



## Home-Based Business

# Doing Your Taxes

Despite efforts at reform, tax laws are complicated and will continue to be so. In fact, tax laws can be one of the most difficult aspects of doing business. Failure to understand them and how to use them to your advantage can result in your paying more than your fair share. Although a conscientious tax return preparer can help, only you are knowledgeable enough about your business to ensure that you comply with these laws and to take maximum advantage of those which are favorable to you.

### Business Taxation

How a business enterprise is taxed depends in part on its form of business organization. Sole proprietorships and partnerships are relatively uncomplicated. Because these simply are individuals or groups of individuals conducting a business enterprise, tax law treats them as individuals and requires all income and expenses from the

business enterprise to be reported on the personal returns of the sole proprietor or partners.

For sole proprietors this is accomplished by attaching a Schedule C, profit or loss from a trade or business, to the individual's form 1040. The schedule C contains a detailed listing of the income and expenses of the business as well as the net profit or loss calculated by subtracting the expenses from the income. This net profit or loss is carried forward to the form 1040.

A partner's share of the profit or loss of the partnership business goes on his or her personal return. However, to avoid having to divide each item of expense and income among the partners, the partnership files a return showing its income and expenses and determining a single net profit or loss. This net figure then is divided among the partners in proportion to their interest in the partnership and reported on their individual returns.

Corporations are treated for tax purposes exactly the same way. Under state law, they are separate persons. That means they report their own income, deduct their own expenses, file their own income tax returns and pay their own taxes. You work for your corporation just like any other employee and are paid a salary, which is subject to income and social security taxes. You cannot take money out of the corporation whenever you want. If you receive money from the corporation which is not salary, then it usually is a dividend, which is taxable.

There is a special election which a corporation can make to be taxed under subchapter S of the Internal Revenue Code. Those which make this election are called "S corporations." The provisions that apply to an S corporation essentially allow it to be taxed as a partnership. This means the corporation itself pays no income tax. Instead, the taxable income of the corporation is divided among its shareholders in

proportion to their stock ownership and reported as income on their personal returns. This income is taxable to the shareholders regardless of whether any cash is actually distributed. If you have incorporated a small, home-based business solely for liability purposes, you should give serious consideration to an S corporation, as it can help minimize the income tax problems associated with corporations.

If you're getting the idea that taxes become much more complicated with corporations, you're right. Corporations have their proper place and purpose, but incorporation by itself never made anyone rich or saved anyone taxes.

## Self-Employment Tax

Although we all know that income from a home-based business may be subject to income tax, many people forget about the self-employment tax. This is the self-employed person's social security tax. It is a tax on your net profit from self-employment, whether as a sole proprietor or as a partner. The amount of self-employment tax you pay depends upon the tax rate and the wage base to which it is applied. However, it can add up fast because it is not reducible by normal deductions and credits. The only way to reduce your self-employment tax is to reduce your self-employment income. You do this by taking as many business expense deductions as are legitimate.

## Deductions

Tax laws generally do not permit the deduction of personal expenses unless there is a specific section authorizing the deduction. The laws governing business expense deductions, on the other hand, are generally liberal. They say, in effect, that you're entitled to deduct all of the reasonable and necessary expenses of running your business. This obviously includes supplies that go into what you produce, but also may include expenses for the business use of your automobile and possibly of your home. There are special conditions specified for some deductions, however. For example, if you use part of your home for your business, the law says you must use that part of your home exclusively for the business to be entitled to *any* deduction. If it's used for both business and personal purposes, you aren't entitled to any deduction. If you qualify, then you simply take the number of square feet of the home used by the business, divide by the total number of square feet in the home and depreciate that percentage of the value of the home. You apply the same percentage to the cost of utilities.

Another expense that will reduce self-employment income is the wages you pay employees. If you're a sole proprietor rather than a partnership, don't overlook the possibility of paying your spouse or your children for work they *actually do* for you.

If you pay your spouse or

children for work, you are required to treat them the same way you treat any other employee, except that there is no social security tax or unemployment tax on the wages paid your spouse and children. Since these wages reduce your self-employment income and thus your self-employment tax, the result can be earnings not subject to social security taxes, although income taxes would still apply.

How much do you pay your spouse or children? The same as you would pay an outsider to perform the work. Remember, you have to be able to prove you did all this, so be sure you actually write pay checks. You'll also have to get an employer identification number from the Internal Revenue Service and your state, possibly do withholding and give the family member a W-2 form at the end of the year. On the W-2 form, the wages should be shown in the box marked "non-FICA wages." You should also write "family income" on the W-2 to alert the Social Security Administration that wages are not subject to social security tax. Note that the family member receiving the wages does *not* have to pay self-employment tax on these.

## Sources of Information

Although tax law is complicated, there are good sources of information that can help you. For example, every year around tax time, many commercial publications

designed to help you do your taxes are released. Look for those which cover business taxes. Those with lists of the various business expense deductions to which you may be entitled will be especially useful. These lists may give you a good idea of expenses to

look for in your business or may help you plan your expenses more wisely in the future.

In addition, the Internal Revenue Service publishes guides to many different tax topics. Single copies are available free from the Internal

Revenue Service and are worth getting.

It's well worth the time and effort to learn how taxes affect your home-based business. After all, the more you legitimately can save in taxes, the more profit you ultimately will make from your business.

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