

Cosmetology

Learning The Art of Doing Business



*Federal Taxation Curriculum
for Cosmetology Students*

Developed by the Internal Revenue Service

Small Business/Self-Employed Division Taxpayer Education & Communication

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Learning the Art of Doing Business

Introduction

"Learning the Art of Doing Business" is a federal tax curriculum for students pursuing a career in the Cosmetology Industry. This diverse industry covers a multitude of occupations including barbers, hair stylists, manicurists, massage therapists, estheticians, and more.

Taxpayer Education and Communication in the Small Business/Self-Employed Division of the Internal Revenue Service (IRS) developed this curriculum.

It is the intent of the Internal Revenue Service to reduce taxpayer burden by providing this text to you, students engaged in the Cosmetology Industry, to have you enter your chosen field with a better understanding of the tax laws and guidelines that govern federal income and employment taxes.

The curriculum will give you an overview of the federal income and employment tax laws as they pertain to you. It is not all-inclusive. You may have other income sources and/or expenses not discussed. For additional information visit the IRS Website at www.irs.gov or consult a tax professional of your choice.

In addition to your federal tax responsibilities, there are various state and local requirements that you need to be aware of such as state income tax, city income tax, and city business licensing procedures. These items are not covered in this material; therefore, we encourage you to contact the appropriate state and local agencies to learn more about their requirements.

What benefits do I receive when I file a correct tax return?

CHAPTER 1

"Filing a correct tax return will provide you with greater benefits today, as well as, tomorrow"

Reporting all of your income and paying the appropriate amount of tax may be confusing. You may wonder why you should comply with the law. This chapter helps to put into perspective the positive side of tax compliance.



How does filing a correct tax return increase my chances of getting a loan?

When you apply for a loan to purchase business equipment, a car, a house, or your own business, the financial institution will review your current and prior years federal income tax returns to determine your loan suitability. The amount of money you can borrow will be based (in part) on the earnings/income you have reported.

By accurately reporting all income received, including tips, your financial picture is clearer, and you will be more apt to receive the amount of loan proceeds you desire.

Example:

Landy wanted to buy new stylist chairs. She did not have the funds to purchase the equipment so she went to the bank and applied for a loan. Landy submitted her prior and current year tax returns. Landy was denied a loan because the bank determined that she did not have adequate income. Landy reviewed her income tax returns and realized that she had not included her tip income in her gross receipts on her Schedule C. Based on the additional income reported, Landy was then able to qualify for the loan.

How does filing a correct tax return affect my Social Security benefits?

The benefits you receive from Social Security are calculated on the total combined earnings that have been recorded under your Social Security Number (SSN).

Correctly reporting all of your income, including tips, will determine how much Social Security is paid into your account.

Social Security is not only for retirement purposes. The benefits also cover individuals who are injured or become disabled. If something happens to you, your spouse and your children can receive benefits based on your reported earnings.

If you are an employee, based upon the amount of wages earned and tips reported, your employer provides matching funds for Social Security and Medicare Taxes.

If you are a self-employed person, you are responsible for reporting and paying self-employment tax (which is your Social Security and Medicare Taxes) by completing Schedule SE.

How does filing a correct tax return affect my unemployment compensation?

If you become unemployed, benefits are paid to you based on the wages and tips you have reported. Unemployment compensation is available for employees only. As an employee, your employer makes payments to an unemployment fund.

Note: The laws governing unemployment benefits vary by jurisdiction. For more information, contact the appropriate agency in your state that handles unemployment compensation.

How does filing a correct tax return affect my workers' compensation benefits?

If you are an employee and are injured on the job, you are entitled to collect workers' compensation. Workers' compensation is based on wages and tips reported. Workers' compensation is not a federal program. As of 2002 all states, except Texas, mandate that employers carry workers' compensation insurance. This is an employer paid private insurance.

What other benefits might I receive by filing a correct tax return?

Filing a correct tax return and claiming all the ordinary and necessary business expenses that you are entitled to may reduce the amount of tax you owe and will provide greater working capital for you to use in your business.

Your employer may offer other benefits based on your wages and reported tips; such as life insurance, disability insurance, 401K retirement plans, and the right to purchase stock options. You will need to check with your employer about these benefits.

Filing a correct tax return will provide you with peace of mind. If you are selected for an audit, you will feel confident that your tax return was accurately prepared.

What is my "worker classification"?

Chapter 2

"Workers can be employees, self-employed, or both"

The Cosmetology Industry is unique because it offers you a variety of career and employment opportunities.

What are the different types of worker classifications?

The obligations and responsibilities for each worker category are different. Proper worker classification will enable you to file and pay the correct tax.

The choices are: employee, salon owner, booth renter, and independent contractor.

- Employees receive Form W-2 for wages earned and are responsible for reporting their tips to their employer as well as maintaining records of their non-reimbursed employee business expenses.
- Salon owners are in business for themselves. They are responsible for recording all income and expenses; withholding employment taxes if they have employees, and paying all taxes due.
- Booth renters, who are not employees of the salon, are self-employed. They are responsible for record keeping and the timely filing of returns and payment of taxes related to their business.
- Independent contractors are always self-employed and are responsible for record keeping and timely filing of returns and payment of taxes related to their business.

What determines worker classification?

The courts have considered many facts in determining whether a worker is an employee or self-employed. These relevant facts fall into three main categories: behavioral control; financial control; and relationship or intent of the parties. In each case, it is very important to consider all the facts – no single fact provides the answer.

What is behavioral control?



Behavioral control is having the authority to determine what to do, when to do it, why it needs to be done, and how it will be accomplished.

What is financial control?

Financial control is having the right to direct or control the business part of the work, such as how much to charge customers, how much to spend on business expenses and equipment, and the opportunity to realize a profit or loss.

What is relationship or intent of the parties?

Relationship or intent of the parties illustrates how the business owner and the worker perceive their relationship. Items to consider would be employee benefits and written contracts.

Am I an employee?

An employee is an individual who performs services subject to the will and control of his or her employer, who has the authority to tell him or her what to do and how to do it.

Example:

Sue works at Bill's Nail Emporium. Sue is told to be at work, Monday through Friday, 9:00 am – 5:00 pm. Bill observes the work that Sue does and has the right to provide direction. Sue reports all of her tips to Bill. Sue is Bill's employee and will receive Form W-2 at the end of the year.

