Taxpayer's Comprehensive Guide to LLCs and S Corps (Shortie Version)

2019 Edition

(last updated on November 20, 2018)

Includes the Tax Cuts & Jobs Act of 2017 and Section 199A Business Deduction

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and

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Introduction

How can I avoid self-employment taxes? This simple question was the inspiration for creating an article describing the benefits of an S Corporation. That original article, which was about four pages long, quickly became a series of KnowledgeBase articles on the Watson CPA Group website. The articles touched on basic topics such as how to elect S Corp status, shareholder payroll, reasonable salary determination, retirement planning, health care, fringe benefits and liability protection.

Those broad topics demanded much more information, both horizontally by spanning into more related issues, and vertically by digging deeper into the granular yet riveting levels of the tax code. The articles were grouped and relabeled as the **Taxpayer's Comprehensive Guide to LLCs and S Corps** which grew to 39 pages in its first edition. Sorry, all the good titles were taken (remember, the longer the title the less important the material is. Bible, Beowulf, Caddyshack… short and sweet). The Hunt for Red October is one exception, yet we digress.

Time marched on, and more information was added to the first edition such as expanded retirement planning concerns, health care options after the Affordable Care Act and business valuations including exit strategies. Boom, we now had our second edition at over 100 pages. At that point it was suggested by some clients and colleagues to convert the PDF into an eBook as well as paperback. So here we are on our fifth edition which is now called the 2017 edition.

Each week we receive several phone calls and emails from small business owners and other CPAs across the country who have read our **Taxpayer's Comprehensive Guide to LLCs and S Corps** and praised the wealth of information. Regardless of your current situation, whether you are considering starting your own business or entertaining a contracting gig, or you are an experienced business owner, the contents of this book are for you.

Our book will show you how to reduce your self-employment taxes through an S Corporation election and how to use your corporation to your retirement and fringe benefit advantage. You will also learn the operational considerations of an S Corp plus the 185 reasons you should NOT elect S Corp status. Want to buy or sell a business? That's in here too.

