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Tax Planning Strategies
for the
Self-Employed

3rd Edition

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Tax Planning Strategies
for the
Self-Employed

3rd Edition

A.J. Cataldo, Ph.D., CPA, CMA

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ABOUT THE AUTHOR

A.J. Cataldo earned his bachelors (finance and accounting) and masters (tax accounting) degrees at the University of Arizona in Tucson, Arizona. He completed his Ph.D. (tax accounting) at Virginia Polytechnic Institute and State University in Blacksburg, Virginia. He became a Certified Public Accountant in 1983, in Arizona. He became a Certified Management Accountant in 1987. He has published approximately 70 articles, columns and books on taxation and business issues, the majority of which are related to the self-employed taxpayer.

This is the third edition of Cataldo's book. Prior versions have been used in over 60 seminars for self-employed taxpayers, including real estate agents/brokers, CPAs, financial planners, and tax attorneys.

Many of these tax-planning strategies have appeared in article form, over the past decade (1990-). This book contains updates for recent tax law changes and additional examples to illustrate the powerful, time-tested tax planning strategies used by Cataldo, his clients, and his seminar participants.

Examples of Cataldo's prior publications on taxation include:

- *Deducting the Home Office*, **Florida Realtor** (June 2001).
- *Tax Payments and the Stock Market Crash*, **Strategic Finance** (August 2000).
- *Taxing E-Commerce*, **Strategic Finance** (May 2000).
- *State Income Tax Prepayment: A "Quick Fix" for Itemizers at Year-End*, **Strategic Finance** (November 1999).
- *Earned Income Credit - Strategies for Self-Employed Taxpayers*, **The CPA Journal** (January 1998).
- *Financing the SE Tax with EICs*, **Management Accounting** (August 1997).
- *Recent Developments in the Marriage Tax: A Comment and Decomposition*, **National Tax Journal** (December 1996).

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- *The EIC Advanced Payment Option*, **Management Accounting** (October 1995).
- *The Earned Income Credit: Historical Predecessors and Contemporary Evolution*, **The Accounting Historians Journal** (June 1995).
- *The EITC: Investigation of a Wealth-Based Phase-Out*, **Tax Notes** (1995).
- *Investing in an IRA or Deferred Compensation Plan? Consider the Risks of Higher Withdrawal Year Tax Rates*, **Management Accounting** (December 1994).
- *Avoiding Hobby Loss Classification for your Small Business*, **Management Accounting** (September 1994).
- *A Case Against Financed Home Ownership*, **Journal of Accountancy** (June 1994).
- *A Historical Analysis of the 'Marriage Tax Penalty'*, **The Accounting Historians Journal** (June 1994).
- *Home Office Expenses*, **Management Accounting** (April 1994).
- *The Marriage Tax Penalty: Inequities and Tax Planning Opportunities*, **Ohio CPA Journal** (December 1993).
- *Inflation-Indexing and Small Business*, **Management Accounting** (November 1993).
- *Various tax columns*, **Alabama Realtor** (January 1991 through August 1993).
- *Shift Gears for Tax Savings*, **Florida Realtor** (April 1990).
- *Taxes: Get the Most from Business Deductions*, **Florida Realtor** (February 1992).
- *Get the Most Out of Your Home Office Deductions*, **Florida Realtor** (November 1991).
- *Tax-Planning Before Year-End*, **Arizona Realtor Digest** (September/October 1991).
- *Use Actual Expenses to Claim Auto Costs*, **Arizona Realtor Digest** (January/February 1990).
- *Keeping Interest Costs 100% Deductible*, **Arizona Realtor Digest** (July/August 1990).
- *Minimize Your Tax Bite Before Year-End*, **Real Estate Business** (Fall 1990).

In addition to the above, Cataldo has published a monograph on the "January effect," a stock market-related and tax-based seasonal anomaly (**JAI Press**). He has also authored two continuing professional education tax courses for CPAs

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and Certified Financial Planners (**Harcourt Brace Professional Publishing** in their *Financial Planner's Library* series).

Cataldo has also published articles on a variety of business topics in other journals, as follows:

- **Research in Accounting Regulation**
- **The Journal of Accounting Education**
- **The Bottomline**
- **Colorado Realtor News**
- **Perspective**
- **Dealers' Choice**
- **Geoforum**
- **Auto Age**
- **The ARN Report**
- **Real Estate Today**
- **Texas Banking**

He has recently completed a second monograph for **JAI Press/Elsevier Science**, *U.S. Individual Federal Income Taxation: Historical, Contemporary and Prospective Policy Issues*.

He lives in Rochester Hills, Michigan, with his wife, son, and two dogs. He teaches accounting at the Oakland University in Rochester, Michigan.

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ACRONYMS

AGI:	Adjusted gross income
AMT:	Alternative minimum tax
EI(T)C:	Earned income (tax) credit
FICA:	Federal Insurance Contributions Act
FIT:	Federal income tax
IRA:	Individual Retirement Account
IRC§:	Internal Revenue Code Section
IRS:	Internal Revenue Service
MACRS:	Modified ACRS (1986-)
M&IE:	Meals and incidental expenses
SE:	Self-employed/self-employment
SIT:	State income tax
TI:	Taxable income
T&E:	Travel and entertainment

PREFACE

Tax laws change every year. Tax rates change, personal exemption and standard deduction amounts are increased, the "marriage tax" is debated and proposals made for its elimination, and so on. However, these changes represent mere *modifications* in tax law. The basic strategies for tax reduction *have not changed!*

The tax-planning strategies contained in this book have proven useful for more than 20 years! Unless the federal income tax is replaced with a national sales tax, an unlikely occurrence, the strategies contained in this book will probably continue to prove useful for another 20 years.

All of the strategies contained in this book have been presented in my seminars. *Some* of the chapters contained in this book represent updates of strategies previously published in my articles. These articles have appeared in magazines *for over a decade!*

The first two chapters provide the foundation for later chapters. Chapters 3 through 6 are relatively easy to follow, but if chapters 7 forward prove difficult to follow, return to and review the first two chapters again.

Read this book like you would a novel...the first time. The illustrations and examples have been simplified and are written with the average taxpayer in mind. You should be able to read it in an afternoon. Then, read it a second time. Keep it handy; refer to it frequently. Learn to *think tax!*

Generally, I do not recommend that you prepare your own individual income tax returns. However, if you are already preparing your own income tax return, you will probably be able to understand and quickly master the techniques contained in this book in a very brief period. I recommend the use of one of the tax software products and the use of a personal computer to explore the impact of these techniques on your personal situation.

If you use a tax accountant, discuss these techniques with him or her. Your accountant will be familiar with *some* of them. In other cases, *you* will be providing *them* with insights that they have not previously considered.

A.J. CATALDO, Ph.D., CPA, CMA

I am interested in your comments. It is to my advantage to constantly improve later editions. If you have suggestions for later editions, please feel free to contact me (or my wife) through email:

Ajcataldo@home.com or cataldoi@oakland.edu (me) or Savage@oakland.edu (wife)

Thank you for buying my book, and I wish you the lowest possible tax bill.

A.J. Cataldo

CHAPTER 1

STRATEGIC TAX PLANNING - A BASIC OVERVIEW

INTRODUCTION

This first chapter provides the foundation for understanding the U.S. federal income tax, as it relates to the self-employed taxpayer. The self-employed taxpayer is (potentially) subject to (1) federal income tax, (2) state income tax, and (3) self-employment taxes. Therefore, earnings from self-employment may be taxed at three levels. Alternatively, business deductions, resulting in a reduction of earnings from self-employment, may *save* tax at these same three levels. *This is your objective...to maximize business deductions at the self-employment level, saving federal and state income tax and self-employment taxes.*

We will begin with the development of an understanding of *before-tax* and *after-tax* dollars at the federal income tax level. Most states provide for a state income tax, so discussion will progress from a pure federal income tax to the development of an understanding of combined federal income tax and state income tax rates (at the average state income tax rate of 5%). Finally, because the self-employed taxpayer is also subject to the self-employment tax, a summary of combined federal and state income and self-employment income tax rates will also be developed.

