

Tax Accounting and Recordkeeping 101

(i.e. Can I deduct this?)

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Overview

Part One: Tax Accounting and Recordkeeping

1. Why Tax Matters
2. Deductions and Credits
3. Justifying a Business Expense
 - a. Business v. Personal
 - b. Ordinary and Necessary
 - c. Recordkeeping
 - i. Statute of Limitations
 - ii. Segregation of Business/Personal
 - iii. Note on Legal Authority
4. Top 10 Small Business Expense Issues (Is it Deductible?)

Part Two: Choice of Entity/Tax Type for Small Businesses

Illustrative Tax Analysis of Effective Federal Income Tax Rate from Different Entity/Taxation Structures

		Entity Type	
		<u>Corporation</u>	<u>Limited Liability Company</u>
		<i>(Taxed as C Corporation)</i>	<i>(Taxed as Partnership)</i>
Net Income Before Entity Level Taxation	A	\$ 10,000,000	\$ 10,000,000
Entity Level Tax Rate ¹	B	35.00%	0%
Entity Level Tax Due	C=A*B	\$ 3,500,000	\$ -
Net Income After Entity Level Taxation	D=A-C	\$ 6,500,000	\$ 10,000,000
Individual Level Tax Rate ²	E	23.80%	39.60%
Individual Level Tax Due	F=D*E	\$ 1,547,000	\$ 3,960,000
Net Income After Taxes	G=D-F	\$ 4,953,000	\$ 6,040,000
Effective Federal Income Tax Rate	(C+F/A)	50.47%	39.60%

Notes

¹ Entity Level Federal Income Taxation: Entities taxed as C Corporations are subject to the 35% corporate tax rate. Entities taxed as partnerships do not pay entity level tax.

² Individual Federal Income Taxation: Dividends from C Corporations are taxed at rates up to 20%. Additionally, they are subject to the 3.8% net investment tax, regardless of whether the owner is active in the business. Taxable income from an entity taxed as a partnership are taxed at progressive tax rates up to 39.6%. Active partners in a LLC taxed as a partnership are not subject to the net investment tax on their share of taxable income.

Deductions v. Credits

- Personal v. Business
- Deduction: Reduces Taxable Income
- Credit: Reduces Tax Due

Business Expenses: The Standard

Section 162(a) “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”

- a) Ordinary: *common and accepted in your trade or business*
- b) Necessary: *helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary.*

Recordkeeping

- Contemporaneous Documentation
 - i. Gross Receipts
 - ii. Purchases
 - iii. Expenses
 - iv. Meals and Entertainment
 - v. Charitable Contributions
 - vi. Employment Taxes
 - vii. Car Expenses

Recordkeeping

Segregation of Accounts

- Not Required BUT...
 - a) Provides clear audit trail
 - a) Helps in hobby loss cases

Recordkeeping

Statute of Limitations (SOL)

- i. General SOL: Three Years from Filing (with extensions) or Two Years from when tax paid
- ii. Substantial Understatement: Six Years
- iii. Fraud (or no return): Unlimited

Authority

1. Statutory: Internal Revenue Code
2. Regulations: Treasury Regulations
3. Other Authority: Notices, General Counsel Memorandum
4. Other Sources: Internal Revenue Manual, IRS Publications, Form Instructions

IS IT DEDUCTIBLE?

1: The Idea

One day while jogging around campus you decide you want to see if you could start your own website design business. You decide to go all out and go to a few conferences, for a total cost of \$4,500. After going you decide to form a LLC. You work with a small business lawyer and pay \$750.

1: The Idea

1. Are the (i) conference costs, and/or (ii) legal fees, deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Organizational and Start Up Costs

- Organizational Expenses: Legal, Accounting etc.
- Start Up Costs: Investigating the Business
- \$5,000 First Year Deduction, Phases out at \$50,000
- Amortize the Remaining Amount over 180 Months

2: The Graduation Gift

You've got your first client, a dorm room buddy with an app idea and are ready to get going. You started using a laptop you had around that you weren't using for the business. Your grandmother gave you the laptop when you graduated from Rice so you didn't pay a dime for it.

2: The Graduation Gift

1. Is the laptop and/or any other related expenses (i.e. software) deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Converting Personal Use to Business Use Property

Determining Depreciable Basis: The Lesser of:

- a) Adjusted Basis
- b) Fair Market Value

What is Adjusted Basis in a gift? Carryover from Gifto

3: The Spare Bedroom

As the business expands, you've started investing more time (and money) into the cause. Lucky you, that same grandmother GAVE you a small two bedroom townhome you live in. You dedicate the spare second bedroom mostly to business, although sometimes somebody sets up an air mattress in there. It's worth about \$200k and utilities are \$300/month.

3: The Spare Bedroom

1. What costs/expenses (if any) are deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Home Office Deduction

Needs to be a “dedicated space” with no more than diminimis personal use.

Non-Safe Harbor: Pro Rata Actual Expenses

- i. Utilities
- ii. Property Taxes
- iii. Depreciation

Safe Harbor: \$5/square foot, up to 300 square feet

4: The Glass Cubes

It's Christmas of business year one and you've read in Forbes that giving business gifts to clients is a great way to keep business going. You give a personalized glass cube to each existing client and a few potential clients. Each gift costs \$50 (base cost) and you paid an additional \$10 cost for each one to get the client's name on the cube.