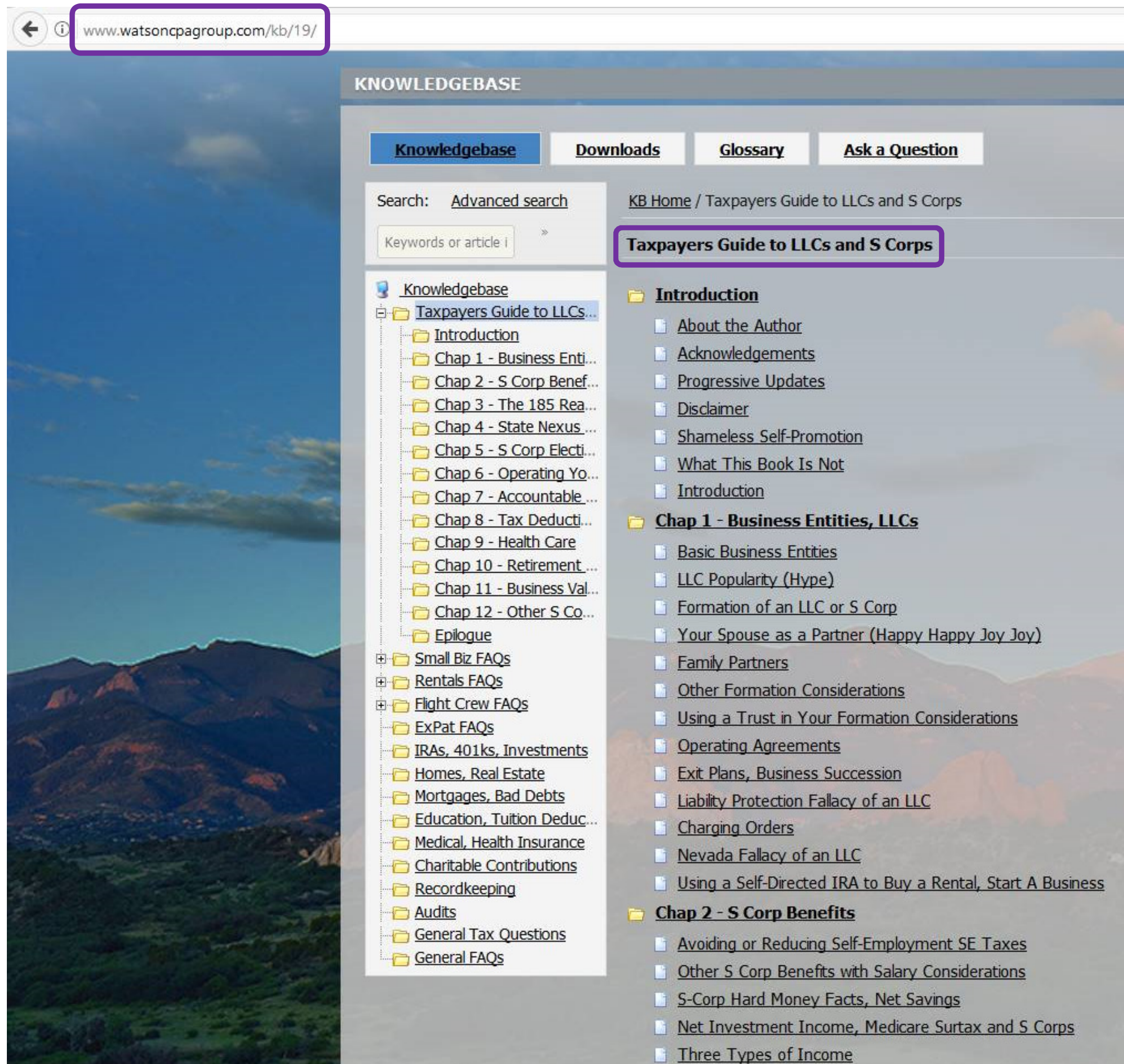
Our book is written with the general taxpayer in mind. Too many resources simply regurgitate complex tax code without explanation. While in some cases tax code and court opinions are duplicated verbatim because of precision of the words, this book strives to explain many technical concepts in layperson terms with some added humor and opinions. We believe you will find this book educational as well as amusing.

Shortie Version

This PDF is our teaser. We want to show you some of the basic concepts you need to consider when operating an LLC with and without an S Corp election. Throughout this PDF we will bring up additional concerns and solutions including tax court cases that are only available in our purchased print copy from Amazon or downloadable electronic PDF copy.

Yes, we are trying to monetize our efforts. Then again if our audience is business owners then this shouldn't come to you as a surprise since you are doing the same thing. Having said that, all this material is available from our KnowledgeBase as individual articles. The only difference is delivery- you can click away and get everything you need, or you can purchase printed and downloadable versions.

Please visit **www.watsoncpagroup.com/book** for more information on purchasing the $12.95 PDF or **www.watsoncpagroup.com/kb** for our KnowledgeBase version which contains the full text in web format.



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About the Author

Jason Watson
Managing Partner

Jason Watson is the Managing Partner for the Watson CPA Group, a Colorado Springs tax, accounting and consultation firm.

Jason has owned two small businesses in the past and holds both a Bachelor's and Master's in Business Administration from the University of Wisconsin – Madison. He also became an Enrolled Agent with the IRS in 2013 and passed the CPA exam in 2018.

Aside from carrying the one in accounting class, his desire is speaking with small business owners and creating a dynamic map for the future. Jason enjoys talking about business planning, corporate structures, self-employment taxes, health insurance issues and retirement planning. He is quick to point out that while 70% of the all situations can be covered with the basics, every business and person is truly unique. One his Jason-isms is "every house has four walls and a roof, but inside, the things that are personal to you, are different than your neighbor's."

Ask a question and have a dry erase board handy, and you'll see the true passion of a person who not only wants to educate but also wants to see small business owners thrive. While this book is on LLCs and S Corporations can be labeled as shameless self-promotion, at the same time it truly came from Jason's heart to help small business owners everywhere.

