STARTING A BUSINESS IN COLORADO

Information you need to consider in your plans to become an entrepreneur

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Unless we have a signed engagement letter, I am not your accountant or advisor and you are not my client. It is not reasonable to expect that I can give complete advice on tax or other matters to you in a book or over the internet without knowing all the details about your individual situation.

In order to comply with requirements imposed by the IRS, I must inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code, or promoting, marketing or recommending to another party any transaction or matter contained in this document.

Introduction

After spending the past thirty plus years working with all kinds of business organizations and assisting many in getting their businesses going, I have seen a need for a very basic and short treatise on the requirements of getting a business started. If you have an idea or a service to offer, you do not want to spend an inordinate amount of time studying all the options possible for all the different things you need to get done to get your business off the ground. There are a wide range of variables which can be hard to keep track of. Accordingly, I am going to put in this document a listing of a variety of the most important things which you may need to address in getting your business started. Some of them may not apply to you. Some businesses may have specific requirements which I do not cover here. But hopefully I can lay out a good groundwork to help you get started and let you know about some of the detail that those of us who start businesses tend to not be aware of or may simply ignore or forget about.

There is a lot of information about starting a business out there, but I have found most of it to either lack important details or not cover a broad enough spectrum of information. I have also found a few sources of information which cover too much information, going into so much depth that you as a user of the information cannot sift through and find what is useful to you, and they usually still skip a few important areas. What I hope to do here is to provide introductory information on a broad range of topics relating to starting a business. I have found that most sources of information do not deal much at all with how to keep records for income tax deductions or some of the deductions you may qualify for which might not be readily obvious to you as a small business owner. If some parts do not apply to your business, you can skip them or just glance through them to have some awareness in case your business eventually becomes involved in those areas.

We are going to assume that you already have a product or service in mind for your business. You will certainly need to identify what it is you are going to do before you start your business. We are also assuming that you already have a location for your business, or you are going to start running the business from your home and grow into another business location.

You should do some research about your idea or service ahead of time. I cannot help you much with that without details about what you will be doing. But today we have the internet. You can find out a lot in just a few minutes using www.bing.com or www.google.com.

It is a bit of an American dream to own a business and an entrepreneurial spirit is common in most Americans. It takes a lot of work and dedication to make a business successful. I hope this information assists in making the first steps just a little easier and bringing profits in just a little sooner.

The need for a financial professional or other assistance

Part of the reason to write this is to assist you in reducing the cost of starting a business and reduce the reliance you have to place in professionals such as attorneys and accountants. But those professionals can provide you advice and steer you away from pitfalls which will save you many times the cost involved. An experienced professional has dealt with your issues in the past. They do charge a lot of money, but it usually does not take them long to solve problems or give the advice you need. Do not hesitate to use them when you need them. Throughout the sections of this document we will suggest when might be a good time to contact them.

An accountant will have experience with a variety of different methods of recordkeeping. He or she can get to know you and your capabilities and make recommendations for what would be the best way for you to handle your bookkeeping and accounting activities and help you find the best ways to plan for taxes, retirement and your financial well being. They can also assist you in recognizing trends in your business and finding ways to operate more efficiently.

Lawyers can assist in the development of your business structure and any necessary operating or partnership agreements or corporate bylaws. They can prove to be extremely important if there are threats of legal action. They can assist you in the protection of your intangible assets such as copyrights and patents. You may need a variety of legal agreements in the course of your business which you should get the assistance of a lawyer in drafting.

If you are purchasing an existing business, I would strongly recommend you have both an accountant and a lawyer assist you in properly analyzing the history of the business and drafting the purchase documents. They will also help you in asking the correct questions to make sure you make good decisions.

You can obtain referrals for accountants at http://www.cocpa.org/for-the-public/find-cpa.html.

You can obtain referrals for a lawyer at http://www.cobar.org/directory/.

You can also ask other people you know for referrals. I would strongly recommend that you have a high degree of respect for the people you ask and that you know their businesses are successful, that they operate with high ethical standards and that you be aware that they follow the advice of their advisors before asking them for their referrals. Also ask your current advisors for referrals to other advisors. Your insurance agent, your banker, your accountant, your lawyer may all know good choices for other advisors for you.

Talk to potential advisors ahead of time and make sure you can develop a good rapport with them. Make sure they seem trustworthy. Do not work with people who suggest unethical ways to do business. Make sure they are knowledgeable about and have experience with businesses similar to yours. Find out how long they have been in business and what credentials they have. Find out up front how they determine their fees and try to get reasonably good estimates of what it will cost for your work. Most people tell you to get references and that is a good idea, but understand that many accountants and lawyers value confidentiality very highly and do not always care to let you know who other clients are. Confidentiality is even part of their ethical standards. In turn they will not divulge any information about you to others.

Structure. Choice of entity

There is a myriad of potential options for organizational structure. We are only going to mention six here. This is an area where it may be a good idea to get input from an accountant or lawyer. There can be long lasting consequences to the choice of entity. Some choices may not be a good choice for your personality as well as for your business activities. Be sure to think through the ramifications of what is required and the tax effects of each potential structure before you make a decision.

1. Sole proprietorship. This is historically the most common kind of organizational structure a new business starts out in. A person has an idea or a service and they start marketing it. By default, they are a sole proprietorship. This is the easiest organization to have because as soon as you start in business, you already have it. There are many advantages to being a sole proprietorship. You have no partners to have to deal with. You have no state organizational requirements to deal with (not including licensing requirements). The main disadvantage is unlimited liability. You are liable personally for the debts of the business. Your income and expenses for the sole proprietorship are reported on your individual income tax return, usually on a Schedule C (or Schedule F for Farmers). You must pay income tax on the income of the business and you must also pay self employment tax (the equivalent of social security and Medicare taxes) on the income of the business.
2. Partnership. This is simply when more than one person has a business. They are partners, therefore the business structure is a partnership. While this sounds reasonably simple and oftentimes is, partnership tax law contains some of the most complicated parts of the Internal Revenue Code. The pitfalls and surprises caused by the structure of the tax law are innumerable. You do also have to deal with partners, and here also, you have unlimited liability for the debts of the partnership. It is extremely wise to prepare a well written and well thought out partnership agreement for the partnership. This should involve consultation with an attorney and perhaps significant drafting work by the attorney. Income tax reporting is usually a little more complicated and costly than with a sole proprietorship. You must file a partnership income tax return. The partnership does not pay taxes, but the tax return shows which portion of the income is taxable to which partner. The income flows through the partnership to the partners and is taxed to the partners on their income tax returns. On an individual return the income is reported to you on a Schedule K-1 and you report it on Schedule E of your individual income tax return. Most of the time, partnership income is subject to both income taxes and self-employment taxes.
3. C Corporation. This is the standard type of corporation which has been around for hundreds of years. We typically refer to it as a C corporation now to differentiate it from the S Corporation we will discuss next. The C corporation is organized under state law as a corporation which has limited liability. That means that the owners are not personally liable for the debts of the corporation. In other words, the most they can lose is their entire investment in the corporation. The C corporation has some legal requirements it must keep up with such as annual meetings. Usually an attorney is involved in setting up the C corporation although you

can go to the Colorado Secretary of State website and figure out how to set one up without much difficulty. The C corporation has a very high income tax rate and because of this is not a common choice for most young businesses at this time. There are a few advantages for a C corporation in that it can pay and deduct more in fringe benefits for its owner-employees. If you think a C corporation might be a good idea for you, be certain your attorney and your accountant agree with you and give you a good listing of all the potential advantages and disadvantages for your situation. C corporations must file their own income tax returns and pay taxes on their income. Any excess income which is paid to shareholders as dividends is taxed a second time to the individual shareholder.

