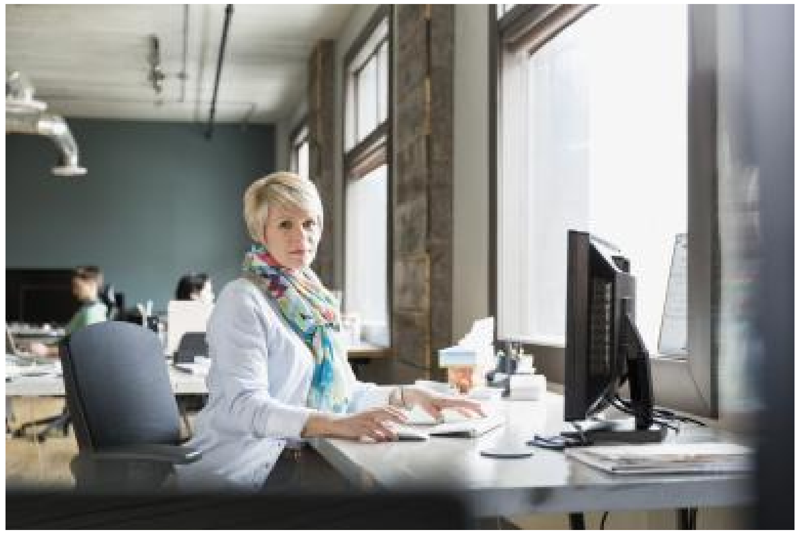
Tips for Reducing Small Business Taxes by Changing Behaviors

By William Perez



Entrepreneurs, did you know that the tax code is filled with incentives that help you lower your income taxes? Tom Wheelwright clued me in on a new way of thinking about tax planning for small businesses. Tom is a certified public accountant in private practice in Phoenix, Arizona, who specializes in tax planning.

His core mantra is that the US tax law is a "series of incentives for businesses and investors."

To take full advantage of tax incentives, entrepreneurs need to expand their way of thinking. In addition to focusing on opportunities to defer tax (such as using individual retirement accounts and other retirement savings strategies), entrepreneurs also need to be alert for opportunities to reduce taxes permanently now.

Turning Non-Deductible into Deductible Expenses

Consider non-deductible personal expenses. If there's a way for me to shift some of that personal spending into tax-deductible spending, I have now lowered my taxes – right now, today – by permanently removing that money from the base of income on which my taxes are calculated.

Here's an example. Suppose I go out to dinner with a friend. Naturally, we talk about what's going on with our lives as we catch up. Inevitably, I'll talk about my business. And my friend might also talk about her tax situation. Normally, I would view this dinner as a personal expense. After talking to Mr. Wheelwright, I see there's an opportunity to turn this into a tax-deductible expense.

Increase Your Deductions by Documenting Business Purposes

"The first thing to understand," Wheelwright said, "really any expense could be deducted under the right facts and circumstances." The challenge thus becomes for entrepreneurs to change their behavior so that they can turn otherwise nondeductible expenses into deductible expenses.

Wheelwright suggested that I "document what we talked about" at dinner. You may see his point immediately. In order for meals and entertainment to be a tax-deductible business expense, the IRS requires that the entrepreneur document five things: the amount, the date and time, the location, the business purpose of the meal and business relationship between the people having the meal. Now the amount, date and time, and location are all documented on the receipt. So you’ve got to keep that receipt for bookkeeping purposes. Now you have three out of the five elements needed to substantiate your deduction. All you have to do is document the business purpose of the meal and the business relationship between the people having the meal. So, following Wheelwright's advice, after dinner, I briefly document what we talked about. I might make a note like this: "Dinner with Mrs. Hendricks, a client and brand consultant: We discussed my challenges in reaching the right customers for my Web site, and she came up with three new messaging alternatives for me to try out. We also discussed the new job she's getting, with stock options and restricted stock as part of her compensation package. I advised her on what she needs to document and how this impacts her tax planning."

Documenting what was discussed at dinner adds an additional layer of work. And normally I would be tempted just to be lazy and say the meal was personal. So I change my behavior. Now, whenever I have a business-related meal, I document what we talked about.

Does Increasing Deductions Raise Red Flags?

But, I pointed out to Tom, doesn't the IRS love to audit meals and entertainment? Aren't we raising a red flag here and making our clients more likely to be audited? This attitude also has got to change, for two reasons. First, the IRS usually disallows meals and entertainment expenses "because they are not well documented," Wheelwright explains. "We have to do the work to get the deduction. What they come down hard on is the documentation, not the deduction."

Secondly, do we really want to live in fear of red flags? Deductions are "very specifically allowed," Wheelwright said. The red flag is not the deduction itself; rather it is the lack of backup documentation. That is the real problem.

So if entrepreneurs want to get serious about increasing their deductions, they have to change their behavior, especially documenting their expenses so that the IRS is satisfied.

How the Home Office Deduction Can Increase Car Deductions

Tom shared with me another of his favorite deductions: the home office deduction.

By itself, the home office deduction is pretty nice. We can write off a portion of our housing expenses (which would otherwise be personal, nondeductible expenses) and turn them into tax-deductible business expenses.

But the home office also helps to boost, indirectly, car and truck deductions. How so? By working from home, entrepreneurs reduce their commute from, say, 15 miles from home to the office to 15 feet from bedroom to the den. Now, when they drive to meet with clients, they get to deduct those miles starting from when they leave their home office. So working from home often results in increasing the amount of miles we use when deducting car-related expenses. Plus we have reduced our commuting miles. So combined, increased business miles and fewer commuting miles, means that a higher percentage of car-related expenses (such as gas and repairs and insurance) can now be deducted on the tax return.

It's exactly this sort of big picture thinking that's required if we are going to spot tax saving opportunities.

Tom's Top Two Tax Tips for Entrepreneurs:

I asked Tom what are his top of mind tips for entrepreneurs. He said he has two tax tips.

"First, choose your tax advisor."

"As soon as you get into business for yourself, you are in a different league. If you do it right, you pay less tax."

The two keys to finding a good tax advisor:

1. Look for a tax advisor who has the right experience and education for your needs.

2. "The most important skill," Wheelwright revealed, is being able to "ask the right questions." "I don't have any of the answers but I do have all the right questions," he said.

Secondly, carefully consider how you structure or set up the business.

In tax jargon, we call this choice of entity. It refers to whether the business is set up as a sole proprietorship, as a C-Corporation, as an S-Corporation, as a partnership, as a limited liability company, and so forth.

Choosing the right structure for your particular business can make a dramatic impact on your tax return. It's possible that we can cut your taxes in half if we set things up the right way.

And for this, it's important to work with the right tax advisor, someone who is able to look at the big picture and knows how to set this up for the most tax advantages.

Tom Wheelwright is a certified public accountant in Phoenix, Arizona, where he is CEO of his practice ProVision Wealth. He has also written a book, Tax-Free Wealth: How to Build Massive Wealth by Permanently Lowering Your Taxes (Rich Dad Advisors). Tom spoke to me by phone. This is an edited recap of that conversation.

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