**Minority Business Development Division (MBDD)**
**Prince George's County Office of Central Services**

*Legal Issues and Taxes Facing Small and Minority Businesses | October 26, 2010*

# "Business Types and Payroll Taxes"

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# Overview

- Tax implications are determined by the type of business
- All for profit businesses with taxable income, will pay taxes directly through its corporative entity or through individual “pass through”
- Nonprofits are not taxed on income
- All businesses, whether for profit or non-profit, will pay payroll taxes on its employees. Businesses should be careful in classifying “employee” and “independent contractors”.
- Businesses should make all tax payments promptly to avoid excessive penalties/interest.
- Business owners who incur tax liabilities as a result of business pass throughs should make estimated tax payments on a quarterly basis.
- Consult with your CPA/tax advisor/business planner as your business grows and tax needs change.

# Entity Types

- Sole Proprietorship
- C Corporation
- S Corporation
- Partnership
- Limited Liability Company

# 1 Sole Proprietorship

- **Organization & Administration**

  The easiest business to organize. Intermingling of business and personal funds is allowed (although not recommended). Business income is reported on Schedule C, which is filed with the owner's Form 1040.

- **Entity Description**

  Consists of one individual. If husband/wife are partners, File 1065 (Partnership Return). EXCEPTION: Married couples residing in community property states may file as a sole proprietorship.

- **Taxation**

  Net profit/(loss) is computed on Schedule C. Reported as income/(loss) on Form 1040.

# Sole Proprietorship (Continued)

- **Wages & Self-Employment (SE) Tax**

  Owner subject to SE tax of 15.3% of net earnings.

  Computed on Schedule SE; reported as "other taxes" on Form 1040.
- **Losses**

  Can offset other income, i.e., interest, capital gains or spouse's wages if filing jointly. NOTE: subject to hobby, passive activity and risk loss rules.
- **Personal Liability**

  You are liable for all business debts and actions.
- **Tax Year/Tax Form**

  Normally calendar (December 31)/fiscal year, Form 1040
- **Return Due**

  15th day of 4th month following close of tax year.
- **First Extension**

  Form 7004 extends deadline 5 months

# C Corporation

- **Organization & Administration**
  Difficult, expensive to organize. Must hold periodic board meetings; keep minutes; comply with federal and state regulations.
- **Entity Description**
  Carries its own legal status, separate from the owners. Cannot elect out of corporate taxation.
- **Taxation**
  Pays tax on its profits. When shareholders take profits, the distributions are usually taxable dividends (double taxation). Personal service corporations are taxed at a high, flat rate. (35%)
- **Wages and Self-Employment (SE) Tax**
  Shareholders who perform services, including officers, are treated as employees. Wages are subject to payroll tax and withholding. Wages should be reasonable. Dividend distributions are not subject to SE tax.

# C Corporation (Continued)

- **Losses**

  Capital losses are allowed only to the extent of capital gains. Net operating loss is carried back/forward against income, but is not passed through to shareholders. NOL back 2 years. Forward 20 years.

- **Personal Liability**

  Shareholders not liable for debts. Liability generally limited to amount invested.

- **Tax Year/Tax Form**

  Normally calendar (December 31)/Fiscal, Form 1120

- **Return Due**

  15th day of 3rd month following close of tax year

- **First Extension**

  Form 7004 extends deadline 6 months

- **Tax Payments**

  Federal tax deposit (Form 8109) made to authorized financial institution quarterly (15th of month following quarter's end).

# S Corporation

- **Organization & Administration**

  A regular corporation. Must make election with the IRS by filing Form 2553. Certain events will cause automatic termination of S status.

- **Entity Description**

  Only domestic corporations with one class of stock are eligible. Limited to 100 shareholders; may not have another corporation as a shareholder. Exception: for qualified subchapter S subsidiaries. Other restrictions apply.

- **Taxation**

  Taxed similar to partnership. Income/expenses flow through to shareholders. Pass-through items retain the character in shareholder's hands as in the corporation.

