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## Chapter **1**

# Small Business Taxes 101

**E**ven though I write about personal finances, including tax issues, I don't particularly enjoy dealing with taxes. I would rather cut my lawn, take care of my neighbor's dog, or even visit my dentist (for a routine cleaning). At least in all these cases, I know my time commitment is reasonably limited, and when I'm done, I'm satisfied that the job has been done well and I can move on to something else.

Filling out state and federal tax forms is often complicated and confusing. Because I write about taxes, I feel that it's essential for me to complete my own income tax forms and returns, which forces me to wallow in the details as much as possible so that I can more fully appreciate the challenges taxpayers face. (By contrast, prior surveys have found that the representatives in Congress who sit on committees that draft the nation's tax laws generally use paid tax preparers themselves.) Not surprisingly, a report from the National Taxpayer Advocate cited "the complexity of the tax code as the No. 1 most serious problem facing taxpayers."

Though some of this book deals with the drudgery of completing required tax forms, much of it deals with the more interesting — and dare I say, fun — part of small business taxes, which is planning ahead and strategizing so as to reduce and minimize your taxes. You see, if you simply view your role with taxes and your small business as jumping through the many hoops that federal, state, and local authorities require, you're missing out on something potentially really big — saving and keeping more of your hard-earned money.

This chapter introduces the basics of small business taxes. Here, I discuss the value of tax planning all year long. I also explain recent tax law changes along with those you may see in the future. Finally, I define some important tax-related terms regarding the taxes you pay or may come across.

## Valuing Year-Round Tax Planning

Taxes are a large, vital piece of your small-business and personal financial puzzle. You're required by law to complete your income tax forms each year and pay the taxes you owe. You do this because you have deadlines and don't want contact initiated by local or state authorities or the IRS to result in fines, penalties, or worse, jail time!

Nothing really forces you to plan ahead regarding your tax situation and small business. That's why the vast majority of small-business owners don't take steps year-round to plan and reduce their taxes. However, tax planning all year is valuable because it enables you to stay on top of your tax and business financial situation and minimize the taxes you legally owe. In this section, I explain typical ways in which taxes enter small-business decisions and some common tax mistakes folks make in this realm.

### Factoring taxes into small business decisions



REMEMBER

Taxes infiltrate many areas of your small business and your personal finances. Some people make important financial decisions without considering taxes (and other important variables). Conversely, in an obsession to minimize or avoid taxes, other people make decisions that are counterproductive to achieving their long-term business and personal financial goals. Although taxes are an important component to factor into your major business and financial decisions, taxes shouldn't drive or dictate the decisions you make.

The following list shows some of the ways that tax issues are involved in making sound financial decisions throughout the year.

- » **Type of business and benefits offered:** The type of business entity you select for your business — sole proprietorship, limited liability company (LLC), S corporation, and so on — can have significant tax and other consequences. The benefits you're able to utilize and offer to your employees, if you have them, also have tax ramifications (see Chapter 2).
- » **Retirement accounts:** Taking advantage of retirement accounts can mean tens, perhaps even hundreds, of thousands more dollars in your pocket come retirement time. Offering retirement account access to your employees can also be a valuable employee benefit for recruiting and retaining good employees if they understand what they have. Refer to Chapter 3 for more on retirement accounts.
- » **Spending:** Throughout this book, I discuss myriad spending decisions you may face in your small business, such as buying equipment (Chapter 8), spending on employee benefits (Chapter 2), and so on. These decisions will often affect your taxes both now and in the future.
- » **Protecting your assets:** Some of your insurance decisions also affect the taxes you pay. You'd think that after a lifetime of tax payments, your heirs would be left alone when you pass on to the great beyond — but that's wishful thinking. Estate planning can reduce the taxes that are siphoned off from your estate. See Chapter 5 to find out more about estate planning.
- » **Tracking your business financials:** Throughout the year, you should stay on top of your business's income and expenses so that you can see your business's financial health and record the numbers you need come tax time. Chapter 6 covers these important issues.

## Checking out common tax mistakes

Even if some parts of the tax system are hopelessly and unreasonably complicated, there's no reason why you can't learn from the mistakes of others to save yourself some money, no matter the time of year. With this goal in mind, this section details common tax blunders that people make when it comes to managing their money.

## Seeking advice after an important decision

Too many people seek out information and hire help *after* making a decision, even though seeking preventive help ahead of time generally is wiser and more financially beneficial.



