

The Six Most Important Things That Entrepreneurs Need to Know About Starting a Business, Keeping Records, and Paying Taxes

By Sheryl Schuff, CPA

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of this report can be made to:**

**Sheryl Schuff
8156 Lieber Road
Indianapolis, IN
46260
317.514.2087**

Disclaimer

This report is intended to be a guide to familiarize the reader with tax concepts. It is not intended to provide legal or tax advice. No report can ever be a complete substitute for advice from your personal tax professional who has knowledge of your particular situation.

This report was written based on the tax laws in effect at that time. Tax laws are subject to frequent changes, so it's possible that by the time you're reading this, the laws could be different.

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Introduction

It's my pleasure to offer you this free report to introduce you to the six most important things that entrepreneurs need to know about starting a business, keeping records, and paying taxes.

If you know others who could benefit from this information, please send them to my web site BusinessStartupSuccessClub.com so they can get their own copy. Thanks in advance.

1. Structure Matters Most

What do I mean by structure? I mean the official (legal) way that your business is organized. There are lots of different ways that you can operate your business.

There's a sole proprietorship, a partnership, a corporation, and an LLC, to name a few. And the way that your business is structured determines which rules you'll have to follow for figuring your taxes.

The business tax system is a little bit more complicated than the individual income tax system. The 1040 might seem complicated, but at least there's just one set of rules and it applies to everyone.

Not so with business taxes. Sole proprietors have one set of rules, partnerships another, and corporations still another. Actually, corporations have at least two different sets of rules, depending on the type of corporation. And if the LLC has at least two members, it can choose from three different possibilities.

So that's why structure matters most. It determines which set of rules you have to use.

There are also some other areas that are affected by differences in business structure. The one you're probably familiar with concerns liability. Some of the things included here have to do with who is responsible for business debts and who can be held responsible for the actions of the company.

Other differences are the way you have to handle payroll and employee benefits, retirement plans and health insurance.

Even if you think you won't have any employees (or at least not for a while), you need to find out about the differences so you're not surprised later on. I want you to understand the definitions of employees and payroll so you don't get into trouble with the IRS.

The right business structure for you depends on the type of business you want to start and your particular family situation. So take your time doing your research and learning about the details of the various business forms.

2. You'll Be Judged By Your Appearance

No, I'm not talking about your clothes or your haircut. I'm talking about your **business** appearance. If you want to be taken seriously by customers, clients, and suppliers, you have to look and act like you mean business.

What does that mean?

That means things like answering the phone in a businesslike way, having printed business cards, and using your business name in all your written correspondence, email, and business contracts.

And then, of course, there's the IRS. If you want them to recognize you as a business, you have to act like a business.

How do you do that?

One way is to run your business like a business and not a hobby. One of the major ways that the IRS differentiates the two is that a hobbyist does things mainly for the fun of it and might make a little money; a business owner is assumed to at least be trying to make a profit, even if he/she might not actually do that every year.

One of the most important business-like things you can do is to get a separate checking account for your business (even if you're a sole proprietor) and keep your business and personal transactions separate.

It's also important to comply with local licensing and tax laws.

You need to find out what's required by your city, county and State. You might need to get a sales tax license. Sometimes it's called a retail merchant's license or a wholesale license.

Depending on your type of business, you might need to find out about special local taxes that you might need to collect, report, and pay. For example, if you wanted to start a bed and breakfast in your home in my community, you would need to find out about the local innkeepers tax.

There are other things that pertain to certain businesses. For example, you might need a barber or beautician's license. This would help show that you're serious about having a profitable business and that you're not just enjoying your hobby of cutting and styling hair for friends and family.

If you're starting a children's daycare or preschool or if you want to provide adult daycare services, you'll need to check into the local licensing and zoning laws.

In Indiana, where I live, local zoning is controlled by cities **AND** counties. The names of the agencies in my area are the Metropolitan Board of Zoning (for my county) and the Department of Metropolitan Development (for my city).

