



Home Based Business Tax Opportunities

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Trade or Business Deductions:

- I.R.C. §162 - There shall be allowed as a deduction all the **ordinary** and **necessary** expenses paid or incurred during the taxable year in carrying on any trade or business
- I.R.C. §183 (Hobby Loss Rules)- In the case of an activity engaged in, if such activity is **not** engaged in **for profit**, **no deduction** attributable to such activity shall be allowed except as provided

Hobby Loss Rules:

- **General Rule of Thumb:**
 - **Positive** net income derived from activity in **3 or more of 5** preceding taxable years
- **Other Considerations:**
 - **Books** and **records** kept
 - **Time** and **effort** put into business
 - Track record of success
 - Personal **pleasure** or **recreation**
- **Consequences:**
 - **Deductions** treated as miscellaneous itemized deductions (**2% of AGI**)
 - **Deductions** can only be taken **up to the amount of gross income** derived from hobby activity

Home Office Deduction:

- Simplified Option:

- Available for tax years beginning on, or after, January 1, 2013
- Flat deduction of **\$5 per square foot** allowed up to a maximum deduction of **\$1,500**, or 300 square feet
- Substantially **reduces substantiation** and **recordkeeping** requirements

- Regular Method:

- Actual **expenses incurred** are used to determine deduction
- Deduction is based on **percentage of square footage** used for home office compared to **total square footage** of entire residence
- Some calculations, allocations, and substantiation requirements exist

Home Office Deduction (cont'd):

- **Requirements to Claim Deduction:**
 - 1.) **Regular** and **Exclusive** Use:
 - Home office must be used **regularly** in order to claim the deduction
 - Home office must be used **exclusively** for conducting trade or business
 - Examples:
 - Extra room used for business containing only desk, computer, and shelving
 - Child sleeps in room, but shares room with desk and computer which you use for business purposes periodically
 - 2.) **Principal** Place of Business (see exceptions):
 - Must be used for **administrative** or **management** activities of business if no other fixed location where substantial administrative or management activities are conducted

Home Office Deduction (cont'd):

- **Principal Place of Business Exceptions:**
 - Don't need to meet "principal place of business" requirements if:
 - Place of business is used by **patients, clients, or customers** meeting or dealing with taxpayer in **normal course of trade or business**
 - Separate structure **not attached** to the **dwelling unit**, used in **connection with** taxpayer's trade or business
 - **Storage Facilities:**
 - Space used within dwelling unit on **regular** basis as a storage unit for **inventory** or **product samples** qualifies for deduction
 - **Note: Exclusive** language **not** specifically mentioned
 - **Example:** Storage shelving in child's room
 - **Example:** Storage shelving in garage
 - **Dwelling unit** must be **sole fixed location** of trade or business

Home Office Deduction (cont'd):

- **Deductible Expenditures:**

- Must be attributable to portion of home (or separate structure) used **exclusively** for business purposes

- Examples:

- Mortgage Interest
- Property Taxes
- Mortgage Insurance Premiums
- Homeowners Insurance Premiums
- Utilities and Other Services (electricity, gas, trash removal, etc.)
- Telephone (only if dedicated second land line for business) and Internet
- Repairs (furnace repair, A/C unit repair, etc.)
- Depreciation of Home

Vehicle/Mileage Deduction:

- Standard Mileage Rate Method:

- Flat deduction of **57.5 cents for 2015** (56 cents for 2014) per business mile driven
- Substantially **reduces** substantiation and recordkeeping requirements
- **Mileage log** can be used to track and record business miles driven

- Actual Expense Method:

- Actual **expenses incurred** used to determine deduction
- Deduction is based on **business use** (deductible) versus **personal use** (non-deductible)
- Some calculations, allocations, and substantiation requirements exist

Vehicle/Mileage Deduction (cont'd):

- **When are Miles Deductible?**

- Deductible:

- Miles from **principal place of business** (home office can qualify as this) to **temporary work location** are considered **deductible** business commuting miles

- Non-deductible:

- Miles travelled from **home** to **regular place of work** are considered **non-deductible** personal commuting miles

*A “contemporaneous” mileage log should be kept throughout the year to substantiate the business use mileage deduction

Vehicle/Mileage Deduction (cont'd):