Salary, tips, and commissions are the most common forms of payment made to employees in the Cosmetology Industry.

Am I self-employed?

A self-employed person works for himself or herself and is not subject to the "will and control" of another person. A self-employed person may be called a salon owner, a booth renter, or an independent contractor.

Fees, tips, and retail sales are the most common forms of income received by a self-employed person and may include the following categories:

Salon Owner

A salon owner is an individual (not a corporation) who owns and operates a salon. Salon owners may have employees, booth renters, independent contractors, or a combination thereof working in the same establishment.

Salon owners are responsible for classifying workers correctly as employees, booth renters, or independent contractors. It is important that this classification is correct so that workers can determine their personal tax responsibilities.



Example:

Sharon owns "Sharon's Massage and Day Spa". Sharon buys all her own supplies and sets her own work hours and fees. Sharon is self-employed.

Booth Renter

A booth renter is a person who rents or leases space in someone else's salon. The booth renter pays the owner an agreed amount for the use of the booth space. Booth renters set their own business hours and fees for their services. They are financially responsible for profit or loss in their own business and receive all income generated from their work.

Booth renters who are not subject to the direction or control of the salon owner are not employees.

Example 1:

Carol signed a lease with a salon owner that provided booth space and use of shampoo and hair dryer stations. In return for the space, she will pay \$500 on the 10th of each month to the salon owner. The contract does not specify the number of days or times Carol will use the booth. The lease does say that the salon owner would like Carol to use, whenever possible, the products the salon owner markets to customers. Carol establishes her own schedule and collects payments from her customers. Carol is a self-employed booth renter.

Example 2:

Same facts as Example 1 except, the contract specifies that Carol must work four days a week, 9:00 am – 5:00 pm and can only use the products the salon owner markets. Carol does not set her own prices. Carol is a booth renter employee.

Note: The lease agreement by itself does not make the booth renter a self-employed person.

Independent Contractor

Independent contractors may provide their services at several different locations. They are always in control of their hours, the fees they charge, and the products they use. They are self-employed.

**Example:**

Cissy is a manicurist and esthetician that has a business contract with two large salons where she provides her services. In her contracts, she is provided with a workstation for which she pays \$450 per month to each salon. She keeps her own appointment book and sets her own hours of operation at her convenience. She also provides her own tools, nail polish supplies, and makeup. Cissy handles her own monetary receipts from customers and is responsible for filing and paying tax on her income and tips. Cissy does not receive a Form W-2 from the salon because she is an independent contractor (self-employed).

What is income and how do I report it?

Chapter 3

"All money you receive, including tips, must be reported on your income tax return"

The money you receive from your work, whether it is wages, commissions, tips, sales, or rent; whether paid by cash, check, charge or bartering is taxable.

All income is taxable unless specifically excluded by the Internal Revenue Code.

What do I need to know about reporting income?

You must report all your income on your tax return including tips. If you are an employee and receive tips, you must report that amount to your employer. If you are a self-employed salon owner, booth renter, or independent contractor, all income received, including tips, must be reported on your Federal Income Tax Return.

Whether you prepare your own tax return or pay a tax preparer, you need to know the tax law so you can file an accurate tax return.

Internal Revenue Code Section 61 states: "Gross income means all income from whatever source received." In the case of workers in the Cosmetology Industry, taxable income includes such payments as: wages, fees, commissions, retail sales, rent/lease payments, tips, and bartering.

What are some examples of income that I need to report?

Income	Description
<i>Wages</i>	Money paid to you as an employee
<i>Fees</i>	Payments you receive from customers for services you perform as a self-employed person
<i>Commissions</i>	Payments you receive for products sold, or as a percentage of fees for services (i.e., pay agreements/ commissions)
<i>Retail Sales</i>	Sales of merchandise or other products such as brushes, shampoo, makeup, etc.
<i>Rent/Lease Payments</i>	Payments the salon owner receives for space rented
<i>Tips</i>	Gratuities received from clients in the form of cash, charges, and non-monetary payments
<i>Bartering</i>	Bartering is an exchange of one taxpayer's property or services for another taxpayer's property or services. The fair market value of property or services received through barter is taxable income (i.e., if a barber agrees to give an accountant a hair cut in exchange for tax return preparation, the fair market value of the hair cut is taxable to the accountant, and the fair market value of the tax return preparation is taxable to the barber)

Why are my tips considered income?

As previously mentioned, all income is taxable income and tips are income. There is a false belief that tips received are gifts and, therefore, not considered income.

TIPS ARE NOT GIFTS

A gift is something that is given to you freely, voluntarily, and without an expectation for any services performed. For instance, it is your birthday; your customer brings in champagne and cake. This is a gift, not a tip.

If you provide a service to a customer and they pay you more than what you have stated as your fee, then that additional amount is a tip and taxable. If the customer pays you at a later date or at a different location for the service you previously provided, it is still taxable income. The date and location are irrelevant when the monies paid are for a service provided.

Tips paid to you in cash, charge, checks, and non-cash (i.e., tickets to sporting events) are subject to income tax. If you are licensed and performing a service these tips are subject to Social Security Tax also known as the Federal Insurance Contributions Act (FICA). Students, employees, salon owners, booth renters, and independent contractors earn tips.

How do I treat tips received as an unpaid apprentice or as a student of a barber/cosmetology school?

While you are an unpaid apprentice or student of a school, the tips you receive are subject to income tax but not Social Security Tax (FICA). This type of tip income is not reported to the school, as you are not an employee of the school. Report this type of tip income as "other income" on Form 1040, if you are required to file an income tax return.

How do I treat tips I receive as an employee?

Any employee, including paid apprentices who receive tips in excess of \$20 in any given month, must report to their employer all tips received that month. This must be done in writing and must include your name, SSN, and the name and place of employment. This report must be done at least once a month and submitted to your employer, no later than the 10th calendar day of the following month after the tips are earned.

An employee who receives tips of less than \$20 in a calendar month does not have to report the tips to his or her employer; however, the tips must be reported as other income on the employee's income tax return.

As an employee, what kind of tip records am I required to keep?

You are required to keep records to show the amount of tip income you received during the year. IRS has created Publication 1244, Employee's Daily Record of Tips. This handy publication allows you to record your tips on a daily basis by completing Form 4070A, which is included in Publication 1244. This form is given to your employer no later than the 10th calendar day of the following month after the tips are earned.