Progressive taxes

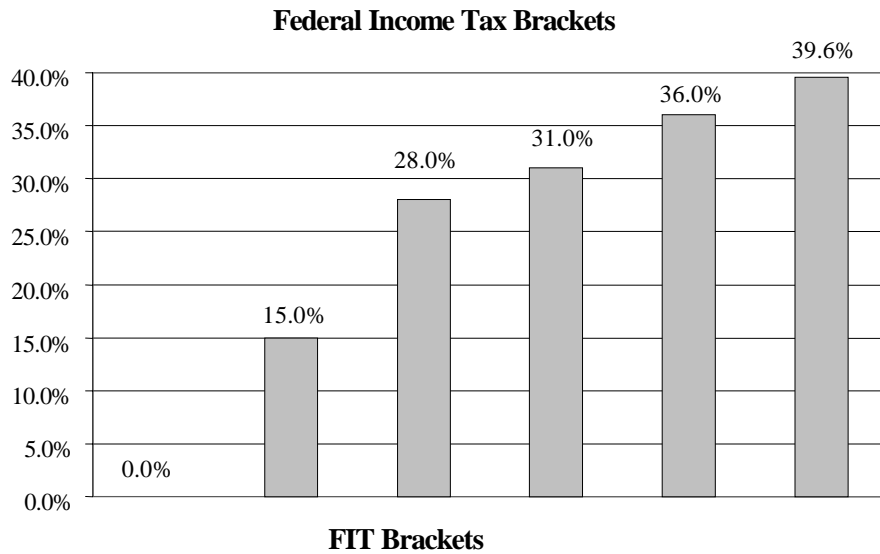
The U.S. system of federal income taxation is *progressive*. As taxable income increases, the federal income tax rate applied to the last dollar earned (or deducted) also increases.

Federal income tax rates. TABLE 1 summarizes the six federal income tax (FIT) rates (or brackets) applicable for the 2000 tax year.

TABLE 1: 2000 federal income tax (FIT) rates or brackets

Tax Rate or Bracket	<u>SGL</u>	<u>MFJ/SS</u>	<u>MFS</u>	<u>HH</u>
00.0%	< \$ -0-	< \$ -0-	< \$ -0-	< \$ -0-
15.0%	< \$ 26,250	< \$ 43,850	< \$ 21,925	< \$ 35,150
28.0%	< \$ 63,550	< \$105,950	< \$ 52,975	< \$ 90,800
31.0%	< \$132,600	< \$161,450	< \$ 80,725	< \$147,050
36.0%	< \$288,350	< \$288,350	< \$144,175	< \$288,350
39.6%	> \$288,350	> \$288,350	> \$144,175	> \$288,350

where the filing status' is indicated for a taxpayer who is (1) single (SGL), (2) married and filing jointly (MFJ), (3) a surviving spouse (SS), (4) married and filing separately (MFS), or (5) a head of household (HH).



TAX PLANNING STRATEGIES FOR THE SELF EMPLOYED

FIGURE 1 (above) illustrates the *progressive* nature of the FIT brackets.

Most of the illustrations and examples in this book will use the 15% and 28% FIT brackets. A few will use the 0%, 31%, 36%, and 39.6% brackets. (The taxpayer with negative or zero taxable income is in the 0% bracket.)

EXAMPLES 1 through **4** should be reviewed to make sure that you understand how to calculate your FIT from these FIT rates.

EXAMPLE 1

For the single taxpayer, 15% FIT on the first \$26,250 of taxable income *equals* \$3,937.50 in FIT (\$26,250 *multiplied by* 15%). This single taxpayer, with taxable income between \$0 and \$26,250, is said to be in a 15% FIT bracket.

EXAMPLE 2

Again, for the single taxpayer, 28% FIT on taxable income ranging from \$26,251 through \$63,550 provides for additional FIT of \$10,444 (\$63,550 *less* \$26,250 *equals* \$37,300 *multiplied by* 28%). Therefore, the 15% FIT on the first \$26,250 of taxable income (from **EXAMPLE 1**) *plus* the \$10,444 on the next \$37,300 of taxable income *equals* \$14,381.50 (\$3,937.50 *plus* \$10,444) on taxable income of \$63,550 (\$26,250 *plus* \$37,300). This single taxpayer, with taxable income between \$26,251 and \$63,550, is said to be in a 28% FIT bracket.

EXAMPLE 3

Assume that a single taxpayer has taxable income of \$50,000. The first \$26,250 is taxed at 15% (\$3,937.50 from **EXAMPLE 1**). The remaining \$23,750 (\$50,000 *less* \$26,250) is taxed at 28% (\$23,750 *multiplied by* 28% *equals* \$6,650). Therefore, the total FIT is \$10,587.50 (\$3,937.50 *plus* \$6,650). This single taxpayer, with taxable income of \$50,000, is in a 28% FIT bracket.

EXAMPLE 4

Assume that a married taxpayer, filing jointly with his/her spouse, has taxable income of \$50,000. (Refer to **TABLE 1**.) The first \$43,850 is taxed at 15% (\$6,577.50). The remaining \$6,150 (\$50,000 *less* \$43,850) is taxed at 28% (\$1,722). The

total FIT is \$8,299.50 (\$6,577.50 *plus* \$1,722). This married couple, with taxable income of \$50,000, is in a 28% FIT bracket.

The above examples illustrate the *progressive* nature of the U.S. federal income tax (FIT) system. Next, an understanding of the concept and mechanics of *before-tax* and *after-tax* dollars and percentages will be developed. These concepts will be used in examples throughout the remainder of this book. The general formulas follow:

BEFORE-TAX DOLLARS less FIT equals AFTER-TAX DOLLARS
and
BEFORE-TAX PERCENTAGE less FIT equals AFTER-TAX PERCENTAGE

Examples of *additions to (or increases in) taxable income.* The next five examples illustrate the concept of *before-tax* and *after-tax* dollars. Once the taxpayer knows his/her FIT bracket, he/she can quickly determine the tax associated with additional revenues or sales. It will be helpful to refer to **TABLE 1.**

EXAMPLE 5

An additional \$100 in taxable income will cost the taxpayer in the 15% FIT bracket an additional \$15 in FIT, and provide for \$85 (\$100 before-tax *less* \$15 in FIT) in *after-tax* dollars.

EXAMPLE 6

An additional \$100 in taxable income will cost the taxpayer in the 28% FIT bracket an additional \$28 in FIT, and provide for \$72 (\$100 before-tax *less* \$28 in FIT) in *after-tax* dollars.

EXAMPLE 7

An additional \$100 in taxable income will cost the taxpayer in the 31% FIT bracket an additional \$31 in FIT, and provide for \$69 (\$100 before-tax *less* \$31 in FIT) in *after-tax* dollars.

TAX PLANNING STRATEGIES FOR THE SELF EMPLOYED

EXAMPLE 8

An additional \$100 in taxable income will cost the taxpayer in the 36% FIT bracket an additional \$36 in FIT, and provide for \$64 (\$100 before-tax *less* \$36 in FIT) in *after-tax* dollars.

EXAMPLE 9

An additional \$100 in taxable income will cost the taxpayer in the 39.6% FIT bracket an additional \$39.60 in FIT, and provide for \$60.10 (\$100 before-tax *less* \$39.60 in FIT) in *after-tax* dollars.

Examples of reductions to (or decreases in) taxable income. The next five examples further illustrate the concept of *before-tax* and *after-tax* dollars. Once the taxpayer knows his/her FIT bracket, he/she can quickly determine the tax associated with additional expenses or deductions.

EXAMPLE 10

For a taxpayer in the 15% FIT bracket, a reduction of \$100 in taxable income will result in a \$15 reduction in FIT. If this taxable income reduction results from an additional \$100 expense or deduction, for example, the actual cost of the expense or deduction is \$85 (\$100 before-tax *less* \$15 in FIT) in *after-tax* dollars.

EXAMPLE 11

For a taxpayer in the 28% FIT bracket, a reduction of \$100 in taxable income will result in a \$28 reduction in FIT. If this taxable income reduction results from an additional \$100 expense or deduction, the actual cost is \$72 (\$100 before-tax *less* \$28 in FIT) in *after-tax* dollars.

EXAMPLE 12

For a taxpayer in the 31% FIT bracket, a reduction of \$100 in taxable income will result in a \$31 reduction in FIT. If this taxable income reduction results from an additional \$100 expense or deduction, the actual cost is \$69 (\$100 before-tax *less* \$31 in FIT) in *after-tax* dollars.

EXAMPLE 13

For a taxpayer in the 36% FIT bracket, a reduction of \$100 in taxable income will result in a \$36 reduction in FIT. If this taxable income reduction results from an additional \$100 expense or deduction, the actual cost is \$64 (\$100 before-tax less \$36 in FIT) in *after-tax* dollars.

EXAMPLE 14

For a taxpayer in the 39.6% FIT bracket, a reduction of \$100 in taxable income will result in a \$39.60 reduction in FIT. If this taxable income reduction results from an additional \$100 expense or deduction, the actual cost is \$60.10 (\$100 before-tax less \$39.60 in FIT) in *after-tax* dollars.

