

Business Taxes and Reduction Strategies.

Many aggressive tax reduction techniques touted by the larger accounting, consulting and law firms have been in the news lately, such as corporate owned life insurance, offshore partnerships and other tax shelters. Many of the most brilliant minds of our country concentrate on finding loopholes and inconsistencies in the tax law instead of traditional methods of increasing business productivity and profitability. Many feel this quest for complicated tax shelters overly distract a company from what should be the primary focus of a business – making a profit. Few, if any, great fortunes were ever created by simply exploiting tax loopholes.

That said, there are often some simple and overlooked strategies that can significantly add to your bottom line as much as increasing gross receipts or reducing expenses. You should understand some basic accounting and the simpler tax strategies that do not require five figure consulting fees or excessive risks of audit. One of the most important tax strategies, using retirement plans and deferred compensation, will be discussed in other chapters. This chapter will introduce some basic concepts of accounting, some important business deductions and then different tax strategies. Some of the different strategies were introduced in the chapter on Choosing the Business Entity.

Accounting Basics

Tax Year. For most businesses, like most individuals, this will be the calendar year ending December 31. C Corporations, however, have more flexibility in choosing their tax year, and may choose a fiscal year instead of a calendar year. A fiscal year is a period of 12 months ending on the last day of any month other than December, or may sometimes be a 52-53 week year ending on the same day of the week. For example, a C Corporation starting business on August 10, 2002 may elect a fiscal year ending July 31, 2003 (or the end of any month before that to create a shorter first year). The following fiscal year would run from August 1, 2003 to July 31, 2004.

Certain partnerships, S Corporations and personal service corporations may elect to use a fiscal year on Form 8716, “Election to Have a Tax Year Other than a Required Tax Year.” However, this often unduly complicates accounting and reporting and any tax advantages perceived by electing a fiscal year are usually lost because of the additional reporting and payment requirements. Thus, it is a relatively rare instance where any business other than a C Corporation uses a fiscal year.

Filing dates. For businesses using the calendar year as the fiscal tax year, the business tax returns may be due before April 15. Form 1120S for S Corporations and Form 1120 for C Corporations is due March 15. An S Corporation must provide the shareholders with a K-1 statement as well. Form 1065 for businesses taxed as a partnership need not be filed until April 15, and must also provide a K-1 statements to the owners of the business.

Accounting Method. Taxable income is computed not only based on the accounting period (tax year), but also on what accounting method the company uses. The most common methods of accounting that you should understand are the *cash basis* method and the *accrual basis* method.

Cash Basis Accounting. Individual taxpayers generally use the cash basis method, and it is instinctively easier to understand. Under this method, income is reported in the year in which it is received. This includes the concept of *constructive receipt* as well.

Constructive receipt occurs when you have control over the income, even though you have not actually received it. For instance, if your company gets paid on December 15, 2002 and you do not cash the check until January 4, 2003, you have constructively received the income in 2002 although you actually received the income in 2003.

However, if your employer holds the paycheck until a certain project is done, then this is not constructive receipt because there are non self-imposed limitations or restrictions on your receiving the money.

Deductions or credits under the cash basis method are treated the same way. They are to be taken in the year in which they are actually paid. There may be some exceptions to this. An expense written by check on December 31, 2002 but not sent to the creditor until January 15, 2003 will be considered paid and deductible in 2003 rather than 2002. Prepayment of substantial expenses can also alter the general rule. For instance, if you prepay a bill in December of 2002 for work that will not be done until February 2003, the IRS may not allow the deduction until 2003 even though the payment was in 2002. The IRS may allow the earlier deduction if the prepayment had a valid business purpose (such as a discount) and if prepayment does not result in a distortion of income. Rev. Rul. 79-229.

Accrual Basis Accounting. Under the accrual method of accounting, income is accounted for when the right to receive it matures. It is not the actual receipt, but the legal right to receive that governs. For example, when you bill a customer, it is considered income, even if the customer is notoriously late in paying their bills and may not pay for another four months. Expenses are treated the same way. It is not the actual payment, but the legal obligation to pay them. For example, when you place an order from a supplier, you get the deduction, rather than when you actually pay the bill, which may be months later.

Business Taxpayers that use inventories must use the accrual method to account for purchases and sales. Certain farming corporations must use the accrual method. Other taxpayers that may be forced to use this method are C Corporations and partnerships that have a C Corporation as a partner (personal service corporations are excluded from this category). IRC § 448(a). There are some significant exceptions to this rule, and cash basis accounting may be used if the entity is a farming or tree-raising business, a qualified personal service corporation, or has had less than \$5 million in gross receipts for the prior three years. IRC § 448(b), (c). The cash method of accounting may also be used by most other taxpayers where the average annual gross receipts of the business do not exceed \$1 million. Rev. Proc. 2000-22, 2001-10. The IRS has issued further rules

that even liberalize this further, especially for primarily service businesses. Notice 2001-76.

