

Starting A Business - Accounting Basics

Identification Numbers

You need to have a taxpayer identification number so that your tax returns can be processed. The two most common identification numbers are the social security number (SSN) and the employer identification number (EIN).

- The Social Security Administration issues an SSN. It is issued to individuals. It follows this format: 999-99-9999.
- The IRS issues an EIN to individuals (sole proprietors), partnerships, corporations, LLCs, and other entities. It follows this format: 99-9999999.

You need to include your ID number (SSN or EIN) on all returns that you send to the IRS and your state treasury department. You also need to furnish it to others who use your number that they send to the IRS. If you do not furnish a number to these users, you are subject to penalties.

You **MUST** have an EIN if you:

1. Have employees.
2. Have a qualified retirement plan.
3. Operate your business as a corporation or a partnership.
4. File returns for excise taxes or employment taxes.

You can get an EIN by using any of the following means:

1. On line at www.irs.gov/businesses/small
2. Phone 1-800-829-4933
3. File form SS-9

If you need it fast use the on line or phone methods, as the EIN is issued immediately. It takes 4-5 weeks by mail. You need to have your EIN by the time you need to file a return

Identification Numbers for Payees

You must get a SSN for each and every employee you have. If they do not have one, advise them to apply for one using form SS-5.

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You may need to report payments you make to non-employees. You need to get their SSN or EIN. If you can't get it from them, then file form W-9 and the IRS will get it for you.

Tax Year

You must calculate your taxable income and file an income tax return based on a 12-month period. There are two kinds of tax years:

1. Calendar tax year – From January 1 to December 31.
2. Fiscal tax year – a year that begins and ends on any dates other than a calendar year. For example, April 1 to March 31.

If you ever want to change your tax year the IRS needs to approve the change. File form 1128 to ask for approval.

Unless there is a compelling reason to use a fiscal calendar, it may be easier for you to just use a calendar year as your tax year.

Accounting Method

An accounting method refers to a set of rules used to determine how income and expenses are reported. You have to choose a method for your business, and there are two choices:

1. Cash Method – report income in the year received.
2. Accrual Method – report income in the year you earn it.

Note that if your business holds inventory for sale, you are forced to use the accrual method. (There are some exceptions, but not many.)

If you operate more than one business, one can use Cash and the other Accrual. Each one stands alone.

Once you decide which method to use, the IRS will have to approve a change in method.

Business Taxes

Income Tax – Unless it is a partnership, your business will have to file an annual tax return. Partnerships file an information return.

Income tax is a pay as you go system. You do this by making estimated tax payments throughout the year. Estimated taxes are due if you think you will owe at least \$1,000 at year-end. Form 1040-ES is available to figure and pay your tax.

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If your business is a corporation then it has to pay estimated tax if you expect it to owe \$500 or more at year-end. The form for corporations is the 1120-W.

Self-Employment Tax – This tax covers social security and Medicare taxes for those who are self employed.

You are liable for this tax if your self-employment earnings were \$400 or more.

You use Schedule SE to figure this tax.

Employment Taxes – Included in this category are: Social Security, Medicare, federal income taxes withheld from employees, federal unemployment (FUTA) tax.

If you have employees you should get a copy of Publication 15, Circular E and read it.

You report these taxes on form 941, which is a quarterly report. A farmer would use form 943.

FUTA is reported on form 940. There is also a simpler version, 940-EZ, if you qualify.

Hiring Employees – Have the employee complete two forms, a W-4 and an I-9.

The W-4 gives the employee's filing status and withholding allowances so you can calculate your payroll correctly.

The I-9 verifies that the employee is legally eligible to work in the United States.

One more form is the W-5. This one is for employees who have a qualifying child and are entitled to receive earned income credit in advance.

At the end of the calendar year you need to furnish employees with a W-2. You must send the Social Security Administration a copy of each one.

Excise Taxes – You may have to pay excise tax. It depends primarily on the type of business you have and what products you sell.

The main form involved is form 720. This is the quarterly excise tax return. It includes several categories of tax including – environmental taxes, communications taxes, air transportation taxes, fuel taxes, sales of heavy trucks, trailers, and tractors, and manufacturing taxes on certain products.

Sellers of heavy vehicles must use form 2290. Businesses in the gaming business must use form 730.

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Depositing Taxes – You need to deposit employment, excise, and corporate taxes before you file your return. Most filers use the Electronic Federal Tax Payment System (EFTPS) to do this. If you don't use that system then you can make deposits, together with a deposit coupon (form 8109), at a bank. You can get a coupon book by calling 1-800-829-4933.

Information Returns – Almost every business makes or receives payments, so almost every business needs to file an information return of some kind.

- Form 1099-MISC – Use this for payments of \$600 or more for services performed for your business. For example, independent contractors, attorneys, and CPAs. Also use if for rent payments of \$600 or more.
- Form W-2 – Use this to report payments made to employees.
- Form 8300 – If you received more than \$10,000 in a single transaction, you must file this form.

