they were doing his withholdings wrong. Maybe he didn't really want to have so much tax taken out of his paycheck each week.

Douglas went on to tell me that he has always had a tremendous fear of having a balance due on his return. For some reason, he just assumed that if he ended up owing money to the government at the end of the year, then somehow he would get in trouble with the IRS. So he went to the opposite extreme.

In addition, Douglas thought that getting a big refund was a great way to save money during the year, so that at the end of the year he got a nice little "bonus" from the government. You know, a forced savings plan.

I spent a few minutes with Douglas and gave him my opinion on this whole topic of getting a big refund.

My biggest objection to getting a large refund is the simple fact that you have given the IRS an interest-free loan of your hard-earned money. If Douglas wanted to save \$5,000 dollars over the course of the year, all he had to do was authorize his employer to deposit \$100 per week into his savings account. Then at the end of the year, his \$5,000 would be sitting in his own bank account rather than sitting at the U.S. Treasury.

That \$5,000 could have been earning interest over the course of the year. So by letting the government keep his money, Douglas was actually losing money!

I also explained to Douglas that getting a large refund does NOT, in and of itself, put you on some IRS "hit list." Plenty of people do what Douglas did (have way too much tax withheld from their paychecks) and the IRS doesn't really care. Hey, they got to keep your money for awhile, so it doesn't really matter to them.

So I urge you to reconsider such an approach to money-management. Why let the government have your money? Why should you wait until the end of the year to get your money back, money that is rightfully yours?

If you are used to getting a big refund, make a change! You can control how much you pay in to the IRS during the year. If you or your spouse are W-2 employees (either of your own business or another business), you can change your withholdings very easily. Just file a new Form W-4 with your employer and you won't have to wait so long to get your money back.

If you are self-employed and making quarterly estimated tax payments, the same principle applies. Don't pay in so much that you get a big refund. With a little number-crunching you can determine the minimum amount of estimated tax payments you are required to make. (For more information on how to calculate your quarterly estimated tax payments, go on to Mistake #2.)

## **MISTAKE #2**

### **Paying Too Much Estimated Tax**

This mistake can lead to Mistake #1 (getting a big refund), but has special significance for the self-employed person and many small business owners.

Many self-employed people and small business owners make quarterly estimated tax payments at both the federal and state level. If your business income fluctuates from year to year, as is often the case for the small business owner, it can be difficult (if not impossible) to know exactly what your tax liability is going to be for the whole year until the year is over.

So many self-employed people end up being way too conservative -- by that, I mean they fear having a balance due on their tax return and so go ahead and pay way too much estimated tax during the year. And so they end up just like the W-2 employee who has too much income tax withheld from his/her paycheck. The end result -- the self-employed person also gets a large refund, and has given the IRS an interest-free loan of his hard-earned money.

The self-employed person has two options to avoid overpayment of estimated tax.

#### **OPTION #1:**

Do your best to track your income and expense during the year. If you are running a successful small business, you should be recording your income and expense activity each month, and you should be able to produce reports that tell you exactly how your business is doing each month. Either you are doing this yourself with the help of a software program like InternetTaxHelper or Quicken, or you are paying a bookkeeper or accountant to do this. In either case, if you don't know how your business is doing every month, you are making a big mistake right there!

If you want to be successful, you've got to know where you stand every month profit-wise. If you are waiting until the end of the year to see what the numbers look like, you are mismanaging your business!

You've got to know the "bottom line" each and every month, both from a business management/cash flow standpoint, and also from a tax standpoint. From a tax standpoint, once you know your profit for a given quarter, you can then calculate the resulting tax liability on that quarter's profit, and so you can make a reasonably accurate quarterly estimated tax payment instead of just "winging it" and paying way too much (or way too little).

## **OPTION #2**

Here's another great way to take care of your quarterly estimated tax payments. Option #2 is what the Tax Code calls "*The Safe Harbor Method*," defined as follows:

The Tax Code says that most taxpayers can calculate the minimum amount of estimated tax to pay by simply paying the previous year's tax liability in the current year. So, let's say you are trying to figure out how much estimated tax to pay for Year 2010. Let's also assume your Year 2009 federal income tax liability was \$10,000. So for Year 2010, you take the \$10,000 and divide it by 4, and you would pay \$2,500 per quarter.

As you can see, this is a much easier method to use than Option #1, because it takes less time to calculate.

There is another advantage to The Safe Harbor Method -- if your income increases in 2010 compared to 2009, and so your tax liability increases in 2010 compared to 2009, you can still pay the Year 2009 tax liability amount in Year 2010 and not incur any penalty or interest for having a balance due on the Year 2010 return. As long as you pay that Year 2010 balance due by April 15, 2011 (the due date of the 2010 tax return), then it doesn't matter how much you owe on the 2010 return. You have complied with the "safe harbor" rule for quarterly estimated tax payments.

So Option #2 lets you calculate your estimated tax payment amount in literally seconds, and it also lets you "get away" with paying a minimum amount of tax during the year without any fear of penalty for waiting until April 15 to pay the rest.

Practically speaking, Option #2 is often best for self-employed people whose income remains relatively constant from year to year. If your income dramatically increases one year, keep in mind that you can still pay the previous year's tax liability and hang on to your money for a few extra months, but eventually you will have to come up with that large balance due. If you like waiting until the last possible day to pay your balance due, then Option #2 is for you. Just make sure you "put something aside" to take care of that large balance due.

<p>One final note -- please notice that I said that <u>most</u> taxpayers can pay last year's tax liability to qualify for the Safe Harbor method. If you are Married Filing Joint and your income is over \$150,000 (\$75,000 if your filing status is Married Filing Separate), then the amount of estimated tax you must pay is 110% of the previous year's tax liability.</p>
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## **MISTAKE #3**

### **Not Understanding What Your Tax Rate Is**

One of the most misunderstood aspects of tax law is probably the most important of all -- how your income tax is calculated! Most taxpayers are literally clueless about this, either because they just don't care or because they've never realized the need to learn about it.

I'm here to tell you that you absolutely **MUST** get a basic understanding of how tax rates work. If you don't, you are missing a big opportunity to pay less tax!

So here goes -- I'm going to keep this as simple as possible. No need to break out into a sweat, but I am going to explain how the tax system "works". And don't worry about whether or not you are very good with numbers. You don't need to be a math wiz to understand this concept of Your Tax Rate. If you can add, subtract and multiply, then you'll do just fine.

And that's really all there is to it -- to figure out how much tax you pay, all you have to do is 3 simple calculations:

CALCULATION #1: ADD  
CALCULATION #2: SUBTRACT  
CALCULATION #3: MULTIPLY

**CALCULATION #1:** Take all your various sources of income and ***add*** them together. For many W-2 employees, that means just adding together your "gross wages" from all your W-2's that you receive from your employer. You may have other types of income, too, like interest, dividends, and capital gains from your investments. And if your return is a bit more complicated, you might have income from a rental property. The end result of Calculation #1 is what is called your GROSS INCOME -- not "gross" in the sense "yucky", but gross meaning TOTAL.

**CALCULATION #2:** Then you take all your deductions and ***subtract*** them from your Gross Income. There are so many different deductions that you can take, and I'm not going to get into a detailed discussion of those deductions right now. The point here is simply that you take your GROSS INCOME, subtract your DEDUCTIONS, and you end up with your TAXABLE INCOME.

