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# How Do I Prepare my Business for Tax Season?

**A useful guide to help you analyze your past tax returns to see opportunities for you to save more money this year.**

Many people feel dread at the mere mention of the word *taxes*. For most individuals, looking back at financial records and trying to understand what amounts fall under the categories you need to report on is not how they want to spend their spare time.

You might feel anxious about starting the tax preparation process, or perhaps you feel worried about the possibility of receiving a large tax bill for the year. These feelings are valid and shared by many. While acknowledging those feelings, you can reframe how you think of tax season as an opportunity for you to save money and head off future business risks.

Taking time to prepare for filing your taxes is very important. This guide will walk you through how to analyze your past tax returns to see opportunities for you to save more money this year. You will also receive links to resources which will help you prepare for your annual tax filing.

This guide will be most useful to **family child care** and **small center providers** who typically file as a sole proprietorship under Schedule C. That being the case, this guide contains useful information for child care businesses of all sizes.

## How do taxes really work?

The government allows certain business-related expenses to be removed from the amount of money that the government considers as your taxable revenue. So, think of proper tax preparation as the way for you to make sure you are not paying the government more than your fair share in taxes.

If you dedicate time and effort to properly documenting eligible business expenses, you can reduce the amount of money you pay in taxes. This preparation process requires thinking back on your expenses throughout the year and getting organized with your receipts and paid invoices.

The eligible expenses that you can use to reduce your taxable income are referred to as *deductions*. Making a list of your eligible expenses and sorting them into categories is referred to as *itemizing deductions*. Your list of deductions shows the government all the expenses you have paid as a small business owner.

When you itemize your eligible expenses, you subtract these expenses from your revenue to obtain a new amount which is your taxable revenue (net profit). This overall process is referred to as *claiming deductions*.

The greater the sum of your deductions, the less your net profit that's subject to tax. The bottom line is thoroughly itemizing your deductions in accordance with federal guidelines will help you to retain hard-earned dollars.

As you can see in the table below, the total of your deductions reduces how much of your profit is subject to tax. If you earned a net profit of $35,000 in 2021, the government will consider your taxable revenue to be $35,000 *unless* you itemize and claim deductions. If you find that you spent $5,000 in expenses which are eligible to claim as deductions, the government will consider your taxable revenue to be $5,000 *less*. In this example, a $5,000 deduction allows for your taxable revenue to be $5,000 less than your total revenues of $35,000; as a result, your taxable revenue amount becomes $30,000.

| Revenues | Deductions Claimed | Net Profit Subject to Tax (Taxable Revenue) | Taxes Owed (Tax Liability) |
|---|---|---|---|
| $35,000 | $0 | $35,000 | More |
| $35,000 | $5,000 | $30,000 | Less |

If you are a self-employed small business owner, you will pay a 15.3% self-employment tax on your business's net earnings *after* all eligible expenses have been taken out of your revenue (gross profit). However, the amount that you will be taxed on is completely dependent on how much you claim as deductions.

It is important to be truthful in reporting your deductions. Trying to fudge your figures to get out of paying more money in taxes can end up being much more costly in the long run. Dishonestly inflating your deductions increases your chances of being selected for audits by the IRS. We will discuss mitigating some risks of a tax audit later in this guide.

## Maximize Your Eligible Deductions

In a review of 60 tax returns filed by child care providers like yourself we found that many providers were paying taxes on money that legally does not need to be taxed. Of the review performed, four in five home-based child care providers did not deduct the business use of their home from their taxes. Common child care business deductions were often included in the incorrect category or there were calculation errors, which increases the chances of being selected by the IRS for a tax audit. Lastly, some providers did not even claim business-related expenses on their taxes.

Child care providers have many opportunities to deduct business-related expenses to reduce their tax costs. Take care not to miss these opportunities to save money!

## When preparing your taxes, be sure to claim the following commonly missed deductions:

**Business use of home:** Home-based child care providers should claim the business use of their home on their taxes. To determine what percentage of your home is for business use, you can find the percentage of time and space that your home is used for business purposes using a time-space calculation. This percentage can then be applied to expenses associated with your home including rent, mortgage, property taxes, utilities, and homeowners/renters' insurance.

**Insurance:** Business-related insurance costs, such as liability insurance, can be claimed on your taxes. Be sure not to include personal or health insurance costs.