4. S Corporation. In the mid 1970s S Corporations started coming into favor for small businesses. They are called "S" because they are created under Subchapter S of Section One the Internal Revenue Code. The biggest advantage the S corporation has over the C corporation is that the income flows through to the owners nearly the same way income flows to the owner of a partnership. The S corporation files its own tax return but does not pay income tax. The income flows through and is taxed by the shareholders. The S corporation has similar legal requirements to the C corporation. It is organized under state law in the same manner as a C corporation. But it must file an election to be taxed as an S corporation with the IRS on Form 2553 Election by a Small business Corporation. The S corporation must meet a variety of specific requirements to maintain its S corporation election:
    a. It must have only one class of stock and there can be no inequity in the treatment of the shareholders.
    b. It must not have more than 100 shareholders.
    c. Shareholders must be U.S citizens or residents.
    d. Shareholders must be people. They cannot be other corporations or partnerships. There are some exceptions for certain trusts, estates, or tax-exempt corporations.

    If it fails to maintain those requirements, it will no longer be an S corporation and become a C corporation. This would almost always create a bad income tax situation. It is often very difficult for many small business owners to properly maintain the necessary records and protect the S corporation status. The income of the S corporation flows through to the shareholders and is taxed on their individual income tax returns. Unlike a partnership, the income of the S corporation is not subject to self-employments taxes, therefore it is often looked at as a place to save money on these taxes. A very careful analysis of most individual situations will usually show the potential savings of self employment taxes to be extremely small or non-existent due to other costs which increase due to the requirement to pay a salary to the owners. There is a requirement that S corporations pay a reasonable salary to its active owners. This generally negates most of the advantage of the lack of self employment taxes. The IRS has been coming down on this very hard in recent years. They do not define reasonable, but it should be at least as much as it would cost to hire a non owner to do the same job. In general, if the income is generated mostly from the personal services of the owner, then the IRS expects that the largest portion of the income be paid to the owner as salary. If substantial distributions are made to an owner in addition to the salary, the IRS will look very closely at the situation and there could be a high risk of them reclassifying some or all of those distributions as salary. This could be costly. In over 30 years of working with various business organizations I have only converted one LLC partnership to an S corporation and it was to increase the amount of retirement plan contributions, not to save on self employment taxes. In general S corporations can provide fewer fringe benefits to its owners, but in some instances there may be some benefits which make it advantageous.

5. Limited Liability Company (LLC). This is a relatively new organization structure which began in this country during the 1980's. It has become extremely popular because of its advantages and its simplicity. The vast majority of the new businesses I see are organized as LLC's. The biggest advantage to the LLC is limited liability. Like a corporation, the owner can only lose what is invested in the organization, not their personal assets. The LLC can easily be organized by anyone by going to the Secretary of State Website. The cost is fairly reasonable. That does not mean you should avoid getting the counsel of your accountant and your lawyer in making the decision. The LLC does not require any form of written documentation other than the Articles of Organization filed with the Secretary of State. It is strongly recommended that you work with an attorney to draft an operating agreement for the LLC, especially if there are partners involved or if you elect to be taxed as an S Corporation (discussed shortly). The LLC does not exist in the Internal Revenue Code, therefore it is treated as a disregarded entity. That means that it is taxed as it would be taxed if the LLC did not exist. If there is one owner, it is taxed as a sole proprietorship. If there is more than one owner, it is taxed as a partnership. There is an additional option of electing to be taxed as a C corporation or an S corporation. So as an LLC, you can be taxed in the way which is most advantageous for you. If you choose to be taxed as an S corporation, you must still meet all the requirements of an S corporation. Because of this, I have found it very unusual that a new organization would organize as something other than an LLC. It does happen and there are sometimes good reasons to do so, but usually an LLC offers the broadest range of options along with simplicity.
6. Not for Profit or Tax Exempt Corporation. This is an organization which uses its revenues to achieve its goals rather than distribute excess revenues to owners as profits or dividends. In general the goals of the organization are for a "public good". There are some private foundations which are also organized as non profit corporations. The main reason to set up your non profit as a corporation is to obtain the limited liability protection similar to that available for profit making corporations. In order to qualify for tax-exempt status as a non-profit, the overall purpose of the corporation must fit one of the 28 categories listed in Internal Revenue Code Section 501(c). While it is possible to file with the Secretary of States office as a non profit corporation fairly easily, it is a good idea to get an attorney and/or an accountant experienced in dealing with obtaining tax exempt status from the IRS to assist in that activity. Donations to the non profit corporation are not necessary tax deductible. The charity must apply to the IRS and receive recognition of exemption pursuant to Internal Revenue Code Section 501(c)(3). There are income tax return filing requirements for a non profit corporation even though they do not pay income taxes unless they have unrelated business income. While

this is not the standard business organization we think of, it is an organization which exists and may be appropriate for an organization for which the main purpose is not making a profit.

Note that when you are registering your organization with the Colorado Secretary of State's office, the forms you are filing are public record and are easily available on the internet. If you do not want your home address showing up on the Secretary of State website on these forms which are easily searchable by anyone, then you should consider using a post office box, a business address, or as is often done, using your lawyer or accountant's business address. You should not use someone else's address without their permission, but it is not uncommon for a lawyer or accountant to have their business address on the filings of businesses they work with.

After suggesting 6 different alternatives for organizational structure, I have found that the vast majority of the time the structure people find best is the LLC taxed either as a sole proprietorship or a partnership. The sole proprietorship is simple but lacks limited liability. The C corporation has a high tax rate and it is very rare that the few advantages it has are significant enough to be worth it. The S corporation has too many complications in structure, the potentially lower self employment taxes are either insignificant or not really there, and if there is an advantage to and S corporation for you, then an LLC can elect to be taxed as an S corporation. The not for profit corporation is for a specific purpose and not for a profit making venture.

DBA/Names/Trademarks

You need to decide on a name for your business. Sometimes these are obvious and easy. Sometimes they require some thought and planning. It is usually a good idea to have your name describe what you do in some way. From a marketing standpoint, it is good if it is easy to spell and pronounce, although there are times when a very unusual name can be advantageous.

At the Colorado Secretary of State website, http://www.sos.state.co.us/, you can do name searches and find out if your name is available. This can help you decide if you should use a different name. You can also reserve the name and register the name as a trade name.

Sometimes you may organize a business under one name and operate under another name or even several other names. This is usually referred to as DBA (Doing Business As). This is sometimes appropriate when you run one business with several different business activities and those activities are appropriately run with different names. Sometimes it occurs when your business changes over time. You can also change the name of your business if that is appropriate.

