TAX BASICS FOR A SMALL BUSINESS

For a small business, "tax basics" is almost an oxymoron. If you, like most other small business owners, have difficulty with this subject matter, don't be dismayed. There is an entire industry dedicated to helping/solving these problems and making sure they are properly addressed – call a local CPA or bookkeeper just like your peers will do or have done. Nonetheless, it is important to have a basic understanding of how taxes work. Here is a brief overview of where to start and how to stay out of trouble.

Designate one specific person in your firm to handle your day-to-day bookkeeping/tax matters, or hire a bookkeeper and/or an accountant. It is important to have the same person responsible for handling all tax matters to ensure consistency and organization. No matter how large or small your firm is, this rule always applies. In firms with annual gross revenue of $3 million or less, an outside bookkeeper and accountant is almost always the best choice.

TAX YEAR – FISCAL OR CALENDAR

When you determine your taxable income and file an income tax return, it must be based on an annual accounting period called a "tax year." A tax year is 12 consecutive months. There are two kinds of tax years.

1. *Calendar tax year. A calendar tax year is 12 consecutive months beginning January 1 and ending December 31.*
2. *Fiscal tax year. A fiscal tax year is 12 consecutive months ending on the last day of any month except December.*

In general, as the owner of a financial services business, you must use a calendar tax year if:

- *You keep no books;*
- *You have no annual accounting period;*
- *Your present tax year does not qualify as a fiscal year; or*
- *You are required to use a calendar year by a provision of the Internal Revenue Code or the Income Tax Regulations.*

Most small business owners use a calendar tax year. If you're not sure, talk to a local accountant or CPA. For more information, visit www.IRS.gov and read Publication 538, Accounting Periods and Methods.

Once you have adopted your tax year, you will have to get IRS approval to change it. To get approval, you must file Form 1128, Application To Adopt, Change, or Retain a Tax Year. You may have to pay a fee, so be sure to check. For more information, see IRS Publication 538, Accounting Periods and Methods.

GETTING A TAXPAYER ID NUMBER

A federal tax identification number, also known as an employer identification number or EIN, is basically a social security number for your business. It is the number the IRS uses to identify your business, and it must be included on tax filings your business makes. Businesses apply for an EIN by preparing IRS Form SS-4 and filing it with the IRS. In most cases, this form is completed and submitted by your CPA or attorney as a part of setting up your business entity.

You need to get an EIN if you have employees, have a pension plan, or operate your business as a corporation or partnership, which includes a limited liability company. Certain states also require a state tax identification number. To learn if your state requires a separate number, contact your state's taxation authority, or simply ask your accountant or CPA.

You may apply for an EIN using several different methods:

- *Online – Click on the EIN link at www.IRS.gov/businesses/small. The EIN is issued immediately once the application information is validated.*
- *By telephone at 1-800-829-4933 from 7:30 a.m. to 5:30 p.m. in the applicant's local time zone.*
- *By mailing or faxing Form SS-4, Application for Employer Identification Number.*

You should apply for an EIN early enough to receive the number by the time you must file a return or statement or make a tax deposit. If you apply by mail, file Form SS-4 at least four to five weeks before you need an EIN. If you apply by telephone or through the IRS website, you can get an EIN immediately. If you apply by fax, you can get an EIN within four business days.

If you do not receive your EIN by the time a return is due, file your return anyway. Write "Applied for" and the date you applied for the number in the space for the EIN. Do not use your social security number as a substitute for an EIN on your tax returns. For more information about EINs, visit www.IRS.gov and read Publication 1635, Understanding Your EIN.

If you currently operate your business as a sole proprietorship or partnership and want to incorporate or form a limited liability company (LLC), you must obtain a new EIN for your business.

EMPLOYER/EMPLOYEE FORMS

When you hire a new employee, you will need them to complete Form I-9 and Form W-4 on or before the first day of employment. Form I-9, Employment Eligibility Verification, is required by the United States Customs & Immigration Service to ensure employer verification that each new employee is legally eligible to work in the United States.