To summarize, the small business will nearly always be a cash basis taxpayer, but care should be taken anytime receipts grow over \$1 million to consult an accountant about possible changes required in accounting method.

Expensing v. Depreciating. You should understand the basic concept of a tax-deductible expense, which can be used to offset income in the year paid or accrued, and a capital expenditure. A capital expenditure must either be *depreciated* (similar terms are *amortized* or *depleted*), meaning that there is a deduction made over several years, or the expenditure may be required to be added to the tax basis of the property, meaning that there is only a tax benefit upon sale of the property. An expense that adds to the value or useful life of property is a capital expense. Capital expenses include expenditures for buildings, significant improvements or machinery. For instance, a repair on a roof may be a deductible expense, but a new roof will be a capital expenditure. Although both may be expensive, the repair reduces income dollar for dollar in year one, and the new roof reduces income only gradually over many years.

This is a very important tax accounting concept. In essence, any significant asset purchased or expenditure that has a useful life of more than one year cannot be expensed, but may be eligible to be depreciated over the life of the asset. This means you have to wait many years to get the full tax benefit from the expenditure.

Some common assets and their default useful life according to the IRS are:

Computers and Peripherals – 5 years

Office Machinery and Equipment – 5 years

Transportation Equipment – 5 years

Office Furniture and Fixtures – 7 years

Certain Watercraft – 10 years

Farm Buildings – 20 years

Residential Rental Property – 27.5 years

Leasehold Improvements – 39 years

Non-residential Real Property – 39 years

Land without improvements – cannot be depreciated

Items held for inventory or ultimate sale – cannot be depreciated

Note that even if your computer hardware becomes obsolete in one or two years that the IRS may make you use the five-year depreciation schedule, but see the following section on Section 179 elections for exceptions. Computer software bundled and included with

hardware must use the same rule. Software that has a useful life of less than a year, such as tax preparation software, may be a deductible expense, but other software costs may be amortized over 3 years. IRC § 167(f)(1). There may also be exceptions to the depreciation requirement for environmental cleanup costs, which may be eligible to be expensed as a deduction. IRC § 198.

Start Up Expenses of a Business. Nearly every business has some expenses that are associated with starting up the business. This may be as simple as initial legal and accounting expenses, or it may be other expenses associated with researching and investigating the potential viability of the business. IRC § 195 permits a business to deduct such expenses prorated, over at a minimum 60 months. Start-up expenses are considered capital expenditures. This election *must* be made on a timely filed first tax return (although a later amended statement may be allowed). Thus, if a business has \$12,000 of start up expenses, it will generate at most a \$2,400 deduction in the first year, or \$200 a month for 60 months.

IRC Section 179 Election. This is an extremely important provision in the tax code for small business owners to understand and take advantage of. Under this provision, a business can elect to expense rather than depreciate the cost of certain property in the year in which it is placed in service. This election can convert up to \$24,000 (rising to \$25,000 in 2003) of capital expenditures each year to an immediately deductible business expense. This only covers tangible personal property, such as machinery, equipment, computers and furniture (although heating and air conditioning units are not covered). As discussed above, such expenditures must usually be depreciated over the useful life of the asset unless eligible for this election. For example, if you spend \$10,000 on computers and office furniture, you may be eligible to expense the entire amount in the first year rather than depreciate the amount over five or seven years.

To make the election, file a Form 4562 “Depreciation and Amortization” with the tax return for the year in which the property is placed in service. Each item must be specifically identified along with the amount claimed as expense. The amount eligible to be expensed may be subject to phaseout when the property placed in service exceeds \$200,000 and may be subject to other limitations. Thus, if you have a large capital purchase to make, it may make sense to spread the purchases out over two years to better use the Section 179 election.

For example, if a business plans to purchase \$300,000 of equipment they may not be able to expense any of it if purchased in one year due to the \$200,000 threshold phaseout. However, if the business is able to spread the purchase to \$150,000 in 2002 and \$150,000 in 2003, then the entire \$24,000 and \$25,000 Section 179 election expense may be used for 2002 and 2003 respectively. For expenditures in the \$24,000-\$49,000 range, spreading out the purchase may allow the entire amount to be expensed. This is one of the more important provisions for small businesses to use and care should be taken to take full advantage of it.

Business Deductions

Subject to the above rule regarding capital expenditures, the general rule for other business expenses is that any ordinary and necessary expense of conducting a trade or business is deductible. IRC § 162.

