ROBERT D FLACH'S
THE SCHEDULE C LETTER

August 2016

"As a citizen, you have an obligation to the country's tax system, but you also have an obligation to yourself to know your rights under the law and possible tax deductions -- and to claim every one of them."
Former IRS Commissioner Donald Alexander

Dear Sole proprietor:

WILLKOMMEN, BIENVENUE, WELCOME!

You are paying too much income and self-employment tax! By becoming informed on federal tax law and using proper tax planning you can make sure that you pay the absolute least amount of federal and state tax possible.

Whether or not you use a professional tax preparer (I strongly suggest you do), the more you know about taxes the more you can properly plan your financial transactions during the year to minimize taxes and the better prepared you will be when giving your "stuff" to your preparer at tax time.

I have been preparing 1040s since February of 1972. I want to share my knowledge and experience from over 40 years as a professional to help you experience the joy of avoiding taxes.

Your comments on this newsletter, and suggestions for additions, improvements, and topics for future issues, are welcomed. You may email me at rdftaxpro@yahoo.com.

MY BEST TAX ADVICE

Let me begin with what I believe is the best tax advice I can give any taxpayer in any situation –

DO NOT ACCEPT FEDERAL OR STATE TAX ADVICE FROM ANYONE OTHER THAN A PROFESSIONAL TAX PREPARER.

Don't listen to a broker, a banker, an insurance salesman, or your Uncle Charlie! You wouldn't ask your butcher for a medical opinion, so why would you listen to tax advice from your MD?

And don't automatically assume that tax advice you read in print or online, or hear on a tv or radio program, is correct or applies to you.

Be sure to check out any tax advice you receive or read with a qualified and experienced tax professional before taking any action.

BIZ BUZZ

+ I have found that Jean Murray's ABOUT.COM blog US BUSINESS LAW/TAXES is a valuable source of information, advice, and resources for small business owners.

For example, in a recent post Jean dealt with the question "Do I Need to Collect Sales Taxes In My State?".

In another recent post Jean explained "Have a Great Business Name? How to Register It".

+ In this issue I talk about putting your kids on the payroll of your Schedule C business. Early this year at TAX SOLUTIONS FOR WRITERS Enrolled Agent Gary Hensley suggested "Sole Proprietors: Hire Your Spouse and Deduct Your Healthcare Expenses on Schedule C".

+ Have you had a bad experience dealing with the IRS? The Tax Revolution Institute wants to hear about any positive or negative experiences that you have had with the IRS. Go to www.AuditIRS.com.

+ Are you aware of the existence of the "First Time Abate: The 'Get Out of Tax Penalties Free' Card"? Paul Mancinone and Alison Walsh explain this special and apparently little-known IRS penalty abatement program at ACCOUNTING TODAY.

BAD ADVICE – PART ONE

I have given you my best advice. So now let's talk about some bad advice.

A while back a tax blogger suggested that every Schedule C business should incorporate for no other reason than to avoid an audit. Not surprisingly the blogger was a lawyer. Lawyers make money by incorporating businesses.

I believe it is bad advice to tell ALL taxpayers who have a Schedule C business to incorporate. **There is no tax advice that applies to all businesses in all situations** – except don't cheat. The decision to incorporate a business requires careful review of all the specific facts and circumstances of the individual situation. And taxes are not the only consideration. In many cases it is not financially beneficial, either in the short or long term, to incorporate.

While incorporating will certainly reduce your audit risk, it is very often not the best idea for the average sole proprietorship. Incorporation can generate much more paperwork, recordkeeping, federal and state tax filings, costs, and general all-round "agita" than it is worth.

For one thing, like a marriage, it may be relatively cheap to "get into" a corporation, but it can be very expensive to "get out of" one.

The advice that one should incorporate solely for the purpose of avoiding an audit seems to me to be saying, "If you want to cheat on your taxes you can incorporate and the IRS will not audit you". This is not good tax or financial advice. And, frankly, it is not true.