TIP

Before making major small business and financial decisions, educate yourself. This book can help answer many of your questions. You may also want to do further research on your own (see Chapter 12) and/or hire a tax advisor (refer to Chapter 13) for some advice before making your decision(s).

## Failing to withhold or submit enough taxes

If you're self-employed (or earn significant taxable income from investments outside retirement accounts), you need to make estimated quarterly tax payments. You also need to withhold taxes for your employees and send those taxes along to the appropriate tax agencies. Some small-business owners don't have a human resources department to withhold taxes and dig themselves into a perpetual tax hole by failing to submit estimated quarterly tax payments.

To make quarterly tax payments, complete IRS Form 1040-ES, "Estimated Tax for Individuals." This form (discussed in Chapter 10) and its accompanying instructions (and payment coupons) explain how to calculate quarterly tax payments. You can submit payments by mail or electronically through creating/using an online account on the IRS website (<https://www.irs.gov/>). For more information on the requirement for employee tax withholding, see Chapter 6.

## Missing legal deductions



REMEMBER

Some taxpayers miss out on legitimate tax write-offs because they just don't know about them. If you aren't going to take the time to discover the legal deductions that are available to you and that I discuss throughout this book, then you should pay for the cost of a competent tax advisor at least once. Fearing an audit, some taxpayers (and even some tax preparers) avoid taking deductions that they have every right to take. Unless you have something to hide, such behavior is foolish and costly. Note that a certain number of returns are randomly audited every year, so even when you don't take every allowable deduction, you may nevertheless get audited! And, if you read Chapter 11, you can find out how to deal with an audit like a pro.

## Forsaking retirement accounts

All the tax deductions and tax deferrals that come with accounts such as 401(k)s, SEP-IRA plans, and individual retirement accounts (IRAs) were put in the tax code to encourage you to save for retirement. That's something that you as a small-business owner should be doing for yourself as well as encouraging your employees to do.

Most excuses for missing out on these accounts just don't make good financial sense. Some folks underfund retirement accounts because they spend too much

and because retirement seems so far away. Others mistakenly believe that retirement account money is totally inaccessible until they're old enough to qualify for senior discounts. (See Chapter 3 to find out all about your small-business retirement account options.)

## Not owning real estate

In the long run, owning a home should cost you less than renting. And because mortgage interest (on up to \$750,000 of mortgage debt) and property taxes (up to \$10,000 when combined with your state income tax payments) are deductible, the government, in effect, subsidizes the cost of homeownership. (Stay tuned as the state and local tax limit — aka SALT — may be increased higher than \$10,000 in 2022.)

If you have a home office, you may be able to take additional expenses on your tax return. If you need a retail or commercial space for your small business, you should compare leasing to buying and be sure to factor in the tax benefits of owning. See Chapter 4 for more about real estate and taxes.

## Neglecting the timing of events you can control



TIP

As a small-business owner, you should pay attention to how your net income for the year is shaping up for the current year and how things are looking for next year. For example, if you're in the early stages of your business and you can see that you'll have more income next year, then it may be in your best interest tax-wise to delay paying some expenses from late in the current year into early next year. (This works when using cash basis accounting.)

Or suppose that you operate on a cash accounting basis and think that you'll be in a lower tax bracket next year. Perhaps business has slowed or you plan to take time off to be with a newborn or take an extended trip. You can send out some invoices later in the year so that your customers won't pay you until January, which falls in the next tax year.

## Not using tax advisors effectively



REMEMBER

If your financial situation is complicated, going it alone and relying only on the IRS publications to figure your taxes usually is a mistake. Many people find the IRS instructions tedious and not geared toward highlighting opportunities for tax reductions. Instead, you can start by reading the relevant sections of this book. When you're overwhelmed by the complexity of particular small-business and tax decisions, get advice from tax and financial advisors who sell their time and nothing else. (Chapter 13 has tips on hiring help.)

As a small business owner, ask yourself how much you're worth running your business versus how much you're worth as a bookkeeper. Then ask yourself which task you enjoy more and consider hiring a bookkeeper.

Note that using a tax advisor is most beneficial when you face new tax questions or problems. If your tax situation remains complicated or if you know that you'd do a worse job on your own, by all means keep using a tax preparer. If your situation is unchanging or isn't that complicated, consider hiring and paying someone to figure out your taxes one time. After that, go ahead and try completing your own tax returns.