From this point forward, it is assumed that the concepts of *before-tax* and *after-tax* dollars and percentages are understood. Having address FIT rates, the next topic is that of state income tax (SIT) rates.

State income tax rates

Some states do not require the payment of an income tax. For those states with income taxes, the tax rates or brackets vary. Generally, states requiring the payment of income tax also use a *progressive* system of income taxation. However, some states use a *flat* tax system.

This book cannot provide separate examples or computations for each and every individual state. Therefore, a *flat* tax rate of 5% (an average that was developed) is used to illustrate combined FIT and SIT rates.

Combined FIT and SIT rates or brackets. TABLE 2 restates the FIT rates or brackets in terms of *combined* FIT and SIT rates or brackets, as follows:

TABLE 2: Combined FIT and SIT rates or brackets

<u>FIT Rate</u>	<u>SIT Rate</u>	<u>Combined FIT & SIT Rate</u>
15.0%	5.0%	20.0%
28.0%	5.0%	33.0%
31.0%	5.0%	36.0%
36.0%	5.0%	41.0%
39.6%	5.0%	44.6%

TAX PLANNING STRATEGIES FOR THE SELF EMPLOYED

The above *marginal* (or incremental) combined FIT and SIT rates or brackets will have to be modified for *your* state.

The self-employed taxpayer is also subject to the self-employment tax. The self-employment tax is a *flat* (or regressive) tax. The next sections briefly explain and add the self-employment tax to the FIT and SIT, providing for an illustration of combined FIT, SIT, and self-employment tax rates.

Flat (or regressive) self-employment taxes

The self-employment (SE) tax is a *flat* tax at a *flat* rate of 15.3%. Some might refer to it as a *regressive* tax, since the majority of the SE tax (Social Security at 12.4%) only applies to an inflation-indexed ceiling of salary, wages and/or net earnings from self-employment. The remainder, a Medicare tax component of 2.9%, is a true *flat* tax, without a ceiling.

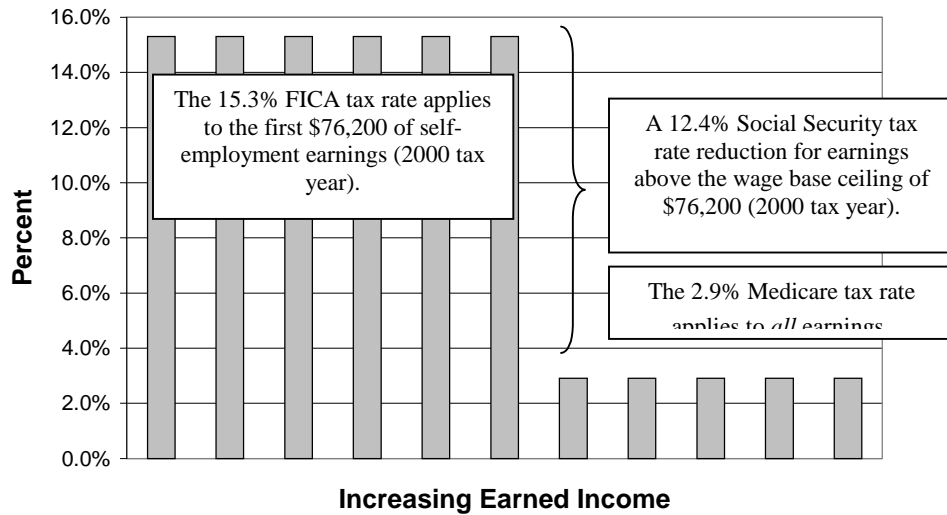
Self-employment taxes.¹ For the 2000 tax year, the self-employment, FICA, or SECA tax is 15.3% of the first \$76,200 of *net earnings* (\$72,600 for 1999 and \$80,400 for 2001). This amount breaks down into a 12.4% component and a 2.9% component (12.4% *plus* 2.9% *equals* 15.3%). The 12.4% component represents Social Security (retirement). The 2.9% component represents Medicare (health insurance).

For *all* net earnings, the self-employed taxpayer pays the 2.9% Medicare tax component. However, the 12.4% Social Security tax only applies to the \$76,200 *wage base* (2000). This wage base is inflation-adjusted and increases each year. For example, the wage base to which the 12.4% Social Security tax applied for the 1999 tax year was \$72,600. Taxpayers with earnings from self-employment in excess of this \$72,600 (1999) ceiling did not pay the 12.4% Social Security tax on earnings above this ceiling. Finally, 50% of the SE tax is deductible as an *above-the-line* deduction or *adjustment to gross income* (discussed later).

FIGURE 2 illustrates the *flat* or *regressive* nature of the SE tax. For the first \$76,200 of self-employment income (for the 2000 tax year), the taxpayer pays a *before-tax* rate of 15.3%.

¹ The IRS produces *Publication 533 - Self-Employment Tax*, updated annually.

FICA Tax: Social Security and Medicare Components



The Medicare tax of 2.9% applies to *all* earned income (without benefit of a wage base ceiling), which includes earnings from self-employment.

The actual computation of the SE tax uses the following SE tax formula:

$$\begin{aligned}
 &15.3\% \times (100\% - 7.65\%) \times (100\% - (50\% \times T)), \\
 &\quad \text{or} \\
 &15.3\% \times (92.35\%) \times (100\% - (50\% \times T)), \\
 &\quad \text{or} \\
 &14.13\% \times (100\% - (50\% \times T))
 \end{aligned}$$

where T = the taxpayer's marginal FIT bracket of 15%, 28%, 31%, 36% or 39.6%. Therefore, the SE tax depends on the taxpayer's marginal FIT bracket.

TAX PLANNING STRATEGIES FOR THE SELF EMPLOYED

The next five examples illustrate the calculation of the SE tax for each of the five (nonzero) FIT brackets. Because tax deductions for the taxpayer in the 0% FIT bracket have no value and do not result in tax savings, the SE tax for taxpayers in the 0% FIT bracket is 15.3%. (The detailed *steps* are shown only for the 15% FIT bracket.)

For now, it is *not essential* that you *completely* understand these calculations. Generally, you can think of the SE tax as equal to 15.3%. However, these examples will come to make sense, over time, and are included for completeness in developing combined FIT, SIT, and SE tax rates or brackets.

EXAMPLE 15

For a taxpayer in the 15% FIT bracket, the after-tax SE tax rate is 13.1%, as follows:

$$\begin{aligned} &14.13 \% \times (100\% - (50\% \times 15\%)), \text{ or} \\ &14.13\% \times (100\% - (7.5\%)), \text{ or} \\ &14.13\% \times (92.5\%), \text{ or } 13.1\% \text{ (rounded)} \end{aligned}$$

EXAMPLE 16

For a taxpayer in the 28% FIT bracket, the after-tax SE tax rate is 12.2%, as follows:

$$14.13\% \times (100\% - (50\% \times 28\%))$$

EXAMPLE 17

For a taxpayer in the 31% FIT bracket, the after-tax SE tax rate is 11.9%, as follows:

$$14.13\% \times (100\% - (50\% \times 31\%))$$

EXAMPLE 18

For a taxpayer in the 36% FIT bracket, the after-tax SE tax rate is 11.6%, as follows:

$$14.13\% \times (100\% - (50\% \times 36\%))$$

EXAMPLE 19

For a taxpayer in the 39.6% FIT bracket, the after-tax SE tax rate is 11.3%:

$$14.13\% \times (100\% - (50\% \times 39.6\%))$$

Notice that the actual cost of the SE tax *decreases* as the taxpayer's marginal FIT rate or bracket *increases*. For example, the 15.3% *before-tax* SE tax costs the

taxpayer in a 15% FIT bracket 13.1% *after-tax* (see **EXAMPLE 15**), but the 15.3% *before-tax* SE tax only costs the taxpayer in the 31% FIT bracket 11.9% *after-tax* (see **EXAMPLE 17**). This is due to the *adjustment to income* or *above-the-line deduction* at the bottom of page 1 of the FIT form 1040, which provides a deduction for 50% of the taxpayer's SE tax.

Now that we have calculated the SE tax for each of the marginal FIT brackets, combined FIT, SIT, and SE tax brackets can now be developed.