Meals and Entertainment Expense. This is an important deduction for business owners, but requires detailed record keeping. The IRS allows 50% of business meals and entertainment expenses to be deducted. Certain meals, such as an annual appreciation dinner, company picnic or staff lunch or dinner taken during overtime, may be eligible for a 100% deduction. 100% deduction meals should be separately accounted for. For entertainment expense deductions, the cost must be either directly related to the active conduct of a trade or business or associated with such business if the expense is for entertainment directly before or after a substantial or bona fide business discussion. For example, you take a client (or prospect) to a Chicago Cubs game and have a substantial

and bona fide business discussion, spending \$80. \$40 is deductible, even if you drank more beer than the client. IRC § 274.

Commuting and Local Transportation Expenses. Normally, standard commuting expenses to and from the home are personal expenses and not deductible. You cannot deduct the cost of your daily commute. There are exceptions, however. Commuting expenses to a temporary location outside of the normal business metro area may be deductible. Expenses traveling from one business location to another are also deductible. If the home is the principal place of business, then travel to work at numerous temporary worksites may be deductible.

Travel Expenses Away from Home. Expenses incurred while traveling away from home in the pursuit of business are deductible, but require good record keeping. IRC § 162(a)(2). This may include reasonable transportation costs such as airfare or taxi service, meals and lodging, telephone and fax, rental car or other costs. This may include tips. If a personal side trip is taken, those expenses are not deductible, but the airfare and other expenses taken for the business part of the trip may still be deductible if the primary purpose of the trip is business. Even dry cleaning and laundering, which would not be a deductible expense at home, are deductible if incurred on a business trip.

Expenses for a non-employee spouse are not directly deductible, but expenses such as a hotel room or rental car that may be shared might still be deductible if required for the employee. Deductions for conventions, seminars or meetings held on cruise ships are subject to more stringent limitations, as are conventions or seminars held outside of North America (which includes much of the Caribbean, Canada and Mexico). IRC § 274(h). Expenses for travel outside of the United States for more than one week are also subject to more limitations if combined with a personal trip. IRC § 274(c).

Taxpayers should keep records showing the nature of the expense, when it was incurred, the amount, and the business purpose.

Automobile Expenses. This may be one of the more important deductions for the small business owner. Deductions may be taken for expenses such as gas, oil, tires, repairs, parking fees, garage rental, tolls, insurance, licenses and depreciation.

Standard Mileage v. Actual Costs. As you will note from the above list of expenses, it can be a formidable task keeping such receipts and then making the proper allocation between business and personal use. Although some taxpayers must use the actual cost method, many taxpayers may elect one of two methods to account for these expenses: the actual cost or the standard mileage rate.

The *standard mileage* method is rather simple. You keep records of the mileage driven for business purposes, and then multiply that number by the standard mileage rate (for 2002, this is 36.5 cents per mile, and this number may change annually). For example, if you drive 10,000 business miles in 2002, the deduction is \$3,650. This method is available for employees and self-employed persons only and cannot be used for cars used

for hire or for business owners using more than one car for a business. It saves you from having to keep track of most of the other expenses (except parking and tolls). Deductibility of car loan interest would be calculated separately, and the interest deductible would be based on the percentage of business use of the car.

The *actual cost* method requires tracking all these expenses. If the vehicle is used for both business and personal use, deductions are allocated between the two. For instance, if you drive 20,000 miles in a car in a given year, of which 8,000 miles were for business, then the applicable percentage of business use is 40%.

Unless the car is leased, depreciation of the car will also have to be calculated over 5 years. Special rules apply to depreciation of passenger automobiles. The amount of depreciation is subject to certain limits, which effectively limits depreciation for “luxury cars”. In 2001, these limits were \$3,060 for the first year, \$4,900 for the second year, \$2,950 for the third year, and \$1,775 for each succeeding year until the basis is recovered. A higher amount may be allowable for qualified clean-fuel or electric vehicles (which may also qualify for a credit) and for trucks or vans exceeding 6,000 pounds gross vehicle weight. Thus, if you buy a \$50,000 passenger car used for business, the depreciation may be limited to roughly \$3,060 in the first year, whereas a qualifying truck, van or electric vehicle purchased at the same price may get up to \$10,000 depreciation allowance (\$50,000 x 20%). The depreciation may be limited further by the amount of personal use. For instance, if the car is only used 50% for business, the limits are \$1,530 for the first year, \$2,450 for the second, etc.

For vehicles that are not mixed use, such as a van used exclusively for business and not for personal use, the Section 179 expense election may be available, allowing up to \$25,000 of the cost of such a vehicle to be expensed. Expensing for passenger cars may, however, be subject to the same “luxury car” limitation noted above.