Other than sharing a beer with other Colorado Springs CPAs and drooling on the latest IRS Notice, Jason likes dirt biking, boating in Wisconsin, watching the Packers beat the Bears (it never gets old), and running trails in Colorado. He used to also be a pilot for SkyWest Airlines, a United Express airline, but resigned in March 2015 to focus on improving the Watson CPA Group.

Lastly and most importantly, he is a father of three wonderful, amazing and perfect children (posturing is the new past time in Colorado Springs) and is married to the Watson CPA Group's founder and Senior Partner, Tina Watson, CPA.

You contact Jason at 719-428-3261 (direct) or **jason@watsoncpagroup.com**.

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Progressive Updates

The tax law is continuously changing from the acts of our government, to the decisions by the Tax Court and Federal courts, and through notices and private letter rulings from the IRS. In addition to changes, other topics of interest pop up in various trade journals such as Journal of Accountancy, Tax Adviser and Kiplinger's Tax Letter. As we discover other issues concerning LLCs, S Corporations and self-employment taxes, we want to get the word out right away.

More importantly, the frequent business consultations we perform and the questions we field provide a steady stream of new ideas that are worthy of being wormed into this book. So here's to you- the curious small business owner helping others.

Currently this book is our 2019 Edition primarily due to the Tax Cuts & Jobs Act of 2017, and specifically the Section 199A Qualified Business Income deduction. This is a major departure from the way things used to be. However, two things remain critically important- S corporations remain a viable tool for reducing self-employment taxes and the Section 199A deduction is simply an add-on component to the S Corp advantages.

We encourage you to visit our website for information on updates-

www.watsoncpagroup.com/book

In addition, please check out our blog from time to time for discussion of current tax issues-

www.watsoncpagroup.com/blog

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Shameless Self-Promotion

This book originally was a collection of Knowledge Base articles that were written to help small business owners and to help our own small business through educational marketing.

Since you probably paid some money for the privilege of being bombarded with shameless self-promotion, we hope you take our comments with a grain of salt. Our primary focus is to educate you, minimize your tax consequence, maximize your wealth and keep you out of trouble. If you read this, arm yourself with knowledge and then ask pointed questions to your accountant, we are completely happy. We have done our job with this book.

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Having said that, if you want the Watson CPA Group's assistance in whatever capacity necessary, from quick second opinions to full-time service, we are also happy to provide that. Want more information? Please visit our website at **www.watsoncpagroup.com/fees** for the most up to date information.

Conversational Tone

Our book is written in a conversational tone. If you like perfect prose and editorial exactness that you would expect in a book on brain surgery, then we will be disappointing. We make jokes, some of which are only funny to ourselves. We don't have the best punctuation. We might even have a missing word or a misspelling. We are nerdy accountants who did everything possible to avoid English literature and writing classes.

Testimonials

Here are some testimonials that we peeled from consultation requests and emails. To say that everyone loved our book is to say that everyone liked sliced bread. We're sure there are people who hate sliced bread. At any rate, here are some testimonials which represent most of our audience.

Justin S, CPA

I love the LLC and S Corp Book and it has been very helpful. I have a question that hopefully you can provide clarification on. I have a client that uses two vehicles for business purposes…

Alex J.

I am in the planning stages of starting my own consulting company that will launch in January 2018. I came across your firm, and specifically your TCGLS document, through a number of various Google searches and was immediately captured by your thought leadership and communication style. I just finished reading the TCGLS Shortie, and will admit that I both externally laughed and internally cried. In both cases, I learned a lot.

Britt S., Esq.

Thank you so much for speaking with me last week! You are amazing and I greatly appreciate all of the information you emailed me. I am in complete adoration of your book!

Tyrone G. says

I just got done reading your book. I'm actually on my second time reading it. The fact that you use humor to help with the complicated wording of the IRC is absolute genius. I like the part where you stated that accountants renamed LLCs to mean 'Lawyers Likely Choice.'

Michael K.