An IRS audit is not something that should be avoided at all costs. Tax returns should be prepared, and decisions about choosing a business entity should be made, in such a manner as to generate the absolute least amount of federal, state and local taxes (income and payroll) within the parameters of federal and state laws. If you will pay less tax, fees and other costs by filing a Schedule C you should do so, honestly and ethically, and not worry about being audited.

There are indeed times when it is better financially to incorporate a one-person business. But certainly not in all cases.

I do believe that all small businesses that would not benefit by incorporating, regardless of the number of owners, should register their activity as an LLC to get the liability protection. More on this next issue.

The offending blogger said that the decision to incorporate was a "no-brainer". There is very little, if anything, about tax law that is a no-brainer – especially when it comes to business taxes. That is why tax professionals exist. The decision to incorporate is by no means a "no-brainer". It involves a lot of brain work!

BAD ADVICE – PART TWO

A while back during my "wanderings" on the internet I came across an article listing 10 ways to avoid a tax audit. While the article did have some good advice, like "choose your tax preparer with care" and "report all your income", one of the 10 items was bad advice.

Item #4 on the list was "Avoid claiming deductions that are audit red flags".

Do not fail to claim a legitimate, documented tax deduction on your Schedule C just because you read somewhere that it is an IRS "red flag" and that claiming it will automatically result in an IRS audit.

(1) If your deduction is legitimate and you have sufficient documentation to prove its authenticity in an audit then what is the problem? An audit is not something that must be avoided at all costs – it is merely an inconvenience.

(2) Just because the IRS pays closer attention to tax returns that contain certain deductions or credits does not mean if your return contains this deduction or credit you will automatically be audited. The IRS only audits a small percentage of 1040s – and several factors are involved in determining which returns are selected for audit.

(3) If you fail to claim a legitimate deduction or credit you have, in effect, audited your own return and disallowed the deduction – neither of which the IRS may actually do.

(4) Just because you read somewhere that an item is an IRS "red flag" does not mean that the item is actually an IRS "red flag".

I must point out one possibility. If claiming a legitimate and documented alleged "red flag" deduction or credit results in an audit, and another item claimed on the return is either not totally legitimate or not properly documented, the audit might turn up the "questionable" item.

The bottom line is obviously to **claim only items that are legitimate on your tax return, and be sure to have sufficient documentation for all deductions and credits you claim**.

Click here to check out my collection of tax planning and preparation newsletters, books, reports, and guides.

PUTTING YOUR KIDS ON THE PAYROLL

Having your Schedule C business pay your children a salary is a good way to reduce your tax bill.

For 2016 a dependent can earn up to $6,300 in wages (or a combination of wages and up to $350 in "unearned income" such as interest, dividends, and capital gains) and pay no federal, and probably no state, income taxes. And if the child is under age 18 you don't have to withhold or pay FICA (Social Security and Medicare) taxes on the salary. Wages paid by a parent's Schedule C business to a dependent child under 21 are also exempt from FUTA (federal unemployment) tax.

Wages paid to your child is considered to be "earned income" and not subject to the "Kiddie Tax".

And, of course, the parent gets a deduction on his/her Schedule C for the wages paid, which will reduce the parent's income tax, self-employment tax, and Adjusted Gross Income.

To be deductible the wages must be for actual legitimate services to the business as an employee, the child must actually be paid the wages, and the amount of wages paid must be reasonable for the type of services provided. Routine family chores will not qualify, you cannot just claim a deduction and not actually give the money to the child, and you are not allowed to pay your 10 year old son $50.00 an hour for sweeping up your office.

When placing your dependent child on the payroll you must make sure that he/she is qualified to handle the job, and can actually do the work for which you claim he/she is being paid. If the job requires special skills, make sure the child has these skills.

You are a contractor and the only job available is "in the field". If state law requires any person working in a dangerous industry must be at least 17 you can't claim your 15-year old son as an employee. And you can't claim that your 10-year old daughter works in your auto body shop. In an audit the IRS is sure to look at family members on the payroll. If it's clearly not possible your child could have performed the work as claimed the deduction will be disallowed.

You will need to look into your state's child labor laws. They vary greatly from state to state and often prohibit the hiring of children by age and type of job.