Form W-4, Employee's Withholding Allowance Certificate, provides an employer with the filing status and withholding allowances of each employee. This form enables an employer to determine the amount of income tax to withhold from the employee's wages.

After the calendar year is over, you must furnish copies of Form W-2, Wage and Tax Statement, to each employee to whom you paid wages during the year. You must also send copies of Form W-2 to the Social Security Administration. Your accountant or CPA can help you with these forms, or you can use a local payroll service such as Paychex to assist.

You can easily download and print a copy of Form I-9 and W-4 at www.IRS.gov. Many states also require that you notify them of any new hires. They use this information to identify people who are required to make child support payments or subject to other types of garnishments.

TAX DEPOSIT COUPONS

Generally, you have to deposit employment taxes, withheld income taxes, and corporate income tax before you file your IRS tax return. You can deliver your deposits with a completed deposit coupon to an authorized financial institution or to a Federal Reserve Bank in your area. The easiest way is to make the deposits online. If you expect to owe taxes of $500 or more when you file your IRS tax return, you generally have to make estimated tax payments.

IRS Form 8109, Federal Tax Deposit Coupon, is used to deposit taxes. Shortly after you file for a tax identification number or EIN, the IRS will send you a coupon book. Generally, a mailed deposit will be considered timely if the taxpayer establishes that it was mailed in the United States at least two days

before the due date. You may be charged a penalty for not making deposits when due, unless you have reasonable cause.

If your total deposits of Social Security taxes, Medicare taxes, and withheld income tax in any year exceeds $50,000, you will likely be required by the IRS to deposit your taxes through the Electronic Federal Tax Payment Systems (EFTPS). Even a taxpayer who makes tax deposits less than this sum can use the EFTPS. For more information, visit www.IRS.gov, or consult with your local accountant.

You can easily download and print a copy of Form 8109 at www.IRS.gov.

INCOME TAX

The form of business you operate determines what taxes you must pay and how you pay them. The following are the four general kinds of business taxes.

- *Income tax*
- *Self-employment tax*
- *Employment taxes*
- *Excise taxes*

The federal income tax is a pay-as-you-go tax. You must pay the tax as you earn or receive income during the year. An employee usually has income tax withheld from his or her pay. As a small business owner, if, like most owners, you do not pay your tax through withholding, you'll likely have to pay estimated tax. If you are not required to make estimated tax payments, you may pay any tax due when you file your return. Shareholders of S-corporations have the option of making estimated tax payments or having taxes withheld from their wages.

Generally, sole proprietors and partners in a general partnership pay income tax by making regular estimated tax payments, or deposits, during the year if they expect to owe tax of $1,000 or more when they file their return. Use Form 1040-ES, Estimated Tax for Individuals, to figure and pay your estimated tax. For more information, visit www.IRS.gov and read Publication 505, Tax Withholding and Estimated Tax.

If your entity is a C-corporation, you generally have to make estimated tax payments for your corporation if you expect it to owe tax of $500 or more when you file its return. Use Form 1120¬W, Estimated Tax for Corporations, to figure the estimated tax. For more information, visit www.IRS.gov and read Publication 542.

All businesses except sole proprietors must file a separate annual income tax return with the IRS and with states where they conduct business (partnerships file an information return). A sole proprietor's business return is included in his or her personal tax return. An information return is a tax filing that notifies the IRS about the partnership's business activity for the year. Which form you use depends on how you've organized your small business.

Figure 1 on page 4 is table listing the specific characteristics of the various business entities.

SELF-EMPLOYMENT TAX

Self-employment tax (or "SE tax") is a Social Security and Medicare tax primarily for individuals who work for themselves. Your payments of SE tax contribute to your coverage under the Social Security system. Social Security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits.

You must pay SE tax and file Schedule SE (within your Form 1040) if your net earnings from self-employment are $400 or more. For more information, visit www.IRS.gov and read Publication 533, Self-Employment Tax.