Combined FIT, SIT and SE tax rates or brackets. **TABLE 3**, below, restates the FIT rates or brackets in terms of combined FIT, SIT (at 5%) and SE tax brackets, as follows:

TABLE 3: Combined FIT, SIT, and SE tax rates or brackets

<u>FIT Rate</u>	<u>SIT Rate</u>	<u>SE Tax Rate</u>	<u>Combined FIT, SIT & SE Tax Rate</u>
15.0%	5.0%	13.1%	33.1% (33% rounded)
28.0%	5.0%	12.2%	45.2% (45% rounded)
31.0%	5.0%	11.9%	47.9% (48% rounded)
36.0%	5.0%	11.6%	52.6% (53% rounded)
39.6%	5.0%	11.3%	55.9% (56% rounded)

The above marginal (or incremental) combined FIT, SIT and SE tax rates or brackets will *not* be used in the cases and examples that follow in later chapters. For simplicity, the 15.3% *before-tax* SE tax rate will be used. However, the rates contained in **TABLE 3** will be useful to you, as a reference, in your personal tax planning endeavors. Some examples follow:

EXAMPLE 20

A self-employed taxpayer in a 28% FIT bracket has net earnings from self-employment of \$50,000. The *gross* SE tax is \$7,650 (\$50,000 *multiplied by* 15.3%). However, greater precision can be achieved by using the SE tax formula, as follows:

$$\$50,000 \times [15.3\% \times (100\% - 7.65\%) \times (100\% - (50\% \times 28\%))] = \text{net SE tax of } \$6,075.71$$

TAX PLANNING STRATEGIES FOR THE SELF EMPLOYED

EXAMPLE 21

A self-employed taxpayer has net earnings from self-employment of \$100,000. The *gross* SE tax is \$11,658.60 (\$76,200 *multiplied by* 15.3%) for the first \$76,200. The wage base ceiling has been reached and exceeded. However, the self-employed taxpayer must continue to pay the 2.9% Medicare component on all net earnings from self-employment. Therefore, the additional Medicare tax is \$690.20 (\$100,000 *less* \$76,200 already taxed equals \$23,800 *multiplied by* 2.9%). The total *gross* SE tax is \$12,348.80 (\$11,658.60 *plus* \$690.20). Again, greater precision can be achieved by using the SE tax formula. However, in this case, the SE tax cannot be precisely calculated, since the marginal FIT rate or bracket of the taxpayer has not been provided.

We have already covered quite a lot of material. In the first 21 examples, we have familiarized ourselves with the *progressive* nature of the federal income tax, been exposed to the concept of *before-tax* and *after-tax* dollars, and considered approaches useful in developing combined federal income tax, state income tax, and self-employment tax rates or brackets.

The next section provides a broad overview of the basic U.S. federal income tax return used to report taxes due for individual taxpayers.

SUMMARY

This first chapter has provided an introduction to the federal income tax and the self-employment tax. The concept of tax rates or brackets has been applied and combined federal income tax, state income tax, and self-employment tax brackets have been developed to assist you in developing an understanding of *before-tax* and *after-tax* dollars. These concepts will be used to illustrate the tax savings associated with the powerful strategies presented in later chapters.

CHAPTER 2

A BASIC TAX RETURN FORMAT

INTRODUCTION

This chapter summarizes the basic tax return format. Your objective should be to become extremely familiar with this basic federal income tax return format. This format is a summary of pages 1 and 2 of your federal income tax form 1040, and you may find it helpful to refer to your most recent tax returns. This section includes an illustration of *bunching*, a powerful tool, used for decades, to maximize the tax savings associated with itemized deductions. Bunching is also useful to the self-employed, non-itemizer taxpayer, and will be discussed in a later chapter.

Pages 1 and 2 of the Form 1040 represent a summary sheet. Other forms and schedules are used to generate detailed information, which is summarized on pages 1 and 2 of the Form 1040. (The SIT is calculated on the SIT return.) For the self-employed taxpayer, the Schedule C summarized *net earnings/(loss) from self-employment*. Before we can discuss the Schedule C, we must familiarize ourselves with the manner in which this (and other) schedules figure into the calculation of taxable income. The basic framework or summary, contained on pages 1 and 2 of the FIT Form 1040, follows:

	Gross or total income
<i>less:</i>	<u>Above-the-line deductions from or adjustments to gross income</u>
<i>equals:</i>	Adjusted gross income (AGI)
<i>less:</i>	the larger of itemized or the standard deduction
<i>less:</i>	<u>Personal exemption(s)</u>
<i>equals:</i>	Taxable income (TI)
<i>multiply by:</i>	<u>Tax rate or bracket (or amount from tax table)</u>
<i>equals:</i>	Tax liability

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<i>add:</i>	Other taxes (including the SE tax)
<i>less:</i>	<u>Tax credits (including FIT withheld or prepaid)</u>
<i>equals:</i>	<u>Tax due (or refundable)</u>

Gross or total income

Gross income (also known as *total income*) includes: wages and salaries, taxable interest and dividends, taxable SIT refunds, alimony received, and *business income*, in the form of *net earnings/(loss) from self-employment*. The detailed revenues and expenses (accrual basis) or receipts and disbursement (cash basis) from self-employment are developed on a separate schedule (Schedule C). The Schedule C represents a *profit and loss* statement for the sole proprietor, the focus of this book.

Also included in gross income are capital and other gains and losses, individual retirement account (IRA) and pension distributions, rental and royalty income and losses, farm income, unemployment compensation, social security benefits, and other income items.

Because the self-employed taxpayer can generate a *loss* from self-employment, these losses may be used to offset or reduce positive income items (e.g., interest income, salaries, dividend income, etc.). This is a very important concept and warrants illustration.

EXAMPLE 22

You have interest income of \$1,000, salary income of \$50,000, and net loss from self-employment of \$10,000. Your *gross income* from interest and salaries is reduced by the net loss from self-employment. Therefore, your *gross income* is \$41,000 (\$1,000 *plus* \$50,000 *less* \$10,000). Though you would have preferred to generate a profit from self-employment, the \$10,000 loss from self-employment shelters \$10,000 of salary income, effectively making the last \$10,000 of salary income *tax free*.

Deductions from/adjustments to gross income

Deductions from gross income are also referred to as *above-the-line* deductions. The *line* represents *adjusted gross income* (AGI), discussed below. Deductions from or adjustments to gross income include: deductions for contributions to IRAs, student loan interest expense, medical savings accounts (MSAs), moving expenses, 50% of the SE tax (as previously discussed), the self-employed health

insurance deduction (discussed below), Keogh and self-employed SEP and SIMPLE plans, penalties imposed by financial institutions on the early withdrawal of savings, and alimony paid.

Some of these deductions or adjustments are *phased-out* (and eventually eliminated) for *high-income* taxpayers.

Adjusted gross income

Adjusted gross income (AGI) *equals* gross income *less* above-the-line deductions from gross income. AGI is used to establish floors (and ceilings) for taxpayers itemizing their deductible personal expenses. AGI is also used in its raw form or as a starting point to develop modified AGI measures, used to determine phase-out ranges for other deductions (e.g., itemized deductions and personal exemptions) for *high-income* taxpayers.

Generally, the higher the taxpayer's AGI, the lower the potential tax savings generated from medical and dental expenses, casualty and theft losses, and miscellaneous itemized deductions. The case of medical expenses can easily be used to illustrate this point.

EXAMPLE 23

Generally, medical and dental expenses are deductible as an itemized deduction. However, only medical and dental expenses in excess of 7.5% of AGI produce increases in itemized deductions. This is because tax law requires the *exclusion* of the first 7.5% of the taxpayer's AGI in calculating the medical and dental expense deduction. Therefore, assuming that your AGI is \$10,000 and your medical and dental expenses are \$1,000, you must first exclude 7.5% of your AGI in arriving at the *potential useful* component of your medical and dental expenses of \$1,000, as follows:

Gross medical and dental expenses	\$1,000
<i>less:</i> 7.5% of \$10,000 AGI	<u>(750)</u>
<i>equals:</i> Excess medical and dental expenses	\$ <u>250</u>

Itemized and standard deductions

Itemized deductions are personal expenses that the law allows taxpayers to deduct in arriving at taxable income. AGI is reduced by itemized deductions. Itemized deductions include medical expenses (above a specified threshold at 7.5% of AGI), state and local income and property taxes, home mortgage

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interest, charitable contributions, personal casualty losses, and miscellaneous employee expenses (also above a specified threshold of 2% of AGI).

A taxpayer has the option of reducing taxable income (and FIT) by the itemized or the standard deduction. The taxpayer should, of course, select the *larger* of the two.

The standard deduction provides taxpayers with some minimum presumed amount of itemized deductions, and is intended to

- (1) Simplify the computation of the tax liability,
- (2) Eliminate lower income individuals from the tax rolls, and
- (3) Ease the IRS administrative burden of auditing detailed itemized deduction for *all* taxpayers.