**CALCULATION #3:** Still with me? Good. Now comes the third and final step of this little exercise: Take your TAXABLE INCOME and multiply it by your TAX RATE and you get your tax for the year. Now what is your "tax rate"? It is a ***percentage*** that the tax law says you must use. There are two incredibly important things for you to understand about this percentage:

FIRST --- there is more than one percentage, and most taxpayers end up paying more than one percentage on their Taxable Income.

SECOND -- the amount of the percentage you pay *increases* as your income increases.

So, when I say that Calculation #3 means "Take your Taxable Income and multiply it by your Tax Rate Percentage", chances are you have to do more than one multiplication calculation.

Here's an example that I think will make this easier to understand:

Let's say you are married and filing a joint return with your spouse. You've added up your Gross Income and subtracted your Deductions, and so you arrive at your Taxable Income of \$75,000. Now we have to go to the IRS handy-dandy "Tax Table", which is a chart that tells you what Tax Rate Percentages to use for Calculation #3. Here's what this Tax Table looks like for a married couple for Year 2009:

<i>If Taxable Income Is:</i>	<i>The Tax Rate Is:</i>	<i>Of The Amount Over</i>
\$0 to 16,750	10%	0
\$16,750 to 68,000	15%	16,750
\$68,000 to 137,300	25%	68,000
\$137,300 to 209,250	28%	137,300
\$209,250 to 373,650	33%	209,250
\$373,650 and higher	35%	373,650

So, here's how to calculate your tax on taxable income of \$75,000:

The first \$16,750 is taxed at 10% :	\$16,750 x 10%	= \$1,675
From \$16,751 to \$68,800 is taxed at 15% :	\$52,050 x 15%	= \$7,808
From \$68,800 to \$75,000 is taxed at 25% :	\$6,200 x 25%	= <u>\$1,550</u>
So your total tax is:		= <u><b>\$11,033</b></u>

Even if you didn't "get it", that's OK. I hope you do understand this simple fact:

**THE MORE INCOME YOU MAKE, THE LESS OF IT YOU GET TO KEEP!**

Do you see that? Your first \$16,750 of Taxable Income is taxed at 10%. *But the next \$52,050 is taxed at 15%! And so on.* The higher your income, the higher your tax rate percentage. So if a person with \$75,000 of Taxable Income gets a raise at work, keep this in mind -- the amount of tax you are going to pay on that additional income is NOT going to be the LOWEST percentage of 10%, but the **HIGHEST** tax rate you are paying, in this case, **25%**! That's why it's so important for you to know what "tax bracket" you are in.

## **MISTAKE #4**

### **Confusing A Tax Deduction With A Tax Credit**

Another common mistake that taxpayers make is to misunderstand the difference between a tax *deduction* and a tax *credit*.

A client of mine name Debbie came to me recently to prepare her personal tax return. She was quite distraught because she had a balance due of about \$400. She could barely stand the thought of paying the government another \$400.

"After all", she said, "I've already paid them several thousands dollars! Isn't that enough! They don't deserve another dime of my money, so I'm going to go back home and check my records one more time to see if I can find some more deductions."

I was sympathetic to Debbie and could certainly understand her frustration. It does seem unfair that a taxpayer has several thousand dollars of tax withheld from her paycheck during the year, and then she has to turn around and write a check for another \$400. Having to write a check to the IRS on April 15 is no fun!

And Debbie had the right attitude about finding more deductions. I know that many taxpayers leave a lot of money "on the table", so to speak, when they don't take all the deductions they are legally entitled to take. So I commended Debbie on her determination to find some more deductions to lower her \$400 balance due.

On her way out the door, Debbie proclaimed: "I know I can find another \$400 worth of deductions. I have some receipts that I didn't bring in yet, and if those receipts add up to \$400, I'll feel much better if I just 'break even' instead of paying the IRS more money."

I rushed over to the door to stop Debbie from leaving my office.

"What do you mean, 'If those receipts add up to \$400 I'll break even'?" I asked.

"Well," said Debbie, "Don't I just have to find another \$400 in deductions to reduce my tax bill down to zero?"

"Sit down, Debbie. We need to have a little chat before you go."

I proceeded to tell Debbie that finding another \$400 in *deductions* would not reduce her *tax* by \$400. Instead, that additional \$400 in deductions would only reduce her *taxable income* by \$400. How much actual tax she would save would NOT be \$400.

Debbie was confusing a tax *deduction* with a tax *credit*.

To know how much tax savings would result from a \$400 deduction required another calculation. And to do that calculation, she had to know what her "tax rate" was. (See Mistake #3 for a detailed discussion of how to figure out your Tax Rate, aka "Tax Bracket.")

It turns out that Debbie was in the 25% Tax Bracket. In other words, the highest Tax Rate Percentage that she paid on her income was 25%. So, if she reduced her Taxable Income by \$400 of additional deductions, her actual tax savings would be:

$$\$400 \times 25\% = \$100.$$

She would save \$100, not \$400.

Debbie was shocked. "You mean I must have more than \$400 in deductions in order to save \$400 in taxes?"

"That's right," I said. "To reduce your taxes by \$400, you need an additional \$1,600 in deductions." I took out a sheet of paper and wrote down the following calculation:

$$\$1,600 \times 25\% = \$400.$$

Debbie was now distraught once again. "There's no way I can come up with that amount of deductions. I guess I'll just have to pay."

"Well, go ahead and find whatever deductions you can. Then you can calculate your tax savings by doing this simple multiplication problem:

**Deduction Amount Times Your Tax Rate of 25% Equals Your Tax Savings."**

In other words, since Debbie was in the 25% Tax Bracket, all she had to do was multiply her deduction amount by her Tax Rate Percentage to figure out her tax savings.

This principle applies to any taxpayer. Once you know your Tax Bracket, you can see how much tax you'll save if you take some additional deductions. A deduction does not reduce your TAX dollar for dollar; instead, a deduction only reduces your TAXABLE INCOME dollar for dollar.

The Tax Law does have something else called a Tax Credit that does reduce your Tax Bill dollar for dollar. There are several of these Tax Credits available, like the Child Tax Credit, the Credit for Child & Dependent Care Expense, and the Education Credit.

## **MISTAKE #5**

### **Having A Large Balance Due**

This mistake is usually the end result of poor (if any) tax planning. Some people just don't spend any time during the year figuring out what their tax situation is going to look like on April 15. So they just ignore it and are literally clueless as to whether they are getting a refund or will have a balance due.

I hope I haven't just described you, but if so, don't despair -- you can avoid a large balance due just as easily as a large refund. I dislike either extreme. A large refund may sound appealing at first, but as I explained in Mistake #1, it really is foolish to let the government have your money interest-free for several months.

Likewise, there really isn't much sense in paying a large balance due with the return. And the reason it doesn't make much sense is because if you have a large balance due, you probably are going to have to pay even more than that large balance due. In addition to the tax payment, you are also going to have to pay penalties and interest.

NOTE: Of course, there is one exception to this general principle. As I explained in Mistake #2, "Paying Too Much Estimated Tax", it is possible that you have a large balance due but do not have any penalties and interest to pay. If you follow the rules of the Safe Harbor Method of estimated and/or withholding tax payments, then you can pay your balance due by April 15 and not incur any extra charges. If you think you fall into this category, great!

But very few taxpayers are savvy enough to take advantage of the Safe Harbor Rule. Instead, most people I've worked with who had a large balance due also had to pay penalties and interest, sometimes to the tune of hundreds or even thousands of dollars extra. And the main reason for these extra penalties and interest was simple laziness or procrastination.

