



CATHEDRAL CONSULTING GROUP, LLC

Tax Planning

Rather than viewing taxes as an annual event, year-round preparation can reduce the stress of this time of year. This begins with organized record-keeping including good financial software which produces timely, accurate financial reports. Procrastination of meeting with the accountant might delay knowing the exact amount of the bill owed, but also limits the time you have to prepare to pay any taxes due. As with all tax matters excellent advice is important. The comments below are designed for general information only. Your tax advisor should be consulted about the application to your situation.

Tax Implications of the Business Structure

How taxes are paid for your company is based on the structure of your business—sole proprietorship, partnership, limited liability corporation (LLC), S corporation, or C corporation. Sole proprietorships, partnerships S Corporations, and LLC's do not pay taxes on income. Owners include the income in their personal tax returns to pay taxes on the profits of the company. Partnerships, S Corporations, and LLC's are also required to file an information-only return.¹

S-Corp Election

Corporations have two possible tax statuses – as a C Corp or an S Corp. C Corps pay taxes at a corporate level as a separate tax entity and the dividends are taxed at a shareholder level as well. This is commonly referred to as double taxation. For an S Corp income is reported by the shareholders on their tax return. Although the shareholders are responsible to pay the tax, private companies often issue shareholders a distribution to cover the amount of the tax. In this regard the company really does bear the tax on the income. However, S Corporation distributions towards tax payments or other distributions to the shareholders are not treated as dividends and therefore not subject to tax. This results in a single taxation of income.

If a private company structured as a C corporation decides to sell, the buyer will generally want to organize assets to get full tax deductions for the purchase price. Any gains on the assets are taxed at the corporate level. When the proceeds of sale are distributed to the C Corporation shareholders they are taxed again as dividends at the shareholder level. This results in double taxes of gains for the owner. The shareholder wants to sell stock so that it has a single level of tax. Because of this, a C corporation structure can cause extra expense and negotiations during a sale transaction.

A company can choose the S Corporation election if they meet the IRS requirements including having less than 100 shareholders.² This election must be made in the first 2

¹ <http://www.irs.gov/businesses/small/article/0,,id=98966.00.html>

² <http://www.irs.gov/pub/irs-pdf/i2553.pdf>. IRS instructions for Form 2553 regarding elections.

months and 15 days of the tax year in order to be effective that year. In a sales transaction the S corporation structure would be advantageous because the buyer could purchase the stock and elect to treat it as if they bought the assets. The seller/shareholder would only report the gains on the sale of the stock and thus experience a single level of taxation.

There are many other benefits of electing to be an S corporation which are not discussed here. We recommend that you consult your tax advisor on the merit of being an S Corp. Please be aware that if you are currently a C Corp there are transitional rules that will need to be followed. Your tax advisor can inform you of these regulations.

An LLC is a unique structure in that it can be treated as a partnership or an S corporation. Since the IRS default is to treat an LLC as a partnership, companies must elect to be treated as an S corporation in the same time frame as the C corporation as noted above.

While both partnerships and S corporations have a single tax attribute, the most notable difference is that in a partnership the owner is viewed as self-employed. In an S corp the owner is viewed as an employee. Partnerships have special rules dealing with the allocation of income and expenses between partners that can be quite useful but are less applicable to corporations. LLC and S corporation elections should be reviewed by a company's tax advisor.

Employees vs. Independent Contractors

Properly identifying your staff as employees or independent contractors is very important in terms of tax liabilities. According to the IRS, "in general, someone who performs services for you is your employee if you can control what will be done and how it will be done."³ The IRS reviews behavioral control, financial control, and the type of relationship when determining whether the company should be treating the staff member as an employee or an independent contractor. A company is responsible to withhold payroll taxes, to pay social security and Medicare taxes, to pay Federal unemployment tax, to issue W-2's annually, and to report wages to the IRS for all employees. Independent contractor wages are reported through Form 1099-Misc.

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Most small businesses are eligible to immediately expense up to \$128,000 in equipment and software purchases under the "Section 179 deduction" (This will change over time). Whether the purchases are new or previously owned, it qualifies as a deduction if it is in use by the end of this year. If considering acquiring equipment, check with the IRS rules⁴ on this that are designed to encourage these purchases.

Upcoming Legislation

Since it is an election year, there is the potential for meaningful tax legislation. The article "New Tax Legislation" (link at the bottom) outlines three tax bills to be considered in Congress this year that could affect small business owners.

Timely Filing

In order to file timely tax returns, proper systems of organization including timely, accurate, financials should be put into place.

Tax Withholdings – Separate Account

³ "Employee or Independent Contractor?" <http://www.irs.gov/govt/fslg/article/0,,id=110344,00.html>

⁴ "Electing the Section 179 Deduction." <http://www.irs.gov/publications/p946/ch02.html>

We encourage the establishment of a separate bank account for all withheld taxes (payroll and sales taxes). These funds, which are withheld and are owed to the government, should be separate from those that are available to the company for use. Too many companies wake up to a surprising tax bill because funds were co-mingled throughout the year and already utilized for other company expenses. Most payroll services (Paychex and ADP) provide tax services and withdraw taxes along with salaries to eliminate this possibility regarding payroll taxes.

Articles for Further Reading

- “New Tax Legislation.”
(<http://www.inc.com/resources/tax/articles/20080103/bweltman.html>)
- “Small Businesses need to plan for Tax Time.”
(<http://www.msnbc.msn.com/id/17280629/>)
- The IRS provides answers to many tax-related questions in its Small Business Resource Area (<http://www.irs.gov/businesses/small/index.html>).
- “Year-End Tax Planning Moves for Small Businesses.”
(http://www.smsmallbiz.com/taxes/Year-End_Tax_Planning_Moves_for_Small_Businesses.html).

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