Substantiation. To successfully claim the full amount of the deduction, you should keep adequate records regarding automobile expenses. For those using the standard mileage method, this will include the dates, purpose and mileage of any business trip. It will also include any receipts for parking or tolls. For those using the actual costs method, this will include receipts for all maintenance and repairs, purchase or lease information and total mileage broken down by personal, commuting and business categories.

Home Office Deduction. Taxpayers are not entitled to deduct any expenses related to their personal residence unless expenses are attributable to a portion of the home used *exclusively on a regular basis* as 1) the principal place of business; 2) a place of business used by clients in meeting the taxpayer in the normal course of business; or 3) in connection with the taxpayer’s business if the taxpayer is using a separate structure not attached to the home. IRC § 280A(c). Simply using a room in the home to track investments or do occasional work or meetings at home will not qualify, and even having an employee working there full-time may not make the use of a home a principal place of business necessarily. See Rev. Rul. 94-24.

The portion of expenses that are deductible without regard to business use (such as mortgage interest and property taxes) must be used first to reduce gross income before such expenses as insurance, maintenance, utilities or depreciation. No deduction is allowed from this latter category to the extent it creates or increases a net loss, but any such losses may be carried forward to the following year. IRC § 280A(c)(5).

Example: assume a taxpayer starts a business from the home and uses 20% of the home for this purpose. The taxpayer grosses \$24,000 from the home business and pays \$10,000 in mortgage interest and property tax, \$2,500 in insurance, maintenance and utilities, \$7,000 in depreciation and \$22,000 in other non-home related expenses. The expenses related to the home must be prorated to 20%, allowing a potential deduction of \$2,000, \$500 and \$1,600 respectively. The \$22,500 in miscellaneous deductions not allocable to the home and the \$2000 for mortgage interest and property taxes must be taken first, leaving a \$500 business loss. The remaining \$2100 in deductions are limited due to the loss, but can be carried forward to the next year. The remaining 80% (not 100%) of the mortgage interest and property tax may be used as an itemized deduction on Schedule A of Form 1040. The remaining 80% of the other home expenses are personal expenses and not deductible.

Life Insurance. Payments for life insurance are generally not excludible from income unless part of a group term life insurance policy with face amounts up to a maximum of \$50,000. IRC § 79. Amounts of insurance greater than this amount will be taxable income to the employee (also subject to employment taxes).

Political Contributions. Political contributions and lobbying expenses are not deductible, even if you can substantiate a direct business interest.

Professional Dues. Dues paid to professional organizations are generally deductible. However, you may notice a disclaimer on some dues notices that indicate a portion of the dues used for political lobbying purposes, which are not deductible. Dues to country clubs, athletic facilities, etc... will not be deductible, unless eligible for the 50% entertainment deduction mentioned earlier.

Retirement Plans. These will be discussed in another chapter, and are arguably the most important deduction available. These include 401(k) plans (generally for larger employers), 403(b) plans (generally for tax-exempt organizations), SIMPLE (Savings Incentive Match Plan) plans, SEP (Simplified Employee Pension) plans and traditional IRAs.

Charitable Contributions. For sole proprietorships and pass-through entities, the charitable deduction will pass-through and be calculated on an individual basis for the owner. This deduction is discussed in the chapter on Personal Income Taxation. If a C Corporation makes a charitable deduction, slightly different rules apply.

The deduction may be limited to 10% of taxable income of the C Corporation before charitable deductions are taken into account. For example, a C Corporation has \$30,000

of income and makes \$4,000 of charitable contributions. The deduction would be limited to \$3,000 and the remaining \$1,000 would carry forward for up to five years. Unlike individuals, the deduction for the C Corporation may be lost forever after the five years. Also note that you cannot zero out a C Corporation's taxable income with this strategy, since you can only do so for 10% of the income. Although it will usually make more sense for owners to pay themselves a bonus and make such contributions individually, this may still be a strategy of limited use for C Corporation owners in certain situations, such as if the owners usually use a standard deduction and an individual donation would not confer much benefit, or the owner has already contributed significant amounts and is somehow limited in ability to claim further personal deductions for the year.

Employer Provided Education. This provision may provide a business owner with a tax-effective way to compensate employees, including family members. An employee can completely exclude from income up to \$5,250 each year paid by the employer for educational assistance to the employee under a qualified educational assistance program. This can include tuition, fees, books and supplies, but not room and board or transportation. IRC § 127.

Some education has always excludible if it was for the benefit of the employer. However, this relatively new provision, which was extended and expanded by EGTTTRA, does not have to meet this requirement. The employer may pay for college, and, starting in 2002, even graduate level courses that do not have anything to do with the employer's business (although courses for sports, hobbies and games are not allowed unless they involve the employer's business). The plan must be non-discriminatory. Employers should file IRS Form 5500, "Annual Return/Report of Employee Benefit Plan", with Schedule F, "Fringe Benefit Plan Annual Information Return".