In other places, I've seen names like the City Planning Commission and the Board of Zoning Appeals. To find the right group in your area, you'll need to search for similar names. You might need to look for a group whose name includes the words "community development."

In Indiana, we have a place called The Indiana Professional Licensing Agency which deals with everything from acupuncture to veterinary medical examiners, accountants to realtors.

We also have The Indianapolis Board of Metropolitan Development, Division of Compliance which takes care of city licenses for general contractors, electricians, plumbers, and others.

You'll have to look in your area for similar groups. Whether you use the phone book, the library, or the Internet, look for government listings for your parish, township, city, county, and State and try the keywords "licensing" and "compliance."

Take your time doing your research and learning about the details of the rules and regulations in your area. Then you'll be able to look and act like a business and be treated as one.

3. Record Keeping Is Critical

As an **individual** who pays income taxes, you probably don't keep a lot of records. You might not keep any. Maybe you just have a W-2 from your regular job and you take a standard deduction on your 1040. So you're not used to keeping records.

But when you're in business, you have to keep records to show the results of your operations. There's no outside party to tell you how much your business earned during the year.

There's two main reasons you need to have good records.

The first is so you can prepare **accurate** tax returns.

The second is so you can **prove** your income and expenses.

Just remember, it won't matter how well you understand which business deductions you can take and how to calculate them, if you don't have the records to prove them.

Some of the things you'll need to keep records on include your sales and any discounts you give; returns and allowances; amount of sales tax collected; your purchases of business supplies; the cost of any products you buy for resale; any furniture, computers, equipment, and machinery you buy for your business; documentation for any business meals and entertainment; and mileage logs for any vehicles used in your business.

Keeping good records is the best way to pay the **least amount of tax** possible.

Another reason that good record keeping is important is that you might have to give financial information to your bank to get a business loan or to refinance the mortgage on your house.

And keeping good records will give you the financial information you need to make good decisions in running your business.

Having a separate business checking account and keeping your personal and business stuff totally separate is the first step you **MUST** take. It's pretty easy to open one, doesn't take long, and most banks today offer them for free.

4. Cash In Minus Cash Out Does NOT Equal Profit

This is the **MOST IMPORTANT** thing you need to know before you start keeping records for your business... so I'm gonna say it again... cash in minus cash out does NOT equal profit. It simply equals cash left over. Or, in many cases, it's a negative number, so it equals cash you owe somebody.

What this means is that you'll need to understand the IRS rules and keep your records according to those rules so you report your profit correctly and take (and be able to prove) all the deductions you're allowed to take. Because you want to pay the least amount of tax possible, right?

Remember in an earlier session when I said, "structure matters."

The way you'll need to keep your books will be different depending on whether your business is a sole proprietorship, a partnership or a corporation. The rules for calculating income and deductions (and therefore profit) and the forms used for reporting to the IRS are different for the different business types.

What counts as income? Most or all of the money you take into your business will count as income. This includes fees for services and/or product sales.

But not all the cash that comes into your business counts as income.

If you get a rebate for a purchase you made at your local office supply store, that's cash in, but it's not income. It's a reduction in your supplies expense.

If you get a refund of part of your insurance premium at the end of the year, that's cash in, but it's not income. It's a reduction in insurance expense.

If you borrow money (and it doesn't matter if it's from your brother or the bank), that's cash in, but it doesn't count as income.

What counts as expenses? Most of the money you spend for your business will probably count as expenses. This includes advertising, postage, office supplies, and similar items.

But not all the cash that goes out of your business counts as expenses.

When you buy business property like cars, computers, and furniture that will last longer than a year, you're not allowed to deduct their entire cost as an expense in the year of purchase (except in special circumstances).

These items are called capital assets. Sometimes they're referred to as fixed assets.

You have to depreciate them over several years. Basically, depreciation is a process of spreading the cost of an item over its useful life.