# S Corporation (Continued)

- **Wages and Self-Employment (SE) Taxes**

  An employee-shareholder receives reasonable wages for services rendered.
  Additional profits pass through to shareholders and are taxable as income but not for SE tax. Double taxation of profits is avoided.

- **Losses**

  Flow through to shareholders. Recognition of loss is limited by shareholder's basic, at-risk rules/passive activity rules. Subject to "hobby loss" rules.

- **Personal Liability**

  Shareholders not liable for debts incurred by corporation. Liability generally limited to amount invested.

- **Tax Year/Tax Form**

  Calendar year, Form 1120S

  Return due 15$^{th}$ of 3$^{rd}$ month following close of business

  First Extension: Form 7004 extends deadline 6 months

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# Partnership

- **Organization & Administration**

  Easy to organize. A written agreement is recommended but not required. Agreement determines how income/losses are allocated. If agreement does not exist, items pass through based on partner's ownership interests.

- **Entity Description**

  Has two or more owners that functions as a trade or business. Joint undertaking merely to share expenses or ownership of property does not necessarily constitute a partnership.

- **Taxation**

  Income/expenses flow through to partners. Income taxed to the partner whether or not distributed. Pass-through items retain the same character to the partner as they had in the partnership.

# Partnership (Continued)

- **Wages and Self-Employment (SE) Taxes**

  A general partner's share of the income (including guaranteed payments) is subject to SE tax; limited partner's share is not unless the partner performs services for the partnership. Other items, i.e., interest and dividends, retain their character; are passed through to the partner's individual income tax return.

- **Losses**

  Flow to partners. Is limited by the partner's basis, at-risk rules and passive activity rules. Subject to "hobby loss" rules.

- **Personal Liability**

  General partner personally liable for all debt. Limited partner's liability usually limited to investment.

- **Tax Year/Tax Form**

  Normally calendar (December 31)/ fiscal, Form 1065

- **Return Due**

  15th day of 4th month following close of tax year

- **First Extension**

  Form 7004 extends deadline

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# Limited Liability Company

- **Organization & Administration**

  An existing partnership can generally register for LLC status in the state in which it conducts business. Registration is generally less complicated than forming a corporation.

- **Entity Description**

  Formed under state law. Treated as a disregarded entity, partnership or corporation. Single-member LLCs are usually treated as disregard entities taxed directly to their owner.

- **Taxation (same as Partnerships)**

  Income/expenses flow through to partners. Income taxed to the partner whether or not distributed. Pass-through items retain the same character to the partner as they had in the partnership.

# Limited Liability Company (Continued)

- **Wages & Self-Employment (SE) Tax**

  Profits subject to income tax (as in partnership). Members' business income (including guaranteed payments) may be subject to SE tax.

- **Losses**

  Flow through to members. Recognition of loss is limited by the member's basis, at-risk rules and passive activity rules.

- **Personal Liability**

  Degree of liability protection varies from state to state.

- **Tax Year/Tax Form**

  Normally calendar (December 31)/Form follows taxes

  (Could be Form 1040, 1120, 112S, or 1065, depending on set-up)


# Tax Planning

## <u>S Corporation vs C Corporation</u>

Factors to Consider

| S Corporation | C Corporation |
|---|---|
| 1. **Tax: Income**: passes directly to shareholders | 1. **Tax: Income**: taxed at corporate level <u>and</u> at individual level |
| 2. **Top tax rate**: 35% | 2. **Top tax rate**: 35% |
| 3. **Bottom tax rate**: Graduated rates for individuals begin at 10% | 3. **Bottom tax rate**: 15% for first \$50K regardless of shareholder's income |
| 4. **Undistributed earnings**: Generally are not taxable, up to share-holder's basis | 4. **Undistributed earnings**: May be eligible for capital gains tax when business is sold |
| 5. **Fringe benefits**: Restrictions for shareholders who own 2%+ of stock | 5. **Fringe benefits**: Few restrictions |