So I must urge you to do some tax planning *during the year*, and not wait until the end of the year to find out what your tax situation is going to be. For W-2 employees, this is usually not a problem. Your employer is usually doing what is supposed to be done as far as withholding the right amount of tax from your paychecks. And if you have little if any other income (like from investments or rental properties), then a W-2 employee can come very close to "breaking even" on his/her return. By "breaking even", I mean a small refund or a small balance due. And it is my contention that having a small refund or a small balance due is the best type of return to have.

But if you fall into any of the following categories, you simply must do some tax planning throughout the year to make sure that you do not end up with a large balance due:

1) You are a W-2 employee, but you also have non-employee income from any of the following sources: investments (interest, dividends, capital gains, etc), rental properties, a part-time "on the side" business that you operate yourself.

2) You are a full-time self-employed person and have to pay your own quarterly estimated tax payments.

3) You own your own business. You may receive W-2 income as an employee of the business, but you also receive profit distributions (dividends) from the business. Your W-2 paychecks may have enough income tax withholdings to cover your entire tax liability, but you may also have to make quarterly estimated tax payments if your paycheck withholdings are not sufficient.

4) Any combination of scenarios #1, #2, and/or #3.

## **MISTAKE #6**

### **Cashing In Your Retirement Plan or IRA**

This is another one of those mistakes that is extremely common. I've seen it happen time and time again over the years.

See for yourself: Does the following scenario sound familiar to you, either because you've done it yourself or know someone else who did this . . .

Joe Taxpayer changes jobs. Maybe he gets a better offer from a new employer. Maybe he loses his job and has to find a new job. So, his old employer sends him a bunch of paperwork regarding his retirement plan at his old employer. Maybe it's a 401k Plan or a 403b Plan or a SIMPLE Plan.

Joe's has several options. He doesn't really understand exactly what all these options mean, but after meeting with someone in Personnel and talking to Uncle Fred, he finds out that he can fill out a form and his old employer will send him a big fat check!

Joe is ecstatic. Since he's worked at this job for many years, he could have tens of thousands of dollars socked away in this retirement plan. He could easily have \$10,000 or \$50,000 or even \$100,000 in his account, and now he can get his hands on this big wad of cash and do something really nice for himself and his family. You know, go on that vacation they've always wanted, get that new car, pay off some old credit card debt that never goes away.

The temptation to get a check for \$50,000 is just too great. Joe gets his check a few weeks later and feels pretty good about the whole situation. Getting laid off wasn't such a bad deal after all!

Unfortunately, because Joe didn't get professional advice regarding the tax consequences of his actions, Joe is in for a big surprise come tax return time.

What Joe doesn't realize is this: because Joe "cashed out" his retirement plan account of \$50,000, he now has \$50,000 of additional taxable income. This \$50,000 must be reported on his personal income tax return, and gets added to all his other income.

Joe's employer may have withheld some income tax when the check was cut, but there's a good chance it wasn't enough to cover Joe's tax liability on the \$50,000.

Here's a very likely calculation of how much tax Joe has to pay on the \$50,000:

1. Federal income tax could be 28%, or \$14,000. Also, note that if Joe had not received the \$50,000, he would have been in the 25% federal income tax bracket. But because he

received the extra \$50,000 of taxable income, he was "bumped up" into the next tax bracket of 28%.

2. State and local income tax of 4.4%, or \$2,200. This is based on the assumption that Joe lives in Indiana (where state income tax is 3.4%) plus county income tax of 1.0% (which is very common in many Indiana counties).

Depending on where you live, your state and local tax may be more or less than Joe. Many states have much higher personal income tax rates than Indiana.

3. Federal penalty tax of 10%, or \$5,000. Because Joe was younger than 59 1/2 years old, he must pay an extra 10% penalty tax for "early withdrawal" of retirement plan money. This one really hurts!

So there you have it:

<b>Federal Income Tax</b>	<b>\$14,000</b>
<b>State/Local Income Tax</b>	<b>\$ 2,200</b>
<b>Federal Penalty</b>	<b>\$ 5,000</b>
	<hr/>
<b>TOTAL TAXES</b>	<b>\$21,200</b>

Amazing, isn't it? Joe's \$50,000 jackpot doesn't look so good any more, does it? The government takes 42% of Joe's retirement plan. **Forty-two per cent!**

After taxes, Joe's \$50,000 is whittled down to \$28,800 -- slightly more than half of what he started with.

And here's the real killer. Joe's employer may have only withheld 20% from Joe's distribution check. So Joe didn't realize that he still owes another 22% (\$11,000) on the distribution. He just gets his check for \$50,000 less the 20% and figures, "Oh well, that figures. I didn't get the whole \$50,000. Big deal. It's still 'free money'. Let the government have their cut. I still came out way ahead."

Then, when Joe files his income tax return, he ends up with a big balance due. All other things being equal, Joe will have to come up with the other \$11,000 and pay that by April 15. If he has already spent his distribution check, chances are he doesn't have \$11,000 sitting around to pay the government.

Joe is shocked. He had no idea what a hassle this would be.

All this trouble could have been avoided with one simple tax strategy: instead of taking the money, Joe could have transferred the money directly from his old employer's

retirement plan to his new employer's retirement plan, or from his old employer's retirement plan to an IRA.

This type of transaction, known as a "direct rollover", is a non-taxable event. Joe never even sees the money. He just signs a form that instructs his old employer to send the money to his new employer or to his IRA, and Voila! No taxable income. No taxes. Joe gets to keep the whole \$50,000 intact. It stays inside a tax-sheltered account and continues to grow tax-free.

It's as simple as that!

Joe's story is not a "hypothetical" situation. This type of situation happens every year to thousands of "innocent" taxpayers. Don't let it happen to you.

## **MISTAKE #7**

### **Putting Your Tax Return In The Mailbox!**

Millions of taxpayers make the mistake of putting their income tax return in a regular letter-sized envelope, sticking on a stamp, and placing the envelope into their mailbox.

And millions of taxpayers "get away" with this mistake every year, and millions of taxpayers continue to make this simple mistake year after year.

Why do I say that "putting your tax return in the mailbox" is a mistake?

Let me explain.

Every year, a small percentage of mail doesn't get delivered. The U.S. Postal Service doesn't like to admit this, but it's true.

Furthermore, even if your tax return gets delivered to the IRS, every year there are a small percentage of tax returns that get lost by the IRS.

Don't believe me? Just send me a self-addressed stamped envelope and I'll send you a copy of an IRS letter received by one of my clients a few years back. The letter begins with these words:

"We regret to inform you that we received your return but have lost it."

Honest to goodness, this actually happened!

So my question to you is this: What are you doing to do if this happens to you!

If your tax return doesn't get mailed, or if it gets mailed but is subsequently lost inside the mammoth IRS, what are you going to do to prove that you really did mail the return?

Just calling the IRS and saying, "Well, I mailed it on time. I know I did!" isn't going to prove anything. And the burden to prove you mailed the return on time will rest on your shoulders.

So here's an easy solution to this potentially dangerous problem:

***Take your income tax return to the post office and spend about \$5.50 to send the letter via Certified Mail, Return Receipt Requested.***

Doing this will accomplish two very important things for you:

1. Certified Mail provides the proof that the return was mailed, and that it was mailed on time, on or before the due date.