For each tax year, the *basic* standard deduction amount is inflation-indexed. The basic standard deduction for the 2000 tax year, based on the taxpayer's filing status, is summarized below:

<u>Filing Status</u>	<u>Basic Standard Deduction (2000 Tax Year)</u>
Single (SGL)	\$4,400
Married Filing Jointly (MFJ)	\$7,350
Married Filing Separately (MFS)	\$3,675
Head of Household (HH)	\$6,450
Surviving Spouse (SS)	\$7,350

Generally, homeowners itemize, while renters use the standard deduction, since home mortgage interest is frequently significant in amount and the largest single deductible item. There are, however, exceptions. For example, some taxpayers make very significant charitable contributions.

Before itemizing, taxpayers should first determine whether it is to their advantage to do so. This is so only when itemized deductions exceed the standard deduction assigned to them. In other words, taxpayers should itemize only when they have itemized deductions in *excess* of the standard deduction.

Phase-out of itemized deductions. For the *high-income* taxpayer, itemized deductions are subject to a phase-out when a taxpayer's AGI exceeds the "applicable amount" (e.g., \$126,600 for married taxpayers who file jointly for

the 1999 tax year). For these taxpayers, otherwise allowable itemized deductions are reduced by the *lesser* of:

- (1) 3% of the excess of AGI above the "applicable amount," or
- (2) 80% of itemized deductions.

Therefore, it is possible for *high-income* taxpayers to lose up to 80% of deductible personal expenses on their Schedule A! For this (and other) reason(s), it is to the taxpayer's advantage to legitimately shift deductions from their Schedule A to their Schedule C. This strategy will be discussed further in Chapter 7.

Marginal itemizers. Marginal itemizers are those taxpayers with only modest amounts of excess itemized deductions.

EXAMPLE 24

You are a single taxpayer and itemize your deductions for the 2000 tax year. Your total itemized deductions amount to \$4,500. If you were unable to itemize, your standard deduction for the 2000 tax year would have been \$4,400. Your *excess* itemized deductions are only \$100 (\$4,500 *less* \$4,400). You are a marginal itemizer. Assuming that you are in a combined 33% FIT and SIT bracket (28% FIT *plus* 5% SIT brackets), you paid \$4,500 for deductible items, and receive additional tax savings of \$33 (\$100 *multiplied by* 33%) for this \$4,500 in expenditures.

Marginal itemizers have long engaged in the strategy of *bunching*, to maximize the tax savings associated with itemizing. This strategy has broad applications.

What is *bunching*? *Bunching* is a tax planning strategy that has been used since the early 1980s. During this period (1) the floor (or exclusion) for itemized medical and dental expenses was initiated at 5% of AGI (1984-86) and increased to 7.5% (1987-), (2) the sales tax itemized deduction was eliminated (1987-), (3) the personal interest itemized deduction was phased-out (1987-90) and eliminated (1991-), and (4) the floor (or exclusion) for the miscellaneous itemized deduction was established at 2% of AGI. This technique suggests that cash basis taxpayers *bunch* their itemized deductions every *other* tax year.

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An illustration of *bunching* - medical and miscellaneous expenses. TABLE 4 provides an illustration of the tax benefits associated with *bunching* for a single taxpayer. EXAMPLE 25 (below) provides the fact pattern for TABLE 4.

EXAMPLE 25

Using the 1998 and 1999 tax years to illustrate, assume that a taxpayer has a AGI of \$10,000 for both of these tax years. The standard deduction for the single taxpayer was \$4,250 and \$4,300 for the 1998 and 1999 tax years, respectively. For both 1998 and 1999, assume that medical and dental expenses were \$1,000, state income taxes paid and withheld were \$500, real estate taxes were \$500, charitable contributions were \$500, and miscellaneous deductions were \$500 per year. Home mortgage interest was \$2,000 for 1998 and \$1,900 for 1999.

Medical and dental expenses are deductible, but only after a floor of 7.5% of AGI is exceeded. As illustrated in EXAMPLE 23, the first 7.5% (\$10,000 *multiplied by 7.5% equals* \$750) of medical and dental expenses are excluded, each year, for the purpose of itemized deduction calculation.

Miscellaneous deductions (e.g., tax preparation expenses, employee business expenses, etc.) are deductible, but are also subject to a floor or *exclusion* amount. The first 2% (\$10,000 *multiplied by 2% equals* \$200) of miscellaneous deductions are excluded, each year, for the purpose of itemized deduction calculation.

Without bunching, the taxpayer is unable to itemize for either the 1998 or the 1999 tax year. *With bunching*, the taxpayer is able to itemize for the 1998 tax year. Excess itemized deductions of \$1,800 can be achieved for the 1998 tax year by (1) prepaying 1999 medical and dental expenses (e.g., insurance) in the amount of \$1,000, (2) making the \$500 charitable contribution for 1999 in the 1998 tax year, and (3) prepaying 1999 miscellaneous items (e.g., tax preparation fees) of \$500.

Even if the taxpayer is only in a 15% FIT bracket and lives in a state without an income tax, the tax savings from *bunching* is \$270 (\$1,800 *multiplied by 15%*). These tax savings are *permanent*.

TABLE 4 **SINGLE TAXPAYER**

Tax Year	<i>Without Bunching</i>		<i>With Bunching</i>	
	<u>1998</u>	<u>1999</u>	<u>1998</u>	<u>1999</u>
AGI	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
Medical & dental	\$ 1,000	\$ 1,000	\$ 2,000	\$ -0-
less: 7.5% of AGI	\$ 750	\$ 750	\$ 750	\$ 750
equals: Net	\$ 250	\$ 250	\$ 1,250	\$ -0-
State income taxes	\$ 500	\$ 500	\$ 500	\$ 500
Real estate taxes	\$ 500	\$ 500	\$ 500	\$ 500
Home mortgage interest	\$ 2,000	\$ 1,900	\$ 2,000	\$ 1,900
Charitable contributions	\$ 500	\$ 500	\$ 1,000	\$ -0-
Miscellaneous	\$ 500	\$ 500	\$ 1,000	\$ -0-
less: 2% of AGI	\$ 200	\$ 200	\$ 200	\$ 200
equals: Net	\$ 300	\$ 300	\$ 800	\$ -0-
Total itemized	\$ 4,050	\$ 3,950	\$ 6,050	\$ 2,900
less: Standard amount	\$ 4,250	\$ 4,300	\$ 4,250	\$ 4,300
equals: Net excess	NA	NA	\$ 1,800	NA

If it is assumed that the taxpayer had to borrow at an interest rate of 10%: \$1,000 to prepay the medical and dental insurance, \$500 to make the charitable contribution in advance, and \$500 to prepay the tax preparation fees, the total interest cost would be \$200 (\$1,000 *plus* \$500 *plus* \$500 *equals* \$2,000, therefore, \$2,000 *multiplied by* 10% *equals* \$200). If this interest expense is *not* deductible, the net tax savings would still be positive at \$70 (\$270 *less* \$200).

The example in **TABLE 4** is extremely simplified, merely to illustrate the concept and the tax benefits of *bunching*. Again, the tax savings from bunching are *permanent*. Furthermore, the tax savings would be much larger if the taxpayer were in a higher FIT bracket and/or was subject to a SIT as well.

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In the case of medical insurance, the self-employed taxpayer has an option that is more favorable than *bunching*. The self-employed taxpayer is entitled to deduct as an *above-the-line adjustment to income*, 60% (for 1999) of the cost of the medical insurance for the taxpayer, the spouse and all dependents. This amount increased from 45% in 1998 and will increase further to 70% for 2002 and 100% for 2003 and future tax years. The remainder is, of course, still available as an itemized deduction for use on the taxpayer's Schedule A.

Personal exemption(s)

A *personal exemption* is a deduction provided for the taxpayer and the taxpayer's dependents. AGI is reduced by personal exemptions. The *personal exemption* deduction is inflation-indexed and increases each year. It is subject to phase-out for *high-income* taxpayers. The personal exemption amount for 2000 is \$2,800.

Phase-out of personal exemptions. For *high-income* taxpayers, the personal exemption is phased out. The personal exemption is phased out for taxpayers, by filing status, based on the below adjusted gross income (AGI) levels:

<u>Filing Status</u>	<u>Begin Phase-out</u>	<u>Complete Phased-out</u>
SGL	\$126,600	\$249,100
MFJ/SS	\$189,950	\$312,450
MFS	\$ 94,975	\$156,225
HH	\$158,300	\$280,800

The taxpayer's personal exemption deduction is reduced 2% for each \$2,500 (or portion of \$2,500) that his AGI exceeds the threshold (e.g., for SGL: \$249,100 less \$126,600 equals \$122,500 divided by \$2,500 equals 49 plus 1 equals 50 multiplied by 2% equals 100% phase-out). Note that this is *not* an extremely valuable deduction (e.g., set \$2,500 equal to 2%, therefore, 2% divided by \$2,500 equals 0.0008%).