## Noting How Corporate and Individual Tax Reform Impacts Small Business

Corporate tax reform in the United States was long, long overdue. For too many years, corporations in the United States faced a much higher corporate income tax rate than did companies based in most overseas economies. As a result, increasing numbers of U.S. companies had chosen to expand more overseas rather than in the United States and to be headquartered outside of the United States, which wasn't good for the long-term health of the U.S. economy and labor market.

Congress passed the Tax Cuts and Jobs Act in late 2017, which took effect with tax year 2018. It was the most significant tax reform package passed since the Tax Reform Act of 1986. What follows are the highlights of the most significant provisions that affect (and mostly benefit) small business.

### Checking out corporate income tax rate reduction and simplification

At 35 percent, the United States had had one of the highest corporate income tax rates in the world before 2018. The Tax Cuts and Jobs Act slashed the corporate income tax rate to 21 percent, which represented a 40 percent reduction.

The corporate tax rules and deductions were simplified, including eliminating the corporate alternative minimum tax and closing some loopholes. The United States also moved to a *territorial* tax structure whereby U.S. companies would no longer pay a penalty to bring their overseas profits back home. The immediate impact of this change was to enable U.S. corporations to bring back to the United States more than \$2 trillion being kept overseas to avoid excessive taxation.

The vast majority of small businesses aren't operated as traditional so-called C-corps (more on those in a moment). Most small business owners operate as sole proprietorships (filing Schedule C), LLCs, partnerships, or S corporations. In those cases, the business owner's profits from the business generally flow or pass through to the owner's personal income tax return, and that income is taxed at personal income tax rates (see the section "Noting 20 percent deduction for pass-through entities" for more information).

## Reducing individual income tax rates

Just as the corporate income tax rate was reduced by the Tax Cuts and Jobs Act legislation, so too were the individual income tax rates. Most of the tax bracket rates were reduced by several percentage points (see Table 1-1). This, of course, is excellent news for the vast majority of U.S. small business owners who operate their businesses as pass-through entities (for example, sole proprietorships, LLCs, partnerships, S-corps).

**TABLE 1-1**

**2022 Federal Income Tax Brackets and Rates**

Federal Income Tax Rate	Single Taxpayers Taxable Income	Married Filing Jointly Taxable Income
10%	\$0 to \$10,275	\$0 to \$20,550
12%	\$10,275 to \$41,775	\$20,550 to \$83,550
22%	\$41,775 to \$89,075	\$83,550 to \$178,150
24%	\$89,075 to \$170,040	\$178,150 to \$340,100
32%	\$170,040 to \$215,950	\$340,100 to \$431,900
35%	\$215,950 to \$539,900	\$431,900 to \$647,850
37%	More than \$539,900	More than \$600,000

Note that at higher levels of income, the individual income tax rates begin to exceed the 21 percent corporate tax rate. Seeing this helps you to better understand the next point as to why pass-through entities are being granted a special tax deduction on their profits.

## Noting 20 percent deduction for pass-through entities

In redesigning the tax code, Congress rightfully realized that the many small businesses that operate as so-called pass-through entities would be subjected to

higher federal income tax rates compared with the new 21 percent corporate income tax rate. *Pass-through entities* are small business entities such as sole proprietorships, LLCs, partnerships, and S corporations and are so named because the profits of the business pass through to the owners and their personal income tax returns.

To address the concern that individual business owners who operated their business as a pass-through entity could end up paying a higher tax rate than the 21 percent rate levied on C-corporations, Congress provided a 20 percent deduction for those businesses. So, for example, if your sole proprietorship netted you \$65,000 in 2022 as a single taxpayer, that would push you into the 22 percent federal income tax bracket. But you get to deduct 20 percent of that \$65,000 of income (or \$13,000) for the pass-through deduction so you would only owe federal income tax on the remaining \$52,000 (\$65,000 – \$13,000).

Another way to look at this is that the business would only pay taxes on 80 percent of its profits and would be in the 22 percent federal income tax bracket. This deduction effectively reduces the 22 percent tax bracket to 17.6 percent.

This is a major change that not surprisingly has made small business owners exceedingly optimistic about being able to grow their businesses. In fact, in a survey of small business owners conducted by the nonprofit National Federation of Independent Business just after the tax bill was passed and signed into law, a record percentage of those surveyed (covering the survey's 45-year history) expressed optimism about it being a good time to expand their businesses.

