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Owning your own business can be rewarding, but as most entrepreneurs know, it also means a lot of work, much more than a traditional salary-based job working for someone else. While many small business owners may consider it a labor of love, there's definitely one aspect than very few appreciate: doing the business' income taxes.

Whether a business is incorporated and files returns as an entity, or is an LLC and the owner files a Schedule C with their personal 1040 income tax return, there are many potential areas for errors, from misreporting income or expenses, to missing potential money-saving tax credits.

Here are some of the most common tax mistakes that small businesses make, according to Jason Hamilton, a CPA and senior tax manager with Decosimo CPAs (www.Decosimo.com), a tax and accounting consultancy serving thousands of businesses and individuals from offices across the country.

1. Mixing business and personal accounts and expenses.

One of the biggest errors that small businesses, especially Sch. C entities, make is what is called "comingling" of accounts. While having separate bank and credit accounts is not strictly required, it is advised by most tax professionals, because it not only makes tax time much easier, it also ensures much more accurate bookkeeping overall, as well as financial reporting.

At the very least, Hamilton says, business owners should maintain an accurate

The rules for determining whether a person should be considered an employee or a contractor is not as vague as many small business owners may think. The IRS has issued general tips for identifying which they are, but it boils down to a few key points:

1. Does the business dictate how, when and where the person does the task they’ve been assigned, including mandated working hours?
2. Does the business reimburse for expenses, or provide tools and supplies at no additional cost to the person?
3. Is there a contract or defined benefits, such as a pension, insurance, vacation time, etc, and is the work relationship considered an ongoing and key aspect of the overall business?

Misidentifying a person who should be considered an employee can lead to penalties and interest for non-payment of the employer share of employment taxes. Also, the business needs to make sure that every employee receives a W-2, and every contractor that was paid more than $600 receives a Form 1099-Misc.

For self-employed individuals, nonpayment of the employer share, aka “self-employment taxes,” can also get the person in trouble with the IRS. These should be included with quarterly estimated tax payments throughout the year, Hamilton noted.

3. Not paying “reasonable” wages to shareholders of an S-Corporation.

For the employee-shareholder in businesses organized as an S-Corp, the IRS requires reasonable wages be paid to them as taxable income. This is before non-wage distributions can be made, because the non-wage distributions are taxed differently.

The official instructions for the 1120S income tax return state, “Distributions and

valid deductions.

A fast way to get the attention of the IRS is to have expenses that either exceed the business’ income over several years, or to have certain types of expenses that are outside of common percentage thresholds. Whether it’s for business travel, meals and entertainment, printing supplies, or other usually legitimate deductions, the IRS’ computers are good at looking at what similar small businesses in an industry type spend on similar expenses.

Hamilton noted that Schedule C small businesses often have the most challenge when it comes to business expenses, since many items may be partially used for business purposes and personal use (mixed-use assets). For home office use, however, the IRS has strict rules that the room is not supposed to be used for any other purposes than the business. And if an audit happens, the business owner had better be able to convince them of that. (No, the corner desk in a bedroom does not pass this test.)

On the other hand, there are many deductible expenses that, as the IRS defines them, are “ordinary and necessary” as a part of running a business- just make sure you keep the receipts. Unfortunately, many Sch. C filers can miss some legitimate expenses when they prepare their taxes and, therefore, miss the deductions. Hamilton says this is especially likely to happen to those who do not strictly manage their business and personal finances independently (see Mistake #1).

For most small businesses, operating expenses are deductible in the year they are incurred. However, capital expenses, such as the cost of purchasing vehicles, buildings, long-life manufacturing equipment, etc, can be depreciated over several years. The IRS has an online resource center for determining how certain business expenses should be treated.

5. Not planning ahead.

CPA, EA or licensed tax attorney can represent the person or business on their behalf. The best way to avoid taxophobia is to follow a few simple suggestions:

- Keep the business' money and expenses separate.
- Make sure employees are not being paid as contractors.
- Pay reasonable wages to the employee-shareholders of S-Corps.
- Keep very good track of expenses.
- Seek professional help!

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