According to the IRS, a paper return is filed on time if it is mailed in an envelope that is properly addressed and postmarked by the due date. When you use Certified Mail, you will get a receipt postmarked by the postal employee, and that date on the receipt is the postmark date.

So, should the return get lost by the IRS, or if the IRS questions whether you mailed it on time, you will have written proof.

Plus, every piece of Certified Mail is assigned a tracking number which can then be traced by the U.S. Postal Service should a problem arise.

2. Return Receipt provides another level of "insurance" to you. When the letter is delivered, the IRS must sign or stamp a receipt that documents the date of delivery. This receipt then gets mailed back to you, so that you now have the written proof that the IRS received it.

Technically, you only need to send the return via Certified Mail to prove that it was indeed mailed on time. But I really like the Return Receipt as well -- it gives you that extra "peace of mind" to know that the IRS received it. And you'll know exactly what day it was received. This is the proof of delivery.

So don't run the risk of having your tax return get lost in the mail.

And don't run the risk of having your tax return get lost in the piles and piles of paper that flood the IRS each year.

Think about it. Well over 100 million personal income tax returns are filed with the IRS every year, and the majority of them are still prepared on paper and mailed by the U.S. Postal Service.

The U.S. Postal Service and the IRS are staffed by hard-working people who are only human. People make mistakes. To greatly reduce the chance of a mistake being made with your return, don't you make the mistake of just putting your tax return in the mailbox.

Instead, take it to the post office (how long does that take?) and send it Certified Mail, Return Receipt Requested (that will cost you a whopping \$5.50). It could be the best \$5.50 you ever spent!

## **MISTAKE #8**

### **Not Filing A Return At All!**

Have you ever heard of "The Underground Economy"?

Well, if you haven't, you're in for a big surprise.

And if you have, I know you are just as frustrated as I am that there are so many people out there who are not filing their tax returns (and not paying their fair share of taxes) and getting away with it!

For those of you who are unfamiliar with The Underground Economy, this is simply the millions of people who somehow manage to go through life making money without reporting it or paying tax on it. They accomplish this by "doing business" strictly on a cash basis.

**EXAMPLE:** You're looking for a painter to paint your house. You look up a painter in the phone book. He comes over and gives you a quote. Then he says, "Oh by the way, I only accept payment in cash. No checks, please."

This guy doesn't want any written record of the money changing hands. That way he can avoid reporting this income on his tax return. He may not even file a tax return at all. He probably doesn't have a bank account, he has no credit cards, and when he has to pay someone else who refuses to accept cash, he goes to the grocery store and gets a money order.

So, he's a member of The Underground Economy, which costs honest taxpayers like me and you a bundle. Why? Since people in The Underground Economy are not paying any tax (or a lot less than they should), the rest of us have to pick up the slack. We pay more than our fair share and end up footing the bill to pay for all the government services that these slackers get for free.

If you happen to be a member of The Underground Economy, here's my message to you: Hey, pal, get with the program! I don't like paying taxes any more than you do, but you are causing the rest of us to pay an unfair share of the nation's tax bill.

And there's more! Now I'm going to actually try to help you by giving you information that will simply amaze you!

Some people who do not file their tax returns are trying to avoid paying any tax at all. But there are other "non-filers" out there who have any number of other reasons for not filing.

For example, procrastination is a very common reason why people don't file their returns. They just put it off one year. Never get around to it. Then one year turns into two years, two into three, and before you know it, they haven't filed for six or seven years.

Every year I have people come into my office and this is their story: "I just didn't file for the past 5 years (or whatever) and I'd like to get caught up. Can you help me?"

You know what usually happens in cases like this? Many times these people are actually due a refund for one or more of these past due years! They didn't even realize it, but the government owes them money and they were just too lazy to get it back!

In fact, the IRS recently announced that \$2.3 billion dollars in unclaimed refunds are awaiting individuals who filed to file their 1998 personal income tax returns.

Did you read that! TWO BILLION, THREE HUNDRED THOUSAND DOLLARS in refunds is sitting in the U.S. government coffers. The U.S. government owes this money to taxpayers who simply haven't filed their return yet!

Here are the numbers for the Top 10 states and their estimated 1998 refund dollars available.

<b>Location</b>	<b># Non-filers</b>	<b>Total Refunds</b>	<b>Avg Refund</b>
California	181,000	\$221,646,000	\$452
New York	106,900	\$185,817,000	\$528
Florida	116,700	\$183,314,000	\$504
Texas	135,900	\$181,908,000	\$524
Illinois	73,900	\$118,799,000	\$540
New Jersey	56,500	\$101,623,000	\$547
Michigan	75,100	\$94,802,000	\$537
Massachussetts	38,200	\$86,491,000	\$541
Pennsylvania	55,600	\$75,963,000	\$524
Georgia	63,300	\$74,075,000	\$471

And here's the real sad thing about this. Virtually all this money will not get refunded to the appropriate people. That's because to get your refund, you have to file your return within 3 years of the due date of the return. Since 1998 tax returns were due April 15, 1999, taxpayers had to file their 1998 return by April 15, 2002, *or they lose their opportunity to claim the refund and the money becomes the property of the U.S. Treasury.*

And even if you are due a refund, there are no penalties for filing after the original "due date" of April 15, 1999. As long as you file by April 15, 2002, you'll get your refund.

This same timetable applies for any year. So for example, your Year 2008 tax return was due April 15, 2009. If you are due a refund and haven't filed yet, the IRS will not penalize you for filing after 4/15/09. But if you don't file by April 15, 2012, you lose the right to get that refund.

So, if you are a non-filer (either because you do business in The Underground Economy or because you are just a good ole' procrastinator), I urge you to get back into the system. If you file past due returns (within the 3-year time period described above), you may actually get a refund, without any penalty for filing late.

## **MISTAKE #9**

### Listening To Uncle Fred (Instead Of Going To A Professional)

A couple weeks ago I met with a nice young lady named Rebecca. She recently received a series of "love letters" from the state tax department. Turns out that Rebecca had not filed any state income tax returns for the past 5 years, and the state government finally caught up with her and was demanding that those returns be filed ASAP.

I asked Rebecca why she hadn't filed these state returns. I'll never forget her response: "Because my mother told me I didn't have to file a state tax return."

This is another "sad but true" story that happens every day to thousands of people.

Someone in your family (or someone at work, or someone at church, or someone you know well and therefore trust) knows somebody else (from work or church or wherever) who read an article or a book or somehow came up with a little nugget of "tax wisdom" that they are dying to pass on to you.

Everybody likes to be an expert, right?

When it comes to taxes (like any number of other subjects), a little knowlege can be extremely dangerous.

Because Rebecca listened to her dear Mother, she was now faced with a 4-figure tax bill, which included hundreds of dollars of penalties and interest that could have easily been avoided.

Rebecca only had to do one thing to avoid the big mess she now faced. *Consult a Tax Professional.*

Sometimes, that's all it takes to save yourself a lot of grief.

Now I realize that many people are capable of preparing their own income tax returns without professional assistance. Every year, millions do it. And maybe you have a simple tax situation. All you have is a W-2, you take the standard deduction, and that's it. Nothing fancy. For those kind of returns, go ahead and do it yourself.

(NOTE: I do have many clients who have a simple tax situation and still come to me year after year, not wanting to prepare their own return even if it is incredibly simple. And I can understand the way these people look at it, too. I'm the same way when it comes to car maintenance. If I really wanted to, I could learn how to change the oil, but why bother? I prefer to let a professional handle even the most basic auto maintenance and repairs. You couldn't pay me to change the oil myself.)

