

The Tax Gap

The Internal Revenue Service developed the concept of the tax gap as a way to gauge taxpayers' compliance with their federal tax obligations. The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time.

The tax gap can be divided into three components: non-filing, underreporting and underpayment. Non-filing occurs when taxpayers who are required to file a return do not do so on time. Underreporting of tax occurs when taxpayers either understate their income or overstate their deductions, exemptions and credits on timely filed returns. Underpayment occurs when taxpayers file their return but fail to remit the amount due by the payment due date.

Slightly more than 6 percent of individual taxpayers filed Schedule C as sole proprietors in 2001. These taxpayers reflect a wide range of economic activity. To draw valid conclusions on Schedule C filers, the NRP examined about 21,000 individuals who filed a Schedule C, slightly less than 46 percent of the total sample.

Among the areas where taxpayer compliance appears to have worsened are:

Reporting of net income from flow-through entities, such as partnerships and S corporations.

Reporting of proprietor income and expenses, such as gross receipts, bad debts and vehicle expenses.

Reporting of various types of deductions.

Business Income, Gross Receipts or Sales

If there is a connection between any income received and a business, the in-

come is business income. A connection exists if it is clear that the payment of income would not have been made if the business did not exist and operate.

Small business owners and self-employed taxpayers must report on their tax returns all income received from their businesses unless specifically excluded by law. In most cases, business income will be in the form of cash, checks and credit card charges.

But business income can be in other forms, such as property or services. The following list includes some examples of other forms of income, such as:

- Bartering
- Real estate rents
- Personal property rents
- Interest and dividend income
- Canceled debt
- Promissory notes
- Lost income payments
- Damages
- Economic injury payments
- Kickbacks

All income earned is taxable. Directing payment of income to a third party does not remove the reporting and payment requirements for small businesses and self-employed taxpayers.

Cost of Goods Sold

Some businesses may make or buy goods to sell. If so, these businesses may deduct the cost of goods sold (COGS) from their gross receipts. To determine these costs, the value of inventory at the beginning and end of the year must be calculated.

There are several factors that go into determining COGS including:

Inventory at the beginning of the year

Purchases less cost of items withdrawn for personal use

Labor costs (generally applies to manufacturing and mining operations)

Materials and supplies (generally a manufacturing cost)

Other costs (generally applies to manufacturing and mining operations)

Inventory at the end of the year

Inventory, net purchases, cost of labor, materials and supplies, and other costs are added together. Inventory at the end of the year is subtracted from this total to determine COGS.

Business Supply Expenses

The tax law allows for the deduction of business supply expenses.

But overstated deductions, adjustments, exemptions and credits account for up to \$30 billion per year in unpaid taxes, according to IRS estimates.

This fact sheet, the seventh in a series, helps taxpayers understand the rules pertaining to business supply expense deductions.

In general, the cost of materials and supplies used in the course of a trade or business may be deducted as a business expense in the tax year they are used. In addition, the cost of incidental materials and supplies that are kept on hand may be deducted in the tax year of purchase provided that:

No records are maintained indicating when supplies are actually used,

No inventory is taken of the amount of supplies on hand at the beginning and end of the year, and

This method does not distort income.

Taxpayers should be careful to avoid deducting expenses as supplies when they are capital assets. For example, if the

Motivational Quote

"Faith is like a standby generator:
it gives you strength when everything fails"

2007 by Jermaine Reynolds, Jamaican

Tax Calendar for Nov

Nov 15 – Monthly Payroll Taxes Due

Nov 20 – Monthly Sales Tax Due

Reminder— Now is the time for making those year-end spending decisions.

If you have been contemplating buy new equipment or adding capital access. These need to be done before the end of the year. If you are not sure about the tax implications of buying and selling assets, call us we will be happy to help understand your situation and provide you with the best advice we can.

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useful life of an item is significantly greater than one year it must be depreciated.

Supplies used directly or indirectly in manufacturing goods are part of the cost of goods sold.

As with all items on the tax return, taxpayers should keep complete records to substantiate deductions for supply expenses. Since many types of supplies can have personal-use applications, demonstrating business use is particularly important.

Deducting "Other" Business Expenses

The Internal Revenue Service has issued a number of educational fact sheets reminding taxpayers to know the rules for deducting several specific business expenses. This fact sheet, the tenth in the series, reminds taxpayers to follow appropriate guidelines when deducting expenses that fall under the category of "Other" on the Schedule C, Profit or Loss from Business.

"Other" business expenses account for just part of the overstated adjustments,

deductions, exemptions and credits that add up to \$30 billion per year in unpaid taxes, according to IRS estimates.

In general, taxpayers may deduct ordinary and necessary expenses incurred in conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. Although many common expenses are deducted on designated lines of the tax schedule, some expenses may not fit into a particular category. Taxpayers can deduct these as "other" expenses. A breakdown of "other" expenses must be listed on line 48 of Form 1040 Schedule C. The total is then entered on line 27.

Examples of "other" expenses include:

Amortization of certain costs, such as pollution-control facilities, research and experimentation, and intangibles including goodwill.

Bad debts. Business bad debts must be directly related to sales or services provided by the business, must have been previously included in income and must be worthless (non-recoverable). If a taxpayer deducts a bad debt expense and later recovers it, the amount must be

included in income in the year collected.

Business start-up costs. These are costs related to creating an active trade or business, or investigating the creation or acquisition of an active trade or business. Generally these costs are amortized. However, taxpayers who started a business in 2006 may elect to deduct up to \$5,000 of certain start up costs, subject to limitations. Refer to chapter 7 of Publication 535, Business Expenses, for more information.

Gulf Opportunity (GO) Zone clean-up costs. Fifty percent of qualified clean-up costs for the removal of debris from, or the demolition of structures on, real property located in the GO Zone which are paid or incurred in 2006 are deductible as "other" expenses. The property must be held for use in a trade or business, for the production of income, or as inventory.

Personal, living and family expenses, do not qualify as deductible "other" business expenses.