Keep a record of the amount of "tip-outs" you pay to other employees through tip sharing, tip pooling, or any other arrangement. It is to your benefit to have both the names of employees to whom you paid the tips and the date you paid them.

Shown below is a completed example of a Form 4070A, Employee’s Daily Report of Tips

4070A Form (Rev. June 1999) Department of the Treasury Internal Revenue Service		Employee’s Daily Record of Tips This is a voluntary form provided for your convenience. See instructions for records you must keep.			OMB No. 1545-0065	
Employee’s name and address Sally Oak		Employer’s name Maple Street Salon Establishment name (if different)			Month and year November, 2002	
Date Tips Rec’d	Date Of Entry	a. Tips received directly from customers and other employees	b. Credit card tips received	c. Tips paid out to other employees	d. Names of employees to whom you paid tips	
1	11/1	\$ 10	\$ 5	\$ 2	Anita Smith	
2	11/2	\$ 11	\$ 4	\$ 2	Anita Smith	
3	11/3	\$ 17	None	\$ 4	Shirley Yale	
4	11/6	\$ 5	\$ 10	\$ 1	Shirley Yale	
5	11/7	\$ 9	None	\$ 1	Donna Hargrave	
Subtotals		\$ 52	\$ 19	\$ 10	XXXXXXXXXXXXXXXXXXXX	
For Paperwork Reduction Act Notice, see Instructions on the back of Form 4070						Page 1

How do I treat tips I receive if I am not a student or an employee?

If you are not a student or an employee, you are a self-employed person. You may be called a salon owner, a booth renter, independent contractor or have some other title. As a self-employed person, report all income including tips on your Schedule C.

Example:

Sarah Cornell rents a booth. She has a resale license and sells retail products. Here is a breakdown of the income she earned during the year:

- Client fees \$57,000
- Tip income 8,500
- Retail sales 4,900

TOTAL Income \$70,400

Line 1, Schedule C →

1. Gross receipts or sales.	\$70,400
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Does the IRS have an education program for Voluntary Tip Agreements for employers?

The Tip Rate Determination and Education Program was initiated by the Internal Revenue Service to improve voluntary compliance by employers and employees in industries where tipping is customary. Under this program, employers can agree to voluntarily enter into a tip agreement. For additional information, please refer to Publication 3144, Tips on Tips, A Guide to Tip Income Reporting.

Where do I report the income I have received?

The following chart lists common types of income received and how it should be reported for workers in each category:

<u>Types of Income</u>	<u>Students</u>	<u>Employees</u>	<u>Salon Owner/Booth Renter/Independent Contractor</u>
Wages	Generally not received	Taxable (Reported to you on Form W-2)	Generally not received
Fees	Generally do not receive (If received, report as "Other Income" on Form 1040, on line 21)	Taxable (Included in Form W-2)	Taxable (Include in Gross Receipts)
Commissions/Retail Sales	Generally not received	Taxable (Included in Form W-2)	Taxable (May be reported to you on Form 1099-MISC. - Include in Gross Receipts)
Rents/Lease Payments Received	Generally not received	Generally not received	Taxable (May be reported to you on Form 1099-MISC. - Include in Gross Receipts)
Tips	Taxable (Report as "Other Income" on Form 1040 on Line 21)	Taxable (Must be reported to employer if more than \$20 per month)	Taxable (Include in Gross Receipts)
Bartering	Taxable	Taxable	Taxable

What is a business expense and how do I report it?

Chapter 4

"If you purchase and pay for a business expense during the year and it is both ordinary and necessary, it will be deductible on your tax return"

There are many kinds of business expenses. It is important to keep track of all of them, as they may reduce the amount of tax you have to pay.

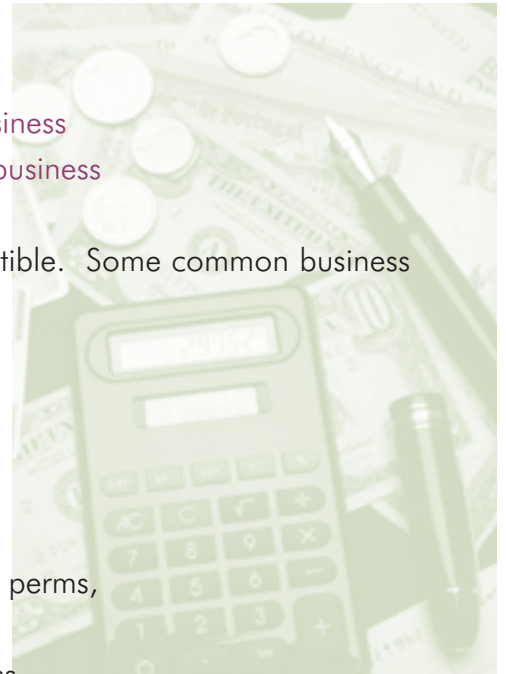
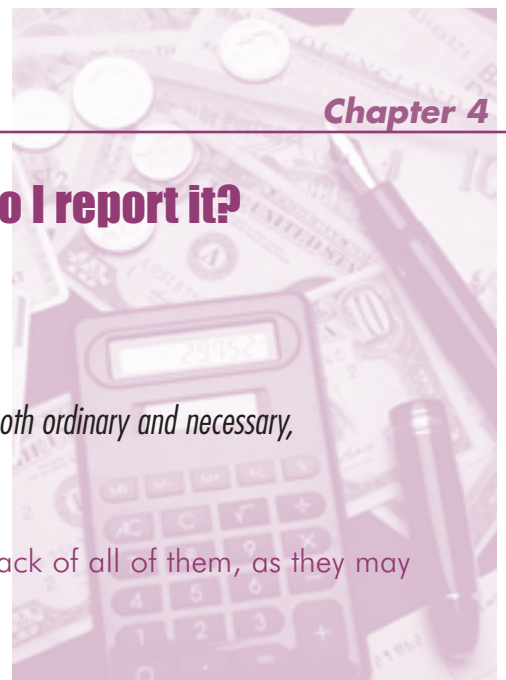
What types of business expenses can I deduct?

To be deductible, the expense must be:

- Ordinary - one that is common and accepted in your trade or business
- Necessary - one that is helpful and appropriate for your trade or business

An expense does not have to be crucial to your business to be deductible. Some common business expenses are:

- Utilities
- Employee salaries
- Trade association dues
- Rental expenses
- Supplies - Salon supplies for client use (not sold for retail) such as perms, papers, colors, and shampoos
- Continuing education - A class that enhances your current business knowledge



What is Cost of Goods Sold (COGS) and where can I deduct it?