4: The Glass Cubes

1. Are the cubes to (i) existing clients and (ii) potential clients, deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Business Gifts

\$25 limit. You can deduct no more than \$25 for business gifts you give directly or indirectly to each person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the \$25 limit.

A cost is incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not an incidental cost if the value of the basket is substantial compared to the value of the fruit.

5: The Midnight Ticket

You have to travel to Dallas for a purely business trip to meet with some clients and a potential new business partner. It's midnight on I-45 and you're going 80 (common the speed limit is 75), then suddenly the red and blues. Apparently the speed limit just dropped to 65. Ticket Time: \$200.

5: The Midnight Ticket

1. Are any of the ticket expenses (fine, defensive driving etc.) deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Fines and Penalties

I.R.C. Section 162 (f) Fines and penalties

“No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.”

How about lawsuit settlements?

6: The Corolla Chronicles

You've been a busy bee with your business driving around using your trusty corolla. Here are just a few trips you've taken:

May 5: 9am: Drove from home to new office
(finally moved from home office)

1pm: Drove from new office to client site

3pm: Drove from client site to home

5pm: Drove from home to prospective client dinner

6: The Corolla Chronicles

1. For each of the four trips, are any car expenses deductible, partially deductible, or non deductible? If deductible, what expenses/amount are deductible?
2. If deductible, what records do you need?

Car Expenses

Actual Expenses OR Mileage Deduction

1. Home to Work is NEVER Deductible
2. Work to Temporary Work Location is ALWAYS Deductible
3. Temporary Work Location to Home is usually Deductible

Record Keeping? Mileage Log

7: The Wesley Snipes Consultation

Your business keeps growing and you decide to take on a partner. She seemed normal until tax time comes around and you find out she's a tax protestor. She insists on talking to your tax attorney about her theories. \$10,000 in attorneys fees later she comes back with a tax opinion saying she's out of her mind.

7: The Wesley Snipes Consultation

1. Are the legal fees deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Fees for Tax Advice

- Individual: Deductible on Schedule A, Misc. Deductions subject to 2% Floor and Itemized v. Standard Deduction Issue
- Business: FULLY DEDUCTIBLE
- This is why everyone should love their tax attorney.

Other Legal Fees

- Need to determine if it is personal v. business
- Generally, all business legal fees will be deductible.
- Personal fees generally not deductible unless:
 - Tax Advice
 - Related to income producing activity (i.e. real estate)
 - Certain Personal Injury Cases

8: The Cayman Islands Trip

Your website design business is hitting it big. Your new business partner REALLY wants to take a trip to the Cayman Islands. You plan this trip:

Thursday: Fly to Cayman Islands

Friday: Meetings with company that hosts websites

Saturday: Party on the Beach

Sunday: Head back to the U.S.

8: The Cayman Island Trip

1. Are the plane tickets, hotel costs, and meals while there deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Travel Expenses

What are travel expenses?

- i. Transportation Costs
 - ii. Lodging
 - iii. Meals (if not entertainment) – 50% Limitation
 - iv. Taxi/Public Transport
 - v. Dry Cleaning
 - vi. Phone Bill
-
- A. Travel ENTIRELY for Business Purposes
 - B. Travel PRIMARILY for Business Purposes
 - C. Travel PRIMARILY for Personal Purposes

Travel Expenses:

Travel ENTIRELY for Business Purposes

Four Exceptions that allow personal during travel:

1. No Substantial Control
2. Outside the U.S. no more than a week
3. Less than 25% of time on personal activities
4. Vacation not a major consideration

Travel Expenses:

Travel PRIMARILY for Business Purposes

- Have to count business and non-business days
- Pro-Rata deduction for Air-Fare
- No deductions for personal days, deductions only for business days

9: The Cayman Islands Trip, Part 2

You get back from the trip and start working on collecting receipts. You submit a receipt for you and your spouse's very very sad \$20 airport meal on Sunday. Your business partner (unbeknownst to you) took some execs from the company you met with Friday out on Saturday to Cayman's nicest restaurant. Total bill: \$800.

9: The Cayman Islands Trip, Part Two

1. Is either or both meal expense deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Meals and Entertainment

A. Meals as Travel Expense

B. Meals as Entertainment Expense: Two Tests

- i. Directly Related Test
- ii. Associated Test

Cannot be “lavish or extravagant”

Have to be physically present

If deductible, subject to 50% limitation

10: The (Business) Partner Swap

You've had it with your old partner and decide to part ways. One day at a client event you meet your favorite football player, J.J. Watt. To your surprise he wants to go into business. However, his one rule is that 40% of the profits for the next 5 years have to go to the J.J. Watt Foundation.

10: The (Business) Partner Swap

1. Assuming the J.J. Watt Foundation is an IRS approved charitable private foundation, are the donations deductible, partially deductible, or non deductible (and if so, how much is the deduction for)?
2. If deductible, what records do you need?

Charitable Contributions

A. Personal Limitations:

- i. Public Charities: 50% of AGI (Cash)/30% of AGI (Property)
- ii. Private Foundations: 30% of AGI (Cash)/20% of AGI (Property)

B. Corporate Limitation: 10%

C. Carryforwards: 5 Years