Hello, your LLC/S Corp book has been extremely helpful, but I am struggling to get proper advice on how to best structure our business long-term. Currently it is setup as an SMLLC, however I would like to add a partner (wife to be) to help expand the business while I continue to work full-time.

Sean D.

My search re: pros & cons of how to own/expense a vehicle used for business purposes dropped me into your KB. Almost a black hole! Hours later, my head throbbing & stuffed with as much as it could absorb in one

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session--vehicles, entity structures, state tax laws, retirement accounts, and more--I figured maybe I should crawl out & get in touch with the people responsible for assembling all that!

Michael B.

Great read by the way. I read another book by Mark Kohler which lead me astray, or maybe I just had poor reading comprehension that night.

Anne M.

From what I read in your excellent book, [my husband] has done (quite) a few things the IRS frowns upon and I'm sure that if I knew more about S-Corps, it might help to give me an edge in negotiations. I would like to tell you more about the specifics of my situation to see if you can be of help in this area.

AJ B.

Hello, first of all I love reading the book on LLC's and S-Corps. I downloaded a copy about a year ago, and it's still a fun read. I currently have a handful of businesses (all within a 2 year period, so some lose money and some are moving ahead) and they involve different industries and structures as well.

Brett B.

I read your "Comprehensive S Corp" book. Wow. You blew my mind. I thought I understood S Corps.

Scott G.

BTW, I read [your] book and really enjoyed it although some of it was beyond me.

Josh H.

Found your book on Amazon--read and enjoyed it. I have some questions about optimizing my business structure, and further understanding taxation on distributions/dividends.

Don't take our word or the words of your colleagues… read on to see if this could help you leverage more out of your business, build wealth and minimize taxes.

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There is a lot of information here. The shortie version is just over 60 pages while our paperback and full PDF versions are over 330 pages of pure reading pleasure.

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www.wcgurl.com/toc

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Quick Reference 2018

Single

Taxable Income	Tax Rate
0 - 9,525	10% of taxable income
9,526 - 38,700	952.50 plus 12% of the amount over 9,525
38,701 - 82,500	4,453.50 plus 22% of the amount over 38,700
82,501 - 157,500	14,089.50 plus 24% of the amount over 82,500
157,501 - 200,000	32,089.50 plus 32% of the amount over 157,500
200,001 - 500,000	45,689.50 plus 35% of the amount over 200,000
500,001 or more	150,689.50 plus 37% of the amount over 500,000

Married Filing Jointly

Taxable Income	Tax Rate
0 - 19,050	10% of taxable income
19,051 - 77,400	1,905 plus 12% of the amount over 19,050
77,401 - 165,000	8,907 plus 22% of the amount over 77,400
165,001 - 315,000	28,179 plus 24% of the amount over 165,000
315,001 - 400,000	64,179 plus 32% of the amount over 315,000
400,001 - 600,000	91,379 plus 35% of the amount over 400,000
600,001 or more	161,379 plus 37% of the amount over 600,000

Standard Deduction Single	12,000
Standard Deduction Married Filing Joint	24,000
Social Security Wage Limit	128,400
IRA Contribution Limit	5,500 + 1,000 catch up
Roth Income Phaseout Single	120,000
Roth Income Phaseout Married Filing Joint	189,000
401k Employee	18,500 + 6,000 catch up
401k Employer	36,500
Max 401k Total	55,000

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Quick Reference 2019

Single

Taxable Income	Tax Rate
0 - 9,700	10% of taxable income
97,01 - 39,475	970 plus 12% of the amount over 9,700
39,476 - 84,200	4,543 plus 22% of the amount over 39,475
84,201 - 160,275	4,382.50 plus 24% of the amount over 84,200
160,275 - 204,100	32,748.50 plus 32% of the amount over 160,275
204,101 - 510,300	46,628.50 plus 35% of the amount over 204,100
510,301 or more	153,798.50 plus 37% of the amount over 510,300