Cost of Goods Sold (COGS) is a formula used to calculate the cost of retail products or merchandise sold during the year. The formula is as follows:

Beginning inventory
 (Items that you have on hand for resale on the first day of the year.)
Plus
 Purchases
 (Items that you buy for resale during the year.)
Minus
 Personal Use
 (Items purchased for resale but used personally during the year.)
Minus
 Ending Inventory
 (Items that you have on hand for resale on the last day of the year.)
Equals

⇒ **COGS**

COGS are deducted on Schedule C, part 1.

Example:	
Beginning inventory You have \$2,000 of product on hand on January 1	\$ 2,000
<i>Plus</i>	
Purchases You buy \$5,000 of product for retail sale	\$ 5,000
<i>Minus</i>	
Personal Use You took home \$1,000 of product during the year that you did not pay for	\$ (1,000)
<i>Minus</i>	
Ending Inventory You have \$3,000 of product on hand on December 31	\$ (3,000)
<i>Equals</i>	-----
Cost of Goods Sold The amount you can deduct on Schedule C	\$ <u>3,000</u>

Is everything I spend deductible?

No, not all expenses incurred are deductible. In fact, you should be aware that there are a number of abusive tax schemes, such as the Home-Based Business Tax scheme. An abusive tax scheme is any investment plan or promotion that claims to allow a person to deduct what would normally be considered a personal expense. As always, a true business purpose must exist prior to claiming any business expense. For more information on this subject, please see Publication 4035 – Is It Too Good To Be True? – Home-Based Business Tax Avoidance Schemes.

When do I deduct my business expenses?

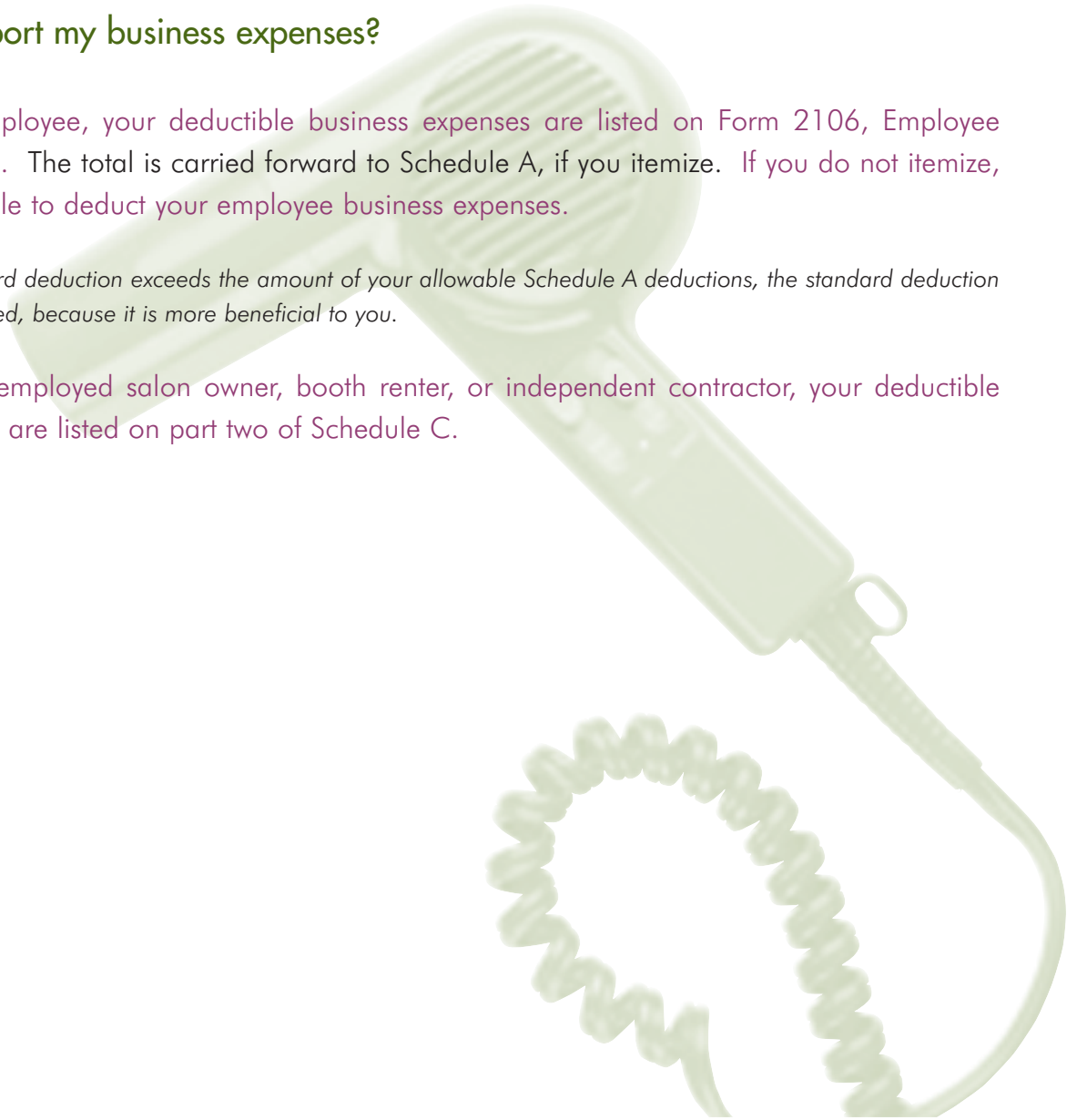
Generally, expenses are deducted in the year they are paid. If you borrow money or use a credit card to make your business purchases, regardless of when the loan or credit card is repaid, the business expense is deductible in the year purchased.

Where do I report my business expenses?

If you are an employee, your deductible business expenses are listed on Form 2106, Employee Business Expenses. The total is carried forward to Schedule A, if you itemize. If you do not itemize, you will not be able to deduct your employee business expenses.

NOTE: If your standard deduction exceeds the amount of your allowable Schedule A deductions, the standard deduction amount should be used, because it is more beneficial to you.