You might have cash of several hundred or thousands of dollars go out the door when you purchase fixed assets, but you can't deduct the entire amount of the purchase price as an expense when you buy them.

Some things that your business pays for might only count as partial expenses. An example of that is business **meals and entertainment** where you can only deduct half of the cost.

That doesn't mean that your business can't **pay** for 100 % of the cost, but only that you're limited in the amount of the tax deduction you can take. This is another example of cash out that doesn't translate directly to expenses.

Some things your business pays for might not be tax deductible at all. An example of this would be a contribution to a Political Action Committee. That doesn't mean that the business can't pay for it, just that it's not a deductible expense on your tax return.

Some more examples of cash that goes out the door that doesn't count as expenses are: draws for sole proprietors and distributions for partners or S corporation shareholders.

And I have an example of an expense that can be **more** than the amount of cash that the business actually spends. It's the home office deduction that some sole proprietors can take.

So you see why it's so important to understand that cash in minus cash out does NOT equal profit.

Unfortunately, the IRS rules and regulations don't always make logical sense; they might seem complicated and unfair. One thing is certain. They are the way they are, so we have to deal with them. Learn what you can. And get help when you need it.

5. There's a Lot More Than Income Taxes

When most small business owners think about taxes, they think about Federal income taxes. But there are other taxes that I want to let you know about, so you're not surprised if you have to pay them.

The first is **self-employment tax**. If you've ever worked for someone else, you know that social security and Medicare taxes get deducted from your paycheck. When you're self-employed, you don't actually get a paycheck.

Here's what happens if you're a sole proprietor. Following the IRS rules and regulations for calculating income and expense, you report your results for the year on your personal 1040 by filling out Schedule C.

Then you take the net profit and put it on Schedule SE for self-employment tax. After a small deduction, you calculate 15.3 % as your self-employment tax. This is double the rate of 7.65 % that's deducted from employee paychecks because as a sole proprietor you're both the employer and the employee so you have to pay both parts.

You get to take half of the amount of self-employment tax as a deduction from your income on the front of your 1040. This has the effect of reducing your taxable income.

The self-employment tax itself goes on the back of the 1040 in the section called Other Taxes on the line that says "self-employment tax." For the 2006 filing year, that was line 58. This tax gets added to your Federal income tax and any other taxes you owe and is paid when you file your 1040.

If you (and/or your spouse on a joint return) have had Federal income tax withheld during the year that adds up to more than your total taxes for the year (which includes self-employment tax), you'll still qualify for a refund.

If your business is operated as a corporation AND you're active in your business, you should receive W-2 wages and you won't be subject to self-employment tax on your earnings. Distributions from S corporations are generally not subject to self-employment taxes.

If your business is operated as a partnership, you might have some items of income that are subject to self-employment tax and some that are not. These items will be reported to you on a schedule K-1 that is part of the business tax return.

Sales tax

Many States have sales taxes. If you sell products to customers, you'll have to charge them sales tax and pay it to the State. In some cases, digital downloads are considered products as far as the sales tax rules are concerned and certain services might also be subject to sales tax. In Indiana, where I live, the rules are put out by the Indiana Department of Revenue. There will be a similar agency in your state who you can contact to find out the rules.

Local Taxes

Some cities and school districts have local taxes that you might have to pay. Some of these depend on your type of business. There might be additional sales taxes, property taxes, innkeeper's taxes, or food and beverage taxes.

Check with the authorities in your area for details.

And then there's the often-dreaded **Estimated Taxes**

This is a subject that confuses many people.

First, let's try to understand the reason that the estimated payment system exists. Our system of Federal taxes is a "pay as you go" system. When you think about it, that makes sense. The government needs money all year long to pay for various things.

When you work for someone else, taxes are withheld from your paycheck each pay period, so the government gets its money over the course of the year. If you're a sole proprietor, this doesn't happen, so you're expected to make estimated payments.