Married Filing Jointly

Taxable Income	Tax Rate
0 - 19,400	10% of taxable income
19,401 - 78,950	1,940 plus 12% of the amount over 19,400
78,951 - 168,400	9,086 plus 22% of the amount over 78,950
168,401 - 321,450	28,765 plus 24% of the amount over 168,400
321,451 - 408,200	65,497 plus 32% of the amount over 321,450
408,201 - 612,350	93,257 plus 35% of the amount over 408,200
612,351 or more	164,709.50 plus 37% of the amount over 612,350

Standard Deduction Single	12,200
Standard Deduction Married Filing Joint	24,400
Social Security Wage Limit	132,900
IRA Contribution Limit	6,000 + 1,000 catch up
Roth Income Phaseout Single	122,000
Roth Income Phaseout Married Filing Joint	193,000
401k Employee	19,000 + 6,000 catch up
401k Employer	37,000
Max 401k Total	56,000

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Chapter 1
Business Entities and LLCs

Basic Business Entities

There are three basic business entities with variations within. The three basic are-

- Limited Liability Company (LLC)
- Limited Liability Partnership (LLP) or General Partnership (GP)
- C Corporation including Professional Corporation (some states require doctors, for example, to be a Professional Corporation)

Two notables missing from the list. First, sole proprietors are not an entity nor is the variant "Doing Business As" (DBA). If you wake up and want to sell used copiers, you can, right now, without any formalized structure. It is not smart, but certainly permissible. At times sole proprietors are interchanged with single-member limited liability companies (SMLLC) since the IRS and most states consider a SMLLC to be a disregarded entity for taxation, and both a sole proprietorship and a SMLLC will end up on Schedule C of your Form 1040. However, they are truly different in several underlying ways.

Also note how an S corporation is not listed. It is not an entity. It is a taxation election. The underlying entity has to be one of the above, and usually it is an LLC (either single-member or multi-member) for the ease of formation.

If you want to learn more about these separate business entities beyond the LLC taxed as an S Corp structure, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

S Corporations

This book is all about S corporations so we saved the best for last. The benefits include corporate financial liability protection and easier ownership transfer yet the big benefit is the reduction of payroll taxes. Read that again. Payroll taxes. There is very little difference between a garden-variety LLC and an S corporation from an income tax perspective; the savings is from the reduction of payroll taxes which comprise of Social Security and Medicare. Recall that Social Security taxes stop at $132,900 (for the 2019 tax year) but Medicare continues into perpetuity. Other payroll taxes such as Unemployment, State Disability Insurance, etc. actually increase by electing S Corp taxation, but they are minor.

S Corporations are a pass through entity and therefore do not pay Federal income taxes, and the shareholders do not pay Social Security nor Medicare taxes on distributions from an S corp. Having said that, S corporations have a various sweet spots in terms of income versus payroll tax savings. In a later chapter, we'll demonstrate the savings from $40,000 to $2 million, between sole proprietorships, LLCs, partnerships and entities taxed as an S corporation.

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S corporations are never formed contrary to popular belief. They are spawned from a limited liability company, partnership or C corporation that elects to be taxed as an S corporation. After the election is made on Form 2553, you are treated as an S corporation for taxation purposes only yet all future governance such as minutes and adoptions should follow the corporate structure. Some attorneys argue that this bolsters your corporate shield however you remain a closely-held corporation where veils are pierced every day during Jerry Springer commercials. Most junior associates can do this left-handed so don't think you have this impervious shield.

All kidding aside, the equity section in your balance sheet should also have a Capital Stock account and an Additional Paid-In Capital account. We can help with the journal entry to populate these accounts correctly so your equity section resembles that of a corporation. This is necessary for tracking basis in your S corporation. Chapter 4 has some examples.

You are in a weird limbo with electing to be taxed as an S corporation. You need to walk and talk like a corporation, but the underlying entity and what the secretary of state will have on file is going to be an LLC, partnership or C corporation. More on the election, and the behind the scenes stuff in a later chapter plus our thoughts on corporate governance such as meetings and minutes.