It is a very good idea to get your name reserved as a domain name for a website, even if you do not plan a website in the near future. The cost is minimal. If you plan to do a website you should check out the name availability right away. The easiest place I have found to do this is at www.godaddy.com. There are a wide variety of places out there which will assist you in taking care of domain names. II have found Godaddy to be the most thorough, consistent, and reasonable service. They can also assist you in purchasing a name if it is owned by someone else who is not using it.

Employer ID number

I would strongly recommend you get an federal employer ID number (FEIN) as soon as possible. If you organize as an LLC or a corporation, you need to have activated the organization with the Secretary of State's office first. Even if you are not going to have employees, you will find the employer ID number extremely useful. You will need to provide some form of number to a wide variety of other organizations during your business life and most of us would prefer not to be providing our social security number to lots of different organizations. Other organizations you do business with will ask for your employer ID number, often via a form W-9, so that they can provide you a 1099 form at the end of the year and help them decide if they should withhold taxes from their payments to you. Some organizations will not pay you until you provide them with the 1099 form. When you go to the bank to set up a bank account, you will be asked for your employer ID number. If you are a corporation, you will be required to have the number. If you are an LLC, there is technically no requirement that you have an employer ID number, but you will find that most banks will have a policy of not allowing you to open an account without one.

You can request your FEIN on federal form SS-4 and this can be done online at http://www.irs.gov/businesses/small/article/0,,id=98350,00.html.

If you do have employees, you will be required to have an employer ID number no matter what. You will also have to file employment tax returns and pay employment taxes. We will discuss this a little more in the payroll chapter.

Form **SS-4**
(Rev. January 2010)
Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

▶ See separate instructions for each line. ▶ Keep a copy for your records.

OMB No. 1545-0003

EIN

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested

2 Trade name of business (if different from name on line 1)

3 Executor, administrator, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box)

5a Street address (if different) (Do not enter a P.O. box.)

4b City, state, and ZIP code (if foreign, see instructions)

5b City, state, and ZIP code (if foreign, see instructions)

6 County and state where principal business is located

7a Name of responsible party

7b SSN, ITIN, or EIN

8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? . . . . ☐ Yes ☐ No

8b If 8a is "Yes," enter the number of LLC members . . . . ▶

8c If 8a is "Yes," was the LLC organized in the United States? . . . . ☐ Yes ☐ No

9a **Type of entity** (check only one box). **Caution.** If 8a is "Yes," see the instructions for the correct box to check.

☐ Sole proprietor (SSN) ______
☐ Partnership
☐ Corporation (enter form number to be filed) ▶______
☐ Personal service corporation
☐ Church or church-controlled organization
☐ Other nonprofit organization (specify) ▶______
☐ Other (specify) ▶

☐ Estate (SSN of decedent) ______
☐ Plan administrator (TIN) ______
☐ Trust (TIN of grantor) ______
☐ National Guard ☐ State/local government
☐ Farmers' cooperative ☐ Federal government/military
☐ REMIC ☐ Indian tribal governments/enterprises
Group Exemption Number (GEN) if any ▶

9b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

10 **Reason for applying** (check only one box)

☐ Started new business (specify type) ▶ ______
☐ Hired employees (Check the box and see line 13.)
☐ Compliance with IRS withholding regulations
☐ Other (specify) ▶

☐ Banking purpose (specify purpose) ▶ ______
☐ Changed type of organization (specify new type) ▶ ______
☐ Purchased going business
☐ Created a trust (specify type) ▶ ______
☐ Created a pension plan (specify type) ▶ ______

11 Date business started or acquired (month, day, year). See instructions.

12 Closing month of accounting year

13 Highest number of employees expected in the next 12 months (enter -0- if none).
If no employees expected, skip line 14.

Agricultural	Household	Other

14 If you expect your employment tax liability to be $1,000 or less in a full calendar year **and** want to file Form 944 annually instead of Forms 941 quarterly, check here. (Your employment tax liability generally will be $1,000 or less if you expect to pay $4,000 or less in total wages.) If you do not check this box, you must file Form 941 for every quarter. ☐

15 First date wages or annuities were paid (month, day, year). **Note.** If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) . . . . ▶

16 Check **one** box that best describes the principal activity of your business.
☐ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Health care & social assistance ☐ Wholesale-agent/broker
☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☐ Accommodation & food service ☐ Wholesale-other ☐ Retail
☐ Other (specify)

17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.

18 Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ Yes ☐ No
If "Yes," write previous EIN here ▶

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name | Designee's telephone number (include area code) ( )

Address and ZIP code | Designee's fax number (include area code) ( )

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Name and title (type or print clearly) ▶ | Applicant's telephone number (include area code) ( )

Applicant's fax number (include area code) ( )

Signature ▶ Date ▶

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form **SS-4** (Rev. 1-2010)

Form **W-9**
(Rev. December 2011)
Department of the Treasury
Internal Revenue Service

Request for Taxpayer Identification Number and Certification

Give Form to the requester. Do not send to the IRS.

Print or type
See Specific Instructions on page 2.

Name (as shown on your income tax return)

Business name/disregarded entity name, if different from above

Check appropriate box for federal tax classification:
☐ Individual/sole proprietor ☐ C Corporation ☐ S Corporation ☐ Partnership ☐ Trust/estate

☐ Limited liability company. Enter the tax classification (C=C corporation, S=S corporation, P=partnership) ▶ ______________

☐ Exempt payee

☐ Other (see instructions) ▶

Address (number, street, and apt. or suite no.)

Requester's name and address (optional)

City, state, and ZIP code

List account number(s) here (optional)

Part I **Taxpayer Identification Number (TIN)**

Enter your TIN in the appropriate box. The TIN provided must match the name given on the "Name" line to avoid backup withholding. For individuals, this is your social security number (SSN). However, for a resident alien, sole proprietor, or disregarded entity, see the Part I instructions on page 3. For other entities, it is your employer identification number (EIN). If you do not have a number, see *How to get a TIN* on page 3.

Social security number
☐☐☐ – ☐☐ – ☐☐☐☐

Note. If the account is in more than one name, see the chart on page 4 for guidelines on whose number to enter.

Employer identification number
☐☐ – ☐☐☐☐☐☐☐

Part II **Certification**

Under penalties of perjury, I certify that:

1. The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me), and
2. I am not subject to backup withholding because: (a) I am exempt from backup withholding, or (b) I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or (c) the IRS has notified me that I am no longer subject to backup withholding, and
3. I am a U.S. citizen or other U.S. person (defined below).

Certification instructions. You must cross out item 2 above if you have been notified by the IRS that you are currently subject to backup withholding because you have failed to report all interest and dividends on your tax return. For real estate transactions, item 2 does not apply. For mortgage interest paid, acquisition or abandonment of secured property, cancellation of debt, contributions to an individual retirement arrangement (IRA), and generally, payments other than interest and dividends, you are not required to sign the certification, but you must provide your correct TIN. See the instructions on page 4.