# Tax Planning


## Tips

- Corporations that distribute most or all profits may consider electing S status to avoid double taxes. Corporations that retain most or all profits may pay tax at a lower rate by remaining a C corporation.
- If net operating losses (NOLs) are anticipated, S status will allow the NOL to pass through. Shareholders can get a current deduction on individual returns.
- If a C corporation has large NOL carryovers, electing S status can cause loss of the NOL deduction. NOL carryovers cannot be used in an S status year, but the clock still runs for purposes of the 15-yr or 20-yr carryover limit.
- A C corporation can offer fringe benefits, i.e., health insurance, for its employee-shareholders. The C corporation is allowed a tax deduction and the employee-shareholder has a tax-free fringe benefit. Shareholders of S corporations who receive 2%+ must pay tax on the fringe benefit.


# Tax Planning

## Tips

- Certain C corporations must convert from the cash method to the accrual method. By electing S status, this may be avoided.
- S corporations have certain restrictions in choosing a fiscal tax year.
- C corporations generally are not so restricted.
- S corporations are not subject to alternative minimum tax.
- S corporation shareholders may be subject to the passive loss rules. C corporations can generally offset passive losses against nonpassive income.

# Tax Planning

## Partnership vs S Corporation – SE Tax

**Problem**: A partnership has two general partners. They each receive guaranteed payments for services and pay SE tax on the guaranteed payments. However, the partners are also subject to SE tax on their distributive shares of partnership income, even though the income is not directly related to their services.

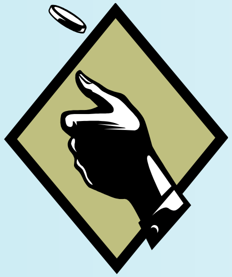
**Applicable Rules:**

(1) General partners are subject to SE tax on guaranteed payments and their distributive shares of partnership income. Each partner pays SE tax on his individual return.

(2) Earnings from an S corporation are passed through to shareholders as in a partnership, but the earnings are not subject to SE tax. NOTE: S corporation shareholders are subject to FICA on amounts earned as employees of the corporation, computed the same as for any other employee.

**Solution:**

Convert a partnership to an S corporation to reduce SE tax.



# Tax Planning

## <u>Partnership vs S Corporation – SE Tax</u>

(Continued)


As an entity, an S corporation is not as flexible as a partnership. For example, if a partnership agreement provides special allocations to a partner, a second class of stock may be created upon conversion to an S corporation. This will disqualify the corporation from electing S status.

Also, if the IRS determines that the wages paid to employee-shareholders are not reasonable, some or all of the S corporation earnings will be reclassified as wages subject to FICA.

# Tax Planning

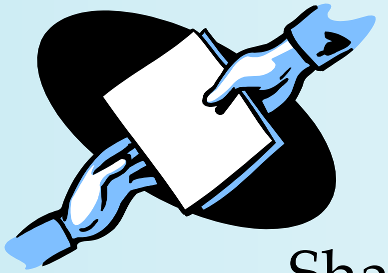
Tips

## Shareholder Loan to S Corporation

**Problem**: Securing a loan for an S corporation often requires a shareholder guarantee. If the loan is not properly structured, the shareholder's ability to deduct losses may be limited.

**Applicable Rules**: The amount of losses an S corporation shareholder can take is limited to the adjusted basis of the shareholder's stock, ploys any direct loans the shareholder makes to the corporation. If a shareholder merely guarantees a loan from a lender to the S corporation, there is no effect on the shareholder's ability to deduct losses.

**Solution:** If a loan is needed to provide capital for an S corporation, the shareholder should take out a personal loan for the amount needed and make a direct shareholder-to-corporation loan (back-to-back loan). With a back-to-back loan, the shareholder's allowable deduction for losses increases.



# Tax Planning

## Shareholder Loan to S Corporation

**Example**: James is sole shareholder in an S corporation. His beginning basis in stock is $10K. James needs to provide an additional $20K in funds to keep the S corporation operating. By year-end, it has a loss of $28K.