But if your tax return is in any way "complicated", then the old adage applies: "Don't try this at home!"

The need for professional tax assistance is especially critical for Small Business Owners and The Self-Employed. Even running a one-person business significantly complicates your tax situation. Business income tax returns are much more complex than your average W-2 employee-type tax return.

Let's take a typical situation. You start a new "part-time" business, and for the first year or two you operate as a Sole Proprietorship. You still have your regular W-2 "day job", so you don't make much money for the first couple years and you stumble through your tax return each year, doing your own Schedule C even if it kills you.

Then, in Year 3, things really take off. Your business becomes profitable and you decide to quit your day job and devote yourself full-time to it. And you find out that since you are selling a widget that could expose your liabilities, you figure you better protect yourself, so you form a corporation.

Now that you've formed a corporation (or maybe it's a partnership or a LLC) you soon find yourself buried in paperwork. Why does our government make it even harder on you with all these time consuming, costly tax-reporting regulations?

Now that you are no longer a Sole Proprietorship, you must file not one but two business income tax returns (one Federal, one State). These business tax returns are totally separate from your personal tax returns that of course must still be filed by April 15.

And if you have employees, well, now things really get interesting! Even if you have just one employee, you must file a bunch of payroll-related tax returns. How many is a "bunch"? How about ***as many as 40 different payroll tax returns must be filed during the year -- whether you have one employee or 100 employees!*** These payroll tax returns are due at different times during the year, some monthly, some quarterly, some at year-end, culminating with the final "blizzard of paperwork" (Forms 941, 940, W-2's, W-3, 1096, 1099's, etc.) due by January 31.

And whether you realized it or not, your corporation does indeed have at least one employee -- YOU!

Please take note: if you, as the corporation's owner, performed services for the corporation (and it is very likely that you did), then the corporation must pay you some type of "reasonable compensation" ***as an employee***. So even if you have no other employees, you are probably the corporation's one and only employee, and so you must file all the above-mentioned payroll tax returns.

[Be sure to read the fascinating article at the end of this report: "My Failed Jobs Program", to see just how difficult it can be to handle the government paperwork that accompanies just one employee.]

So that's why I now ask you this very important question: Do you really want to prepare all these business tax returns without the help of an experienced Tax Professional?

Maybe you do. Maybe you like filing reports and processing paperwork. But even if you are capable of figuring out all these business tax returns, perhaps you are better off letting a professional handle this, *so that you can spend more time running your business instead of "running the numbers."*

And if you are not that good at government "paperwork" (which is true for many business owners), it is easy to see why bureaucratic "red tape" is one of the main reasons new business start-ups "drop like flies" in the first couple years they're open.

Business income tax returns (regardless of what type of entity you own: Sole Proprietorship, Partnership, Corporation, Limited Liability Company) contain a multitude of mind-numbing forms and calculations. If you don't do tax returns for a living, you are really playing with fire here.

Do yourself a favor and find a competent Tax Professional.

## Just How Complicated Can It Be To Prepare Business Tax Returns?

**Read the article on the next page to find out!**

*"The government makes it comically difficult for the honest citizen to hire a single employee -- and makes it virtually impossible to do it correctly. I'm fairly bright. My assistant is very bright. Between us we have spent many, many hours struggling over the forms. Yet it is inconceivable that we can have got it all right."*

Does this man's experience sound familiar to you? If you have tried to tackle the world of payroll tax returns, you may very well understand exactly what Michael Kinsley is talking about. This article, published in the April 4, 1994 issue of Time Magazine, is just as applicable today as it was 15 or 20 years ago.

*Having just one employee "plunges you into an entirely new dimension of complexity. By my count (which undoubtedly is wrong), it takes a minimum of 37 different forms and 50 separate checks to hire a single employee for a year, even if she graciously agrees to be paid only once a month."*

Mr. Kinsley's article expresses so well the frustration experienced by so many small business owners. Having just one employee creates a literal "mountain of paperwork" that boggles the mind. And please don't forget, if you formed a corporation, even if you have no other employees, *if you performed any work for the business, then you are considered an employee of the corporation and must be paid as an employee of the corporation.* So, you, as owner of the corporation, may also be the corporation's only employee, and the corporation must file all the necessary payroll tax returns.

If you already have a competent accountant or bookkeeper who is handling your payroll tax returns, great. If you don't, and are thinking about "going it alone," please reconsider! There is an easy way to avoid the headache of filing all these business tax returns by yourself! Just contact me to schedule a free, no-obligation consultation. Why put yourself through the hassle of trying to figure out all these forms on your own. I can take this burden off your shoulders and free you up to do more important things -- like running your business!

NOTE: Michael Kinsley's article mentions both federal payroll tax returns and District of Columbia payroll tax returns. Obviously, if you do not live in D.C, you will not have to file D.C. tax returns. But guess what? You will have to file a bunch of *state* payroll tax returns! So whenever this article mentions "District of Columbia", just substitute "Indiana" or whatever state you live in. No matter where you live, the burden of filing payroll tax returns is about the same. For example, in Indiana, having just one employee requires the employer to file about 40 different tax forms over the course of one year.

## **My Failed Jobs Program**

by Michael Kinsley

April 4, 1994 (but just as relevant today!)

Time Magazine

One of those 2 million jobs created in the U.S. last year -- the ones President Clinton is so proud of -- was created by me. Around September, I decided to hire an assistant. I dreamed of mundane clerical and research tasks being lifted from my shoulders, so that I could devote myself more fully to pure cogitation on the pressing issues facing humankind. Less nobly, I dreamed of joining the ranks of those Washingtonians who have "aides." Perhaps, I fantasized, I would even have a "key aide" or a "senior aide."

And, needless to say, there would be no "Zoe Baird problem." I was among those people who had spent the early months of 1993 feeling mighty smug because I have always paid the Social Security tax for my once-a-week cleaning lady and have the paperwork to prove it. This second demonstration of my job-creating prowess would not be allowed to mar that record. Anyway, the paperwork would not be my problem. What are assistants for, after all?

Little did I realize. The government makes it comically difficult for the honest citizen to hire a single employee -- and makes it virtually impossible to do it correctly. I'm fairly bright. My assistant is very bright. Between us we have spent many, many hours struggling over the forms. Yet it is inconceivable that we can have got it all right. Now, as a result of my rash attempt to create a job, neither one of us can ever become Attorney General.

Obedying the rules for a part-time household employee is fairly simple, once you get the hang of it. The government sends you a form every three months. You return it with an easy-to-compute check. Once a year, the government sends you a W-2 form, which you fill out in something like octuplicate.

But hiring a full-time business employee plunges you into an entirely new dimension of complexity. By my count (which undoubtedly is wrong), it takes a minimum of 37 different forms and 50 separate checks to hire a single employee for a year, even if she graciously agrees to be paid only once a month.

Forms. At the federal level, there is the employer-registration form, which gets you your employer number; the W-4, which counts the employee's deductions; the annual W-2, listing all income earned and taxes withheld; the W-3, summarizing all the W-2s (required, even when there is only one W-2); Form 941, "Employer's Quarterly Federal Tax Return"; plus forms with each check you write. The District of Columbia requires its own employer-registration form (with, of course, a different employer number); its own D-4 model of the federal W-4; and the ever-popular FR-900BO, "Annual Reconciliation and Report," plus forms with each check.