- **Deductible Expenditures (Actual Expense Method):**
 - Determine what it actually costs to operate vehicle for portion of use that relates specifically to business
 - Examples:
 - Fuel and Oil
 - Repairs and Maintenance
 - Tires
 - Insurance
 - Licenses and Registration
 - Depreciation or Lease Payments (if vehicle is >50% business use)

Meals and Entertainment:

- **When are Meals and Entertainment Deductible?**
 - **1.) Directly Related Test:**
 - Must have general **expectation of deriving income** at some point in the future from business meeting
 - Must **engage** in active **trade or business** with person being entertained
 - **2.) Associated With Test:**
 - Must directly precede or follow a **bona fide and substantial business** discussion
 - Business discussion must be **principal aspect** of meeting

***50% Limitation - In general, meals and entertainment incurred while in the pursuit of business are subject to a 50% limitation on deductibility**

Other Miscellaneous Expenditures:

- **Direct Home Office Expenditures:**
 - Benefit only **business part** of home, not entire home
 - **Example:** Repairs and maintenance specific to room home office is in (painting, repairs, etc.)
- **Office Supplies:**
 - **Example:** Paper, pens, folders, envelopes, etc.
- **Cell Phone:**
 - **Business use percentage** of cell phone can be deducted

Tax Substantiation/Documentation:

- Complete separation of personal and business income and expenses (**Comingling**):
 - **Comingling defined** – The act of mixing the funds belonging to or designated for one purpose (Business) with the funds belonging to or designated for another purpose (Personal), resulting in the inability to properly identify which funds are designated for which purpose
 - **Most common ways to commingle:**
 - Having only **one bank account** for personal and business needs
 - Depositing business checks into your **personal bank account**, and vice versa
 - Writing business checks for personal reasons/expenses, and vice versa
 - **Transferring** money between **business** and **personal accounts** without **documentation**
 - **Withdrawing** money from your business account to pay **personal expenses** without documentation

Tax Substantiation/Documentation:

- **How to avoid commingling:**
 - Create a separate **Bank Account** for your business activity
 - Obtain separate **Credit Card** to be used for business expenses only
 - Create a **separate** set of **books/records** to record only business activities

- **Benefits of not commingling:**
 - Establishing and maintaining the “**corporate veil**”
 - Reduce taxes by maximizing proper business expenses, as previously discussed

Tax Substantiation/Documentation:

- Proper recordkeeping or documentation of business expenses:
 - Document retention rules:
 - **3-year rule** – Records such as receipts, canceled checks and other documents that support an item of income or a deduction, or a credit appearing on a return must be kept at least until the period of limitation expires for that particular return, which is generally **3 years** from the date the return is due, including extension
 - **6-year rule** – If income that should have been reported, but has not been, and caused **omission of more than 25% of the gross income** shown on a particular return, the IRS has 6 years to assess additional tax, thus requiring document retention for certain income items for 6 years from the date the return is due, including extension
 - **Unlimited year rule** – There is **NO period of limitation** to assess tax when a return was **fraudulently filed** or where **no return** for a particular year was filed

Tax Substantiation/Documentation:

- **Types of documents to be retained:**
 - **Receipts** – Retain receipts for any expenditures related to meals and/or entertainment, fuel and oil, auto repairs and maintenance, tires, insurance, paper, pens, folders, envelopes, etc.
 - *For meals and entertainment, be sure to note names and number of people in attendance
 - **Mileage Log** – Document the starting and ending odometer mileage numbers daily for miles specifically related to business use
 - *For mileage deduction, be sure to maintain “contemporaneous record” as IRS will enforce this
 - **Bills/Invoices** – Retain billing statements/invoices for cell phones, utilities (electricity, gas, trash removal, etc.), telephone, internet, etc. (necessary for documentation for home office deduction)
 - **Repairs/Maintenance** – Retain invoices for repairs made to your home related to furnace repair, A/C unit repairs, water heater, etc., as portions of these expenses can be included in the home office deduction
 - **Tax Forms (1098/1099)** – Retain forms related to mortgage interest, property taxes, etc., as portions of these expenses can be included in the home office deduction

Entity Types for Home Based Businesses:

- **Single Member LLC:**

- Single owner
- Tax reporting occurs on individual owners **Form 1040, using Schedule C**
- Affords the owner **liability protection** of a separate business entity

- **Multi-member LLC:**

- 2 or more owners – Partners
- Tax reporting occurs on a **separate tax form** than that of the owners, typically a **Form 1065**
- May afford partial relief from self-employment taxation for non-active members