Penalties – There are many penalties to watch out for, including:

- Failure to file a tax return by the due date.
- Failure to pay taxes on time.
- Failure to withhold or deposit taxes.
- Failure to comply with information return requirements.
- Failure to provide a taxpayer identification number.

Business Expenses

To be deductible for tax purposes, a business expense has to meet two tests: it must be ordinary, and it must be necessary.

- Ordinary – one that is common and accepted in your business, trade, or profession.
- Necessary – one that is appropriate for you business, trade or profession.

Business start-up costs are costs that you incur before you actually begin operating your business. These costs are typically amortized over a period of time.

Most businesses have to buy certain assets that have useful lives longer than one year. In these cases you have to spread the cost of this equipment over a period of more than one year. This is called depreciation.

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If you use part of your home for your business you may be able to deduct expenses related to that use. But you have to be able to meet certain requirements, as follows:

- The use must be exclusive (meaning the use cannot be a mix of business and personal), regular and for your business, and
- The business part of your home must be your principal place of business. You use it for administrative and management activities. You have no other fixed location where you conduct these activities.

If your business is a day care facility though, then you do not need to meet the exclusive test.

Vehicle expenses can be deducted using either actual costs or using a standard cost per mile driven. Actuals include depreciation or lease payments, gas, insurance, repairs, and similar.

If your vehicle is used for both business and personal purposes then the expenses must be divided accordingly based on miles driven.

Keeping Records

Good record keeping is essential for any business. As the owner of the business you need accurate information on how your business is doing. Useable financial statements depend on sound record keeping.

Good records are also critical for preparing a tax return and being able support the information on those returns.

There is nothing in the law that tells you what kind of record keeping you should have. But there are a few fundamentals that you should adhere to.

1. You should keep your personal transactions and business transactions separate. Definitely open a business checking account and consider getting a different credit card for business spending.
2. Keep your business checking account reconciled with your bank statement, or pay someone to do it for you. The bank statement, your checkbook, and your accounting books all need to agree. Common reconciling items are:
 - 2.1. Bank charges that appear on the bank statement but not in your checkbook or accounting books.
 - 2.2. Deposits made and checks written after the bank statement cutoff date will not appear on that statement, but will be in your checkbook and accounting books.

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3. If you have more than one business, keep a different set of records for each one.
4. You need to keep supporting documentation for your transactions. Examples include invoices, deposit slips, credit card slips, receipts, 1099's, and canceled checks. There is no one best way to maintain this documentation, but one common practice is keeping them in an expanding file folder available from any office supply store. Keep them organized by year, at a minimum.
5. Any spending you have for travel, transportation, meals and entertainment require particular attention to record keeping.
6. You need to keep records about the assets you use in your business – when and how you acquired the asset, how much you paid for it, depreciation deductions you have taken on it, and the selling price if you sell the asset are all good examples.
7. You need some way of summarizing all that supporting documentation. The way you do that is to have an accounting system. This can be manual or computer based, and you can do it yourself or hire a firm to do it for you. This is generally called 'keeping the books'.
8. A journal is a book where you record the transaction per your supporting documentation. You normally have several journals – one for cash receipts, one for cash disbursements, one that is a general journal, etc. A ledger is another book that pulls information from all your journals. A 'Chart of Accounts' is a listing of all your account numbers, and a ledger is organized according to account number.
9. There are five types of accounts – asset, liability, equity, revenue, and expense. The first three types are permanent accounts, you never close these out. Together they form your balance sheet. Assets minus liabilities always must equal equity (hence the term 'balance' sheet).
10. Revenue and expense accounts are closed out every year. Revenues and expenses are used on your income statement. Revenue minus expense equals income, and each year's income adds to your equity.
11. What are debits and credits? Each account has a left side and right side. The left is for debits and the right is for credits. An accounting system is self-balancing because every transaction has a debit in one (or more than one) account and a credit of the same amount in one (or more than one) other account. This is known as the double entry system and dates back centuries to the time of the Venetian traders. Here is one example – you pay your business phone bill of \$100. You would debit your telephone expense \$100 and credit your cash \$100.

How Long Do You Need To Retain Your Records

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You need to keep them at least as long as the statute of limitations for tax returns. The statute of limitations is summarized here:

1. The general statute of limitations for most cases is 3 years.
2. However:
 - 2.1. If you file a fraudulent return – no limit.
 - 2.2. If you fail to file a return – no limit.
 - 2.3. If you fail to report income that should have been reported – 6 years.
3. Keep all employment tax records for 4 years.
4. Keep asset records until the statute of limitations runs out for the tax year you disposed of it.
5. Insurance companies may have a requirement for record retention that exceeds the IRS statutes so check that before you start discarding records.