TAX CONSIDERATIONS FOR SMALL BUSINESSES

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Overview of Topics

- General federal tax issues
- Federal tax incentives
- Entity selection tax issues
- State tax issues
- Sales & use tax issues
- Filing Requirements
What Deductions are Allowed?

- Ordinary and necessary business expenses
- Certain exceptions apply
  - Meals and entertainment
  - Penalties
  - Illegal payments
  - Key man life insurance
- Capital expenses must be depreciated over their lives

Depreciation of Business Property

- Items of property generally may not be expensed in the year of purchase; instead, the cost is deducted over a number of years. This is known as depreciation.
- Depreciation lives for personal property are generally 5 to 7 years.
- Depreciation lives for real property range from 27 to 39 years.
Depreciation as an Economic Incentive

- Bonus depreciation
  - Added in 2008
  - 50% write off in year of purchase for qualifying property
  - Property must be new and have a life of 20 years or less
  - Scheduled to expire after 2009, but a House Bill was introduced on January 6, 2010 to extend it to the 2010 tax year

Depreciation as an Economic Incentive

- Section 179 expensing election
  - First $250,000 of equipment purchases can be expensed rather than depreciated
  - The expensing limit decreases to $134,000 for 2010
  - This provision is targeted to "small" businesses
  - If total equipment purchases exceed $800,000, Section 179 deduction is phased out
  - Generally, this deduction is only available for profitable businesses
Section 179 and Depreciation Example

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>New 5 Year Asset</td>
<td>$800,000</td>
</tr>
<tr>
<td>Less 50% bonus depreciation</td>
<td>($400,000)</td>
</tr>
<tr>
<td>Less 179 Expense</td>
<td>($250,000)</td>
</tr>
<tr>
<td>Net Depreciable Basis</td>
<td>$150,000</td>
</tr>
<tr>
<td>Depreciation - MACRS 200DB</td>
<td>20%</td>
</tr>
<tr>
<td>Current Year Depreciation Expense</td>
<td>$30,000</td>
</tr>
<tr>
<td>1st YR Tax Deduction (400 + 250 + 30)</td>
<td>$680,000</td>
</tr>
</tbody>
</table>

Credits and Incentives

- Foreign sales incentives
- Research incentives
- Incentives to purchase business assets
- Energy efficiency or "green" incentives
- Removal of barriers to the handicapped
Entity Selection Tax Issues

- Most common types of business entities
  - Corporation
    - S Corporation
    - C Corporation
  - Limited Liability Company
    - Single member
    - Multimember

Entity Selection Tax Issues

- "C" Corporation
  - Income and loss stays at the entity level
    - Losses don’t provide a tax benefit to the owner
    - Income may be subject to “double taxation”
  - Most shareholder benefits are deductible at the corporate level
    - Shareholder health insurance
  - No limitation on type of shareholder
“C” Corporation Double Taxation

- Many times, the profits are subject to two layers of taxation when profits are distributed
  - Profits are taxed at the corporate level as they are earned
  - Profits distributed as dividends are taxed again at the shareholder level and are not deductible at the corporate level
- This is one of the most significant disadvantages of C-Corporations for small businesses

Example of Double Taxation

- Assume that a C-corporation has $250,000 of income before tax and wishes to distribute all after tax income to the shareholders
- Corporate level tax:
  - Federal income tax $80,750
  - Illinois income tax $18,250
  - Total corporate tax $99,000
- This leaves $151,000 to pay as a dividend to shareholders
Example of Double Taxation - Continued

- Shareholder level tax on $151,000 dividend
  - Federal income tax $22,650
  - Illinois income tax $4,530
  - Total shareholder tax $27,180
- This leaves $123,820 of after tax cash to the shareholder

Example of Double Taxation - Continued

- Corporate income before tax $250,000
  - Total corporate tax ($99,000)
  - Total shareholder tax ($27,180)
- Remaining after tax cash $123,820
- This is an effective tax rate of 50.472%
Entity Selection Tax Issues