Business-Related Tax Credits

In addition to business deductions, you should be aware of certain business and investment related tax credits. Like most of the personal credits discussed in the prior chapter, most of these credits are non-refundable, but may be allowed as carry forwards to the next year, or carry backs to prior years.

The General Business Credit. The general business credit is really a sum of many different credits, including the following:

- 1) the investment credit, which includes the rehabilitation credit, energy credit and the reforestation credit;
- 2) the work opportunity credit;
- 3) the welfare to work credit;
- 4) the alcohol fuels credit;
- 5) the increased research expenditures credit;

- 6) the low-income housing credit;
- 7) the enhanced oil recovery credit;
- 8) the disabled access credit;
- 9) the renewable resources electricity production credit;
- 10) the empowerment zone employment credit;
- 11) the Indian employment credit;
- 12) the employer social security credit;
- 13) the orphan drug credit;
- 14) the new markets credit;
- 15) the small employer pension plan start up costs credit;
- 16) the employer-provided child care credit

For more details on how these credits work together, see IRS Form 3800, “General Business Credit”. There may be limitations on how many total credits can be used based on a taxpayer’s tax liability. However, unlike many of the personal tax credits listed in the prior chapter, these credits are not generally subject to “means testing” and limited to lower income taxpayers. The following is a very brief description of some of these. The last two are new credits established by EGTTRA. See the relevant IRS Form and instructions if you believe you may qualify.

Investment Credit. This credit includes the rehabilitation credit, energy credit and the reforestation credit. The rehabilitation credit may be up to 20% for expenses incurred regarding certified historic structures. The energy credit encourages investment in solar energy, geothermal energy and may be up to 10% for equipment that meets quality and performance standards. The reforestation credit may be up to 10% for up to \$10,000 in reforestation costs incurred for commercial woodlands in the United States. See Form 3468, “Investment Credit”.

Work Opportunity Credit. This credit is for wages paid to certain target groups, such as persons on Aid to Families with Dependent Children, veterans, ex-felons, high-risk youth, vocational rehabilitation referrals, summer youth employees, food stamp recipients, or SSI recipients. It can be for up to 40% of the first \$6,000 of wages for those beginning work before January 1, 2002. Congress may extend this deadline. See Form 5884, “Jobs Credit.”

Welfare to Work Credit. This credit is for employers who hire long-term family assistance recipients. It may be for up to 35% credit on first year wages up to \$10,000 and 50% credit on second year wages up to \$8,500. This credit is due to expire in 2002 unless Congress extends it. See Form 8861, “Welfare to Work Credit”.

Alcohol Fuels Credit. This credit is the sum of the alcohol mixture credit, the alcohol credit and the small ethanol producer credit. If you produce alcohol for fuel, see IRS Form 6478, “Credit for Alcohol Used for Fuel”.

Increased Research Expenditures Credit. This credit is applicable to more business owners and startups. Research expenditures eligible for this credit must be to discover information that is technological in nature and intended for development of a new or improved business component. The research must relate to new or improved function, performance, reliability or quality. This credit is currently for expenditures paid or incurred before June 30, 2004, but Congress may extend this provision. See IRS Form 6765, “Credit for Increasing Research Activities” for more details.

Low-Income Housing Credit. This credit is for owners of qualified low-income housing projects and may extend over 10 years. The owner must agree to a 30-year low-income use agreement with the housing agency. See Form 8586, “Low-Income Housing Credit”.

Enhanced Oil Recovery Credit. This credit is for expenses incurred in domestic oil recovery. See Form 8830, “Enhanced Oil Recovery Credit.”

Disabled Access Credit. This credit is for eligible small businesses that make a business accessible to disabled people. The credit may be 50% of qualifying expenditures that exceed \$250 but that do not exceed \$10,250. To be eligible, a small business must have gross receipts of \$1 million or less or have had no more than 30 employees during the preceding tax year. Eligible expenditures may include physical changes to the building, changes to the communication system, providing interpreters, acquiring or modifying equipment, or other accommodations for disabled access. See Form 8826, “Disabled Access Credit.”

Renewable Resources Electricity Production Credit. This credit is to encourage domestic production of electricity. Qualified expenditures include closed-loop biomass facilities, wind energy and poultry waste facilities, and are generally for expenditures prior to January 1, 2002, but this may be extended. See Form 8835, “Renewable Energy Credit”.

Empowerment Zone Employment Credit. This credit is to encourage employment in “empowerment zones” established by the Secretary of Housing and Urban Development (HUD) and the Secretary of Agriculture. This provision may provide up to a 20% credit on the first \$15,000 of wages paid to full or part-time residents of these zones. See Form 8844, “Empowerment Zone Employment Credit”.