Sign Here | **Signature of U.S. person** ▶ | Date ▶

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

A person who is required to file an information return with the IRS must obtain your correct taxpayer identification number (TIN) to report, for example, income paid to you, real estate transactions, mortgage interest you paid, acquisition or abandonment of secured property, cancellation of debt, or contributions you made to an IRA.

Use Form W-9 only if you are a U.S. person (including a resident alien), to provide your correct TIN to the person requesting it (the requester) and, when applicable, to:

1. Certify that the TIN you are giving is correct (or you are waiting for a number to be issued),

2. Certify that you are not subject to backup withholding, or

3. Claim exemption from backup withholding if you are a U.S. exempt payee. If applicable, you are also certifying that as a U.S. person, your allocable share of any partnership income from a U.S. trade or business is not subject to the withholding tax on foreign partners' share of effectively connected income.

Note. If a requester gives you a form other than Form W-9 to request your TIN, you must use the requester's form if it is substantially similar to this Form W-9.

Definition of a U.S. person. For federal tax purposes, you are considered a U.S. person if you are:

• An individual who is a U.S. citizen or U.S. resident alien,

• A partnership, corporation, company, or association created or organized in the United States or under the laws of the United States,

• An estate (other than a foreign estate), or

• A domestic trust (as defined in Regulations section 301.7701-7).

Special rules for partnerships. Partnerships that conduct a trade or business in the United States are generally required to pay a withholding tax on any foreign partners' share of income from such business. Further, in certain cases where a Form W-9 has not been received, a partnership is required to presume that a partner is a foreign person, and pay the withholding tax. Therefore, if you are a U.S. person that is a partner in a partnership conducting a trade or business in the United States, provide Form W-9 to the partnership to establish your U.S. status and avoid withholding on your share of partnership income.

Cat. No. 10231X

Other Licensing

Most businesses that you start in Colorado require no licensing, however some do have licensing requirements. Many professions require licensing, as do some carpentry and contracting trades. You should check on your specific business activity regarding any licensing requirements. If you work out of your home, there may be local ordinances which control what you can do to some extent. You will need to check on that with your local governmental entities. You may have a homeowners association which even limits what you can do. There may be limits on how many cars can be parked at your property or can visit you during the day.

Sales tax and payroll requirements will be discussed in later sections.

To find out about business which require licensing and regulation in Colorado and the requirements to license your activity go to:

http://www.dora.state.co.us/index.html

The state Office of Economic Development and International Trade also has a listing of occupations which require licensing:

http://www.colorado.gov/oed/industry-license/

These websites also have a lot of information which potentially could be useful for your business. You should poke around a little and see if there is anything they can offer you.

Insurance

Anytime you go into business for yourself you increase your risk. You could do something wrong or accidents simply happen. Things which happen create a risk of loss for you. You can set up an organization with limited liability, but that does not remove the risk that something could happen which could create liability which could cause you to lose the business. Adequate insurance can often protect you from those situations. While that limited liability supposedly protects the amount you can lose, that protection is not complete. You can still suffer personal liability in certain circumstances. You will still want to protect your business from losses as well.

Discuss your new business venture with your insurance agent. You may use your vehicle in your business. Your vehicle insurance policy may not be in effect if you are using your vehicle for business purposes. You may be used to other people driving your car, but they may not be covered in a business situation. You may use your house in your business activities. You need to discuss the coverage with your insurance agent and make sure the coverage you have is appropriate for what you will be doing.
It is likely that you will want to obtain liability coverage for your business. Some of your customers may require you to have liability coverage. You may also want to have an umbrella policy to cover a potential large claim.

All these things should be discussed with your insurance agent. It is not uncommon for many businesses to start up without addressing these insurance issues, but if you begin to have any sales volume at all, you should contact your insurance agent and get a plan for coverage in place right away. Your agent may even refer you to a different agent who handles different types of coverage.

Banking

You should open a separate checking account for your business. It shows other businesses you are serious about being in business. It makes record keeping a lot cleaner and easier. It also avoids comingling of funds and legal and tax problems which can be associated with that.

Other Banking issues to consider:

- Most businesses today accept credit cards; check with your bank about setting up a merchant account and accepting credit cards.
- Assuming you have a website, you may be able to set up your credit card processing through the website hosting service.
- Check into using paypal.
- Also talk to your financial advisors about other sources of credit card providers appropriate for your business.

Sales Tax

If you sell personal property (a product) to an end user, you are most likely going to have to collect sales taxes and report them to state and/or local tax authorities. In general the sales tax is computed at the location where the product is delivered. If you have a retail store that is easy If you ship to various locations, it can become very complex. In general you do not compute or collect sales tax on product shipped to another state unless you have a presence in that state. If you sell a product to others who resell it, you will not have to collect or pay sales taxes but you will still have to get a sales tax license. In this case it is sometimes called a resellers license or wholesalers license.

You can obtain a sales tax license from the State of Colorado by filling out form CR0100 Sales Tax Wage Withholding Account Application. There is currently a sales tax license fee of $16.00 and a deposit of $50.00. The CR0100 form can be found at:

http://www.colorado.gov/cs/Satellite?c=Page&childpagename=Revenue%2FREVXLayout&cid=1178305431219&pagename=REVXWrapper

You will also need to check and see if you need a local sales tax license for the city and the county you are located in. Some local jurisdictions allow you to file on the state sales tax return, but many, particularly cities require their own sales tax return.

Sales taxes are not a cost of doing business for you, other than the time and cost of reporting. You will charge the customer the sales tax and then remit that amount to the government.

In general you should only be liable to collect, report and pay sales taxes within Colorado if you are located in Colorado and ship product to Colorado locations or have it picked up at your location. If you ship to other states, you usually will not be subject to sales tax responsibilities there. But, there are 45 states and 1,700 local jurisdictions with sales taxes and the laws and requirements vary considerably. If you ever travel out of state or hire outside sales reps, you should discuss the possibility of sales tax liabilities with your tax advisor. Many states are hungry for cash and are looking at taxing products coming in if they can, sometimes successfully.

There are a variety of special rules related to sales taxes and they can vary from location to location, so if you are selling personal property to an end user, you should discuss the specifics of what might apply to your situation with your tax advisor. There are also use taxes on equipment purchased from out of state for your business as well as exemptions from sales tax available to you on equipment you purchase if you are making products. There can even be exemptions on sales taxes you pay on your utility bills if you make products. Talk to your tax advisor about this also.