This 20 percent pass-through deduction gets phased out for service business owners (such as lawyers, doctors, real estate agents, consultants, and so on) at single taxpayer incomes above \$170,050 (up to \$220,050) and for married couples filing jointly incomes that exceed \$340,100 (up to \$440,100). For other types of businesses above these income thresholds (for tax year 2022), this deduction may be limited so consult with your tax advisor.

## Enjoying better equipment expensing rules

Through so-called section 179 rules, small businesses have historically been able to immediately deduct the cost of equipment, subject to annual limits, they purchase for use and place into service in their business. But the Tax Cut and Jobs Act bill expanded these rules.

Now, more businesses can immediately deduct up to one million dollars in such equipment expense annually (up to the limit of their annual business income). And, this deduction can also now be used for purchases on used equipment. These provisions, which don't apply to real estate businesses, remain in effect through

2022 and then gradually phase out until 2027 when the prior depreciation schedules are supposed to kick back in.

## Increasing maximum depreciation deduction for automobiles

The new tax bill included a major increase in the maximum amount of auto depreciation that can be claimed. The annual amounts of auto depreciation have more than tripled. Effective with tax year 2022, the maximum amounts that can be claimed are as follows:

- » **Year 1:** \$10,000 up from the prior limit of \$3,160
- » **Year 2:** \$16,000 up from the prior limit of \$5,100
- » **Year 3:** \$9,600 up from the prior limit of \$3,050
- » **Year 4 and beyond:** \$5,760 up from the prior limit of \$1,875, until costs are fully recovered

These limits increase annually with inflation.

## Limiting interest deductions

Effective with 2018, companies with annual gross receipts of at least \$25 million on average over the prior three years are limited in their deduction of interest from business debt. Net interest costs are capped at 30 percent of the business's earnings before interest, taxes, depreciation, and amortization (EBITDA). Farmers and most real estate companies are exempt.

Effective in 2022, this provision actually gets more restrictive and would thus effect even more businesses. At that point, the 30 percent limit will apply to earnings before interest and taxes.

## Reducing meal and entertainment deductions

The tax reform bill of 2017 eliminated the entertainment expense deduction for businesses. Under prior tax law, 50 percent of those expenses was deductible, for example, when a business entertained customers and even employees at sporting events, fitness clubs, and restaurants.

The new rules do include some exceptions. On-site cafeterias at a company's offices and meals provided to employees as well as business meals associated with travel are 50 percent deductible. Meals provided to prospective customers as part of a seminar presentation are still fully deductible. Holiday parties and company picnics are also fully deductible as long as they are inclusive of everyone.



TIP

In early 2021, the Consolidated Appropriations Act 2021 introduced a temporary 100 percent deduction for expensing business meals purchased from “qualifying restaurants” from January 1, 2021, through December 31, 2022 (tax years 2021 and 2022). Qualifying restaurants per the IRS are establishments that prepare and serve food and beverages for immediate consumption, either on or off-premises.

## Eliminating the health insurance mandate

Since the Affordable Care Act (also known as Obamacare) was passed by Congress in 2010, some Republicans in Congress vowed to repeal it. With the election of Republican Donald Trump in 2016, it seemed that the pieces were in place for Obamacare's successful repeal. But, Republicans fell one vote short in the Senate when the late Arizona Senator John McCain gave the repeal measure his infamous thumbs-down vote.

So, the 2017 tax bill included a little known or discussed measure that eliminated Obamacare's mandate effective in 2019, which required people to have or buy health insurance coverage and if they didn't, they'd face a tax penalty. So, the penalty tax also disappeared in 2019.

## Revising rules for using net operating losses

Net operating losses (NOLs) can no longer be carried back for two years. However, NOLs may now be carried forward indefinitely until they are used up. Previously the carryforward limit was 20 years (the CARES Act allowed 2018–2020 NOLs to be carried back five years).

NOLs are limited each year to 80 percent of taxable income.