Indian Employment Credit. A credit of up to 20% of the first \$20,000 in wages and health insurance benefits paid to qualified employees who are enrolled members of an Indian tribe or their spouses. Substantially all of the services performed must be within an Indian reservation and the employee must live on or near the reservation. See Form 8845, “Indian Employment Credit.”

Employer Social Security Credit. This credit is for employers in the food and beverage business who pay social security taxes on employee cash tips. See Form 8846, “Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.”

Orphan Drug Credit. This credit is for qualified clinical drug testing expenses. This credit may be for up to 50% of expenses incurred. See Form 8820, “Orphan Drug Credit”.

New Markets Credit. This credit was created to encourage investment in low-income communities. There are penalties if the investment is terminated within seven years, but the credit may reach as high as 39% over seven years. Active involvement of the low-income community is required as well. See Form 8874.

Small Employer Pension Plan Start Up Costs Credit. Starting in 2002, small businesses may qualify for a 50% credit for up to \$1,000 of expenses incurred to create or maintain a new employee retirement plan established after 2001, including defined benefit plans, defined contribution plans (including 401(k) plans), savings incentive match plans (SIMPLE), or simplified employee pension plans (SEP). Eligible businesses must have not employed more than 100 employees receiving more than \$5,000 of compensation. IRC § 45E

Employer-Provided Child Care Credit. This credit also starts in 2002. This credit may reach a maximum of \$150,000 and seeks to encourage small and mid-size companies to provide child-care services for employees. Requirements include open enrollment to all employees and no discrimination in favor of highly compensated employees. Qualified expenditures may include acquiring, expanding or constructing new facilities for child care, operating costs of the facility, or contracting with an existing child care facility. IRC § 45F

Payroll Tax Strategies

Any business with employees has to concern itself with payroll taxes. This includes any C or S Corporation with a sole owner/employee. Payroll taxes include: 1) income tax withholding for any employee for federal, state and local taxes; 2) the employer portion of federal social security and Medicare taxes (also called OASDI – old age, survivors and disability insurance); 3) the employee portion of federal social security and Medicare taxes; 4) state and federal unemployment tax. See IRS Publication 15, Employer’s Tax Guide.

A non-employee business owner (which may be a partner in a tax partnership) must pay the equivalent of these taxes, called Self-Employment Taxes, in lieu of the above taxes. IRC § 1401. These include a social security tax of 12.4% on earned income up to \$84,900 (a number increased annually) and Medicare taxes of 2.9%. In lieu of income tax withholding, the owner pays Estimated Taxes on a quarterly basis. A non-employee owner is unlikely to be required to pay unemployment taxes.

This section will discuss some strategies to minimize these taxes, especially the social security and Medicare taxes. Both the employer and the employee must pay a

social security tax of 6.2% of wages up to \$84,900 (this base is a 2002 number and may increase annually), and a Medicare tax of 1.45% of all wages. This totals 15.3% of the first \$84,900, and 2.9% of all wages above that. You will notice that when combined, the employee and employer tax rates equal the self-employment tax rates.

Although tax planners often only discuss income tax planning, payroll taxes may sometimes be greater than the corporate income tax (starting at 15%) or individual income tax (which may be as low as 0, 10 or 15%), and should be considered just as important in planning to avoid excessive taxation. Unlike income taxes, there is no standard deduction, exemption or delayed starting point for these taxes. The tax starts on the first dollar. Although there are not nearly as many tax “loopholes” with payroll taxes as with income taxes, there are a few strategies that you should note.

Retain Earnings. As discussed briefly in the chapter on Choosing the Corporate Entity, earnings retained in a C or S Corporation and not distributed to shareholders are not subject to social security and Medicare taxes. This may be a substantial savings of 15.3% when you have owners working in the company. This technique is not as likely to work in a tax partnership (discussed more below), and will certainly not work in a sole proprietorship.

Pay Out Profits as Distribution not Wages. This is certainly correct for passive investors not working in the business. If no work was done to earn the distribution and the profits earned based only on the owner’s capital contribution, then the distribution should not be subject to social security and Medicare taxes as wages. As discussed earlier, this may be a more aggressive strategy for owners working in the business. However, many tax practitioners are comfortable characterizing a certain amount of payment to owner/workers as a distribution of profits to owners rather than as wages, which could save up to 15.3% employment tax.