FIGURE 1 | Ages of Producing Advisors

If you are a:	You may be liable for:	Use form:
Sole Proprietor	Income Tax	1040 and Schedule C1 or C-EZ (Schedule F[1] for farm business)
	Self-employment tax	1040 and Schedule SE
	Estimated tax	1040-ES
	Employment taxes: • *Social Security and Medicare taxes and income tax withholding* • *Federal unemployment (FUTA) tax* • *Depositing employment taxes.*	941 (943 for farm employees) 940 or 940-EZ 8109[2]
	Excise taxes	*See Excise Taxes*
Partnership	Annual return of income	1065
	Employment taxes	Same as sole proprietor
	Excise taxes	*See Excise Taxes*
	Income tax	1040 and Schedule E[3]
Partner in a partnership (individual)	Self-employment tax	1040 and Scheduled SE
	Estimated tax	1040-ES 1120 or 1120-A (corporation)[3]
C-corporation or S-corporation	Income tax	1120S (S corporation)[3]
	Estimated tax	1120-W (corporation only) and 8109[2]
	Employment taxes	Same as sole proprietor
	Excise taxes	*See Excise Taxes*
S-corporation shareholder	Income tax	1040 and Schedule E[3]
	Estimated tax	1040-ES or withheld from your wages as an employee of the S-corporation

[1]File a separate schedule for each business. [2]Do not use if you deposit taxes electronically.
[3]Various other schedules may be needed.

EMPLOYMENT TAX

Employment taxes refer to the taxes you must pay when you have employees, and the forms you must file to report them. Employment taxes include the following:

- *Social Security and Medicare taxes*
- *Federal income tax withholding*
- *Federal unemployment (FUTA) tax*

If you have employees, you will need to visit www.IRS.gov and read Publication 15, Circular E, Employer's Tax Guide. This publication will explain your tax responsibilities as an employer.

If you are not sure whether the people working for you are your employees, see Publication 15¬A, Employer's Supplemental Tax Guide. This publication has information to help you determine whether an individual is an employee or an independent contractor. If you incorrectly classify an employee as an independent contractor, you can be held liable for employment taxes for that worker plus a penalty. An independent contractor is someone who is self-employed. Generally, you do not have to withhold or pay any taxes on payments to an independent contractor.

You must withhold federal income tax from your employee's wages. To figure how much federal income tax to withhold from each wage payment, use the employee's Form W-4 and the methods described in Publication 15. As a practical matter, most small business owners do not handle their own payroll, outsourcing it instead to local payroll companies such as Paychex or having payroll handled by an experienced bookkeeper.

Social Security and Medicare taxes pay for benefits that workers and their families receive under the Federal Insurance Contributions Act (FICA). Social Security tax pays for benefits under the old-age, survivors, and disability insurance part of FICA. Medicare tax pays for benefits under the hospital insurance part of FICA. You withhold part of these taxes from your employee's wages and you pay a matching amount yourself. To find out how much Social Security and Medicare tax to withhold and to pay, visit www.IRS.gov and read Publication 15.

The federal unemployment tax is part of the federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. You report and pay FUTA tax separately from Social Security and Medicare taxes and withheld income tax. You pay FUTA tax only from your own funds. Employees do not pay this tax or have it withheld from their pay.

Many states have additional employer taxes, such as disability insurance, worker's compensation, head taxes, or transportation assessment. It is important to check with your tax professional to determine the total cost of each employee.

EXCISE TAX

Excise taxes generally do not apply to a financial services business. This tax category applies to businesses that manufacture or sell certain products, operate certain types of businesses, or use various types of equipment, facilities, or products (e.g., heavy trucks, firearms, tobacco, alcohol products, wagering, etc). For more information, visit www.IRS.gov and read Publication 510, Excise Taxes.