As with many IRS rules, there are some exceptions, and some penalties if you don't pay enough or pay on time. There are some cases where you might not be required to make estimated payments (and you won't have a penalty if you don't), but it would still make sense to make them anyway, to avoid having to pay a large amount on April 15th.

If you have another job in addition to your self-employment, you can increase your Federal withholding on that job to cover the amount of the estimated taxes that you would otherwise have to pay. And if you're married and file a joint return and your spouse has wages from another job, he/she can have additional Federal withholding taken out to cover the estimated payments.

Or, you can make quarterly payments using Form 1040-ES. You can also sign up to make the payments on-line.

You might also need to make estimated payments towards your State taxes.

Payroll

If you have employees, you'll need to pay various Federal, State, and local payroll taxes. But we'll have to save that conversation for another time.

The most important thing you need to understand is that it's your responsibility to find out what taxes your business has to pay. And that the laws vary from place to place and by type of business.

A good source of information is an accountant who specializes in consulting with small businesses.

6. The Right Way To Pay Yourself

Please think back for a minute to our first topic when I talked about “Structure Matters Most.” Payroll is an area where your business structure determines exactly how you should get paid.

And please keep in mind that what you call “payroll” might not be “payroll” in the IRS sense of the word. I’ll explain what I mean by that.

If you’re a sole proprietor, you don’t get paid, at least not in the way you’re used to being paid as someone else’s employee. And since you don’t get payroll in the IRS sense of payroll, you don’t deduct payroll taxes.

Hopefully, you remember I talked about this earlier when I explained self-employment taxes.

So as a sole proprietor, your business keeps records to calculate profit or loss and that number gets included on your personal 1040. So if you have a profit, that will add to your other income and if you have a loss you’ll be able to deduct it (if you meet all the requirements).

But the money that’s in your business checking account actually belongs to you, so if there’s cash available, you can withdraw some for your personal use. You might consider that as getting a paycheck, but technically, it’s not. It’s called a distribution. It doesn’t count as an expense. It’s called a reduction in owner’s equity. It’s not income to you when you withdraw it, and you’re not taxed on it when you take it out.

Be sure to keep track of it correctly.

What if your business is organized as a corporation?

Assuming you’re active in the business, then you’ll actually be considered an employee of the company. And you’ll get regular wages or a salary that will be reported to you on a W-2 at the end of the year. Your company will withhold payroll taxes and follow the rules for paying them to the IRS and your State at the correct times during the year.

If your company is a regular corporation (also known as a C corporation) you’ll need to make sure that your pay is reasonable and not too much. That means you should pay yourself about the same as you’d pay another employee to do the same work. If the IRS ever decides to examine your corporate tax return and they think that your pay has been too much, then they might decide that part of it was really a dividend.

If your company is an S corporation, you also need to make sure that your pay is reasonable. The IRS is concerned that you won't pay yourself enough and that you'll simply take money out of the company in the way that's called a shareholder distribution and not pay payroll taxes on that amount.

You're allowed to do both. You can pay yourself as an employee AND get a shareholder distribution, just as long as the IRS thinks your payroll is reasonable. You can't ignore payroll if you're active in the company. This is a red flag to the IRS and one of their top audit priorities for small businesses.

Now, what if your company is a partnership? This can get tricky. It depends on the type of partnership and whether you're a general partner or a limited partner. Remember earlier when I said that partners can receive different types of income, some that's subject to self-employment tax and some that's not? This has to do with something called guaranteed payments. These might seem like payroll to you, but partners in a partnership are never considered employees by the IRS.

If you're considering operating your business as a partnership, I suggest you work with an accountant or tax attorney who specializes in this area, because it can get pretty complicated.

Conclusion

Thank you for reading this special report. If you have any questions or comments, please email me at Sheryl (at) BusinessStartupSuccessClub dot com.

I hope you found the information to be a useful introduction to the area of small business taxes. The tax laws change frequently, so I encourage you to continue learning more about this subject.

Wishing you much success in your business,

A handwritten signature in cursive script that reads "Sheryl".

Sheryl Schuff