Checks. Once a month, one check goes to the employee, and another goes to pay for health insurance. One monthly check goes to the feds and another goes to the District of Columbia, reflecting federal income-tax withholding, federal Social Security and Medicare (employee's and employer's shares), and local income-tax withholding. Separate checks go to the feds and the District of Columbia -- only one a year each! -- for unemployment insurance. (The District of Columbia form is called "Quarterly" but needs to be filed annually. Or so I think.) The chance that all these checks are for the right amounts is slim.

The wrinkles are endless. Federal withholding is due the 15th of every month; District of Columbia withholding is due the 20th. The D.C. check may be mailed (Thank you, District of Columbia!), but the federal check must be physically taken to the bank. Not only that, but the check must also be written on the same bank it is taken to. Honest. Because my checking account is from out of town, this presented quite a challenge.

There are companies that specialize in taking these hassles off your hands. One of these firms wanted a mere \$650 to handle the paperwork for one employee for a year.

Hiring an assistant is a wonderful way to keep an assistant busy -- and to keep busy yourself. It wasn't long after we started sending paperwork to the government before the government started firing paperwork back at us. The IRS wanted to know: Where was my Form 941 for the quarter before my employee was hired? We confidently batted that one right back again -- no Form 941 was due for that quarter, you idiots! -- and got the undaunted response, "We are taking no further action at this time, but we may need to contact you again if other tax issues arise." And indeed they have arisen. As for the government of the District of Columbia, it is a constant source of delightful surprises.

As a liberal, I am chagrined by this experience. The total burden of all the different taxes actually seems reasonable (if, that is, I have the amounts even approximately correct). But the complications involved in trying to pay them honestly are a disgrace. Yet conservatives should be chagrined as well. A large part of the problem is the need to go through most of the rigmarole twice: once for the federal government and again at the state level. Federalism is traditionally more of a conservative conceit than a liberal one.

Meanwhile, President Clinton can count on one fewer job when the stats come out for 1994. My assistant is moving on, and I'm retiring the position. Having an assistant simply takes too much time.

**Wayne M. Davies'**  
**Tax Reduction Toolkit**

**PART FOUR**

**How To Audit-Proof Your  
Income Tax Return Forever!**

**by Wayne M. Davies**

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## **Learn From The Mistakes Of Others**

Or

### **"How To Guarantee That You'll Lose Every Deduction If You Get Audited"**

The best way to begin this discussion of "How To Audit-Proof Your Income Tax Return Forever" is to share a true story. (The names have been changed to protect the innocent.)

A few years ago, during the middle of tax season (early March), one of my clients (let's call him "Mr. Jones") got one of those "love letters" from the IRS.

The IRS wanted to audit Mr. Jones' income tax return, and so the IRS just went ahead and scheduled an appointment to meet with him.

The appointment was scheduled for March 29. Mr. Jones was petrified at the thought of meeting with a real live IRS agent without me, and so it was critical that I be able to attend this meeting.

But in late March, you can imagine what my life is like.

I'm swamped with work, trying to get as many tax returns done as possible before April 15. For me to take a half-day (or more) to meet with the IRS in late March is like asking a farmer to take a day off his tractor during harvest time.

So I called the IRS and asked to re-schedule the appointment. The appointment scheduler was very pleasant at first, so I was very optimistic that we could get the meeting pushed back a few weeks, until mid-May or something. After all, I usually take some time off after tax season to recuperate.

Well, the IRS appointment scheduler says that the appointment can be postponed - until April 17! I was flabbergasted! I said, "How about postponing the appointment until May?" No way, says the IRS employee. April 17 was the latest possible postponement date.

Some cooperation. We have no choice but to meet on April 17, two days after tax season is over. There isn't much I can do but re-schedule my "post-tax season recuperation time" and get over it.

Oh well, I thought to myself. So much for a more "understanding" IRS.

Now for the really fun part. The audit itself. Now, please understand, 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".

You then have a few weeks to respond. So you either send a letter which explains the discrepancy, or if the discrepancy is legitimate, you bite the bullet and go ahead and pay the additional tax (plus penalties and interest).

But 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.

What do you think happened at the audit? Did Mr. Jones win or lose? Were we able to prove that these deductions were valid? Did Mr. Jones have good records?

Well, let's cut right to the chase! As you may have guessed, Mr. Jones lost the audit, and he lost "big time." The IRS disallowed several of Mr. Jones' deductions, which then increased his taxable income and resulting tax liability.

The end result was not pretty. Mr. Jones 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, you ask? Well, I'm glad you asked. Mr. Jones made two "classic" taxpayer mistakes that turned out to be very costly:

1. Inadequate documentation -- "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! 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:

2. Improper deductions -- by "improper", I mean unlawful, illegal, or bogus. It turns out that Mr. Jones reported deductions that simply were not real, bona fide 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.

Well, Mr. Jones would estimate what he would have had to pay someone else to do the work that he did himself, and then he would report that amount as a deduction, even though he didn't actually pay anybody to do the work!

In other words, Mr. Jones deducted the value of his time.

## THIS IS A BIG "NO-NO"!

This is an important point -- you can never legitimately deduct the value of your time for work you did. You have to actually pay someone else to do the labor.

Well, that's what happened to Mr. Jones. I hope you benefited by learning what can happen in a real audit. If you ever get a letter from the IRS which demands additional information regarding a return, you'll have nothing to worry about if you do exactly the opposite of what Mr. Jones did. If you can properly document your deductions and assuming your return has no bogus information, you'll pass the audit with flying colors!

Now that you've got "the big picture" on what to expect from the IRS if you ever get audited, let's delve even deeper into this area of audit-proofing your income tax return.

The two most important things to remember are this:

1. Your deductions must be adequately documented
2. Your deductions must be lawfully legitimate

Let's take a closer look at each of these requirements.

## Deductions Must Be Adequately Documented

First, let's make sure you understand why it is so important that your expenses be documented. What happens if they are not documented? You lose them, that's what happens! Without written proof that your expenses really happened, the IRS can disallow the deduction.

And here's the real tragedy when a valid deduction is disallowed because of inadequate documentation: You may have actually spent the money on a legitimate deduction. But you lost the receipt and/or your proof of payment (like the cancelled check or the bank statement or the credit card charge slip) and so you cannot provide the "paper trail" required by the IRS.

Guess what? Too bad. Tough luck. Kiss that deduction good-bye.

And now your taxable income has just been *increased* by the amount of the disallowed deduction. So, if you have \$1,000 dollars of disallowed deductions, your taxable income just went up by \$1,000 -- *and now you have to pay the income tax on that \$1,000.*

If you happen to be in the 25% federal income tax bracket, and the IRS disallows \$1,000 of deductions, they will send you a bill for \$250, plus penalty and interest for late

payment of that \$250, because by the time you get audited, it is probably at least a year or two after the tax return was due.

It doesn't matter that the IRS waited a couple years to audit your return. If they disallow some deductions and thereby increase your taxable income and your tax liability, you have to pay the penalty and interest for paying the tax late -- because that's what you are now doing. By law, that \$250 should have been paid by the due date of the return, which could be a couple years ago.

Here's another example: Instead of \$1,000 of disallowed deductions, let's say the amount of disallowed deductions is \$10,000. Now the math gets really depressing. Again, assuming your federal income tax rate is 25%, the additional tax on those disallowed deductions will be \$2,500 -- plus penalty and interest!