CR 0100 WEB (11/10/10)
COLORADO DEPARTMENT OF REVENUE
1375 SHERMAN STREET
DENVER CO 80261-0009

COLORADO SALES TAX / WAGE WITHHOLDING ACCOUNT APPLICATION

Departmental Use Only

INSTRUCTIONS FOR THIS FORM ARE IN THE PUBLICATION CR 0101

A

1. REASON FOR FILING THIS APPLICATION
☐ Original Application ☐ Change of Ownership ☐ Additional Location

Do you have a Department of Revenue Account Number?
☐ Yes ☐ No IF Yes, Account #

2. Indicate Type of Organization
☐ Individual ☐ Limited Liability Company (LLC) ☐ Corporation/'S' Corp. ☐ Government
☐ General Partnership ☐ Limited Liability Partnership (LLP) ☐ Association ☐ Joint Venture
☐ Limited Partnership ☐ Limited Liability Limited Partnership (LLLP) ☐ Estate/Trust ☐ Non-profit

B

1a. Taxpayer Name (Owner, Partners or Corporate Name) (Last, First, Middle) | 1b. Taxpayer ID (Requirements—see page 2)

2a. Trade Name/Doing Business As (If applicable, and for informational purposes only) | 2b. FEIN | 2c. SSN

Physical place of business

3a. Principal Place of Business | City | State | ZIP Code

3b. County | 3c. If business is within limits of a city, what city? | 3d. Telephone ( )

Mailing address

4a. Name (Last, First, Middle) | 4b. Telephone ( )

4c. Mailing Address | City | State | ZIP Code

5. List Specific Products and/or Services you Provide and EXPLAIN IN DETAIL (See page 2, section B5 for additional space)

Do you sell motor vehicle tires? ☐ Yes ☐ No
Is your business in a special taxing district? ☐ Yes ☐ No
Do you rent out items for 30 days or less? ☐ Yes ☐ No
Do you sell prepaid wireless service? ☐ Yes ☐ No

6a. Owner/Partner/Corp. Officer (Last, First, Middle) | 6b. Title

6c. FEIN | 6d. SSN | 6e. Telephone ( )

6f. Address (Residence, P.O. Box, or Street) | City | State | ZIP Code

7a. Owner/Partner/Corp. Officer (Last, First, Middle) | 7b. Title

7c. FEIN | 7d. SSN | 7e. Telephone ( )

7f. Address (Residence, P.O. Box, or Street) | City | State | ZIP Code

If you acquired the business in whole or in part, complete the following:

8a. Prior Taxpayer Name | 8b. Date of Acquisition

8c. Address | City | State | ZIP Code

C

1. ☐ If Seasonal, mark each business month ☐ Jan. ☐ Feb. ☐ Mar. ☐ April ☐ May ☐ June ☐ July ☐ Aug. ☐ Sept. ☐ Oct. ☐ Nov. ☐ Dec.

2a. Filing Frequency: If sales tax collected is:
☐ $15.00/month or less—Annually
☐ Under $300/month—Quarterly
☐ $300/month or more—Monthly
☐ Wholesale only—Annually

2b. First Day of Sales (Mo/Day/Yr)

Revenue Registration Account Number (DEPT. USE ONLY)

3. Indicate which applies to you: ☐ Retail-Sales ☐ Wholesaler ☐ Charitable ☐ Retailers-Use

D

1. Filing Frequency: If wage withholding amount is
☐ $1–$6,999/Year - Quarterly ☐ $50,000+/Year—Weekly
☐ $7,000–$49,999/Year - Monthly Must file by Electronic Funds Transfer (EFT)

2. Oil/Gas
☐ Withholding

3a. First Day of Payroll, if applicable (Mo/Day/Yr) | 3b. Payroll Records Telephone ( )

3c. Payroll Records Location (List Address)

E

Period Covered From	To		FEES (see page 2)	
Mo / Yr	Mo / Yr	(0020-810)	State Sales Tax Deposit (355)	$
Mo / Yr	Mo 12 / Yr	(0080-750)	Sales Tax License (999)	$
Mo / Yr	Mo 12 / Yr	(0100-750)	Wholesale License(999)	$
Mo / Yr	Mo / Yr	(1000-750)	Wage Withholding (999)	$ 0.00
Mo / Yr	Mo 12 / Yr	(0160-750)	Charitable License (999)	$
			TOTAL	$ .00

MAKE CHECKS PAYABLE TO: Colorado Department of Revenue, 1375 Sherman St., Denver, CO 80261-0009

F

I declare under penalty of perjury in the second degree that the statements made in this application are true and complete to the best of my knowledge.

SIGNATURE of Owner, Partner, or Corporate Officer Required | Title | Date

(continue on reverse side of this page.)

See page 2 for Return Check Policy

Payroll

It is quite possible that starting out you will be doing the vast majority of the work for your business yourself. Having employees and a payroll may not be something you are looking at yet. At some point as your business grows you will need to look at hiring people to help you get the work done. This creates a whole new set of challenges dealing with people and dealing with governmental requirements. As an employer you will have to withhold federal and state income taxes, Social Security and Medicare taxes, pay federal and state unemployment taxes and obtain workers compensation insurance. You are also likely to have to deal with workers needs and requests for vacation time, holiday pay, personal time off, health insurance coverage, medical reimbursement plans, dental coverage, vision coverage, child care reimbursement plans, retirement plans and a host of other issues. You also have to issue W-2 forms at the end of the year and report the information to the IRS, as well as a number of legal issues which come up as a part of having employees. You will have to deal with a significant number of employment laws at a variety of governmental levels, some of which conflict with each other.

You can do all this yourself, but it will use up precious time that you could spend running your business. I used to provide payroll services and was amazingly efficient at it. It was the one area of my clients business where nobody objected to me being as efficient as possible. They did not want to do anything to interfere with the processing of their paychecks. I thought I was providing a great service to my clients as I was so efficient. Then I discovered Professional Employer Organizations, also known as employee leasing organizations. These organizations specialize in handling only payroll and employee issues. They are just as efficient as I was, but have the ability to reduce the costs associated with having employees in ways that I could not. They can significantly reduce the cost of benefits and workers compensation thereby costing much less than if you did it yourself. They have staff on hand who are highly experienced in all the issues which normally come up with employees, as well as having legal counsel available to provide advice on the legal issues which come up. I highly recommend using PEO's to handle your payroll issues.

I can specifically recommend and organization called Staffscapes, Inc. located on the north side of the Denver area. Visit their website at http://www.staffscapes.com/.

It is common for a small business to hire contractors to do work for them. This can be a very good idea if you do not need regular employees. But these should be real contractors. Many people think that using independent contractors is a way to avoid paying payroll taxes or benefits and a way of reducing paperwork. And it is. But if those independent contractors are really employees that you are misclassifying you could find that you will have to pay significant penalties and back taxes to the IRS, the state, to state and federal unemployment as well as have significant problems with the state labor board, workers compensation and OSHA. Just calling someone contract labor or an independent contractor does not make them one, even if you sign an agreement where you both agree to call them an independent contractor.

There are a large number of factors that are looked at when attempting to determine if someone is an independent contractor or employee. These relate mostly to the amount of control you have over the worker and how much risk of losing money the worker has. A fair warning is that when the IRS is asked if someone is an employee or an independent contractor the results are 98% of the time an employee.

Financing

The funds to finance most start up businesses come from the owners. It can be difficult to find outside financing for an unproven business, especially in today's economic conditions. It is often better to minimize or avoid outside financing as much as possible. I am not a fan of obtaining significant debt to get your business going. I am also not in agreement with those who say you should never borrow money. I have watched many businesses over the years and my conclusion is that somewhere around 90 percent of the loans made which were not made in connection with the purchase of real estate probably should not have been made. The remaining 10 percent were very important for a business and successfully got the business through a tough time or financed an important expansion for the business.