**Mortgage interest:** For non-home-based providers, mortgage interest for a business property you own can be claimed as a deduction. For home-based providers, total mortgage payments (which includes mortgage interest) is already included in your business use of home calculation and deduction.

**Supplies:** Be sure to include expenses for any items you use with or for the children, such as classroom supplies, learning materials, diapers, toys, and food for snacks and meals you serve.

**Wages:** Annual salaries and wages for W-2 employees and yourself (if you pay yourself through payroll) can be deducted on your taxes. However, you will need to subtract any tax credits that you received for employee wages (such as the Employee Retention Tax Credit) from total wages. Also be sure that you are only claiming W-2 employees' wages; wages paid to 1099 contractors cannot be claimed. Please stay tuned for more resources on paying yourself as a sole proprietor and how to distinguish whether your staff should be classified as a contractor or an employee of the business.

## Check the accuracy of your revenue reporting and deduction methods.

Small businesses' tax returns receive more scrutiny from the IRS than ever before[1]. Often, businesses are selected for audit because one element of their tax forms falls outside of a designated criteria set by the IRS, which triggers an automatic flag. One example of this could be not reporting or misclassifying income received. With app-based payments such as Venmo and Zelle, being a common method for what otherwise would be cash-based payments, it's important to not miss those when reporting your income. The IRS receives a copy of the amount the vendor has paid out to you and your business will receive a 1099-K and must report that income.

Another common circumstance which can trigger an audit risk is when a deduction line appears to be misused. To reduce the chances that you will be selected for IRS auditing, a time-consuming and sometimes costly process, ensure you accurately calculate your deductions and add them to the correct line.

## We have found that the following deductions are frequently misused, so pay close attention to these as you itemize your own deductions.

**Cost of goods sold:** Child care businesses can very rarely use this line as it usually applies to retail and manufacturing businesses. This line refers to inventory that a business has on hand that they were unable to sell or get rid of it. Using this line could trigger an IRS audit alert because this is not applicable to your business field.

**Deductible meals:** This line is intended for business-related meals, such as business dinners. For the average child care provider, the deductible meals line will not be a

[1] https://www.bloomberg.com/news/articles/2020-11-17/irs-plans-a-50-ramp-up-in-audits-of-small-businesses-next-year

sizable sum. Following an evaluation of child care providers' tax returns, we hypothesize that providers might be using the deductible meals line for the costs of food served to children; in which that expense would fall under the Supplies line. When a child care program reports a high dollar amount in the deductible meals line, it appears as if you are trying to deduct all your personal meals as a business expense.

**Business vehicle use:** Car, van, and truck expenses are a great deduction, as long as you are only claiming the amounts used for business purposes. Make sure that you are following IRS guidelines for these expenses.

## Reviewing last year's tax returns

You can easily assess your taxes by using the *Confidence in Quality Tax Prep Rubric©* for Child Care Providers and following the below three simple steps. This rubric is set up to align with Form 1040, Schedule C, which is the tax form that child care providers most commonly use.

1. Retrieve your tax return from last year and look to Schedule C (profit and loss from a business) in your 1040 return.
2. Use the guidance in the rubric in Attachment A to assess your use of each line.
3. Note the areas where you can change your methods for this year and share with your tax preparer.

As you are reviewing last year's tax return, don't worry if you believe you missed a deduction or see a way to head off a potential audit as you can revise your taxes for up to three years after they are submitted. First, congratulate yourself for applying your new knowledge and taking the initiative to keep your business in top financial shape. Then, reach out to your tax preparer or use your online software to make appropriate changes.

## Preparing this year's taxes

Now that you understand how you can effectively report your revenue and deductions for your taxes, you need to collect your numbers for this year and find the best preparer you can. Whether you choose to prepare your taxes yourself or use a qualified professional, be sure to refer to the *Confidence in Quality Tax Prep Rubric©* to make sure you are maximizing your deductions and minimizing your risks.

We recommend using this tax prep guide from Home Grown Child Care. The guide is designed for family child care providers, but will work with almost any provider who reports their business taxes on a Schedule C. Take care to fully fill out the rubric so that you capture all your deductions.

**Note:** The review of your tax situation using the information contained within this guide is not a substitute for carefully selecting a qualified tax preparer and should not be used in place of legal or accounting advice when needed.

## Need More Assistance?

For more assistance on improving your business management practices to ensure financial success and stability, contact SWHD Early Childhood Business Solutions at (602) 265-4768 or ECBS@swhd.org.

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