# Considering the SECURE ACT of 2019 and COVID-19 Relief Tax Acts

A number of smaller tax-related bills passed in recent years made some changes that affect small businesses. These bills include the SECURE (Setting Every Community Up for Retirement Enhancement) ACT of 2019 as well as the COVID-19

relief bills. Here are the highlights of the SECURE Act that small business owners should be aware of:

- » Small-business owners are eligible for up to \$5,000 in tax credits when starting a retirement plan. This credit applies to new 401(k), profit sharing, SEP, and SIMPLE plans for small employers with up to 100 employees.
- » More part-time workers can participate in company 401(k) plans. Previously, employees had to work at least 1,000 hours per year to take part in a company's 401(k) plan. Now, workers who achieve at least 500 hours over three consecutive years may participate.
- » You can withdraw up to \$5,000 per parent penalty-free from your retirement plan for a "qualified birth or adoption distribution" for the birth or adoption of a child. This new provision waives the normal 10 percent early withdrawal penalty and allows you to repay the withdrawn money as a rollover contribution.
- » Required minimum distributions (RMDs) from retirement accounts begin at age 72, not 70½. This gives you more options and flexibility, but delaying required distributions which are based upon your life expectancy may or may not be in your best long-term interests. It's impossible to know for sure, but you and/or your tax advisor may want to crunch some numbers, which requires making some assumptions, to see what the optimal age is to begin your RMDs.
- » You can make traditional IRA contributions past age 70½ so long as you continue earning employment income. This will bring the contribution rules for these accounts into alignment with those for Roth IRAs and 401(k)s.

## Contemplating Potential Upcoming Tax Law Changes

Congress continually tinkers with our nation's tax laws. Bigger changes tend to occur when the same party controls both chambers of Congress as well as the Presidency. As this book goes to press in late 2021, we have been through a lengthy period where there has been lots of talk of tax increases by the Democrats, the party currently in control of Congress and the Presidency, but that has largely been blocked to date due to their super slim majorities in both the House and Senate.

With the 2022 Congressional mid-term elections on the horizon, history suggests that the most likely outcome for those elections will be divided government, which will mean even more gridlock and less likelihood for tax increases or tax changes in general. That said, here's a short list of changes that have been discussed and that have the highest likelihood of being part of a tax package within the next year, if one ever passes:

- » Higher federal income tax rates on high-income earners
- » Some elimination of the step-up cost basis at death for investors in the highest tax brackets
- » Expansion of the state and local income tax deduction from \$10,000 to some higher amount
- » Increased corporate federal income tax rate
- » Higher federal capital gains tax rate for those in the highest federal income tax brackets
- » Reduction in the federal estate exemption amount
- » Application of the Social Security tax to more income for the highest income earners

## Understanding the Different Types of Taxes You Pay and Your Tax Rates



REMEMBER

Most small business owners pay income taxes at the personal income tax rates. That's because the vast majority of small businesses are run as sole proprietorships. And many of those that aren't, such as partnerships, LLCs, and S corporations, pass through their income in such a way that the income is generally taxed to its recipients as personal income. Some small business owners pay a corporate rate if their business is incorporated as a regular so-called *C-corporation*. (The type of business entity you elect is discussed in Chapter 2.) See the later section "Corporate income tax rates" for more details.

When it comes to federal income taxes, many people remember only whether they received a refund or owed money. But you should care how much you pay in taxes and the total and marginal taxes that you pay so you can make decisions that lessen your tax load. Although some people feel happy when they get refunds, you shouldn't. A refund simply signifies that you overpaid your taxes during the previous year. When you file your income tax return, you settle up with tax

authorities regarding the amount of taxes you paid during the past year versus the total tax that you're actually required to pay, based on your income and deductions.

In this section, I define important tax terms such as total taxes, taxable income, marginal tax rates, and corporate tax rates, and I also discuss the federal and state income tax systems.

## Defining total taxes and taxable income

The only way to determine the total amount of income taxes you pay is to get out your federal and state tax returns. On each of those returns is a line that shows the total tax. Add the totals from your federal and state tax returns, and you probably have one very large expense!

Your taxable income is different from the total amount of money you earn during the tax year from employment and investments. *Taxable income* is defined as the amount of income on which you actually pay income taxes. You don't pay taxes on your total income for the following two reasons:

- » **Not all income is taxable.** For example, you pay federal income tax on the interest that you earn on a bank savings account but not on the interest from *municipal bonds* (loans that you, as a bond buyer, make to state and local governments).
- » **You get to subtract deductions from your income.** Some deductions are available just for being a living, breathing human being. And, the Tax Cuts and Jobs Act greatly increased the standard deductions. For tax year 2021, single people receive an automatic \$12,550 standard deduction, heads of household qualify for \$18,800, and married couples filing jointly get \$25,100. (People older than 65 and those who are blind get slightly higher deductions.) Other expenses, such as mortgage interest and property taxes, are deductible to the extent that your total itemized deductions exceed the standard deductions.

