



2005

Small Business

advisor

TIMELY TALK ABOUT BUSINESS, TAXES AND TRENDS

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Writing Off Your Start-Up Expenses

Business owners – especially those operating small businesses – may be helped by a recent tax law change allowing them to deduct up to \$5,000 of the start-up expenses in the first year of the business' operation. This is in lieu of amortizing the expenses over 180 months (15 years). Note: Start-up expenses incurred prior to October 23, 2004 generally were deducted by amortizing the costs over no less than 60 months. These expenses continue to be eligible for the 60-month amortization.

Generally, start-up expenses include all expenses incurred to investigate the formation or acquisition of a business or to engage in a for-profit activity in anticipation of that activity becoming an active business. To be eligible for the election, an expense also must be one that would be deductible if it were incurred after the business actually began. An example of a start-up expense is the cost of analyzing the potential market for a new product.

As with most tax benefits, there is always a catch. Congress put a cap on the amount of the start-up expenses that can be claimed as a deduction under this special election. Here's how: If the expenses are \$50,000 or less, you can elect to deduct up to \$5,000 in the first year, plus you can amortize the balance over 180 months. If the expenses are more than \$50,000, then the \$5,000 first-year write-off is reduced dollar-for-dollar for every dollar start-up expenses exceed \$50,000. For example, if start-up costs were \$54,000, the first-year write-off would be limited to \$1,000 (\$5,000 – (\$54,000 - \$50,000)).

The election to deduct start-up costs is made by claiming the deduction on the return for the year in

which the active trade or business begins, and the return must be filed by the extended due date.

On Schedule C, the deduction is taken as part of the "Other Expenses" in Part V. If the entire amount of start-up costs isn't deductible in the business' first year, use Form 4562 to amortize the excess amount over 180 months.

Qualifying Start-Up Costs – A qualifying start-up cost is one that would be deductible if it were paid or incurred to operate an existing active business in the same field as the new business, and the cost is paid or incurred before the day the active trade or business begins. Not includible are taxes, interest or research and experimental costs. Examples of qualified start-up costs include:

- Surveys/analyses of potential markets, labor supply, products, transportation facilities, etc.;
- Wages paid to employees and their instructors while they are being trained;
- Advertisements related to opening the business;
- Fees and salaries paid to consultants or others for professional services; and
- Travel and other related costs to secure prospective customers, distributors, and suppliers.

For the purchase of an active trade or business, only investigative costs incurred while conducting a general search for or preliminary investigation of the business (i.e., costs that help the taxpayer decide whether to purchase a new business and which one to purchase) are qualified start-up costs. Costs incurred attempting to buy a specific business are capital expenses that aren't treated as start-up costs.

Preparing for an

The recent hurricanes, tsunamis, and terrorist attacks make it clear that even smaller companies are not immune to an unexpected loss. What can you do to prepare and minimize your risk to ensure that such a disaster won't run you out of business?

Unplanned events can have a devastating effect on your business. You need to be protected from any number of natural and unnatural events such as fire, computer failure, and illness of key staff, all of which can make it difficult or even impossible to continue day-to-day operations.

Good planning can help you take steps to minimize the impact of a disaster and protect your business. The following recommendations can help your business cope with an unforeseen calamity.

Why the Need to Plan? By identifying possible disasters that may affect you and your business, you may be able to minimize the risks and losses that might occur. A well thought-out business continuity plan will identify an action plan, safety concerns, applicable computer back-ups, and alternative operation headquarters. It will also provide a road map back to normal activities by highlighting the points of contact for insurance and emergency relief way ahead of time.

Educate Your Staff. How will you escape? Where will you meet up? How will you communicate? Map out and practice escape routes from your building. Familiarize yourself with local authorities and emergency radio signals announced at the time of a disaster. What happens if you survive the disaster but your biggest supplier does not? Develop back-up vendors and relationships ahead of time. Don't forget that many employees will have families to care for and may have their homes affected by the disaster. Have you stockpiled water, batteries, first aid kits and food in case emergency services are delayed?

Back Up Key Business Information. Does your computer system have a nightly back-up tape? If the answer is yes, where are the back-up tapes stored? And more importantly, will the back-ups include all of the software needed for your computers to function at another location? Many businesses now have outside vendors that host and back up their computer systems for them. Inquire if they have redundant back-up systems and request information on their emergency plans. If the disaster is only temporary and shuts down the electrical grid to your business, a generator may be a sound investment. The generator can power your computer system, equipment, refrigerators, and other items that might be crucial.

Review Your Insurance Coverage. As many realize after the fact, they are not insured for many natural disasters under their existing business policy.

Un- expected Disaster

You may need to add or increase coverage if it is available. Check with your carrier for details on your coverage.