A recent Tax Court case, *John and Lisa Fisher, TC Summary Opinion 2016-10*, emphasizes the fact that it is very important to keep detailed documentation of your Schedule C deductions, especially when paying your kids a salary.

The Fishers were lawyers with three children under age 9. Lisa Fisher had her own law practice.

During the summer Lisa brought her kids to her office and had them do shredding, mailing, photocopying, and answer phones (to be perfectly honest, I would not have a child under age 9 answering my office phone or using a shredder). She claimed a total of $29,000 in "wages to minor children" on her 2006, 2007, and 2008 Schedule Cs.

During these years Fisher did not keep any payroll records or issue W-2s to the children. She did not actually give money to the children, either in cash or by check. The "wages" were paid via contributions to 529 college savings plans for the kids.

The IRS disallowed the deduction, and the Court agreed because the Fishers did not substantiate the deduction via proper documentation. The Court could not determine the actual amount paid to each child each year because there were no records of the hours worked or the rate of pay.

Surprisingly, the Court felt that the children actually did some work for Fisher and allowed a deduction of $250 per child per year.

The moral of the story

It is very important that you "cross your t's and dot your i's" when it comes to documenting a deduction for wages paid to your dependent children. You must make sure you pass the "duck test" (if it waddles like a duck and quacks like a duck . . .). Forget that these are your kids and treat them as you would any other employee.

- Create a written job description for each position held by your child outlining the duties and responsibilities involved.

- Pay the kids on an hourly basis.

• Use a time card or sheet to document hours worked and work performed. A sample time sheet is included at the end of this issue.

• Write a company check as payment each week or every-other week.

• Report your child's earnings as wages, and issue a W-2 in January to report the wages paid. Do not treat him/her as an "independent contractor" and issue a Form 1099-MISC.

• Even though the wages are not subject to FICA and FUTA tax, and possibly state unemployment and disability contributions, report the wages on all appropriate quarterly payroll tax returns, such as the federal Form 941 (you can indicate that the wages are exempt from FICA on the form), and submit an annual federal Form 940 indicating the amounts paid as "exempt", whether or not you have any other employees.

So remember, as the decision in this case emphasized – **you must keep good records of all your business deductions.**

OPEN A ROTH FOR YOUR KIDS

If your child has a summer or after-school job, whether working for your Schedule C business or for someone else, you should open up a Roth IRA account for him or her.

The earlier in your child's life that you begin to make ROTH contributions, the more that will have accumulated when he or she is ready to retire. The Tax Court case discussed in this issue shows that a child under age 9 can legitimately receive wages from your business.

To qualify for an IRA your child must have "earned income" — wages or "net earnings from self-employment." Money you give your child for doing chores around the house will not count, but earnings from babysitting or mowing lawns may qualify.

You can contribute 100% of your child's earnings to the account, up to a maximum of $5,500. If your son earns $2,400 you can contribute $2,400 to a Roth IRA for him. If he earns $6,500 you can contribute $5,500.

You can put your own money in the ROTH account. There is nothing in the Tax Code that says the money deposited in an IRA for your son or daughter has to actually come from the child's funds.

There is no tax deduction for contributing to a Roth IRA, but most teenagers don't need the deduction. Qualified distributions from a Roth will be exempt from federal, and probably state, income tax (assuming the idiots in Congress don't change the law in the future).

You can use a Roth IRA to encourage your children to work or to save. If your son earns $5,000 in a part-time job, open a Roth IRA for him. Or, if your daughter agrees to put $2,500 of her salary from a summer job in a Roth, match it and put in another $2,500.

If you put the maximum into a Roth each year for your 16-year-old from 2016 through 2021, when he/she will turn 21, and no other contributions are ever made, the account could grow to 6 figures by the time the child turns 65.

One caveat - there exists a potential problem with opening a Roth account for a child. Once the child reaches the "age of majority," usually 18, he/she will have full access to all the funds and can "take the money and run."

CALL YOUR TAX GUY FIRST!

Since we began this issue with my best advice, let me end with some final best advice.

A while back fellow tax pro and tax blogger Joe Kristan had some essential advice for business taxpayers in a post at his ROTH AND COMPANY TAX UPDATE BLOG titled "Don't Try This At Home!".