This may be done through a partnership or S Corporation (this technique would lead to potential double tax in a C Corporation), though many practitioners feel treatment of S Corporation distributions are more likely to safely avoid recharacterization as wages due to older IRS proposed regulations that are more negative on this point to tax partnerships. Proposed Regulation § 1.1402(a)-2(h)(2). This regulation has not been passed and is not law, but is the closest thing to guidance on IRS thinking in this area. The IRS will not likely subject a distribution of a tax partnership to self-employment taxes unless one of the following apply:

- 1) the partner or member has personal liability for debts of the partnership (common in a general partnership or LLP, but not in an LLC, and not for a limited partner in a LP);
- 2) the partner or member has authority to contract on behalf of the partnership (common in member managed LLP or LLC, but not for a limited partner in a LP or a non-managing member in a manager managed LLC); or
- 3) the partner or member participates in the business more than 500 hours a year.

As you can see, at least one of these criteria will often apply to many partners or owners of LLP or LLC interests, but will not apply to a limited partner or an LLC owner

whose interest closely resembles that of a limited partner. That said, some practitioners go beyond these regulations because they are not binding interpretations.

Remember the adage, however, that “Pigs get fat and hogs get slaughtered”. If you try to declare everything you make as a dividend style distribution and not wages, the IRS will use the “reasonable salary” guideline to recharacterize the distribution as truly wages. The company must pay its owner/employee a reasonable salary for work done based on the nature of the job. Basically, what would it cost to hire someone to do what you do? The IRS may be more successful in treating a distribution as wages where a company is primarily a service business and capital investment is not a factor in production of income, or where there are no other employees that one can claim as helping to produce the excess income.

Using independent contractors/temps instead of employees. Be careful overusing this one. The IRS has successfully attacked many companies that tried to classify their workers as independent contractors rather than employees. The back taxes and penalties can be fierce. However, many tasks may be successfully delegated to independent contractors or consultants without fear of such characterization. A company does not have to withhold payroll taxes for an independent contractor, but must file a 1099-MISC whenever payments exceed \$600 a year.

To distinguish between the two, there are several factors to consider. In general, the more you have control over a worker, the more the worker looks like an employee. A brief chart will note a few differences:

<u>Employee</u>	<u>Independent Contractor</u>
Works at site of employer	Works off-site
Uses company tools or equipment	Uses own tools and equipment
Cannot delegate or hire others for job	Can hire others or delegate
Method/timing of job specified/controlled	Method/timing of job uncontrolled
Expenses reimbursed	Expenses borne by worker
Little invested by worker	More invested by worker
Payment weekly, bi-weekly or monthly	Payment by the job or flat fee
Only works for one employer	Works for several clients
No risk of non-payment if poor job	Risk of non-payment or loss
Profit/bonus limited	Opportunity for profit
No advertising	Advertising to general public
Contract states employee relationship	Contract says independent contractor
Position seems permanent	Position temporary
Work done is essential to business	Work done is non-core function

No single one of these factors determines status. The IRS has a 20-factor test outlined in Revenue Ruling 87-41 and discussed in Publication 1976, “Independent Contractor or Employee”. When you have a relationship that is unclear, you should consult with the IRS guidelines and publications. If your intent is to hire an independent contractor, try to make sure the relationship has more of the factors indicative of that status, checking the latest IRS publication for all relevant factors. Because of the large amounts at stake, you should err on the side of employee status if uncertain. You may

wish consult a tax attorney or accountant as well, especially if you have multiple workers in a gray area. In addition, you can request that the IRS make a determination of worker classification by submitting Form SS-8, "Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding".

Common Paymaster. This will unlikely apply to most start up businesses, but is still a good technique to note. If employees work for two related companies sharing 50% of the officers or 30% of their employees, or a company owns 50% or more of another, this technique may save the companies payroll taxes. For example, you have two sister companies that meet this criteria. John Doe, Jane Doe, James Dean and Daffy Dean all work for XYZ, Inc and ZYX, Inc. The Does are 60% owners of XYZ and 40% owners of ZYX; the Deans own the rest of each company. Each one works in the each business and makes \$50,000 from each company. Without a common paymaster, XYZ and ZYX pay 6.2% social security taxes on the full \$400,000 in salaries. With a common paymaster, only the first \$84,900 of each worker's wages is subject to social security taxes, rather than all \$100,000, saving 6.2% of 4 times \$15,100, for over \$3700 of savings.

Employ your children under 18. A sole proprietor may not be required to pay social security taxes on wages of his or her child under the age of 18. This exception does not apply to an incorporated business. IRC § 3121(b).

Use certain fringe benefits. Amounts paid into a flexible spending account (FSA), for instance, are taken out on a pre-tax basis and are not subject to social security, Medicare and unemployment tax. Note, however, that some fringe benefits, such as employee contributions to retirement plans, are taken out on a pre-tax basis and not counted as income tax, but the amount contributed is still considered wages for payroll tax purposes and reported on the employee's W-2. Fringe benefits that may be excluded for both income and wages are medical insurance and reimbursement, group-term life insurance up to \$50,000, dependent care assistance up to \$5000, educational assistance up to \$5250, meals and lodging, qualified parking, transit passes, moving expenses and small employee awards.