Generally, these phase-outs begin for taxpayers in FIT brackets at 31% levels or above (based on the assumption that AGI is approximately equivalent to taxable income).

Taxable income

Taxable income (TI) is represented by the following formula:

	AGI
<i>less:</i>	greater of <i>Itemized/standard deduction</i>
<i>less:</i>	<i>Personal exemption deduction</i>
<i>equals:</i>	TI

Federal income tax (FIT)

The federal income tax (FIT) is imposed on TI.

Other taxes (including the SE tax)

The SE tax is paid in addition to the FIT. Just as the employee must pay both (employee's portion of) FICA and the FIT, the self-employed taxpayer must pay both SE and FIT.

For high-income taxpayers the alternative minimum tax (AMT) may also be imposed in the calculation of FIT. The AMT prevents high-income taxpayers and/or taxpayers taking advantage of *tax preference items* (including accelerated depreciation) from achieving excessive tax savings, or even completely avoiding the FIT, through aggressive tax planning strategies. The AMT is generally avoided or minimized by using the strategies employed in this book, but is a separate topic, beyond the scope of this book.

Additional taxes include those imposed on tip income, taxes imposed on IRA or deferred compensation (including MSAs) and retirement plan distributions, advanced earned income credit (EIC) payments received from low-income taxpayers, and household employment taxes imposed on taxpayers employing others for domestic assistance.

Tax credits (including FIT withheld and prepayments)

Having calculated the total tax liability, tax credits are applied against this liability. Tax credits include federal withholding taxes from employee salaries, estimated taxes paid by self-employed or other taxpayers, the EIC generated for low-income taxpayers, the child tax credit, amounts paid with extension requests, excess social security (or the alternative railroad retirement taxes) paid, typically, by high-income employees with more than one employer within the tax year, and other payments made to the IRS.

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Tax due/(refund available)

If the tax credits (payments and amounts withheld) are larger than the tax liability, a refund is due. If the tax credits do not completely offset the tax liability, a payment is due to the IRS.

SUMMARY

The basic U.S. individual federal income tax return format has also been reviewed in this first chapter. In general, most of the tax-planning strategies presented in later chapters are designed to *reduce or eliminate earnings from self-employment*. The result is a reduction in *gross income*. As gross income is reduced, so is *adjusted gross income*. As adjusted gross income is reduced, so is *taxable income*. As taxable income is reduced, so is the *federal income tax* (and, for most states, the *state income tax*).

An illustration of *bunching* was also presented in this chapter. **EXAMPLE 25** and **TABLE 4** provided this illustration. Bunching is not a new strategy, but it is an important one. A very similar strategy will be presented in later chapters, which will focus on the calculations of tax savings that can be achieved for combined federal and state income and self-employment taxes.

Generally, it is best not to proceed to later chapters until you have worked through (and understand!) all of the examples in this first chapter.

The next chapter focuses on primarily non-quantitative or conceptual matters...how to avoid hobby loss classification and the loss of the deductibility of self-employment losses.

CHAPTER 3

AVOIDING "HOBBY LOSS" OR "NOT-FOR-PROFIT" CLASSIFICATION¹

INTRODUCTION

Self-employed taxpayers frequently generate tax losses. These taxpayers may have other income (e.g., salaries, interest, dividends, etc.). The self-employment losses can be used to offset these other income items, reducing the federal and state income taxes otherwise payable by the taxpayer. In these cases, the disallowance of the self-employment loss as a *hobby loss* would result in higher tax collections by the IRS. The taxpayer is, therefore, likely to have his or her federal income tax return closely scrutinized.

If a self-employed taxpayer generates a *net loss* from trade or business activities, the taxpayer is at risk for *hobby loss* or *not-for-profit* classification. *This status is extremely undesirable!* It prevents the taxpayer from using *net losses from self-employment* to offset other income items for the reduction of taxable income.

This chapter is devoted to the avoidance of the *hobby loss* or *not-for-profit* classification of self-employment losses. Such classification is based on *evidence*. This evidence has its root in tax court cases. And this chapter provides numerous examples of the elements of evidence used to determine whether the taxpayer is really in business for the purpose of generating a profit, or is merely converting non-deductible personal expenses to business status for the illegitimate purpose of reducing the overall tax bill.

¹ A summarized version of this chapter, from an earlier edition of this book, was published in the September 1994 issue of *Management Accounting* magazine.

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EXAMPLE 26

Assume that a taxpayer has a full-time job, but also has a small business. Assume further that this small business self-employment activity generated a tax loss of \$10,000 for the year, while the taxpayer's salary was \$40,000 for the same tax year. If there is evidence of *profit motive*, the self-employment loss will be allowed. The taxpayer will have an AGI of \$30,000 (\$40,000 less \$10,000). If the \$10,000 self-employment loss is denied, due to the absence of profit motive or *hobby loss* classification, the taxpayer will have an AGI of \$40,000. The difference is the tax on an additional \$10,000!

At a 15% FIT bracket, this represents an addition \$1,500 in FIT. Assuming that the taxpayer's state has an income tax rate of 5%, the combined FIT and SIT results in additional tax of \$2,000 (15% plus 5% equals 20% multiplied by the \$10,000 self-employment loss) in combined FIT and SIT.

Some taxpayers attempt to deduct expenses associated with hobbies or recreational activities under the guise of a legitimate trade or business activity. For example, a taxpayer with a salary of \$40,000 attempts to deduct his *personal* skydiving expenses of \$5,000 per year. His gross income, adjusted gross income, and taxable income are, as a result, reduced by \$5,000, to \$35,000 (\$40,000 less \$5,000). Therefore, the motivation of the taxpayer is to shift these *personal* expenses into a *business* category. The objective - to reduce taxable income and FIT and SIT.

Guidelines and case law has evolved to prevent a taxpayer from taking deductions associated with an activity *not* engaged in for profit. However, the expenses of *not-for-profit* activities may be deducted:

- (1) ONLY if otherwise allowable as a deduction elsewhere on the FIT return (e.g., home mortgage interest expense that would be deductible as an itemized deduction),
- (2) ONLY to the extent that the trade or business activity income exceeds losses (up to the point of zero profit and zero loss), AND
- (3) ONLY if the deduction does not result in a tax basis adjustment (e.g., depreciation of the business use portion of your, otherwise non-depreciable, personal residence).

The first restriction prevents the taxpayer from being penalized (or losing a deduction) that would be deductible whether or not the taxpayer had self-employment losses.

EXAMPLE 27

For example, an itemizing taxpayer with a large home mortgage may use 10% of their personal residence for their self-employment trade or business activity. Therefore, 10% of the home mortgage interest was included with the self-employment activity (on the taxpayer's Schedule C), increasing the self-employment loss. The other 90% of the home mortgage interest remain deductible as an itemized deduction (on the taxpayer's Schedule A). If an IRS audit resulted in the denial of the self-employment loss as a *hobby* or *not-for-profit* activity, the taxpayer would still be permitted to deduct 100% of the mortgage interest. In other words, the taxpayer's FIT return would be adjusted. The 10% of the home mortgage interest deducted for the taxpayer's self-employment trade or business would be restored (to 100%) for use to increase their itemized, non-business deduction (on their Schedule A).

The second restriction permits the deduction of *hobby* or *not-for-profit* related expenses, but only to the point of revenues. The IRS is saying that they will allow you to avoid being taxed on the revenues generated from the *hobby*, but will not permit the offset of salary, interest, dividends, or other income items. This is an *extremely undesirable* position. Deductions associated with an activity not engaged in for profit are deductible only to the extent of income, but are subject to the 2%-of-AGI exclusion (see chapter 1). For all practical purposes, the taxpayer loses part of their deductions and pays tax on the *hobby*.

