

By Larry Kopsa

Break Time

How you handle tax time can make a big difference in how much you owe.

OPERATING A BUSINESS WITHOUT BEING TAX SAVVY is like skydiving without a parachute; when you hit the ground, there's no getting up. In fact, "blissful ignorance" and lack of planning for taxes are major factors in spa failures. Consider this: Most spas are in a 20% to 30% income tax bracket, but depending on profits, type of business and other factors, a spa's tax bracket can go up to almost 50%. In other words, the government is like a big silent partner who comes around at year-end to claim his share of your profit. Think about it: For every day you put in 8 hours working, 2 hours and 32 minutes of your toil goes to the government.

If you're like most people, after April 15 you probably won't think about taxes again until next year, but as a business owner, the enormous cost of taxes makes it imperative for you to commit to thinking about your taxes year-round. If you aren't motivated enough already, consider this thought: Through knowledge and good record keeping you could reduce your income tax bill by \$1,000. For example, let's assume that your "marginal" tax bracket is 33%. This means at your current income level, any additional income or deduction will

cost you—or save you—33% in taxes, and to keep \$1,000 in your pocket after taxes you'll need to make \$1,500. How much revenue will you need to put \$1,500 in your pocket? If you're like most spa owners, every time you ring up \$100, \$60 of that is going to technicians, suppliers, the credit card company, back bar and other variable costs. Assuming that your fixed costs such as rent and utilities don't change, you'll have to ring up \$3,750 to put that additional \$1,000 in your pocket. If your average ticket is \$75, that's 50 clients.

Knowledge Is Power

As the old saying goes, "Knowledge is power"—especially when it's knowledge of how taxes work in your particular situation. You might be tempted to defer to your accountant, but hiring someone to simply prepare your tax return isn't enough; a good tax professional should be as much your teacher as your accountant. These people will pay for themselves many times over by helping to guarantee that you're minimizing your tax bill, so choose wisely. As Senator Charles Grassley (R-IA), the lead tax writer for the U.S. Senate, said recently, "Something's wrong when you have to have a license to cut hair, but anyone can hang out a shingle and call themselves a tax professional."

To ensure that you're getting the best service, work with a certified public accounting (CPA) firm. Stringent educational standards and entry requirements should provide some comfort that CPAs are up to date on tax laws. Additionally, any CPA who is found to have intentionally cheated on a tax return is subject to stiff fines and the loss of his or her license. To find a CPA, look to your state's society of certified public accountants. Many states list accountants along with their areas of specialty.

There are also numerous books full of information on taxes. Many such references are quite similar, but always purchase the



newest edition of whichever you choose because tax laws are constantly changing. In addition, the Internal Revenue Service (IRS) website (irs.gov) answers many questions about small businesses, and there are also several reputable blogs available.

Understanding what's deductible is also important. Tax law recognizes that a business must spend money to make money, and according to our tax codes, just about any expenditure to produce business income is deductible. That sounds simple, but the tax code lays down about a million rules for exactly how and when you can and can't take a deduction. (See "The Power of Deduction," below.)

According to the Internal Revenue Code, a deductible business expense must be ordinary and

necessary for the business, not extravagant and not for personal use. The tax law doesn't define "ordinary and necessary," so taken literally, this means any reasonable business expenditure is deductible. Since there's no established list of reasonable expenses, you and your accountant must determine if an expense meets the criteria.

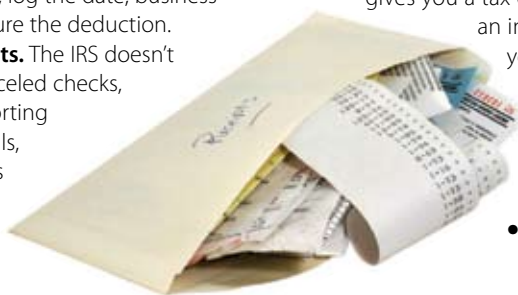
The Right Documentation

Americans who overpay their taxes tend to do so because they're afraid of the IRS, which is understandable. The IRS considers us guilty until we prove our innocence, and as anyone who has been through an audit will tell you, documentation is the key to keeping the IRS

The Power of Deduction

Don't miss these legitimate tax deductions:

- **Mileage.** In 2007, the rate of mileage is 48.5 cents per mile (it was 44.5 cents in 2006). Before getting in the car, make it a habit to think about the purpose of your trip and document your mileage when appropriate.
- **Equipment purchases.** Normally, you must depreciate the purchase of equipment by deducting a small portion of its cost over a few years (normally five to seven years). But Section 179 of the tax code (commonly known as first-year expensing) allows you to "elect" to write off the entire amount of the equipment in the year of purchase. The maximum amount that you can write off in one year is \$112,000 in 2007 (\$107,000 in 2006) and if you missed the depreciation election, you may amend any of the last three years' tax returns.
- **Meals and entertainment.** Meals and entertainment are deductible if you pick up the tab for a client, customer or other business associate with the purpose of benefiting your business. You should discuss business before, during or after the meal or event. As with mileage, log the date, business purpose and amount spent to ensure the deduction.
- **Documentation for small amounts.** The IRS doesn't require that you keep receipts, canceled checks, credit card slips or any other supporting documents for entertainment, meals, gifts or travel expenses totaling less than \$75; however, you still must document the date, amount, place, purpose and business relationship.
- **Magazines and newspapers.** It's fairly obvious that the cost of magazines and newspapers kept in your spa are deductible, but did you know that the publications you receive at home and utilize for business purposes are also deductible? Many publications contain business information and fashion trends, which makes them an ordinary business expense.
- **Obsolete inventory.** Every business accumulates an inventory of unsold retail goods. To take a deduction when reducing inventory, the IRS requires that you discard or destroy these items. It's better to get rid of the obsolete items and take a tax deduction than to clutter up your storage space.
- **Home office.** Many spa owners have an office in their homes, which may allow them to deduct a portion of the cost of their homes as a business expense. Although the rules are fairly stringent, many people qualify but miss taking this deduction.
- **Clothing.** Simply put, the cost of purchasing clothing you'd normally wear on the street isn't deductible, but uniforms and garments displaying your company logo are. Additionally, costs for cleaning and repairing clothing damaged on the job site are ordinary and necessary business deductions. The fair market value of the used clothing is deductible.
- **Employed children.** A minor can make up to \$5,350 without paying income taxes, so hiring your child to work at your spa gives you a tax deduction and provides your child with an income tax-free paycheck. If you employ your child, make sure to keep good records to show that the amount paid to the child is reasonable. (Tip: If you have an office in your home, payments made to the child for cleaning that home office are deductible.)
- **Cash donations.** Starting in 2007, you can't deduct any cash contributions unless you have a receipt.
- **Credit card interest.** On credit cards used for both business and nonbusiness expenses, you're allowed a deduction for the credit card interest on your business expenses, but it will be difficult to prove which expenses qualify as business-related. To solve this problem, maintain separate business and personal credit cards.



Tax Trivia

It's common knowledge that the tax code is complex, but these facts may surprise you.

- The IRS estimates that the average taxpayer spends 37.8 hours preparing a return. Double that number if you own a business.
- There are 66,498 pages in the tax code, up from 19,500 in 1969.
- In 2006 Congress passed four major tax laws, each impacting all taxpayers in some way.
- The last of the 2006 laws was passed in December, after the tax forms were printed, so the changes aren't reflected on the forms or the instructions.
- H&R Block, the world's largest tax preparation company, just paid the IRS \$32 million for errors that they made.
- How would you like to be General Electric? Its tax return contained a whopping 24,000 pages.
- Albert Einstein once said, "The hardest thing in the world to understand is the income tax."

from challenging your deductions. Without supporting material an IRS auditor can legally disallow any deduction, so a good set of books with receipts, invoices, canceled checks and handwritten journals is critical. Time spent record keeping can save you some of your hard-earned money.

Remember, you'll never get a deduction that you don't take, so when in doubt, take an ambiguous deduction as long as you have a legal justification. If the IRS happens to audit you and the auditor wants to argue it, deal with the ambiguity then. Given the opportunity that the tax code provides, and the fact that spa people are generally creative types, you should have the tools to keep taxes to a minimum. ●

Larry Kopsa is a partner in Kopsa Otte & Associates (koacpa.com), a NE-based CPA firm.