If you are a self-employed salon owner, booth renter, or independent contractor, your deductible business expenses are listed on part two of Schedule C.



What do I need to know about keeping records?

Chapter 5

"A good record keeping system can reduce your taxable income"

Record keeping is any system you use to keep track of and document all items of income and expenses.

Why do I need to keep records?

You want to keep good records for preparing your income tax return and for budgeting purposes. There are many deductions and tax credits for which you may qualify that will lower your tax. If you do not keep good records, you may not have verification to claim your expenses.

There are many reasons why you need to keep good records. The most important reasons are listed below:

1. *To monitor your business success*

You will be able to answer questions such as: How much is my business earning each week? What were my expenses last week, month, or year?

In addition, good record keeping enables you to identify changes you need to make in your business to be more successful. For example, if you eliminated unwanted services or products, which did not sell, you could increase your profits.

2. *To identify your sources of income*

You may receive money from many sources. Good record keeping helps you identify and separate business and non-business income and taxable and nontaxable income. For example, good records will allow you to distinguish between the \$500 birthday gift that you deposited, which is not taxable, from the \$500 tip income you deposited, which is taxable.

3. To identify deductible expenses

Regardless of your employment status, you may have deductible expenses that could reduce your taxable income. A good record keeping system will help you to identify and document these deductible expenses throughout the year. Without an accurate record keeping system, you risk losing the benefit of a business deduction.

4. To accurately prepare your tax return

A record keeping system supports the income, expenses, and credits you report on your income tax return and promotes accurate return preparation. Without good record keeping you may overlook taxable income, deductible expenses, or tax credits to which you are entitled.

5. To support income, expenses, and credits reported on your tax return

You must keep records to support all items shown on your income tax return. If the IRS examines any of your tax returns, you may be asked to explain or verify items you reported. If you are unable to present the required information, you may be subject to payment of additional taxes and penalties.

What types of records should I keep?

You should keep records for any items you have listed on your tax return. It is strongly recommended that you keep business and personal funds separate. Maintaining a separate bank account for your business is one way to do this.

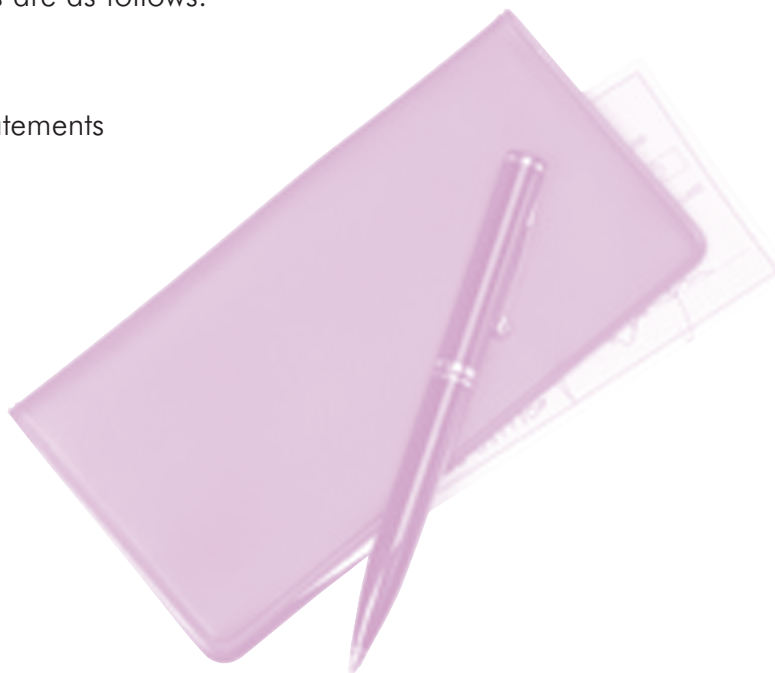
Some examples of business records are as follows:

Business *income* records:

- Bank deposit slips and bank statements
- Credit card charge slips
- Appointment book/calendar
- Receipt books
- Form(s) 1099-MISC received

Business expense records:

- Invoices
- Receipts
- Cancelled checks
- Sales slips
- Credit card receipts



Your supporting documents should show the amount paid and how it relates to your business. You must provide proof (i.e., supporting documents) that the purchase was for business use only.

How should I keep my records?

There are no specific guidelines for maintaining your records; however, a good record keeping system should be easy to use, understandable, reliable, accurate, and consistent.

You should select a record keeping system and accounting method that is suitable for your business, which will allow you to determine your income and deductible expenses.

You can use something as simple as a notebook to record taxable income, as it is received, and deductible expenses, as they are paid.

The manner in which you store your records is up to you - a file cabinet, shoebox, or other type of container. What's important is that you organize the documents by date and type of income and expense. You may want to separate deductible business expenses into categories such as rent, utilities, insurance, advertising, and professional publications. No matter how you keep your records, they should be organized and easy to find.

How long must I keep records for tax purposes?

Keep all records until the statute of limitations expires for that particular tax return. Generally, the statute of limitations expires three years after the return becomes due or is filed, or two years from the date the tax is paid, whichever is later.

Keep all employment tax records for at least four years after the tax return becomes due or is filed or two years from the date the tax is paid, whichever is later. Employment taxes are discussed in the chapter, "What are my federal tax responsibilities."

Note: Major purchases, such as buildings and equipment, may have special record keeping requirements. Please refer to Publication 946, How to Depreciate Property, for additional information.

What are the consequences of filing an incorrect tax return?

Chapter 6

"If you do not file correct tax return(s) you may be subject to various penalties"

Filing accurate tax returns and paying taxes when due is the LAW. Penalties are assessed for noncompliance of tax laws.

What are the consequences of not filing my income tax return and/or employment tax return "on time"?

If you are an employee, employer or self-employed person and you fail to file your personal income tax return and/or employment tax return by the due date, including extensions, you may be subject to the failure to file penalty. The failure to file penalty will be assessed at 4^{1/2}% of the unpaid tax for the first month the penalty applies and an additional 4^{1/2}% for each additional month or fraction of the month that the return remains un-filed, not to exceed 22^{1/2}% of the tax due. Minimum penalty is the lesser of 100% of the tax due or \$100.

Note: Percentage figures may be subject to change.

What are the consequences if I fail to fully pay my income tax liability and/or my employment tax liability by the due date of the return?