I have found the most successful businesses are those that manage to finance the largest portion of their growth with their own profits. Those businesses tend to pay down their debt substantially faster than the terms on the debt. Creating debt can be very expensive, so the business owner must be very careful in deciding when to use it.

Generally I have found that the most appropriate time to use debt is when new real estate is purchased and you have a reasonable down payment available. Just make sure that you are producing profits adequate to make the payments on the real estate ahead of time. Most other debt should be looked at very carefully and other options than debt considered very seriously. It is almost always better to find ways other than debt to finance increases in inventory and small to medium equipment purchases. Larger equipment purchases should be analyzed very carefully, but some debt may be appropriate in the purchase of equipment with a higher cost. In any case a very careful and thorough cost benefit analysis should be done for any significant purchases. Be certain that it will produce more profits than the cost of the equipment.

There can be business activities which are very seasonal and need to do significant purchasing ahead of a busy season. This can create the need for some short term financing. I would still recommend that you attempt to do this financing as much as possible from previous profits. You will find that your business will be stronger and you will be more careful about what is being purchased.

If you have a long term relationship with a banker, they can be one of the best sources of financing.

- They will be aware of your ability to run the business.
- They will often be the source of some of the best interest rates as well.
- They will usually have access to funds for almost any kind of purpose.
- There are a number of government programs available to assist with financing. Generally I have found that your banker is aware of these programs and if they are a good choice for the loan you need, the banker will bring them up and provide assistance.

Lease financing is often used in the acquisition of equipment. While this can be a good idea and I have used it a number of times with clients, I tend to suggest avoiding it in most instances There may be some situations where you need a piece of equipment for a short period of time and a lease could be a good option. Leasing is generally a much more expensive method than financing with equipment loans. Lease financing is somewhat common with copiers and computer equipment. It is often sold to the business as having the advantage of upgrading to newer technology during the lease term. While this is true, it is typically a very expensive method of upgrading. Usually the original lease is just added to the lease of the new equipment and over the course of a couple of upgrades you end up paying an excessively high payment for the equipment you are using and you are locked into making that payment for the term of the lease. I generally recommend a purchase rather than a lease. You can always upgrade by buying a new machine and selling the old one. This would typically work out better anyway.

There are many companies out there which will offer you financing on your receivables, sometimes called factoring. This can be a way to get funds in more quickly than waiting for the customer to pay, but the interest rates are generally very high. I have found that businesses who have been required to resort to this kind of financing are often managing many parts of their businesses poorly and it is possible that they may not last much longer. I have see a few on the other hand who have successfully used it on a short term basis. A somewhat similar method is often referred to as contract financing where a loan is given for a specific project and as the customer pays, the loan is paid down. This can be an advantageous way of getting large contracts which would be otherwise difficult or impossible to undertake.

There have been many people who have financed their business with credit cards and I have even seen it work out well in a couple of situations. In the vast majority of situations it does not work out well. I do not recommend using credit cards to finance the business. Credit cards generally have an excessively high interest rate and if you are forced into using them for financing a business, it is likely because other methods and organizations do not have enough faith in the success of the business to lend funds to it. There is a place for credit cards in your business to facilitate purchasing, but just as in your personal life, they should generally be paid off each month.

There are also a few forms of equity financing available such as selling ownership interests in your business to others and using venture capital firms. In some business models these can be a good idea. It may bring in outside expertise as well as stabilize and strengthen your financial position, but it will dilute your ownership. Outside investors will require a much higher return on their investment than the interest rate on loans, and may ask for control you will not want to give up.

Inventories

If you are selling a product, you will also potentially have to have inventory. The existence of inventory brings up a few factors you should be aware of ahead of time.

- Having inventory requires some amount of funds be invested in product which is not immediately generating revenues.
- The amount of money spent on inventory is not deductible against income until the period (or year) in which you sell that inventory.
- You must keep track of and account for your inventory. This is usually done for income tax purposes by an annual count of what is on hand and adjusting the balance in your inventory to what is actually on hand.
- This can mean that you spend all of your money in a given year on inventory and cannot deduct it, resulting in a high tax bill which you have difficulty paying because your money is all tied up in inventory. You must be aware of this and plan for it.
- If you have inventory that means you are selling a product and must have a sales tax license and collect and report sales taxes on your sales.
- On the other hand when you buy the inventory for **resale**, you do not pay sales tax on the purchase, but will still need to obtain a sales tax (resale) license.
- If you use inventory for personal purposes, you must account for your personal use as a draw or wages from the business and a reduction in the purchases made. If you use inventory originally purchased for resale in your business, you may owe use tax on it also (in the place of sales tax).

Websites

Today almost every business should create a website. More and more people everyday use websites to learn about your business and check to see how legitimate you are. Even if you are not tremendously computer savvy, there are easy ways to create a website which are not very costly. It is a great opportunity to put information out there about your business, what you do, what your qualifications are, and what your products are. It is often a good idea to begin blogging also. If you have particular expertise in a field, you can regularly blog about that field to show your knowledge as well as keep your name in front of potential customers. In general websites should be relatively simple, clear and easy to navigate.

Here are 7 steps for implementing a website at minimal cost:

1. Register a domain name. Your name should be related to your business and the content of your website. It should be short, descriptive and easy to remember.
2. Set up an account with a website hosting service. Some to look at would be HostGator.com, bluehost.com. Godaddy.com has hosting services as well.
3. Point your domain name to your website host. This is not very difficult and godaddy has very easy steps to follow to do this. Your hosting service will most likely also have easy steps to follow and may provide you assistance.
4. Install Wordpress on your site. Wordpress is a free platform which allow you to easily build your website and supports blogging extremely well. Most website hosting services have an easy way to automatically install Wordpress.
5. Set up your website preferences and theme by following the wordpress directions.
6. Assuming you need to accept credit cards on your website, you will need to work with your merchant processor to link to your site and properly handle credit card transactions. You may also consider accepting paypal on your website.
7. If you are selling products you will need to set up a shopping cart and product pages. Your hosting service should have easy ways to do this.

There are many companies who will do website development work and computer/internet marketing for you or work with you in developing your skills in those areas. Unless you need a fairly sophisticated site, you are likely to be able to do most things yourself using wordpress. You may be able to get some assistance from friends or young people. It seems like the younger they are the more they know about this area of activity. You may also be able to work with some small businesses who do this kind of work. If you need more help are need a little more sophistication in your website and marketing one company to look at would be www.madwiremedia.com.

Goalsetting/business plans/Long term planning

Some form of planning is very important for your business. You need to be able to both understand what your goals are and communicate those goals to others. In order to do that, you need to have goals.

I am not a big fan of the traditional standard business plan. They can help to create a roadmap for where your business is going and help you focus your ideas, and probably most importantly they can sometimes help you obtain financing for your business. But, I have rarely seen a startup business which has actually followed a business plan. There is a risk that the plan will stifle the creativity of the business. It is quite possible the business will develop in a different direction from the plan. This means the plan will be constantly changing. Most business plans are set up in a way that is to just copy boilerplate information from other business plans inserting facts and goals about your business. This process does give potential lenders and investors some specific information they need to make their decisions, but it rarely provides you with the information you need to run your business on a day to day basis.