Recovering and Government Assistance – The following government agencies may provide assistance:

- **Small Business Administration (SBA)** – Provides low interest loans to businesses, homeowners and renters who are victims of a disaster. They even provide loans for the replacement or repair of damaged or destroyed clothing, appliances, furnishings, and automobiles. For more information, visit their website at: www.sba.gov.
- **Federal Emergency Management Agency (FEMA)** – Disaster assistance is provided in the form of money or direct assistance to individuals, families and businesses in an area whose property has been damaged or destroyed and whose losses are not covered by insurance. It is meant to help with critical expenses that cannot be covered in other ways. For more information, visit their website at: www.fema.gov.

Since a disaster strikes without warning, being prepared can help your business recover more quickly from a catastrophic emergency. Take the necessary steps to ensure that both you and your business investments are well-protected.

Keep Track of Meal & Entertainment Expenses

When looking for deductions to add to your taxes, don't overlook your meal and entertainment expenses. These types of expenses must be "ordinary" and "necessary" to your business or trade and must be "directly related to" or "associated with" the active conduct of business.

In order for the IRS to allow these deductions, good documentation is a requirement and should include the following items:

- The amount
- Date, time and place
- Business purpose
- Names of guests & business relationship

In addition, the surroundings must be conducive for a business meeting, and any discussion before, during or after any meal should be business-related for it to be considered for a deduction. An intimate and quiet location would be appropriate for a business discussion. Refrain from going to places with loud and distracting events that can interfere with the main objective: to talk about business.

A 50% deduction on entertainment expenses is allowed by the IRS if the purpose of the business is to conduct a specific business agenda. The 50% rule also covers the cost of meals during away-from-home business travel. In addition, deductions for expenses related to the meals (e.g., taxes, tips and cover charges) are also limited to 50% of cost; however, this is not true for costs of transportation to and from the meal or entertainment location.

There are other important guidelines to consider so please call our office for assistance.

IRS Splits Mileage Rates for 2005

Recognizing the increased cost of operating vehicles due to higher fuel prices, the IRS has increased the standard mileage allowance to 48.5 cents per mile for business miles driven between September 1 and December 31 of 2005. The business allowance remains at 40.5 cents per mile for January through August of 2005. This unusual split mileage allowance for the year adds complexity, because it requires taxpayers using the optional mileage allowance to keep separate records for the two periods in 2005.

Medical travel and moving allowances have also been increased for the last four months of 2005. The allowance for charitable travel is set by statute and generally remains unchanged. The table below summarizes the mileage allowances for 2005.

2005 Mileage Rate Table (cents per mile)

Type of Use	Jan – Aug	Sept - Dec
Business Travel	40.5	48.5
Medical Travel	15.0	22.0
Charitable Travel	14.0	14.0
Moving	15.0	22.0

Special Rate for Hurricane Katrina Disaster – A taxpayer who uses a vehicle in providing donated services to a charity for relief related to Hurricane Katrina during the period of August 25, 2005 to December 31, 2006 can compute the charitable mileage deduction using 70% of the standard business mileage rate in effect at the time the vehicle is used. For example, the rate for Katrina relief-related charity miles driven from September 1 to the end of 2005 is 34 cents per mile (70% x 48.5¢). The IRS will not announce the 2006 mileage rates until late 2005 or early 2006.

Self-Employed Education Twists

Self-employed taxpayers should consider their options carefully when it comes to applying tax benefits for their own education tuition and expenses. Tax law provides multiple ways to benefit from the educational expenses and one may provide more benefit to you than another based on your particular set of circumstances. In addition, your tuition may qualify for one tax benefit while other education expenses qualify for another.

As a Business Expense – Generally, if the education qualifies, it is better to take the cost as a business expense since it will offset both income taxes and self-employment tax. The expenses can include tuition, books, supplies, and allowable travel for the education. To qualify as a business expense, the education must either be to maintain or improve your skills or be required in your business. You may, however, not wish to use the education's costs as a business expense when doing so limits your net profit and consequently limits your pension plan contribution. Another situation when you may not want to claim the education costs as a business expense is when your Schedule C only has a very small profit or shows a loss for the year.

As an Adjustment to Income – If the education expense is tuition at an institution of higher education and you are under the AGI phase-out limit for this deduction, you have the option to deduct up to \$4,000 as an adjustment to overall income for the year. You can take this deduction whether or not the education maintains or improves your skills required in your business. Other expenses related to this education such as books, supplies, and travel can still be deducted on your Schedule C as long as the education maintains or improves your skills required in your business. The deduction is a maximum of \$4,000 if AGI does not exceed \$65,000 (\$130,000 for married couples filing jointly) or a maximum of \$2,000 if AGI doesn't exceed \$80,000 (\$160,000 for married joint filers). 2005 is the last year this deduction is available.