If you are an employee, employer or self-employed person and you fail to fully pay your income tax liability and/or your employment tax liability by the due date of your return, the failure to pay penalty may be assessed. The failure to pay penalty is 1/2 of 1% of the unpaid tax. This penalty will be assessed each additional month or fraction of a month until the tax is paid, not to exceed 25% of the tax.

What are the consequences if I fail to make my estimated tax payments?

If you are an employee or self-employed person and you did not pay enough tax either through withholding or by making your estimated tax payments, you will have an underpayment of tax. Based on this underpayment you may be assessed a penalty. For further information, please refer to IRS Publication 505, Tax Withholding and Estimated Tax.

What are the tax consequences if I do not file an income tax return and/or employment tax return at all?

If you fail to file an income tax return and/or employment tax return when required, the IRS may file a "substitute for return" on your behalf, without crediting you with the exemptions, deductions, or credits of which you may be entitled. You may also be subject to additional penalties and interest as described above.

What are the consequences for employers who fail to make Form 940 and Form 941 deposits timely?

Penalties may apply if you do not make the required deposits, are late making deposits, make deposits for less than the required amount, or if you do not use Electronic Federal Tax Payment System (EFTPS) when required.

For any amounts not properly or timely deposited the penalty rates are:

- 2% - Deposits made 1 to 5 days late.
- 5% - Deposits made 6 to 15 days late.
- 10% - Deposits made 16 or more days late. The penalty also applies to amounts paid within 10 days of the date of the first notice the IRS sent asking for the tax due.

The penalties do not apply if any failure to make a proper and timely deposit was due to reasonable cause and not to willful neglect.

Note: Penalties and interest assessed on tax and penalties are not deductible on your tax return.



What are my federal tax responsibilities?

Chapter 7

"Federal taxes may be required to be paid by you or someone else on your behalf"

Your federal tax liability will be based upon your worker classification. The tax system is a pay-as-you-go system.

What are my federal tax responsibilities as an employee?

As an employee, you will receive a Form W-2, Wage and Tax Statement, from each employer you have worked for during the year. Employers issue these forms in January of the following year. Form W-2 combines all wages and reported tips. It shows the amount of federal taxes withheld and paid throughout the year.

Taxes are withheld based upon how you completed your Form W-4, Employee's Withholding Allowance Certificate. Tax withheld may differ depending upon the filing status you chose and the number of allowances you claimed. When you file your federal income tax return you should report the income shown on all Form W-2's.

If you do not report all of your tips to your employer during the year, you may be required to pay additional income tax such as Social Security and Medicare Taxes on any unreported tips when you file your federal income tax return. A penalty for underpaying your required taxes during the year may be assessed.

What are my personal federal tax responsibilities if I am self-employed (i.e., salon owner, booth renter, independent contractor)?

If you are self-employed, you are responsible for filing and paying all of your own taxes, which include both federal income and self-employment taxes.

- Federal income tax is the tax calculated on the net (or adjusted gross) income, after all deductions have been taken.
- Self-employment tax is comprised of 100% of your Social Security and Medicare Taxes.

NOTE: It is possible to not owe any federal tax but still owe self-employment tax.

If you are self-employed you may be required to make quarterly estimated tax payments based upon your net income and any self-employment taxes. For help in calculating your estimated payment amounts, refer to Publication 505, Tax Withholding and Estimated Tax.

Form 1099-MISC is required to be issued to any person (not a corporation) to whom you have paid \$600 or more during the year, who is not your employee. If you, yourself have received \$600 or more from one person for services you provided, you should also receive Form 1099-MISC. If you do not receive this form, but have received the income, you are still required to report that income on your return.

What are my federal tax responsibilities if I am an employer?

If you are an employer, in addition to your own personal tax obligations, you will have employment tax responsibilities.

As an employer, you are responsible for all of the following:

- Form 941, which is filed quarterly, shows the amounts that have been withheld and paid for each employee's federal income, Social Security and Medicare Taxes. It will also include the employer's matching portion of Social Security and Medicare Taxes. As the employer, you must deposit all income tax withheld and both the employer and employee's share of Social Security and Medicare Taxes. Refer to Publication 15 for further information.
- Form 940, the Employer's Annual Federal Unemployment Tax return (FUTA) form is filed annually. The tax is paid 100% by the employer. Refer to Publication 15 for specific filing requirements.
- Form W-2, reflects total wages paid and tips reported, is filed annually and is issued to each employee.
- Form 1099-MISC is required to be issued to any persons (not a corporation or your employee) to whom you have paid \$600 or more during the year for services provided.

What are tax credits?

Chapter 8

"A tax credit reduces the amount of tax you owe"

When you file your income tax return, there are many tax credits to which you may be entitled. This section will focus on the Earned Income Tax Credit and the Education Credits.

What is Earned Income Tax Credit (EITC)?

EITC is a tax break for people who work, but do not earn high incomes. Those who qualify could pay less federal tax, no tax, or even get a tax refund.

Do I qualify for EITC?

You may qualify for EITC if you meet the following:

- You must have a valid Social Security Number (SSN)
- Your filing status cannot be Married Filing Separate
- You must be a U.S. Citizen or resident alien all year
- You cannot file Form 2555 or Form 2555 EZ
- Your investment income (as of 2002) must be \$2,550 or less
- You must have earned income



Additionally, if you are claiming EITC and you have a child, you must meet the following:

- The child must meet the relationship, age, and residence test
- If the child being claimed for EITC is the qualifying child for more than one person, only one person may claim the EITC for that child. You and the other qualifying person may choose which person gets the credit. If you cannot agree on who is to file for the credit, refer to Publication 596 to determine the criteria for un-agreed cases.
- You cannot be the qualifying child of another person and claim EITC for your child

If you are claiming EITC and you do not have a qualifying child, you must meet the following:

- You must be at least age 25 but under age 65
- You cannot be the dependent of another person
- You cannot be the qualifying child of another person
- You must have lived in the U. S. for more than half of the year

What is the Advance Earned Income Tax Credit (Advance EITC)?

The Advance EITC allows those taxpayers who expect to qualify for the Earned Income Tax Credit (EITC) and have at least one qualifying child to receive part of the credit in each paycheck during the year the taxpayer qualifies for the credit.

How do I get Advance EITC payments?

First you must determine if you qualify for Advance EITC payments. To do so, obtain from your employer the Form W-5, Earned Income Credit Advance Payment Certificate, making sure to answer the five questions on the back of the form that determine qualification.