I would suggest an alternative to the traditional business plan to be related more to goal setting for the business. You want to identify your products and the markets for those products. You also want to identify the process you will use to reach those markets with your products. Most business owners need operating plans more than they need a business plan with the blanks filled in. You need to be able to describe the things you are going to do over the next few months and next few years to get your business going and to improve the way it operates.

You need to identify what you want to accomplish, then ask what you need to do to get there. What specific tasks do you need to do. You also need to estimate the time it will take. Then put the things you need to do on a timeline and see if it is possible to get there in that amount of time. Then you will make adjustments.

Mission Statements/Vision Statements

While I am a big believer in mission statements and vision statements, I think they are often misunderstood and I also think they often take a bit of time to develop. They may be clear to you from day one, but most often they are molded and developed over a period of time as the culture of the business develops.

You have seen a lot of mission and vision statements out there, but they are two different things. Many companies provide what they call a mission statement which is a paragraph long. That is not a mission, that is a vision statement masquerading as a mission statement.

Your mission should be extremely concise and clear. It should be very short. It does not even have to make sense out of context. It does not even have to be a complete sentence. The mission will usually carry a lot of meaning beyond just the few words. In a few cases a single word can convey the mission of a company. Usually the statement will be a few words to a sentence. It should be able to explain the purpose of the organization and the uniqueness of the organization. Try not to copy the mission statement of anyone else. Make it unique to your organization.

An example of a good mission statement which can easily be shortened and still carry all the meaning of the full sentence is from The Olive Garden restaurant: "To build a company of champions through innovation, speed and commitment to one guest at a time -- focusing on Hospitaliano!" This mission statement is a bit too long. It appears to have the input of a committee which wanted to cover all the bases. In fact there are many employees at Olive Garden who consider the mission to be the last three or even last word. The last word carries enough meaning to be all that is needed for Olive Garden's mission. And it is not even a real word.

The Vision Statement is the place you can create a paragraph describing all the things you want to be; where you can give more information about the things you want to do. The Mission should be extremely short. The shorter the better.

Some other mission statements to keep in mind:

3M: We solve problems by putting innovation to work.

Wal-Mart: Value through low prices.

Charles Schwab: To help everyone be financially fit.

Google: Organize the world's information and make it universally accessible and useful.

ING: Lead Americans back to savings.

North Point Community Church: Be a church where the unchurched want to attend.

Bookkeeping/accounting software

It is very important that you keep adequate records for your business. You will want to:

- Know if you are making a profit.
- Know where the money is going.
- Know that all your customers are paying you and that they are paying in a timely manner.
- Be certain you are maintaining good relationships with your suppliers by paying them timely and properly.
- Report your operations to the government for tax purposes.
- Report your operations to your bankers or sometimes insurance companies.
- Maintain the safety and control of your assets.

Often people who start businesses do not understand the importance of maintaining good records. Sometimes business owners can get so involved in meticulously tracking every transaction that they do not spend adequate time running their business.

The methods you use to keep track of your business activities will depend on the size of your business and your skill levels. Many very small businesses can get away with keeping track of activities manually or with a simple computer spreadsheet. Sometimes just a well kept check register is adequate. But as your business grows, you will most likely need to obtain some form of computerized bookkeeping or accounting program or hire a bookkeeper to keep track of things for you. Many accountants provide bookkeeping services as part of their business. Quickbooks is probably the most well known and widely used program for very small businesses. It is quite inexpensive and most people find it very easy to use. It is also very easy to make a mess of. Even if you use Quickbooks, you should work with your accountant to make sure you set things up correctly, and have them check your work regularly. An improvement over Quickbooks is a program called Peachtree which is currently changing its name to Sage 50. Peachtree does come in several versions in a similar price range to Quickbooks. It has a slightly larger learning curve, but is much easier for an accountant to use and less prone to major problems. I know other accountants who make a lot of money helping people with their Quickbooks and helping them fix their Quickbooks. Those who have clients using Peachtree or a higher end accounting program get to spend more time helping their clients improve their business operations.

As your business grows and becomes more complex you may want to use a higher end accounting program. This will require substantial analysis and working with your accountant to determine what will be best for you in the long run as it can be a significant investment.

Income Tax Deductions

As a business owner there are a variety of tax deduction opportunities available to you. Some are obvious; some are not so obvious; some have unusual restrictions on them. In general you can deduct expenses which are ordinary and necessary for your business. An ordinary expense is defined by the IRS as one that is common for the trade or business. Necessary is defined as one that is appropriate for your trade or business. In general, expenses such as the cost of goods sold, business insurance, business payroll, advertising, supplies used in the business, along with some other costs clearly related to the activity of providing a product or service are deductible. What I am going to discuss here are some of the more unusual expenses and those with unusual rules regarding how to deduct them.

Meals and entertainment. You may not deduct the cost of meals you eat in the ordinary course of business, but if you take business associates or customers out, you may deduct 50% of the cost of entertaining them. You must document the meal or entertainment in some fashion including who was entertained and what business was discussed. This is commonly done by writing notes on the receipts for the activity. Note that tips which are listed separately on the receipt are 100% deductible. Some meals are 100% deductible. If you provide occasional meals or parties for employees such as meals for overtime work, a thank you lunch for a good month, or a Christmas party, these meals are 100% deductible. Also, meals when out of town overnight on business are deductible at 50%.

Per diems. As a sole proprietor you can deduct a per diem amount for overnight business travel away from home. These rates vary by location and can be found at the GSA website: http://www.gsa.gov/portal/category/21287. You can also reimburse employees at these rates for their overnight business travel. The per diem rates include a portion for lodging and a portion for meals and incidentals. You can take actual expenses instead of the per diem, but you must have a consistent policy in place of doing one or the other. It is fairly common for the business to pay actual expenses for lodging and use per diem rates for meals and incidentals. The meals and incidentals portion of the per diem is 50% deductible. For a subchapter S owner, the business may pay the owner the meals and incidentals portion of the per diem and deduct it, but may not pay a per diem to the owner for lodging. An S corporation owner cannot just take a per diem expense on their income tax return, it must be reimbursed to them and deducted by the S corporation according to a corporate policy. There are also international per diem rates located at the US Department of State website: http://aoprals.state.gov/web920/per_diem.asp.

Office in home. Economic conditions often dictate that many of us work out or our homes. This creates an opportunity for a home office deduction which could reduce your tax burden if you qualify for it. Usually the home office deduction applies to self employed individuals. Here are some things to be aware of if you think you might be able to take a home office deduction:

The home office must be used in a trade or business activity. It must be used in operations which are intended to be profit making. Usually these operations would be reported on Schedule C or Schedule F of your federal tax return. You cannot take a home office deduction to manage

your personal investments or finances.
The home office must be used regularly and exclusively for business. It must be in a separate room or space which is specifically identifiable. You cannot conduct any personal activities within that area. All activities must be business related. The equipment and computers located in that area must only be used for business purposes. In the case of a child day care type of business in your home, you do not have to meet the exclusive use tests and the deduction is based on time the home is used rather than square footage.
The home office must meet one of the following three qualifications:
1. Principal place of business. That means where nearly all business activity takes place or where the focus of your business activity occurs. It can also qualify as the principal place of business if you have no other fixed location where you conduct administrative activities; or
2. Meet with customers. Occasional meetings or phone calls are insufficient. It should be the place where a large portion of your contact with customers, clients, or patients takes place; or
3. Separate structure. If your home office is a separate structure not attached to your dwelling, it does not have to be the principal place of business or a place where you meet customers.