***Direct Loan from Shareholder***. James takes out a personal loan from his bank in the amount of $20K. He then makes a direct loan of $20K to the S corporation. James's limit for deduction of S corporation losses is not $30K (10 initial + 20 direct loan). James can deduct the S corporation loss of $28K on his individual tax return because the loss does not exceed his basis plus the amounts loaned directly to the S corporation.

***Loan Guarantee***. Assume the facts shown, except instead of making a personal loan, James has the bank loan funds directly to the corporation. In order to approve the loan, the bank requires James' signature as guarantor. Although he is liable for repayment of the loan, James; basis for deducting losses remains at $10K because he did not loan the funds directly to the corporation. James' deduction for the S corporation loss is limited to $10K. The remaining $18K loss is suspended until his basis increases.

# Tax Planning

## Shareholder Loan to S Corporation

(Continued)

**Note:** The same result would occur if James had loaned the S corporation $20K from a second S corporation solely owned by James. To avoid this situation, James should distribute the $20K from the second S corporation and then loan the $20K directly to the S corporation requiring the funds.


An S corporation can have only one class of stock. For S corporations with more than one shareholder, a loan must be structured so that a second class of stock is not created. If debt is convertible to equity, or if loan terms are contingent on profits or dependent on the borrower's discretion, the loan may be considered a purchase of a second class of stock, which will disqualify a corporation's S status.

# Tax Planning

## Shareholder Loan to C Corporation

**Problem**: When a shareholder provides cash to a corporation, it is often advantageous to structure the payment as a loan as opposed to a purchase of stock. Under a loan agreement, repayment of principal is generally nontaxable to the recipient, and interest on the loan is deductible by the corporation. However, if the loan is not properly structure the payment is considered an equity transaction, and repayments are treated as taxable dividends.

# Tax Planning

## Shareholder Loan to C Corporation

(Continued)

**Applicable Rules**:

1. **Purchase of stock vs loan**
   - When a shareholder buys stock, basis is not recovered until the stock is sold. Distributions to the shareholder are taxable dividends to the extent paid out of current or accumulated earnings and profits (E&P).
   - When a shareholder loans money to the corporation, repayment of principal is not taxable to the shareholder. Loan interest is taxable, but is also deductible by the corporation.

# Tax Planning

## Shareholder Loan to C Corporation

(Continued)

2. ***Constructive dividends***. If a corporation with E&P makes a distribution to a shareholder and does not report the payment as a dividend, the IRS may reclassify the distribution as a constructive dividend. In the case of loan payments, instead of being treated as a tax-free repayment of principal, the distribution may be taxed as a dividend up to the E&P of the corporation.

**Solution**: Loans between C corporations and shareholders must be carefully structured to avoid constructive dividend treatment. Loan agreements should be in proper legal form and executed in an arms-length manner, with a reasonable interest rate.

# Tax Planning

## <u>Shareholder Loan to C Corporation</u>

## (Continued)

**Example**: Nora, a shareholder in sunrise Corporation, wants to provide $20K in operating funds to the corporation. Nora expects the corporation to earn enough within the next two years to repay the $20K. Nora’s individual marginal rate is 25%, and the corporation’s marginal rate is 34%.

***Bona fide Loan***. The corporation executes a written loan agreement with Nora. The agreement is in proper legal form and contains a repayment schedule with specified maturity date. Nora will charge the corporation 8% interest, which is a reasonable interest rate under the current economic conditions. The corporation agrees to pay Nora $133/month, accrued interest, and will repay the $20K principal amount in 24 months.

**Note:** There is a *de minimis* exception for below-market interest on loans if the principal balance is $10K or less as long as the primary reason for the loan is not tax avoidance.

The corporation pays Nora $3,192 interest over the term of the loan. The interest is taxable to Nora and is deductible by the corporation. Nora pays $798 tax on the interest income ($3,192  x 25%). The corporation realizes tax savings of $1,085 from the interest deduction ($3,192 x 34%). The principal payment of $20K to Nora is not taxable.