As a Tax Credit – As with the adjustment to income above, if the education expense is tuition at an institution of higher education, you might qualify for the lifetime learning credit. It may be more beneficial than the business expense or AGI adjustment for the tuition portion of the expenses, especially if you are in a lower tax bracket or the business profits are low. The lifetime learning credit allows you a credit of 20% of the cost of your tuition (up to \$10,000 of costs) as a tax credit. It, too, has an AGI phase-out limitation. For 2005, the credit for single taxpayers phases out between \$43,000 and \$53,000 and \$87,000 to \$107,000 for joint filers. Please note that beginning in 2006, this credit will not be allowed if you are taxed by the Alternative Minimum Tax (AMT).

If you have any questions regarding these various options, please call our office.



FOR SMALL
BUSINESSES

QUESTION: I am self-employed and work out of my home. I converted a den in the home to an office that I use only for business. We also have a guesthouse on the property I have been considering remodeling and using as my office. Are you aware of any reason that could make that a bad tax move?

ANSWER: If you own and use the home for two of the prior five years preceding the sale of the home, you are allowed to exclude up to \$250,000 (\$500,000 if you are married and both you and your spouse qualify for the exclusion) of gain from the home. The fact that a portion of the residence is not being used as a home presents no problem if the home office is an integral part of your residence. The exclusion is allowed against the entire gain, except that you are required to recapture as income the depreciation deducted on the home office after May 6, 1997. However, if the portion of your home that you use as an office is located in a separate structure, then the sale would be treated as two sales: one of the home portion and the other the business portion. The exclusion would not be allowed against the business portion. Although complicated, it is possible to combine a home sale subject to the exclusion and a tax-deferred exchange for the business portion where the gain on the office

portion is deferred into a replacement office. This is a simplified explanation of a very complex set of rules, so we recommend that you contact this office before taking action.

QUESTION: I have a big project coming up soon and need to hire some people quickly. Should I hire employees or independent contractors?

ANSWER: Generally, if the workers are under your direction and control and you are telling them where, when, and how to do their jobs, they are employees and you should treat them as such. You can treat workers as independent contractors only if they have their own business and offer services to other clients. You may save money hiring an independent contractor since you will avoid payroll taxes, insurance, etc. but their hourly rate may be higher than that of an employee.

Incorrectly classifying your workers as contractors could get you into big trouble if the IRS later audits you and reclassifies your "independent contractors" as employees. The result would be assessment of hefty back taxes, penalties, and interest against you.

To avoid any potential worker classification issues, hire from a temporary agency if the employment need is short-term.

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Tax Calendar

November 2005 – April 2006

November-December 2005:

Time for 2005 Year-End and 2006 Tax Planning. This is especially true if you have substantial increases in income or fewer deductions. Tax planning provides an opportunity to make adjustments before year's end that can improve your tax situation and minimize potential penalties. Please call for an appointment.

December 31, 2005:

- Last day to pay deductible expenses for 2005 return (this doesn't apply to IRA, SEP or Keogh contributions, all of which can be made after December 31, 2005).
- Last day to make minimum required withdrawal of funds from a Traditional IRA Account and avoid a penalty if you turned age 70½ before 2005.
- Last day to set up a Keogh Retirement Account if you plan to make a 2005 Contribution.

January 16, 2006:

Fourth-Quarter 2005 Federal Estimated Tax Payment due unless 2005 return is filed by January 31, 2006. **Caution:** Some states may have different filing dates.

January 31, 2006:

Deadline for providing 1099s and W-2s to those people you paid during 2005. If you're a business owner or rental property owner,

and you paid \$600 or more for the services of individuals (other than employees) during the year, you need to provide 1099s for those workers by January 31, 2006. "Services" can mean everything from labor and professional fees to rents on property. In addition, in order to avoid a penalty, copies of 1099s need to be sent to the IRS by February 28, 2006. If you would like this firm to prepare these documents for you, please give us a call.

February 28, 2006:

Deadline for filing (sending) 1099s and W-2s to the government.

April 3, 2006:

Last day to withdraw funds from your Traditional IRA if you turned age 70½ in 2005 and you haven't taken your 2005 Distribution yet. In addition, this is the last day to withdraw funds from your SEP or Keogh plan if you're retired and turned age 70½ in 2005. Failure to take the required distributions can result in substantial penalties.

April 17, 2006:

- Deadline for individuals to file a 2005 Federal Return or request an extension of time to file.
- First Installment of 2006 Federal Estimated Tax Payment due.
- First Installment of 2006 Defined Benefit Pension Plan Contributions due.