If you qualify, complete the bottom part of the Form W-5, and give it to your employer. Then, based on your income, your employer adds additional money to your take-home pay in each paycheck.

Note: If your only income is from self-employment, you cannot qualify for Advance EITC payments.

What are the income limits for claiming EITC?

In order to qualify for earned income tax credit, as of 2002, your earned income and adjusted gross income must be less than:

- \$11,060 (\$12,060 MFJ) if you do not have a qualifying child
- \$29,201 (\$30,201 MFJ) if you have one qualifying child
- \$33,178 (\$34,178 MFJ) if you have more than one qualifying child

Note: Income limits are subject to change

How much Earned Income Tax Credit can I qualify for?

When you file your tax return (1040 EZ, 1040 A, or a 1040), you can calculate your EITC by using a worksheet included in the tax form instruction booklet or you can let the IRS calculate your Earned Income Credit for you.

For more information on the Earned Income Tax Credit, please refer to Publication 596, Earned Income Tax Credit.

What are education credits?

Education credits are tax credits for students only. You may be eligible for education credits, depending on your filing status, income level, and other factors. There are two kinds of education credits:

- The Hope Credit
- The Lifetime Learning Credit

Expenses that qualify for the education credits are based on qualified tuition and related expenses.



Can I qualify for the Hope Credit?

The Hope Credit is available to students for the first two years of undergraduate education including trade and/or vocational schools. You might be entitled to a credit of up to \$1,500 of the money you paid out for tuition or other qualifying expenses. Here are some of the requirements:

- 1) The student has not completed the first two years of post-secondary education
- 2) The student is enrolled in a program that leads to a degree, certificate or other recognized education credential
- 3) The student is taking at least half of the normal full-time workload for his/her course of study for at least one academic period, beginning during the calendar year
- 4) The student has no felony drug conviction

Example:

Brian is a first year student at Willow Barber College. Brian is attending school full time. His tuition costs are \$5,800, which includes lab fees and books. Brian is a dependent on his parents' tax return. Brian is not entitled to take the Hope credit on his return, but Brian parents' may be entitled to take the Hope Credit for Brian's educational costs on their tax return.

For additional information, please refer to Publication 970, Tax Benefits for Higher Education.

Can I qualify for the Lifetime Learning Credit?

The Lifetime Learning Credit is a tax credit, but unlike the Hope credit, there is no limit to the number of years you can claim the credit! You may be able to claim up to \$1,000 of the money you paid out for tuition or other qualifying expenses.

These are the requirements:

- 1) The student only has to take one (or more) courses, it's not based on workload
- 2) The student can be beyond their first two years of post secondary education
- 3) It is available for an unlimited number of years
- 4) The student does not have to be pursuing a degree or any recognized education credential

Example:

Ralph is taking a hair braiding class so he can offer an additional service to his clients. This class is not part of a certificate or degree program from an accredited school. This class qualifies for the Lifetime Learning Credit.

Beginning in 2003, the maximum Lifetime Learning Credit increases to \$2,000.

How much education credit can I qualify for?

The education credit cannot be more than the amount of your tax. You cannot get a refund for any part of the credit that is more than your tax. Neither the Hope nor the Lifetime Learning Credits are "dollar-for-dollar" credits. The amount of credit you qualify for will be based upon your income. Just because you claim \$1,500 in expenses, does not mean your tax credit is \$1,500.

Can I take both the Hope and the Lifetime Learning Credit in the same year?

No. If a student qualifies for both the Hope and Lifetime Learning Credit for the same year, you can claim either credit, but not both. You will want to determine which credit gives you the best benefit. Please refer to Publication 970, Tax Benefits for Higher Education.

What is e-filing? (Electronic filing)

Chapter 9



"e-filing is the way to file your return electronically instead of mailing a paper return"

e-file is the preferred way of filing your tax return. It is so easy, that in 2002 over 46 million people used it.

Who can participate in e-file?

- Individual taxpayers
- Sole proprietors
- Employers
- Partnerships
- Tax practitioners

How can I participate in e-file?

- Telefile – direct to the IRS via a telephone – you must receive a Telefile package to participate
- IRS e-file using an authorized e-file provider
- E-file through your personal computer

What tax forms can you currently e-file?

- 1040
- 1040 A
- 1040 EZ
- 940
- 941 - Certain qualified filers may use the 941 TeleFile program
- 1065 - The IRS accepts nearly all related forms and schedules

What are the benefits of e-filing?

- * Electronic acknowledgement within 48 hours of filing confirming the IRS has accepted your return for processing
- * Chances of getting an error notice from the IRS are reduced
- * There is only a 1% error rate on e-filed returns
- * Receive your refund in half the time of paper filing, even faster with direct deposit

To find a list of software companies (authorized providers) or tax professionals who participate in the e-file program, visit the IRS Web site at www.irs.gov

File Smart...file Electronically!



What is Electronic Federal Tax Payment System (EFTPS)?

Chapter 10

"EFTPS is a free service offered by the Department of Treasury"

EFTPS enables individual taxpayers to pay all their federal taxes electronically including estimated taxes, balance due payments, installment payments, and estate and gift taxes. Business taxpayers can pay employment taxes, excise taxes, and corporate income taxes. EFTPS is easy, fast, accurate, and convenient.

Who can use EFTPS?

Any individual taxpayer making more than one tax payment a year can use EFTPS. Any business taxpayer can use EFTPS for all taxes.

What are the benefits of using EFTPS?

EFTPS offers you many benefits over the traditional paper system:

- It's **fast**... you can make a tax payment in minutes
- It's **accurate**... because there are verification steps along the way, you can check and review your information before it is sent
- It's **convenient**... EFTPS is available 24 hours a day, 7 days a week via Internet, PC software, or telephone – and can be used to schedule payments in advance
- It's **easy to use**... a step-by-step process that tells you the information you need to successfully complete your federal tax payments
- It's **secure**... EFTPS offers the highest levels of security on the Internet

How can I participate in EFTPS?

You can enroll through the Internet at www.eftps.gov or by completing an enrollment form which is available from EFTPS Customer Service at 1-800-945-8400 or 1-800-555-4477. Once EFTPS receives and verifies your information, confirmation materials including instructions on how to obtain your Internet password will be mailed to you within 10 – 15 days after you complete your enrollment. Your Personal Identification Number (PIN) will also be mailed to you.

