

## Tax Aspects of Becoming Self-employed

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Individual taxpayers are opting to start their own businesses for myriad reasons. Regardless of why you're contemplating self-employment, you should consider several basic tax-related issues before and immediately after actually leaving your current job. Following are some tax issues to consider.

**Know the Rules for Rolling over Retirement Plan Funds.** Upon leaving your job, you generally will be entitled to immediately receive vested amounts in your qualified retirement plan accounts. Most distributions from qualified retirement programs [pension plan, 401(k) plan, etc.] can be rolled over tax-free into an IRA account. However, you must arrange for a "direct rollover," or the plan administrator is required to withhold 20% of your distribution for federal income tax. Direct rollovers involve having the funds transferred directly from your former employer's retirement plan into your designated IRA account. Failure to arrange a direct rollover means you will have to replace the 20% withheld to accomplish a totally tax-free rollover.

**Use All Your Flexible Spending Account (FSA) Funds before You Quit.** If you have an FSA (or cafeteria plan reimbursement account) for uninsured medical expenses and/or childcare expenses, make sure you incur sufficient qualifying expenses to use up the funds in your account before you leave your job. Otherwise, that money will be left behind.

**Open a Separate Business Bank Account.** Segregate your business and personal financial matters by keeping separate bank accounts. Deposit all business income into the business account and pay all business expenses out of that account. If you pay business expenses in cash or out of your personal account, reimburse yourself with checks drawn on your business account and document this with receipts. This will make your year-end recordkeeping easier. Keeping separate accounts shows you are serious about running things in a businesslike manner, and IRS examiners like to see that.

**Keep Tax Records.** In addition to maintaining a separate business bank account, you need to keep documentation of your business income and expenses.

**Keep Good Auto Records.** Personal auto expenses used for business are deductible, but only if you document the date, number of miles, and business

purpose for each business use of the car. Mileage not properly substantiated is considered personal use, and the related expenses are not deductible. You should also record the car's mileage at the beginning of the year or when you first start your business. Unless the standard mileage rate is used, receipts or invoices and cancelled checks should be retained documenting the car's purchase price, fuel costs, repairs, taxes, insurance, and other out-of-pocket costs. Auto logbooks for recording mileage and expenses are available at local discount and office product stores.

**Set up Your Own Retirement Plan.** If you work for yourself, you are on your own when it comes to retirement planning. A retirement plan set up for your benefit accomplishes two goals: it is a way to save money for your later years, and it saves taxes now. Using a defined contribution Keogh plan, you can contribute and deduct up to 25% of your net self-employment (SE) income (maybe more if you set up a defined benefit Keogh plan), but Keogh plans must be in existence before the end of this year for you to take a deduction. If it is a 401(k) plan, you may also make elective deferrals. A simplified employee pension (SEP) plan can be set up in the following year—as late as the extended due date for your return—and still provide a current-year tax deduction. SEPs are simpler and cheaper to administer, and you can contribute and deduct up to approximately 20% of your net SE income. SIMPLE retirement plans are another option available to self-employed persons. A possible disadvantage of these qualified retirement plans is that you may have to make contributions for your employees.

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