MISCELLANEOUS TAXES AND FORMS

You must file Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, if you receive more than $10,000 in cash in one transaction or two or more related business transactions. Cash includes U.S. and foreign coin and currency. It also includes certain monetary instruments, such as cashier's and traveler's checks and money orders.

Use Form 1099-MISC, Miscellaneous Income, to report certain payments you make in your trade or business. These payments include the following items:

- *Payments of $600 or more for services performed for your business by people not treated as your employees, such as subcontractors, attorneys, accountants, or directors*

- *Rent payments of $600 or more, other than rents paid to real estate agents*
- *Prizes and awards of $600 or more that are not for services, such as winnings on TV or radio shows*
- *Royalty payments of $10 or more*

EXPENSES AND DEDUCTIONS

No tax article/whitepaper would be complete without a discussion and understanding of what you can deduct as a business owner and how you can avoid (not evade) tax liabilities. As a basic rule, you can deduct business expenses on your income tax return. This may be the first good news you've read in this article.

Business expenses are the current operating costs of running your business. 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, trade, or profession. A necessary expense is one that is helpful and appropriate for your business, trade, or profession. An expense does not have to be indispensable to be considered necessary.

As a new business owner, business start-up costs and depreciation are two of the more important categories to understand and appreciate. As the owner of a financial services business, there are many other expenses that you may be able to deduct. For more information, talk to your accountant or CPA, or visit www.IRS.gov and read Publication 535, Chapter 9, Business Expenses.

A) Business start-up costs and organizational expenses are the expenses you incur before you actually begin business operations. Your business start-up and organizational costs will depend on the size and type of the business you are starting. Expenses for assets to be used in the business are not considered start-up costs. A company can elect to amortize both of these costs in as little as 60 months. Start-up costs include money spent to investigate an industry for its suitability, meals and entertainment costs, and travel costs, all related to investigating whether this venture is really something you're interested in. Some of the more common organizational expenses include: a) legal services incurred in setting up a corporation or LLC; b) accounting services rendered when organizing the company; and c) registration fees paid to the Corporation Division or the Secretary of State.

B) Depreciation is a concept that is related to, but distinct from, a business expense. If property you acquire to use in your business has a useful life that extends substantially beyond the year it is placed in service, you generally cannot deduct the entire cost as a business expense in the year you acquire it. You must spread the cost over more than one tax year and deduct part of it each year. This method of deducting the cost of business property over its useful lifetime is called depreciation.

Business property you must depreciate includes the following items:

1. *Office furniture*
2. *Buildings*
3. *Machinery and office equipment*

You can choose to deduct a limited amount of the cost of certain depreciable properties in the year you place the property in service. This deduction is known as the "section 179 deduction." For more information about depreciation, talk to your accountant or CPA, or visit www.IRS.gov and read Publication 946, How To Depreciate Property.

MISTAKES TO AVOID

1. You are not alone. Don't try/bother to figure all of this out by yourself. Find a local bookkeeper and/or CPA, possibly one who is a fellow small business owner, to help you through this. With their assistance, you can greatly shorten the learning curve, and save a lot of your time and money as a result.

2. Don't let tax issues overwhelm you. First of all, take the time to understand What your tax liabilities are, and then place a reminder on your calendar to stop and examine your tax situation every quarter, at least, throughout the year. Tax liabilities must be handled in a timely manner. Tax issues are relatively simple to handle if you know what to look for and if you stay on top of the situation. But, if you get behind, don't despair. There are solutions and methods to work your way out of the problem. Remember a basic rule: it is hard to have a tax problem unless you're making money.

3. Don't be afraid of the IRS. The Internal Revenue Service is not as scary or intimidating as you might think. If you follow the rules and file your returns on time, you won't have trouble with the IRS. And even if you find yourself in a position where you can't pay your taxes on time, you can often arrange for a repayment schedule that is easy to handle and negotiate. Take the initiative and move to address tax issues as soon as they appear. This will minimize any penalties or interest charges.

FP Transitions is the nation's leading provider of equity management, valuation and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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