Do I have to use EFTPS?

No, you do not have to use EFTPS unless you are a business whose total deposits for all federal deposits exceed \$200,000 during the calendar year.

Can I schedule payments in advance?

Yes. If you are an individual, you can schedule payments up to 365 days in advance of the due date. If you are in business, you can schedule payments up to 120 days in advance of the due date.

How do I know my payment was received?

Every EFTPS transaction receives an immediate acknowledgment number that can be used as your receipt of the transaction. This number is used to check status, tracking, and to communicate with the IRS.

Related Products and Services

Chapter 11

The Internal Revenue Service, in response to the needs of the business community, has created customer-focused products and services. We provide assistance to educate business customers and help them meet their taxpayer obligations and reduce taxpayer burden. For your reference, a list of these products and services follows:

- Small Business/ Self-Employed Community Web site - www.irs.gov/smallbiz
Provides up-to-date information regarding business and industry
- IRS "Digital Daily" - www.irs.gov
Provides links to business and individual topics, electronic filing and paying options, forms and publications, and opportunities to e-mail questions to the IRS
- Paying federal taxes electronically - www.eftps.gov
- EFTPS customer service – 1-800-555-4477
- Toll-free telephone assistance – 1-800-829-1040
- Forms and publications – 1-800-829-3676 (FORM)
- IRS TaxFax Service - (703) 368-9694 (not a toll-free number) for forms and publications to be faxed to you
- Small Business Workshops – www.irs.gov/smallbiz

Industry Specific Publications:

- Pub 531 Reporting Tip Income
- Pub 1244 Employee's Daily Record of Tips
- Pub 1244SP Employee's Daily Record of Tips (Spanish Version)
- Pub 3144 Tips on Tips – A Guide to Tip Reporting (Employers)
- Pub 3148 Tips on Tips – A Guide to Tip Reporting (Employees)
- Pub 3374 Tips on Tips – Reporting Your Tip Income Video
- Pub 3518 Beauty, Barber, and Cosmetology Industries
- Pub 3518SP Beauty, Barber, and Cosmetology Industries (Spanish Version)
- Pub 3634 Beauty, Barber and Cosmetology Industry Video
(Korean, Vietnamese, Mandarin)
- Pub 3933 Beauty is More Than Hair, Skin, or Nails (California only)

General Publications:

- Pub 334 Tax Guide for Small Business
- Pub 505 Tax Withholding and Estimated Tax
- Pub 583 Starting a Business and Keeping Records
- Pub 966 EFTPS
- Pub 1779 Independent Contractor or Employee
- Pub 1857 Filing Your Taxes was Never Easier
- Pub 3207 The Small Business Resource Guide (CD)
- Pub 3603 e-File for Business Brochure
- Pub 3611 Electronic Payments Brochure
- Pub 3693 Introduction to Federal Taxes for Small Business
Self-employed (CD)
- Pub 3700 Virtual Small Business Workshop (CD)
- Pub 4035 Home Based Business Tax Avoidance Schemes

Publications can be found at www.irs.gov or by calling 1-800-829-3676.

Test Your Knowledge

Chapter 12 - Circle the best answer

1. Reporting all my wages, including tips will:
 - a) Increase my Social Security benefits
 - b) Decrease my Social Security benefits
 - c) Have no effect on my Social Security benefits

2. In determining your worker classification you must consider:
 - a) Who owns the building I am working in
 - b) How long I have been in business
 - c) Financial control, behavioral control, and relationship or intent of the parties

3. As a personal service professional, the tips I receive from my customers are:
 - a) Fully taxable and reportable as income to me
 - b) Gifts and not taxable
 - c) Taxable if they exceed 8% of my sales

4. Products that I buy for my business but use personally are:
 - a) Taken as an ordinary and necessary business expense
 - b) Used by me to demonstrate how good the product works and then taken as an ordinary and necessary business expense
 - c) Not deductible as an ordinary and necessary business expense

5. Good record keeping requires:
 - a) That I keep all tax returns until I am 65
 - b) That I can substantiate all of the income and expenses shown on my income tax return
 - c) That I have a locked file cabinet

6. I did not file my income tax return on time:
 - a) If I owe money, I will be assessed a failure to file penalty
 - b) If I do not have a balance due, no failure to file penalty will be assessed
 - c) Both A and B

7. I am self-employed. I need to make payments for both Social Security and income taxes:
- a) Whenever I have extra money
 - b) Quarterly
 - c) Once a year
8. I am attending a barber/cosmetology school:
- a) I will not be entitled to the Hope Education credit
 - b) I may be entitled to either the Hope Education or Lifetime Learning credit
 - c) I can take both the Hope Education and Lifetime Learning credit in the same year
9. If I use e-file:
- a) I need to use a paid preparer
 - b) I can use my personal computer
 - c) My refund will arrive at the same time as if I filed a paper return
10. If I pay my taxes using EFTPS:
- a) There is no cost to me
 - b) I will not get a receipt for my tax payment
 - c) I must be depositing more than \$1,000

Answers To Test Your Knowledge

1. A

Social Security benefits are calculated on the total combined earnings (wages and tips) that have been recorded under your SSN. (Chapter 1)

2. C

You must consider all three factors: financial control, behavioral control, and relationship or intent of the parties when making a determination as to your worker status. (Chapter 2)

3. A

All income, including tip income, received in the course of business whether it is cash, check, charge or non-monetary (barter) is taxable. (Chapter 3)

4. C

Only business related expenses are deductible. Personal expenses are not deductible. (Chapter 4)

5. B

Good record keeping requires that you are able to substantiate both income and expenses as reported on your income tax return. (Chapter 5)

6. C

Penalties will only be assessed when there is a balance due on the due date of the return. (Chapter 6)

7. B

As a self-employed person I need to make quarterly estimated tax payments, which are comprised of my Social Security and Medicare Taxes and income tax liabilities. (Chapter 7)

8. B

As long as the barber/cosmetology school you are attending is an accredited school, you may be entitled to claim an educational credit. You cannot claim both the Hope and Lifetime Learning credit in the same year. (Chapter 8)

9. B

You can e-file your income tax return in a fast, safe, and convenient way using your personal computer. (Chapter 9)

10. A

There is no cost to you to use EFTPS. Also, it is convenient, safe, and secure. (Chapter 10)



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