EXAMPLE 28

A single taxpayer is a skydiving instructor, but also enjoys skydiving as a sport or *hobby*. The taxpayer's skydiving is classified as a *not-for-profit* activity for the 1999 tax year. Instructional fees in the amount of \$500 were generated. Expenses associated with the activity were \$1,000. The taxpayer's AGI, before including these amounts, is \$9,500. The taxpayer is unable to itemize deductions. The entire \$500 is included in income, increasing AGI to \$10,000 (\$9,500 *plus*

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\$500). The taxpayer has \$1,000 in miscellaneous itemized deductions before subtracting the 2%-of-AGI exclusion of \$200 (\$10,000 *multiplied by* 2%). Therefore, \$800 (\$1,000 *less* \$200) is available for itemized deductions, but the taxpayer does not have more than \$4,300 (the standard deduction amount available to single taxpayers for the 1999 tax year) in itemized deductions. The taxpayer pays tax on the entire \$500, but receives no tax benefit from the \$1,000 in related skydiving expenses. FIT is computed, as follows:

	AGI	\$10,000
<i>less:</i>	Standard deduction	\$ 4,300
<i>less:</i>	Personal exemption	\$ <u>2,750</u>
<i>equals:</i>	Taxable income	\$ <u>2,950</u>
	FIT	\$ <u>443</u>

EXAMPLE 29

Assume the same facts as presented in **EXAMPLE 28**. In this case, however, assume that the taxpayer provides evidence of *profit motive* and the skydiving is *not* classified as a hobby or not-for-profit activity. FIT is computed, as follows:

	AGI	\$ 9,000 (\$9,500 <i>less</i> \$500*)
<i>less:</i>	Standard deduction	\$ 4,300
<i>less:</i>	Personal exemption	\$ <u>2,750</u>
<i>equals:</i>	Taxable income	\$ <u>2,950</u>
	FIT	\$ <u>293</u>

*Skydiving revenues of \$500 *less* expenses of \$1,000.

The third restriction was designed to prevent the taxpayer from depreciating the estimated *business use* portion of their personal residence and other otherwise *personal use* assets.

What is a hobby?

A *hobby* is an activity *not* engaged in for profit. The term *hobby* suggests an activity that is personal and *recreational* in nature. It is unlikely that an electrician would be concerned about having his/her business classified as a hobby. Alternatively, a skydiving instructor, who also engages in this sport for

pleasure or recreation, may be a more likely candidate for IRS scrutiny and hobby loss classification.

The IRS 3-out-of-5 year rule

The Internal Revenue Service has established an *administrative rule* regarding their *presumption of profit*:

An activity is presumed to have a profit motive if it produces a profit in at least 3 of the past 5 tax years including the current year.

-Publication 535: Business Expenses, IRS, p. 6.

This is merely an *administrative rule* used internally by the IRS. It does *not* have the effect of law and it does *not* follow that an activity failing to produce a profit in at least 3 out of 5 years will be presumed to a *not-for-profit* activity. Yet many taxpayers have this misconception.

No single factor constitutes evidence of profit motive, although some have evolved from case law and have been adopted by the IRS.

Determining factors for profit motive

Factors used to determine profit motive include the following:

- Is the activity carried on in a business-like manner?

EXAMPLE 30

To support the presence of a profit-motive, a taxpayer should prepare monthly, quarterly, semi-annual or annual profit and loss statements and forecasts or projections. The taxpayer does not have to be a financial expert and these profit and loss statements can be crude. But, this taxpayer can provide evidence of her concern and interest in generating a profit from her self-employment endeavors.

EXAMPLE 31

A self-employed taxpayer puts his business receipts and notes in a shoebox and goes to a tax accountant at year-end. This taxpayer has, over several years, consistently generated a tax loss, and has significant salary income from a full-time job. The taxpayer has no business plan, financial projections, and cannot estimate when (or if) he will (ever) earn a profit from self-employment activities. There is, therefore, no evidence to

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support the position that this taxpayer has any intention of ever generating a profit from self-employment activities. If audited by the IRS, this taxpayer may lose the right to deduct losses from self-employment.

SUGGESTION/EXAMPLE 32

Maintain a separate checking account and separate credit cards for business and personal revenues and expenses. Periodically, preferably monthly, generate some form of profit and loss statement and make notes of your comparative analyses of monthly changes in net earnings.(losses) from self-employment trade or business activities.

- Does the time and effort expended on the activity suggest profit-motive?

EXAMPLE 33

A taxpayer spends a few hours per week, intermittently, on some part-time self-employment activities. No time record is kept. The taxpayer has consistently generated tax losses from self-employment. These tax losses have been used to offset salary income. This taxpayer may be suspected of using the self-employment activities to generate tax losses to offset salary income. By not keeping time records, the taxpayer would not have evidence of profit motive.

EXAMPLE 34

A taxpayer spends at least 20 hours per week on part-time, self-employment activities. This taxpayer maintains a crude log of the hours and activities engaged in to operate her self-employment endeavors. These notes include some of the modifications in operating strategies that she has engaged in to increase profits or reduce losses. This documentary evidence supports her position that her self-employment activity is engaged in for profit, even though she has continued to generate tax losses used to offset salary income (and reduce total income taxes). This taxpayer *has* documentary evidence of profit motive.

SUGGESTION/EXAMPLE 35

Maintain a written log of the time spent on self-employment trade or business activities. This written record need not be neat or formal, but must be retrievable in the event of an IRS audit. Taxpayers devoting 100% of their time to self-employment endeavors are in a very strong position, regardless of losses. Taxpayers devoting little or no time to their self-employment activities are in a relatively weak position. However, the anticipated profits are relevant. Therefore, a small investment of time combined with anticipated enormous profits may provide strong evidence of profit motive.

- Does the taxpayer depend on the activity for his/her livelihood?

EXAMPLE 36

A taxpayer is engaged in some self-employment trade or business activity on a full-time basis. He is also a part-time employee and uses the salary from his employer to finance the self-employment start-up activity. The self-employment activity is generating tax losses, which reduces his taxable income. For example, a salary of \$30,000 and self-employment losses of \$10,000 provide for an AGI of \$20,000 (\$30,000 *less* \$10,000). This taxpayer is clearly committed to his self-employment trade or business activity and has strong evidential support for profit motive. Though other facts and circumstances are relevant, he is *not* likely to run the risk of having the loss of \$10,000 disallowed as a *hobby loss*.

EXAMPLE 37

A taxpayer is engaged in full-time employment. She is also engaged in some self-employment activity, on a part-time or intermittent basis, and is using the salary from her employer to finance the self-employment start-up activity. The self-employment activity is generating tax losses, which reduces her taxable income. For example, a salary of \$30,000 and self-employment losses of \$10,000 provides for an AGI of \$20,000 (\$30,000 *less* \$10,000). This taxpayer has less evidential support, compared to the previous example, for profit motive.

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Though other facts and circumstances are relevant, she has failed to provide evidential support for profit motive. However, if the time expenditure is the only factor failing to support profit motive, she may not be at risk for disallowance of the \$10,000 loss of from self-employment.

SUGGESTION/EXAMPLE 38

The *high-income* taxpayer with large, offsetting losses from self-employment endeavors is likely to be suspected of engaging in a *hobby loss*. Generally, the greater the tax benefits from the losses, the greater the scrutiny. However, if the other facts and circumstances suggest profit motive, the taxpayer is likely to prevail in retaining the deductibility of losses generated from self-employment.

- Are losses due to circumstances beyond taxpayer control?

EXAMPLE 39

A taxpayer experiences a significant increase in operating costs. The price of gasoline and other fuels increase. At the same time, minimum wage laws provide for an increase and the economy begins to dip into a recession. Gasoline and labor are two of the primary expenses that the taxpayer incurs in the operation of her business and, because of the recession, many customers cancel the services provided by this self-employed taxpayer. Losses result. These external economic conditions were beyond the control of the taxpayer and will *not* result in hobby loss classification for this tax year.

- Has the taxpayer modified operating methods to improve profitability?

EXAMPLE 40

A self-employed taxpayer has generated tax losses for five consecutive years. During this period, no attempt has been made to alter operations. Depending on other facts and circumstances, this taxpayer has not provided evidence of profit motive and is risking hobby loss classification and the disallowance of all or a part of the tax losses generated from self-employment.

EXAMPLE 41

Assume the same fact pattern as above. However, in *this* case the taxpayer has attended tax deductible business operations seminars, consulted and paid tax deductible fees to business experts, and enrolled in and completed tax deductible business courses at the local college or university. This taxpayer has made (and retained) notes of the changes made to increase self-employment revenues and decrease self-employment expenses, even though these efforts have resulted in increased tax losses (i.e., all of these efforts represent additional tax deductible self-employment expenses). This taxpayer may have failed to generate a profit, but these efforts provide *evidence* of profit motive. *Despite the increased losses*, this taxpayer is at *lesser* risk for hobby loss classification.

SUGGESTIONS/EXAMPLE 42

If your past practices have not resulted in reduced losses or increased profits in your self-employment trade or business endeavors, change them. It is not reasonable to continue doing the same thing and expect different outcomes.