# Tax Planning

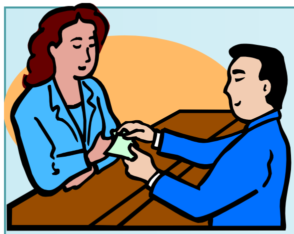
## Shareholder Loan to C Corporation

(Continued)

**Constructive Dividends**. Assume the same facts as the previous example, except there is not a legally binding agreement executed between Nora and the corporation. The IRS reclassifies the initial $20K payment as a *contribution to capital*. Subsequent distributions to the shareholder are considered taxable dividends, and the corporation is not allowed to deduct the interest.

When the payments are reclassified as constructive dividends, Nora must pay $3,479 tax on the distributions from the corporation ($23,192 x 15%). The corporation also loses the interest deduction, costing the corporation $1,085. Nora’s basis in stock is increased by $20K.

CAUTION! Closely held corporations are particularly susceptible to having distributions reclassified as constructive dividends. Transactions with their shareholders must be carefully structured in an arms-length manner to avoid unwanted tax consequences.



# Employee vs Independent Contractor

**7 things to consider about hiring people:**

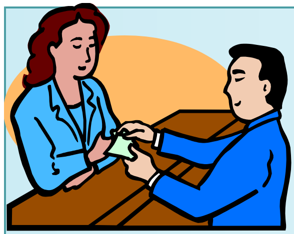
- The IRS uses these characteristics to determine the relationship between businesses and workers:

  - Behavioral Control (business directs/controls how the work is done through instruction, training, etc.)

  - Financial Control (directs/controls financial aspects of worker's job)

  - Type of Relationship ( how workers/business owner perceive their relationship)

2. Employer: has right to control/direct what is done, how it is done.
3. Employer: control/direct only result of the work (not means/methods)



# Employee vs Independent Contractor (Continued)

4. Employers who misclassify workers can end up with BIG tax bills and face penalties for failing to pay employment taxes/failing to file require forms.
5. Workers avoid higher tax bills/lost benefits knowing their proper status.
6. Ask the IRS to make a determination.

   - File Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes & Income Tax Withholding*
7. Learn more at www.irs.gov. Click on Small Business link.

# Payroll Tax Deposit Requirements

Employers are **REQUIRED** to deposit federal payroll taxes electronically (EFTPS) or use Form 8109

Court Case: The employer is responsible for payment of these taxes and cannot avoid its responsibility by transferring the taxes to another party, such as an employee or agent, and delegating payment to that party. The employer is liable until the government receives payment. (Pediatric Affiliates, 99 AFTR 2d 2007-2240 (3rd Cir. 2007)

State withholding taxes are deposited quarterly or monthly

# Payroll Tax Deposit Requirements

- Depository taxes include
  - Federal income tax withheld from employee wages
  - Social Security (SS) tax withheld
  - Medicare tax
  - Employer matching amounts for SS and Medicare
  - Federal unemployment (FUTA) taxes

- Penalties

  May apply if deposit is not on time, made at an unauthorized financial institution, deposits less than the required amount or does not use the EFTPS when required

# Payroll Tax Deposit Requirements (Continued)

- Late deposit and other penalties
  - 2% if made 1-5 days late
  - 5% if made 6-15 days late
  - 10% if made 16+ days late
  - 10% if paid at an unauthorized location, paid directly to the IRS or paid with the return
  - 10% required to be electronically deposited if deposited instead of using Form 8109, paid directly to IRS/with tax return
  - 15% required if amount is still unpaid 10+ days after date of the 1st IRS notice asking for tax due or the day demand for immediate payment is received, which ever is earlier.

**NOTE:** Penalties may be waived if the failure to make proper, timely deposit was due to a reasonable cause.


Successful Businesses Manage Taxes – Taxes Do Not Manage Successful Businesses!