Now a few comments about the mechanics of maintaining proper documentation. Just how do you go about keeping the kind of records that will pass the scrutiny of an IRS audit?

Don't worry! This is not going to be nearly as bad as you think! For some of you, this is basic stuff. For others, it's just what you need to keep the IRS off your back and out of your life.

1. Maintain a separate bank account for your business. Never use your personal bank account for business expenses. Having a separate bank account automatically creates the "shell" for the perfect documentation tracking system.

2. The business bank account should only be used for business! Only business income goes into this account. Only business expenses come out of this account. Sounds simple, doesn't it? But you'd be amazed at how many small business owners and self-employed people are not using this type of record-keeping system.

3. For each major income and expense category, create a simple filing system each calendar year -- one file folder for each major category each year. Every time you write a check for a business expense, you assign that expense to the appropriate expense category and file the supporting documentation (receipt, invoice, cancelled check, or whatever) into the corresponding file folder.

Again, isn't this common sense? But I come across small business owners every year who aren't doing this! Many are lucky to be saving any receipts at all, and if they are, they are literally throwing them into the proverbial shoebox.

4. Maintain a separate credit card account for your business. Same deal as the bank account -- pick one credit card that you use exclusively for business expenses. Save all credit card receipts and any corresponding invoices, and follow the same type of filing

procedure: every time you charge a business expense, save the receipt and/or invoice, assign it to the appropriate category, and file it away in the corresponding file folder.

5. Keep a separate file folder for all monthly bank account statements and credit card statements.

6. Use a simple bookkeeping software program to record all deposits, checks, and credit card charges. Every month (or even better, once a week), input all transactions and assign each transaction to the appropriate income or expense category.

There are any number of software programs out there for this purpose. I've used them all: Quicken, Quickbooks, Money, etc. Spreadsheet programs like Excel can also be used to automate business record-keeping.

Using a software program is a tremendous time-saver. Once you've input all your individual income and expense transactions, and assuming you've assigned each transaction to the appropriate category and filed the paperwork, you've already done virtually all the work necessary to audit-proof your income tax return!

[NOTE: If you aren't "computer-savvy", that's OK. You can still use good ole pencil and paper to categorize your business expenses. I have clients who use nothing more sophisticated than a spiral notebook. Each year they buy a new notebook and label each page with a particular income or expense category. Every transaction gets written down in the notebook on the appropriate page. At the end of the year, they add up the totals for each page, and presto, they give me an annual recap of all major income and expense categories. Get the picture? It doesn't have to be fancy. It just has to be in writing, accurate, and supported by actual paper documents.]

Every single transaction has been assigned to the appropriate category, and every transaction has the corresponding "paper trail" -- every receipt, invoice, cancelled check, credit card charge (or whatever) has been filed into the appropriate category file folder. Should the IRS question any income or expense amount on your return, you'll be ready!

## **Deductions Must Be Lawfully Legitimate**

Here's where "a little knowledge" can be a two-edged sword. Knowing what you can and cannot deduct is the subject of volumes of printed material. The Internal Revenue Code, the official U.S. Treasury Department "regulations" which interpret the Tax Code, plus all the books, magazine & newspaper articles devoted to this subject is overwhelming.

Where's the average Small Business Owner to start. Right Here!

Let's start with a basic checklist of the most common and obvious legitimate deductions. This list is not necessarily exhaustive, but it's a great starting point:

- Accounting fees
- Advertising
- Bad debts
- Bank service charges
- Car & truck expenses
- Charitable contributions
- Commissions
- Contracted services
- Cost of goods sold
- Credit card fees
- Depreciation
- Dues
- Education expenses
- Employee benefit programs
- Insurance
- Interest
- Internet access fees
- Lease expenses
- Legal fees
- Licenses
- Meals & entertainment (50%)
- Moving expenses
- Office expenses
- Pension & retirement plans
- Regulatory fees
- Rent expenses
- Repairs & maintenance
- Subscriptions
- Supplies
- Taxes--property
- Taxes--payroll
- Taxes--sales
- Telephone
- Travel
- Utilities
- Wages & salaries
- Website fees

Keep in mind that when you file your business income tax return, many of the above-listed expenses are not even mentioned on the various business income tax return forms.

Which particular form you use depends on what type of business you own:

<b><u>Type of Business</u></b>	<b><u>Income Tax Form</u></b>
Sole Proprietorship	Schedule C
Partnership	Form 1065
Limited Liability Company	Form 1065 (multi-member)
Limited Liability Company	Schedule C (single member)
"S" Corporation	Form 1120S
"C" Corporation	Form 1120

Go to the IRS web site at <http://www.irs.gov> and download any of the above forms. You will be amazed at how few expense categories are listed on the main part of the tax return where expense categories are listed.

Just because a particular expense category is not listed does NOT mean you cannot deduct it! What you will also notice is that each of these forms has a section for you to report any number of "miscellaneous" deductions. You just list whatever category you like, in your own words.

<b><u>FORM</u></b>	<b><u>Where to deduct miscellaneous expenses</u></b>
Schedule C	Part V: Other Expenses. List below business expenses not included on lines 8-26 or line 30.
Form 1065	Line 20: Other deductions. Attach schedule.
Form 1120S	Line 19: Other deductions. Attach schedule.
Form 1120	Line 26: Other deductions. Attach schedule.

So, in effect, you've been given a "blank slate" to report all the various business expenses that your particular form doesn't list for you.

Here's where you need a quick lesson on how to determine whether your "miscellaneous deductions" are legitimate. Most Small Business Owners and Self-Employed People are able to take advantage of one of the most important rules in the Tax Code. This rule is known as the "Ordinary And Necessary" rule.

Generally speaking, *if the expense in question is "ordinary and necessary", it is deductible.*

What does the Tax Code mean by "ordinary and necessary"? I'm glad you asked!

Let's go right to the horse's mouth, shall we? IRS Publication 334, Tax Guide for Small Business, explains it this way:

**"To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary."**

This short and simple paragraph is filled with tax-saving opportunities for the Small Business Owner or Self-Employed Person.

1. First, notice that it says that the expense must be BOTH ordinary AND necessary. That is critical. Just ordinary OR just necessary isn't enough. It has to be both! Got it!

2. "ORDINARY" is defined as common or acceptable. Other words like "customary", "usual" or "normal" communicate this all-important concept. In other words, if it is common practice in your trade or business to incur a particular expense in the normal course of operations, then you have a deductible expense.

3. "NECESSARY" means helpful or appropriate. This, too, opens the door to a wide range of legitimate business expenses.

4. Here's another important point: Over the years, the courts have determined that if an expense is "ordinary", then it is also automatically "necessary." But an expense may be "necessary" but not "ordinary." And don't forget, if the expense is necessary but not ordinary, it is not deductible. (See #1 above!)

So there you have it: To audit proof your return, keep good records and no "funny money." That's all there is to it.

Do you need more detailed information on how to audit-proof your return? Be sure to read Part Five of the Tax Reduction Toolkit: "Starting A Business And Keeping Good Records." Pages 11 - 16 of Part Five provide excellent information on topics such as:

Kinds of Records To Keep  
How Long To Keep Records  
Sample Record System

**Wayne M. Davies'**  
**Tax Reduction Toolkit**

**PART FIVE**

**Starting A Business  
And  
Keeping Records**

**IRS Publication 583**

Believe it or not, the Internal Revenue Service provides some helpful information for the Small Business Owner / Self-Employed Person.