Joe told the story of an old friend who had organized as a Subchapter S corporation and, without first consulting a tax professional, made a big mistake that would ultimately prove very costly. The bottom line of Joe's post, and the final best, is –

"*When you mess with the ownership of your business, it's a lot cheaper to call a good business lawyer and a tax guy before you do the deal; it costs a lot more to repair a deal than to do it right in the first place*".

However I feel I must revise Joe's excellent advice a bit to make it truly "best advice". **Call your tax guy first before calling the business lawyer!**

Over the years I have had several clients who came to me after already forming their business organization. Often the client had formed a corporation and told me that it was an S-corporation (whether or not it actually was). In many cases incorporating was not the best way to go considering the specific facts and circumstances, especially with the LLC option. When I asked the client why they incorporated, or why they did what they did, the answer I have been given is almost always – "Because the lawyer said I should."

Lawyers love to form corporations because they can charge you an excessive fee to do so and they can charge you an additional excessive fee each year thereafter for acting as the corporation's "Registered Agent".

The average "general practitioner" lawyer does not necessarily know anything about the intricacies of the federal and state tax treatment of the various forms of business organization. And you do not need a lawyer to form a simple corporation. In most cases it can be easily done online at your state's website.

The bottom line is that **if you are considering starting a business, or making a change to your existing business – or for that matter any transaction that could have tax consequences – call your tax guy first**. You may also need to talk to a competent and experienced business lawyer, but the lawyer should be the second person you call.

If you have a question about any of the topics discussed above I recommend that you consult your, or a, tax professional.

Your comments on this issue, and suggestions for future issues, are welcomed. Email me at rdftaxpro@yahoo.com with "Schedule C Letter Comments" in the subject line

EMPLOYEE TIME CARD WEEK ENDED ____________________

EMPLOYEE NAME: ______________________________ HOURLY WAGE __________

DATE	TIME IN	TIME OUT	TOTAL HOURS	WORK PERFORMED

TOTAL HOURS = _________ x __________ = ____________

Check # ____________ Check Date ____________

EMPLOYEE TIME CARD WEEK ENDED ____________________

EMPLOYEE NAME: ______________________________ HOURLY WAGE __________

DATE	TIME IN	TIME OUT	TOTAL HOURS	WORK PERFORMED

TOTAL HOURS = _________ x __________ = ____________

Check # ____________ Check Date ____________

ABOUT THE AUTHOR - ROBERT D FLACH

Robert D Flach, a recent transplant from Jersey City NJ to rural Northeast PA, has been preparing 1040s for individuals in all walks of life since 1972. He is "winding down" his tax practice and no longer accepts new clients.

In 45 years of preparing individual income tax returns he has never used tax preparation software. One of the last of the dinosaurs, he prepares close to 300 sets of returns each year manually.

Robert learned how to prepare 1040s by preparing 1040s.

"On my first day at work for my uncle's tax preparer, having never prepared a tax return before, I was taken by my new boss to a desk. He gave me a copy of a client's prior year 1040 and a briefcase with the current year's 'stuff' and told me to 'jump in and swim!'"

Robert has been writing the popular tax planning and preparation blog THE WANDERING TAX PRO (http://wanderingtaxpro.blogspot.com) since the summer of 2001. He is the creator and author of the websites FIND A TAX PROFESSIONAL (http://www.findataxprofessional.com) and THE TAX PROFESSIONAL (http://thetaxprofessional.webs.com), and is the founder of TAX PROFESSIONALS FOR TAX REFORM (http://www.taxprosfortaxreform.com).

He has been a member of the National Association of Tax Professionals for over 30 years, and often write for the Association's TAXPRO JOURNAL as well as the newsletter of the New Jersey state chapter. He has created and compiled several packages of forms, schedules and worksheets and special reports and guides on tax planning and preparation for the average taxpayer.

Robert is available to write articles and columns for websites and portals and print or email newsletters, on general tax topics, or specifically for your individual audience. You can find samples of his writings at http://robertdflach.blogspot.com.

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