- **S Corporation:**

- 1 or more owners – Stockholders
- Tax reporting occurs on a **separate tax form** than that of the owners, typically a **Form 1120S**
- Will afford **partial relief** from **self-employment taxation** if reasonable salary paid to employee owners

Single Member Limited Liability Company:

- Advantages:
 - **Limited Liability** – owners have separation between their business assets/debts and personal finances
 - **Income Reported on Personal Returns** – profits or losses from the business activity are reported on the individuals tax return and taxed at individual tax rates (reporting ease)
 - **Save on Tax Prep Costs** – may save on tax return preparation costs, since do not need to file a separate business entity tax return
 - **Complete Control** – owner has complete control/say in business decisions, etc.
- Disadvantages:
 - **Subject to Self-Employment tax** – Since profits/losses reported on individual's tax return, all income is subject to self-employment tax, in addition to income taxes
 - **Potential Liability Risks** – if commingling of business and personal finances occurs, individual assets/property may be subject to business creditors

Multi-member LLC:

- Advantages:
 - **Partial Self-Employment Tax** – Since profits/losses shared among the multiple members, possibility to only be required to pay self-employment taxes on non-passive income
 - **Limited Liability** – Owners have separation between their business assets/debts and personal finances
 - **Flexibility** – Allows for “special allocation” of profits and losses for more flexibility
 - **Inexpensive Start-up Costs** – Cost of setting up an LLC is relatively inexpensive
- Disadvantages:
 - **Self-Employment/NII Taxes** – Actively participating owners will likely be subject to self-employment taxation, non-active owners potentially subject to NII tax
 - **Additional Tax Prep Costs** – Due to having to file an IRS Form 1065 to report income/loss, will likely incur additional tax preparation costs
 - **Potential Liability Risks** – If commingling of business and personal finances occurs, individual assets/property may be subject to business creditors

S Corporation:

- Advantages:

- **Liability Protection** – Protects the personal assets of its owners/shareholders
- **Avoidance of Self-Employment Taxation** – Only portion of income subject to SE tax is wages
- **Tax-favorable Characteristics of Income** – Owners/shareholders can be employees of the business and draw salaries, as well as, receive tax-free distributions to the extent of basis
- **Straightforward Transfer of Ownership** – Interests in S corps can be freely transferred without triggering adverse tax consequences

- Disadvantages:

- **Formation and Ongoing Expenses** – Costs to file Articles of Incorporation and potential yearly annual report or franchise tax fees imposed (typically not significant)
- **Ownership Restrictions** – Only one class of stock, less than 100 shareholders, no C corp. owners
- **Potential of IRS Scrutiny** – Close scrutinization of wages vs. distributions to owner employees
- **Lack of Flexibility** – Must have proportionate distributions based on ownership %'s

Estimated Tax Payments:

- **Who Must Make Estimated Tax Payments:**

- Sole Proprietors
- Partners in Partnership or LLC
- S Corporation Shareholders

- **Threshold:**

- Estimated tax payments are generally **required** if you expect to owe tax of **\$1,000 or more** for the tax year in question

- **How to Pay:**

- Estimates made on **Form 1040-ES**
- Can elect “**safe harbor**” (100% of PY income) or “**annualized income**” (90% of CY income) method

- **Underpayment Penalties:**

- If proper estimated payments not made, may be subject to underpayment penalties

Additional Taxes:

- **W-2 Wage Taxes:**

- Employee pays 7.65% of FICA taxes
- Employer pays 7.65% of FICA taxes

- **Self-Employment Taxes:**

- Self-employed individual treated as both employer and employee

- **Rate:**

- 15.3% (7.65% X 2)

- **Types of SE Income:**

- Sole Proprietorship income (Form 1040, Schedule C)
- Partnership/LLC income for which taxpayer is considered “active”

Additional Taxes (cont'd):

- **Net Investment Income Taxes:**
 - **Rate:**
 - 3.8% of all income classified as “Net Investment Income”
 - **Types of NII:**
 - Interest
 - Dividends
 - Capital gains
 - Rental income
 - Business income classified as “passive”

***NII Tax only applies when income > \$200K for single taxpayers and \$250K for MFJ taxpayers**

Active vs. Passive Income:

- **Classification of Income:**
 - **Active:**
 - Taxpayer **materially participates** in activity (7 step test)
 - Income from activity is considered “**active**” income
 - Income treated as **earned income**
 - Income subject to **SE Tax**
 - Income **not** subject to **NII Tax**
 - **Passive:**
 - Taxpayer does **not materially participate** in activity (7 step test)
 - All income from activity is considered “**passive**” income
 - Income is **not** treated as **earned income**
 - Income **not** subject to **SE Tax**
 - Income subject to **NII Tax**

Active vs. Passive Income (cont'd):

- **7 Step Test Issued by Internal Revenue Service:**
 - 1.) Individual participates in activity for **more than 500 hours** during the year
 - 2.) Individual's participation in activity constitutes "**substantially all**" of the participation in activity of all individuals involved
 - 3.) Individual participates in activity **more than 100 hours** and such participation is **not less** than participation in activity of **any other** individual
 - 4.) Activity is "significant participation activity" and **aggregate participation** of all "significant participation activities" **exceeds 500 hours**
 - 5.) Individual materially participated in activity for any **five taxable years** during **ten taxable years** immediately preceding current taxable year
 - 6.) Activity is **personal service activity** and individual materially participated in activity for any **three taxable years** preceding current taxable year
 - 7.) Based on **facts and circumstances**, individual participates on **regular, continuous, and substantial** basis during year

Retirement Plan Options:

- **Simple IRA:**
 - Savings Incentive Match Plan for Employees (SIMPLE)
 - Available if **100 or fewer** employees
 - Maximum **contribution** amount is **\$12,500** for 2015
 - Employer **required** to do one of the following two options:
 - 1.) Contribute **matching** contribution **up to 3%** of compensation if employee contributes
 - 2.) Contribute **2% nonelective contribution** for each employee (even if employee doesn't contribute) up to \$255,000
 - Employee can **elect** to contribute
 - Employee is always **100% vested**
 - **No** separate **filing requirements** for employer
 - Easily established

Retirement Plan Options (cont'd):

- **SEP IRA:**

- Simplified Employee Pension (SEP)
- Available to **any size** of business
- Maximum **contribution** amount is lesser of:
 - 1.) **25%** of employee's compensation
 - 2.) **\$53,000** for 2015
- **Employer** makes all contributions
- Employee is always **100% vested**
- **No** separate **filing requirements** for employer
- **All** employees **must** be included and **contribution percentages** must be equal for all
- Easily established

Retirement Plan Options (cont'd):

- **Solo (Individual) 401(k):**
 - Business owner is treated as both **employer** and **employee**
 - Maximum **contribution** amount by employee is **\$18,000** for 2015
 - **Employer** can contribute up to **25%** of compensation (or SE income) in **addition** to employee limitation
 - **Total** overall contribution limit is **\$53,000** for 2015 (\$18,000 EE and \$35,000 ER)
 - Employee contributions are **elective**
 - Employee is always **100% vested**
 - Additional **complexity** and **costs** of setup and operation exist
 - Separate **filing requirement** for employer exists once account reaches **\$250,000**

Resources:

- Richey May & Co. Website: www.richeymay.com
- Questions Regarding Tax Matters Related to Home Based Businesses: homebasedfaqs@richeymay.com
- Home Based Business Tax Resources:
 - http://www.richeymay.com/firm-news/home_based_business_tax_resources/
 - http://www.freemileagelogs.com/docs/mileage_logs/free_mileage_log_1.pdf
- Small Business and Self-Employed IRS Website: <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Publications-and-Forms-for-the-Self-Employed>
- Tax Guide for Small Businesses (IRS Publication 334): <http://www.irs.gov/pub/irs-pdf/p334.pdf>
- Travel, Entertainment, Gift, and Car Expenses (IRS Publication 463): <http://www.irs.gov/pub/irs-pdf/p463.pdf>
- Tax Withholding and Estimated Taxes (IRS Publication 505): <http://www.irs.gov/pub/irs-pdf/p505.pdf>
- Business Expenses (IRS Publication 535): <http://www.irs.gov/pub/irs-pdf/p535.pdf>
- Starting a Business and Keeping Records (IRS Publication 583): <http://www.irs.gov/pub/irs-pdf/p583.pdf>
- Business Use of Your Home (IRS Publication 587): <http://www.irs.gov/pub/irs-pdf/p587.pdf>