One publication I recommend you read is Publication 583, Starting A Business and Keeping Records. To get your free copy, go to:

<http://www.irs.gov/pub/irs-pdf/p583.pdf>

Publication 583 provides an excellent overview of how to maintain financial records for any small business or self-employment activity.

Another excellent IRS resource is Publication 334, Tax Guide for Small Business (For Individuals Who Use Schedule C):

<http://www.irs.gov/pub/irs-pdf/p334.pdf>

Publication 334 also has some good basic small business tax information.

Just right-click on any of the links on the webpage listed above to download the appropriate pdf file for these free publications.

**Wayne M. Davies'**  
**Tax Reduction Toolkit**

**PART SIX**

**The Complete Financial  
Check-Up System**

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## Introduction To The Complete Financial Check-Up System

Welcome to the "The Complete Financial Check-Up System." This System contains numerous worksheets and instructions that all fall under the category of "financial planning". You are welcome to use this Financial Check-Up System on your own. I must warn you, however, that completing these worksheets on your own takes some "number crunching" -- so if you like to work with figures, you may very well learn alot about yourself and your finances on your own.

As an alternative to using the Financial Check-Up System on your own, please consider having me help you with these worksheets. As you may already know, I don't just "do taxes." I am interested in helping you with any and every "money matter" that concerns you.

Since you have expressed an interest in receiving The Complete Financial Check-Up System, the most important question I can ask you right now is:

**"Are you interested in developing a comprehensive financial plan for yourself and your family?"**

If so, I can help you! I am available to discuss any topic presented in the Financial Check-Up System. If this idea appeals to you, here's an easy way to get started: Complete the enclosed **"ISSUES AND CONCERNS"** questionnaires. If you are married, both spouses should complete this questionnaire -- just make a photocopy of the questionnaire so that each of you has his/her own copy to fill out.

After you have completed the questionnaires, give me a call at 260-459-3858 or send me an email at [Wayne@YouSaveOnTaxes.com](mailto:Wayne@YouSaveOnTaxes.com). I'd like to discuss your interest in developing a comprehensive financial plan.

Thank you for your sincere desire to improve your financial situation.

**NOTE:**

**The Complete Financial Check-Up System is contained in a separate file that you should have downloaded when you purchased the Tax Reduction Toolkit. The file name is "Check-up.pdf".**

## ISSUES AND CONCERNS

NAME (please print) \_\_\_\_\_ DATE \_\_\_\_\_

Please circle the answer that best describes your situation:

### TAX PLANNING

Is your income tax liability acceptable?	YES	NO	Don't Know
Are you using all the legal tax loopholes to reduce your taxes?	YES	NO	Don't Know

### RETIREMENT PLANNING

Are you already retired?	YES	NO	Don't Know
Do you anticipate a rollover of retirement plan account?	YES	NO	Don't Know
Do you plan on retiring soon?	YES	NO	Don't Know
Do you know at what age you would like to retire?	YES	NO	Don't Know
Do you have enough money for retirement?	YES	NO	Don't Know
Do you have any funds "ear-marked" for your retirement?	YES	NO	Don't Know
If you do have any funds "ear-marked" for retirement, are you satisfied with the way these funds are performing?	YES	NO	Don't Know

### EDUCATIONAL PLANNING

Do you have sufficient funds for your children's education?	YES	NO	Don't Know
Do you have any funds "ear-marked" for your children's education?	YES	NO	Don't Know
If you do have any funds "ear-marked" for your children's education, have those funds been reviewed by an independent advisor?	YES	NO	Don't Know

### INVESTMENT PLANNING

Do you have sufficient cash flow?	YES	NO	Don't Know
Do you need household or family budget planning?	YES	NO	Don't Know
Do your financial assets protect you from financial disaster?	YES	NO	Don't Know
Do you feel like your financial assets are adequately diversified?	YES	NO	Don't Know
Do you think your financial assets protect you from inflation?	YES	NO	Don't Know
Do you believe your financial assets match your risk tolerance?	YES	NO	Don't Know
Do you plan on making additional investments?	YES	NO	Don't Know

### BUSINESS PLANNING

Are you using all the tax loopholes available for your business?	YES	NO	Don't Know
Is your business tax planning coordinated with your personal tax planning?	YES	NO	Don't Know
Do you plan to buy or sell a business?	YES	NO	Don't Know

### INSURANCE

Have you had an objective, independent review and analysis of your insurance? (life, health, auto, home, renters, liability)	YES	NO	Don't Know
Do you feel you have the right amount of insurance?	YES	NO	Don't Know
Are you paying too much for insurance?	YES	NO	Don't Know

**COMPANY BENEFITS**

Are you taking full advantage of your company benefits?	YES	NO	Don't Know
Do you plan on changing jobs?		YES	NO Don't Know
Do you know if your retirement plan and/or pension plan is adequate?		YES	NO Don't Know

**ESTATE PLANNING**

Do you have wills or trusts?		YES	NO Don't Know
Have you had your wills reviewed recently?		YES	NO Don't Know
Do your wills have provisions for new family members?		YES	NO Don't Know
Have you done inheritance planning?		YES	NO Don't Know
Will your estate avoid probate?		YES	NO Don't Know
Are you the beneficiary of any trusts or wills?		YES	NO Don't Know

**MORTGAGE PLANNING**

Do you plan on moving?	YES	NO	Don't Know
Do you plan on buying a home?		YES	NO Don't Know
Do you plan or need to refinance your mortgage?	YES	NO	Don't Know
Do you need mortgage and/or other financing analysis?		YES	NO Don't Know

**LONG-TERM CARE & ASSET PROTECTION**

Is your wealth protected if someone has to go into a nursing home?		YES	NO Don't Know
Do you have a Medicare Supplement?		YES	NO Don't Know
Do you have a Long Term (Nursing Home) policy?		YES	NO Don't Know
Do you have a Medicaid Trust?		YES	NO Don't Know
Have you set up any Asset Protection plans?		YES	NO Don't Know
Is anyone in the immediate family already in a Nursing Home, or will be soon?		YES	NO Don't Know

**OVERALL PLANNING**

Do you need a coordinated comprehensive financial plan	YES	NO	Don't Know
Do you spend enough time on planning your finances?		YES	NO Don't Know
Do you know what a Financial Advisor does?		YES	NO Don't Know
Have you set specific financial goals?		YES	NO Don't Know

**ADDITIONAL COMMENTS OR CONCERNS**

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**Wayne M. Davies'**  
**Tax Reduction Toolkit**

**PART SEVEN**

**The Science of Getting Rich**  
by Wallace D. Wattles

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*What is*

## **The Science of Getting Rich?**

*You're about to discover . . .*

**Timeless wisdom and a practical prosperity program from a forgotten 1910 classic -- free!**

"The ownership of money and property comes as a result of doing things in a certain way. Those who do things in this certain way, whether on purpose or accidentally, get rich. Those who do not do things in this certain way, no matter how hard they work or how able they are, remain poor."

"It is a natural law that like causes always produce like effects. Therefore, any man or woman who learns to do things in this certain way will infallibly get rich."

Wallace D. Wattles,  
*The Science of Getting Rich*, Chapter 2

For more information about this amazing man and his amazing book, go online  
And CLICK HERE => [The Science of Getting Rich Network](#)

**NOTE:**

**The Science of Getting Rich is contained in a separate file that you should have downloaded when you purchased the Tax Reduction Toolkit. The file name is "GettingRich.pdf".**