- Does the taxpayer (or advisors) possess expertise sufficient for success?

EXAMPLE 43

You decide to start your own business. You have no prior business experience, coursework, degrees, or experience in the field you are entering. You are at *high risk*, depending on other facts and circumstances, for tax loss disallowance from *hobby loss classification*.

EXAMPLE 44

You decide to start your own business. You do not possess expertise, but you consult experts. Your lack of personal expertise will *not*, in and of itself, result in hobby loss classification and the disallowance of your losses from self-employment. The fact that you consulted experts suggests a strong desire for success and is *evidence of profit motive*.

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SUGGESTION/EXAMPLE 45

If you do not possess expertise, hire it or acquire it. If you do possess the expertise, write articles and speak before interested groups, maintaining records of such expertise, to support your profit motive.

- Has the taxpayer experienced success/profits in similar past activities?

EXAMPLE 46

You decide to start your own business. You have worked as an employee in this same field for over 5 years. Your last position was that of a manager. Despite the fact that you generated losses from self-employment, your prior expertise provides evidence of the reasonable expectation of a profit and, therefore, *evidence of profit motive*.

EXAMPLE 47

You are the son of a millionaire. Your trust fund provides you with taxable income of several hundred thousand dollars per year. You have experienced a series of business failures - nightclubs that you have consistently mismanaged. You have never held a job in your life. The losses generated from these business failures have significantly offset other income items, leading to large reductions in federal and state income taxes. This is exactly the type of fact pattern that suggests the denial of self-employment losses and hobby loss classification.

- Has the activity generated a profit (and how much) in past years?

EXAMPLE 48

Your self-employment endeavors generated a modest profit of \$500 for the 1996 tax year. For the 1997 tax year, your losses totaled \$2000. Your profits approximated \$5,000 in 1998 and \$8,000 in 1999. You are *not* likely to be at risk for hobby loss classification for the 1997 tax year loss.

EXAMPLE 49

Your self-employment activities have generated increasing losses from 1996 through 1999. Even greater losses are likely for the 2000 tax year. Unless are factors are favorable, you

are likely to come under very heavy scrutiny and are at *high risk* for self-employment loss deniability and *hobby loss classification*.

SUGGESTION/EXAMPLE 50

Do not misunderstand the above examples. You can, literally, generate losses *tax year after tax year* and still not have your self-employment trade or business activity classified as a hobby. Profit *motive* does not suggest profit *requirement*. Many large corporations generate losses year after year, before finally going broke. They are not denied their deductions. You have the same rights! However, the facts and circumstances must support your position that, though failing to generate a profit, you have behaved reasonably in your efforts to become profitable.

- Can the taxpayer anticipate appreciation of assets used in the activity?

EXAMPLE 51

You are self-employed and purchase and depreciate collectibles, with a high probability of appreciation, for use as office furniture (e.g., antique desks, work of art, etc.). You consistently generate tax losses from these self-employment endeavors. It would appear that your only purpose for the operation of the business is to lend credibility to the depreciation of these *business* assets used in the production of your self-employment losses. In other words, your only profit motive is a sham, where you are deducting/depreciating the cost of your investments.

- Does the activity have elements of personal pleasure or recreation?

EXAMPLE 52

EXAMPLE 41 illustrates the *personal pleasure* pitfall.

EXAMPLE 53

For many years you practiced skydiving as a hobby. During this period, you never deducted the cost of your skydiving hobby. You decide to become a self-employed skydiving instructor after your 1,000th jump. You generate a tax loss for

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the first year of your skydiving instruction, a self-employment endeavor. You are not likely to be at risk for hobby loss classification. Your expertise is unquestionable and the fact that you have never before deducted the costs associated with what was previously a hobby lends credibility to your position of profit motive.

Evolution of the *hobby loss* classification

The above examples illustrate factors that have evolved from tax court cases and the need to ascertain the motives of taxpayers who were self-employed and using small business losses to offset high income from other sources. This *offsetting* strategy results in lower taxable income and tax brackets. The classic example is that of the highly compensated business executive. He wants a second home/ranch in the country, but would like to (inappropriately) deduct all or a portion of this second home in the form of interest, depreciation, stables, horses, utilities, maintenance, etc. The objective is to reduce the after-tax cost of this second *residence*.

EXAMPLE 54

A taxpayer has a salary of \$300,000. Taxable income would ordinarily be \$100,000, but this taxpayer enjoys horses and has a second home in the country. The total expense of operating the second home or "horse ranch" is \$30,000. The taxpayer (inappropriately) deducts the expenses of the second home, reducing his/her taxable income to \$270,000. Under IRS review, in the absence of significant compliance with the above evidentiary requirements to avoid hobby loss classification, the \$30,000 in expenses for the operation of the second home would be disallowed. (Of course, mortgage interest and real estate taxes for the second home would still be deductible, subject to the itemized deduction phase-out for this high-income taxpayer.)

Losses that are excessive and unreasonable, but which offset income from other sources, are immediately suspected as *recreational* or *hobby-related*. The continuation of such unprofitable activities (when they have not proven successful in reducing losses or generating profits in the past) provides very strong evidence of the *absence* of profit motive. However, increasing gross profits, even when combined with increasing expenses of operation, may provide sufficient evidence of profit motive.

Credentials, publications, previous successes in similar or related activities or other evidence of expertise (or the hiring of experts) provides strong evidence of profit motive.

Generally, the more time and effort put into the activity, the greater the perception and presumption of profit motive. When a taxpayer is employed in a non-related activity as well, it is useful to maintain some form of written evidence of the dates and hours spent on the activity. (Such logs need not be terribly detailed.) Dependence or reliance on income from the activity implies an absence of hobby or recreational involvement, particularly when other taxable income items (e.g., salaries) are not significantly offset.

The purchase of activity-related assets expected to appreciate implies *investment*. Investment expenses do not warrant the generation of allowable trade or business losses, but require capitalization or the accumulation of costs to eventually calculate the gain or loss from the investment when the sale of the asset takes place. Reclassification of the activity as investment-related will result in the disallowance of (interim) operating losses.

A Checklist Approach

The following "hobby loss checklist" summarizes the above points in a narrative format. Using the examples contained in this chapter, you should constantly review your exposure to *not-for-profit* classification. Of course, if your self-employment trade or business results in taxable profits, you need not be concerned with this checklist.

Generally, a "yes" response on all or most factors would suggest clear compliance with a factor and overall support for the evidentially supporting position of profit motive. A "no" response on a factor identifies a weakness. Weaknesses should be pursued, if possible, to upgrade the response to an "uncertain" or "yes" response. Finally, an "uncertain" response should be pursued with the objective for upgrading or strengthening the evidentiary requirements for this factor to a "yes" response.

These factors are only relevant to the self-employed taxpayer (1) with a tax loss from self-employment endeavors and only become critical (2) if audited by the IRS. However, to the extent practicable, all factors should be pursued with the intention of strengthening your position in the event of a loss or an audit.

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Hobby Loss or Not-for-Profit Checklist

- | | <u>Yes</u> | <u>No</u> | <u>Uncertain</u> |
|--|------------|-----------|------------------|
| ○ Is the activity carried on in a <i>business-like</i> manner? | | | |
| ○ Does the <i>time and effort</i> expended on the activity suggest profit-motive? | | | |
| ○ Does the taxpayer <i>depend</i> on the activity for his/her livelihood? | | | |
| ○ Are losses due to circumstances <i>beyond</i> taxpayer control? | | | |
| ○ Has the taxpayer <i>modified operating methods</i> to improve profitability? | | | |
| ○ Does the taxpayer (or advisors) possess <i>expertise</i> sufficient for success? | | | |
| ○ Has the taxpayer experience <i>success/profits</i> in similar past activities? | | | |
| ○ Has the activity generated a <i>profit</i> (and how much) in <i>past</i> years? | | | |
| ○ Can the taxpayer anticipate <i>appreciation of assets</i> used in the activity? | | | |
| ○ Does the activity have elements of <i>personal pleasure or recreation</i> ? | | | |

SUMMARY

This chapter was designed to provide common sense examples to assist you in avoiding *hobby loss* or *not-for-profit* classification. These rules were not designed, nor are they intended, to prevent taxpayers from deducting legitimate losses occurring in the ordinary course of profit-motivated trade or business activities. Taxpayers should not be dissuaded from deducting their legitimate, *ordinary and necessary* trade or business losses, simply out of fear of an IRS audit.

The next chapter is designed to further assist you in determining whether your self-employment trade or business expenses would be viewed as *ordinary and necessary* business expenses.

Strategies to reduce self-employment, federal and state income taxes.

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