## Your marginal income tax rate for federal income taxes

*Marginal* is a word that people often use when they mean “small” or “barely acceptable.” But with taxes, marginal has a different meaning. The government charges you different income tax rates for different portions of your annual income. So your *marginal tax rate* is the rate that you pay on the so-called “last dollars” you earn. You generally pay less tax on your first, or lowest, dollars of

earnings and more tax on your last, or highest, dollars of earnings. This system is known as a *graduated income tax*, a system that goes back hundreds of years to other countries.

The fact that not all income is treated equally under the current tax system isn't evident to most people. When you work for an employer and have a reasonably constant salary during the course of a year, a stable amount of federal and state taxes is deducted from each paycheck. Therefore, you may have the false impression that all your earned income is taxed equally.

Table 1-1 gives the 2022 federal income tax rates for singles and for married people filing jointly.



REMEMBER

Your marginal tax rate is the rate of tax that you pay on your last, or so-called highest, dollars of taxable income. For example, according to Table 1-1, if you're single and your taxable income during 2022 totals \$55,000, you pay federal income tax at the rate of 10 percent on the first \$10,275 of taxable income. You then pay 12 percent on the amount from \$10,275 to \$41,775 and 22 percent on income from \$41,775 up to \$55,000. In other words, you effectively pay a marginal federal tax rate of 22 percent on your last dollars of income — those dollars in excess of \$41,775.

After you understand the powerful concept of marginal tax rates, you can see the value of the many financial strategies that affect the amount of taxes you pay. Because you pay taxes on your employment income and your investment earnings (other than retirement accounts), you need to make many of your personal financial decisions with your marginal tax rate in mind.

- »» For example, when you have the opportunity to earn some extra money, how much of that extra compensation you get to keep depends on your marginal tax rate. Your marginal income tax rate enables you to quickly calculate the additional taxes you'd pay on the additional income.
- »» Conversely, you quantify the amount of taxes that you save by reducing your taxable income, either by decreasing your income — for example, with pretax contributions to retirement accounts — or by increasing your deductions.

Actually, you can make even more of your marginal taxes. In the next section, I detail the painful realities of income taxes levied by most states that add to your federal income tax burden. If you're a middle-to-higher income earner, pay close attention to the sidebar later in this chapter where I discuss the alternative minimum tax.

# State income taxes

Your total marginal rate includes your federal *and* state income tax rates. As you may already be painfully aware, you don't pay only federal income taxes. You also get hit with state income taxes — that is, unless you live in Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington, or Wyoming. Those states have no state income taxes. As is true with federal income taxes, state income taxes have been around since the early 1900s.



TIP

You can look up your state tax rate by getting out your most recent year's state income tax preparation booklet. Alternatively, Figure 1-1 gives you an idea of your state tax rates; it reflects state individual income taxes. Some states impose other taxes — such as local, county, or city taxes; special taxes for nonresidents; or capital gains taxes — which aren't included in this table.



**FIGURE 1-1:**  
State marginal tax rates.

Source: The Tax Foundation.

## THE ALTERNATIVE MINIMUM TAX

In 1969, Congress created a second tax system — called the alternative minimum tax (AMT) to ensure that higher-income earners with relatively high amounts of itemized deductions pay at least a minimum amount of taxes on their incomes. When it was added to the federal income tax code in 1969, the AMT affected a mere 155 high-income taxpayers; in 2017 before tax reform was passed, it hit about 5 million taxpayers! Thanks to the Tax Cuts and Jobs Act, which took effect in 2018, AMT only impacts “just” 150,000 taxpayers annually.

If you have a bunch of deductions from state income taxes, real estate taxes, certain types of mortgage interest, large miscellaneous itemized expenses, or passive investments (such as limited partnerships or rental real estate), you may fall prey to the AMT. The AMT is a classic case of the increasing complexity of the U.S. tax code. As incentives were placed in the tax code, people took advantage of them. Then the government said, “Whoa! We can’t have people taking that many write-offs.” Rather than doing the sensible thing and limiting some of those deductions, Congress created the AMT instead.