Use Deferred Compensation. This technique may provide savings when employees have income higher than the applicable social security ceiling (currently \$84,900 in 2002, subject to annual increase). The reason is that deferred compensation is subject to social security taxes in the year earned, rather than in the year paid. At first glance, this would appear to be a negative, since the income is taxed even before you actually receive it. However, if you go beyond the wage base cap, there is no tax anyway.

For example, Maria earns \$90,000 annually, and enters into a deferred compensation agreement to defer an anticipated bonus of \$20,000 until retirement. In 2002, she earns the bonus and the employer and employee must pay their share of social security and Medicare taxes. However, the \$20,000 bonus is not subject to social security tax because the annual income is already above the \$84,900 wage base. The bonus is taxed at 1.45%

each for Medicare, however. When Maria retires and receives her bonus, there is no social security tax paid on it.

Use accountable plans for reimbursing employee expenses. The general rule for employee advances and reimbursements of travel and entertainment expenses is that payroll taxes should be withheld and the employee can later get an itemized deduction for expenses incurred. This is terrible tax treatment for the employer as well as the employee. However, there is an exception for accountable plans. Be certain that the company has a reimbursement plan that requires employees to substantiate expenses within 60 days and reimburse excess advances within 120 days. An advance can be made within 30 days of the expense.

Loaning money to the entity. If you loan money to the business to meet cash flow, the business must pay fair market value interest on the loan. The interest paid by the business is deductible, and the interest paid to the lender is income. However, it is not subject to employment taxes as wages. This may have limited application, but may be a consideration when debating between a loan and a capital contribution to the business.

Leasing assets to the business. Any reasonable payment for business property leased by the business from an owner will be a deduction to the business/lessee and income to the owner/lessor. Payment should not be subject to payroll taxes. Some businesses may not realize that they are really paying owner/employees for more than their actual labor, such as for the use of their equipment or tools not contributed as capital to the business, or even for the use of an owner's name as a trademark or trade name. Such payments may actually be for other than wages, and should be segregated from wages under a separate contract. Payments under the contract would not be subject to social security, Medicare and unemployment taxes.

Employing Your Family

There may be tax advantages to employing your spouse or children, provided they do actual work for your business. First of all, your child will pay very little tax, if any, on the wages he or she receives, thus any income paid to them lowers your tax bracket and is paid at a low rate (perhaps even zero) at the child's income tax bracket. The so-called "Kiddie Tax" discussed in the prior chapter does not apply to earned income. The amounts paid would lower your AGI, which in turn may make you eligible to claim many credits and deductions that phase out when your AGI increases.

If the business is taxed as a sole proprietorship, your children will not be subject to Social Security or Medicare taxes until they are 18 or over. Thus, getting \$8 an hour from Dad may be worth more to a child than working at the local McDonald's for \$8 an hour, due to 7.65% employment taxes withheld by an ordinary employer. You may also avoid unemployment taxes on employing a child under 21 if you are a sole proprietor.

Employing a spouse does very little to shift income, and with significant income paid, may actually increase the tax burden. For instance, if you and your spouse are paid

\$60,000 each from your business, you will have 15.3% employment taxes due on the entire \$120,000, whereas if the salary went to only one earner, the 15.3% would only apply to the first \$84,900, and the remaining income would only be taxed at the 2.9% Medicare rate. This is more than a \$4,300 increase overall in social security tax. There would be increases in unemployment and worker's compensation expenses as well.

However, employing a spouse can be used to convert non-fully deductible health insurance to fully deductible health insurance, and take advantage of other fringe benefits. For instance, if you employ your spouse and insure them under the company health insurance plan, and such plan includes spouses of employees, you are then employed under your spouse's insurance, not your own, and such insurance would be 100% deductible to the company rather than only 70% deductible. However, even this advantage will wane as the self-employed health insurance deduction increases to 100% in 2003.

Year-End Planning Review

A business may want to do the following before the year-end to minimize their tax liability and plan for the upcoming year:

- 1) evaluate the form of business entity (January 1 is a good time to start as a different tax entity for accounting simplicity);
- 2) review estimated taxes if applicable so that penalties are avoided (see the prior chapter on estimated tax rules);
- 3) estimate income and expenses to see if acceleration or deferral of income or deductions is possible or desirable;
- 4) review equipment purchases to best use the Section 179 expense election;
- 5) review inventory to take losses or reduce prices on slow selling goods.