If you store inventory or product samples the storage space does not have to meet the exclusive use test to qualify for the home office deduction. If your home is used as a day care center, you do not have to meet the exclusive use test. If you are an employee, the home office must be for the convenience of the employer which generally means the employer does not have another place of business where the employee could have an office. If you are an employee, the home office deduction is taken via form 2106 and would show up on your Schedule A as an itemized deduction subject to various limits.

Note that even if you qualify for the home office deduction, your deduction may be limited by a variety of factors. In particular it is limited to income from the business prior to the home office deduction.

The office in home deduction is generally computed by using a percentage of the expenses for the home during the year. This percentage is normally determined by dividing the square footage of the office space by the square footage of the home. Be sure to discuss the possible requirement that you may have to pay tax on a portion of the sale of your home if you take depreciation on it as part of your home office deduction.

Vehicle expenses. If you use your vehicle for business purposes there are a couple of choices available to you. You can use actual expenses and take depreciation expense on the vehicle or you can use a standard mileage rate for the business miles. In either case you must keep careful track of the business mileage. Which choice is best depends on the facts and circumstances. In general if the vehicle is only used for business purposes a small amount, it is likely that the standard mileage rate would be best. If it is a higher priced vehicle, it might be a good idea in the early years to take actual expenses because you may get higher depreciation write-offs. This could create problems later with percentage of business use and recapture of depreciation if the vehicle is sold. I do look at each situation individually and work with my clients to come up with the best arrangement for them, but in general I tend to prefer that if the business use is much less than 100%, they use a standard mileage rate. There can still be exceptions both directions. A subchapter S corporation owner cannot use the standard mileage rate or actual expenses on their personal return. It is more appropriate for the Corporation to reimburse the owner at the standard mileage rate for any business use of their personal vehicle. This is the preferred method for partners as well.

Charitable contributions. In general for an individual, charitable contributions made are deductible on schedule A of their 1040 as an itemized deduction. If a charitable contribution is made by your sole proprietorship, partnership, or S corporation they are not deductible by the business, but flow through to the owners Schedule A. Donations of time are not deductible. Donations of business property, supplies or inventory may be deductible, but generally only up to the amount of cost of the property less any depreciation taken on the property. You cannot effectively deduct the amount twice, once as a purchase for business use, and once as a charitable contribution. If you have already deducted the cost of the property for business use, your basis is now zero and that is the amount of deduction available to you.

Political contributions are not deductible. Fines and penalties are not deductible.

Section 179. You may deduct the cost of small supplies and tools as you spend the money, but with larger equipment with a useful life of over 1 year, you should depreciate the asset over the life of the asset, only taking a deduction for a percentage of the cost each year. There are so many rules regarding depreciation, you should discuss your specific purchase with your tax preparer. Internal Revenue Code Section 179 is designed to provide incentive to small businesses to invest in equipment by allowing them to write off the full purchase price in the first year the asset is placed in service. This can often create significant tax savings in the first year of an assets life. In the case of assets which are financed with loans, you should be aware that in later years you will still be making the loan payment, but will not have the deduction for the amount you are paying on the principal of the loan. You will be able to write off the interest. There are also several bonus depreciation rules in effect which have been changing on a regular basis, so these are things you should discuss with your tax professional prior to making a purchase, so you can be advised regarding current rules and limits. There are special rules for vehicles, livestock and farm property, so be sure to talk to your tax preparer about purchases of these items.

You need to also be aware that you should be making quarterly estimated income tax payments based on the income of the business. Since you are not an employee (unless paid by a corporation you own), you are not having taxes withheld. You may not be used to this. Often times people put aside in a savings account an amount equal to some percentage of their income as they go to cover these taxes. This may be a good idea for you, but as your income will vary, so will the amount needed for taxes. You should discuss the proper amount with your tax preparer. These deposits are due on April 15, June 15, September 15, and January 15 each year.

Is it a Business or a Hobby?

According to the IRS, taxpayers can generally deduct the ordinary and necessary expenses of conducting a trade or business. An ordinary expense is an expense that is a common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. An activity qualifies as a business if it is carried on with the reasonable expectation of making a profit.

The IRS has come up with a rule of thumb that an activity is carried out for profit if it makes a profit during at least three of the last five tax years, including the current year. For activities involving breeding, showing, training, or racing horses it is as least two of the last seven years. While this is a rule of thumb, the facts and circumstances of each individual situation will be very important. It is quite possible to be in business to make money and lose it for a considerable number of years, but if you do not make any money for five straight years (7 for horse activities), you had better be prepared to justify and prove the profit making motive.

To help decide if your activity is a hobby or a business you should ask yourself the following questions. The answers will most likely help lead you one direction or the other.

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the startup phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?
- Does the taxpayer look like a business? Do you have a website? Do you advertise and promote your business in similar ways that other businesses involved in the activity do?

There are some very different ways you are required to report income and expenses if your business activity turns out to be a hobby instead of a business. If it is determined that your activity is a hobby you cannot deduct expenses against income to determine a net income from the business, you must recognize all the revenue as income from the activity. Then you can deduct only an amount up to the amount of the revenue. The activity cannot create a loss to be written off against other income. Then those deductions up to income can only be taken on Schedule A of the 1040 as miscellaneous itemized deductions. There are further restrictions regarding certain types of deductions and the order in which certain deductions can be taken.

In effect the benefit to the taxpayer of the deductions related to their hobby is limited, so you want to be sure your business activity is truly a business activity and you are in it to make a profit.

About the Author

John Gallo, CPA, has an accounting and income tax preparation practice just north of Denver, Colorado handling a wide range of issues for clients. He works very closely with some of his larger clients serving both as an out of house and an in house Chief Financial Officer. He consults on process improvement for organizations – sometimes known as lean manufacturing or lean production – improving the efficiency and profitability of organizations in small steps. He assists individuals and small businesses with their financial and tax planning, both long term and short term. He teaches seminars and trains individuals in entrepreneurship and a variety of tax and business related subjects. He has run an accounting business for over 30 years as well as run a guide service, a photography business, a real estate investment business, a seminar and workshop business and assisted numerous other businesses in getting started. In the past he has taught skiing, avalanche awareness, climbing, mountain travel and taught instructors to teach those courses along with organizing programs for outdoor activities. He has written a number of operation plans, business plans, employee manuals, and procedure manuals. He has also written an avalanche field study handbook, several outdoor activity and equipment training guides, a backpacking guidebook, a family cookbook, and a book on preparation of 1099 forms and using independent contractors for businesses. He is currently writing a book providing financial advice and general life lessons for young people. You may contact him at john@johngallocpa.com.