The AMT restricts you from claiming certain deductions and requires you to increase your taxable income. So you must figure the tax you owe both under and out of the AMT system, and then pay whichever amount is higher. Unfortunately, the only way to know for certain whether you’re ensnared by this second tax system is by completing — you guessed it — another tax form. Form 6251, “Alternative Minimum Tax — Individuals” is a bear of a form, so if you’re confronting it for the first time, you may want to enlist the support of a qualified tax advisor. Also, be aware that if you don’t calculate the AMT on your return and you should have, the IRS will calculate the bill for the additional tax, interest, and possibly late payment penalties.

## Corporate income tax rates

As I explain earlier in this chapter, the vast majority of small business owners pay income taxes on their business earnings at the personal income tax rates. That’s because most small businesses are organized as sole proprietorships, which have income taxed as personal income. Also, many other small businesses that are organized as partnerships, LLCs, and S corporations pass through their income to the business owners in such a way that it, too, is taxed as personal income.

Thus, only a small percentage of small business owners have their income taxed as regular, so-called C-corporations. The Tax Cuts and Jobs Act, which took effect in 2018, compressed the previous numerous corporate income tax brackets to just one rate — 21 percent. In the next chapter, I discuss how the tax rate a business

pays along with other factors play a role in determining what the best business entity is for your business.

## Employment (payroll) taxes

Business owners are responsible for the timely payment of all employee-related payroll or employment taxes. Some of these are withheld from the employees' pay while others are paid by the employer. Here are the taxes I'm talking about:

- » Federal income tax withholding
- » State income tax withholding
- » Social Security and Medicare taxes (also known as FICA) — half paid by employer, half paid by employees
- » Federal unemployment tax — paid by employers
- » State unemployment tax

It's imperative that you understand and properly withhold and pay all of these taxes on a timely basis. For a list of state tax authorities, visit [www.taxadmin.org/state-tax-agencies](http://www.taxadmin.org/state-tax-agencies). Otherwise, you and your business could be subject to stiff penalties and interest charges. Here's an overview of the frequency with which employment taxes are required:

- » Larger employers (those who paid more than \$50,000 in employment taxes the previous calendar quarter) must submit/deposit their employment taxes every two weeks.
- » Moderate-sized employers (those who have between \$2,500 and \$50,000 in employment taxes) can submit their employment taxes monthly.
- » Smaller employers (those who have less than \$2,500 in employment taxes quarterly) may submit their employment taxes with their quarterly employer tax returns. Those with \$1,000 or less for income tax withholding and Social Security and Medicare tax payments or federal unemployment tax payments under \$500 can pay annually.

Employers must generally deposit these taxes electronically using the Electronic Federal Tax Payment System (EFTPS), which was originally launched in 1996 and doesn't charge users. This system enables the transfer of your funds from your bank account to the U.S. Treasury.

If your annual employment taxes for your business exceed \$1,000, you must file IRS Form 941, "Employer's Quarterly Federal Tax Return," each quarter. You can

instead file IRS Form 944, “Employer’s Annual Federal Income Tax Return” if your annual employment taxes are less than or equal to \$1,000.

To ensure the timely credit of your taxes, plan on submitting them at least one day before they’re actually due. Alternatively, your tax advisor, payroll service, bank, or other financial institution can make the deposit on your behalf.

For more information, visit [www.eftps.gov](http://www.eftps.gov) or call 800-555-4477.

Also, remember that self-employed individuals need to pay self-employment taxes, which are Social Security and Medicare taxes. See Chapter 10 for all the details.

## Sales taxes

As you probably already know from your years as a consumer, many towns, cities, counties, and states levy sales taxes on the purchase of particular goods and services. A related tax, known as a *use tax*, may be levied on the buyer of certain products from out of state.

As the seller of goods or services within a state with a sales tax, your business is obligated to collect and submit said tax to the relevant agency for sales tax collection in your state.

The Streamlined Sales Tax Governing Board was created by the National Governor’s Association (NGA) and the National Conference of State Legislatures (NCSL) in 1999 to simplify sales tax collection. By visiting their website at [www.streamlinedsalestax.org/](http://www.streamlinedsalestax.org/) you can find a list of Certified Service Providers that can help you collect and remit sales tax to the state(s) in which you do business. There is no cost to your business for this service, and using it eliminates any risk of your business being audited for sales tax collections.