- S corporation
  - Flow through entity
    - Income is taxed to shareholders regardless of the amount of cash actually distributed
    - This may result in shareholders filing tax returns in many states
    - Losses are generally deductible to shareholders and can offset other income sources, subject to limitations
  - Limitation on types and numbers of shareholders

Entity Selection Tax Issues

- S Corporation losses
  - Shareholder deduction of losses are subject to two types of limitations
    - Passive loss rules – generally not a problem for an active shareholder
    - At-risk rules
S Corporation at Risk Rules

- Losses are only deductible to the extent the shareholder has basis. Basis is made up of:
  - Capital put into the corporation by the shareholder
  - Direct shareholder loans
- Basis does not include
  - Third party loans, even if guaranteed by the shareholder
- Basis is determined on the last day of the corporate tax year

S Corporation Shareholder Fringe Benefits

- There are limitations on shareholder fringe benefits
  - Shareholder health insurance paid by the corporation must be added to the shareholder's W-2 form
  - Shareholder may not participate in Section 125 plans to pay health insurance with pre-tax dollars
  - Shareholder may not participate in cafeteria plans
Limited Liability Companies

- Multi-member LLCs are taxed as a partnership
- Flow through entities
  - Income is taxed to shareholders regardless of the amount of cash actually distributed
  - Losses are generally deductible to shareholders and can offset other income sources, subject to limitations

Limited Liability Companies

- Members in an LLC who receive compensation are not treated as employees and do not receive W-2 Forms
- Payments are treated as guaranteed payments
  - Still deductible by the business and taxable to the member
- If health insurance is paid by the LLC, it is treated as a guaranteed payment and taxed to the member
State Issues

- State Nexus – what states will be you required to file
  - Many activities can create a filing obligation
    - Employees in a state
    - Assets in a state
    - Delivering product into a state
  - States are getting very aggressive in tracking down non-filers

Illinois Credits & Incentives

- Investment tax credit
- Enterprise zone credit
- Research credit
Employment Tax Rates – 2010 Wage Base

- Employer/Employee
  - FICA 6.2% 1st $106,800
  - Medicare 1.45% No limit
  - Employer and employee each pay this tax
- Self employed
  - FICA 12.4% 1st $106,800
  - Medicare 2.9% No limit
  - Self-employed pays both halves

Example of Employment Tax Calculation - 2010

- Assume an employee with $160,000 salary
  - $106,800 @ 6.2% $6,622
  - $160,000 @ 1.45% $2,320

- Total payroll tax $8,942
- A self-employed person would pay $17,884
Unemployment Taxes

- Federal – return filed annually
  - .8% on the first $7,000 of wages per employee per year
- Illinois – return filed quarterly
  - 1% to 8% on the first $12,000 of wages per employee per year
  - New employers start at about 4%

Employee vs. Independent Contractor

- Why it's important
  - Tax withholding obligations
  - Employer’s FICA
  - Fed & state UC
  - Workman’s compensation
  - Filing requirements
  - Employee benefits
  - Labor laws
  - Aggressive IRS audits
Employee vs. Independent Contractor - Factors

- Instructions
- Training
- Services rendered personally
- Hiring assistants
- Continuing relationship
- Set hours of work
- Location of work

Employee vs. Independent Contractor - Factors

- Payment terms
- Furnishing of tools & materials
- Realization of profit or loss
- Services available to others
- Right to fire
Sales Tax

- Collected from your customers
  - Doesn’t cost you anything if it is done correctly
  - Can be an enormous burden if not collected from your customers
- Illinois rate 6.25%
- Local rate varies
- Exceptions apply to some merchandise

Use Tax

- Applies to an item that was purchased without sales tax and used in Illinois
- Applies to all taxpayers, not just businesses
1099 Filing Requirements

- Information returns used to report various types of income
- Only applies to business related payments
- Completed and filed by payer
- Copy to IRS and recipient for income
- Penalties for failure to file

Any Questions?