Section 199A Pass-Pass Thru Tax Deduction

Section 199A deduction also known as the Qualified Business Income deduction arises from the Tax Cuts & Jobs Act of 2017. This is a significant tax break for small business owners but there are rules and limits of course. As with any major revision to the tax code, there will be modifications and interpretations which will change how Section 199A can be used for pass-through businesses. Stay tuned to updates.

Defining Terms

Pass-thru entities and structures include-

- ▲ Sole proprietorships (no entity, Schedule C).
- ▲ Real estate investors (no entity, Schedule E).
- ▲ Disregarded entities (single member LLCs).
- ▲ Multi-member LLCs.
- ▲ Any entity taxed as an S corporation.
- ▲ Trusts and estates, REITs and qualified cooperatives.

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Specified Service Trade or Business is defined as-

- ▲ Traditional service professions such as doctors, attorneys, accountants, actuaries and consultants.
- ▲ Performing artists who perform on stage or in a studio.
- ▲ Paid athletes.
- ▲ Anyone who works in the financial services or brokerage industry.
- ▲ And now the hammer… "any trade or business where the principal asset is the reputation or skill" of the owner. Why didn't they just start with this since everything else would have been moot. Oh well…

Interestingly, removed from the traditional service profession are engineers and architects. But an engineer operating a business based on his or her reputation or skill is still a specified service trade.

The IRS released Proposed Regulations 1.199A on August 8, 2018. In there they expanded on the concept of specified service trades or businesses such as nurses, real estate agents and others. Our full book has more details.

Sit on the ledge, sure, but don't jump off a bridge just yet. The specified service trade or business problem only comes up when your taxable income exceeds the limits. So, a financial advisor making $150,000 might still enjoy the Section 199A deduction. Keep reading!

Income Limits

- ▲ Based on taxable income including all sources (not just business income). Also limited to 20% of taxable income.

  See Line 43 of 2017's Form 1040 to assess your 2018 taxable income using 2017 as a proxy, adjusted for itemized deductions and exemptions (or lack thereof).

- ▲ Single is $157,500 completely phased out by $207,500 (adjusted for inflation).
- ▲ Married filing jointly is $315,000 completely phased out by $415,000 (adjusted for inflation).

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Calculating the Qualified Business Income Deduction

The basic Section 199A pass-through deduction is 20% of net qualified business income which is huge. If you make $200,000, the deduction is $40,000 times your marginal tax rate of 24% which equals $9,600 in your pocket. Who says Obamacare isn't affordable now? Here is the exact code-

(2) DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS. The amount determined under this paragraph with respect to any qualified trade or business is the lesser of-

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) the greater of-

(i) 50 percent of the W-2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

There are some devils in the details of course. The best way is to show some examples-

- ▲ Wilma makes $100,000 in net business income from her sole proprietorship but also deducts $5,000 for self-employed health insurance, $7,065 for self-employment taxes and $10,000 for a SEP IRA. These are not business deductions- they are adjustments on Form 1040 to calculate adjusted gross income. Her deduction is the lessor of 20% of $100,000 (net business income) or 20% of her taxable income, which could be less (see Pebbles below). This might change as the IRS clarifies.

- ▲ Barney owns three rentals with net incomes of $20,000 and $5,000, with one losing $8,000 annually. These are aggregated to be $17,000. He would deduct 20% of $17,000.

- ▲ Barney has passive losses that carried forward and are "released" because he now has net rental income, those passive losses are taken first. With using the same example above with $10,000 in passive loss carried forward, Barney's deduction would equal $17,000 less $10,000 or 20% of $7,000.

- ▲ Pebbles earns $100,000 from her pass-thru business but reports $80,000 of taxable income on her tax return due to other deductions such as her itemized deductions. Her Section 199A deduction would be $16,000 since it limited by the lessor of 20 % of $100,000 or $80,000.

- ▲ Mr. Slate operates an online retailer S corporation which pays $100,000 in W-2 wages and earns $400,000 in net qualified business income. Because he is considered a "high earner" by exceeding the income limits, his deduction is limited to 50% of the W-2 or $50,000 which is less than 20% of $400,000.

- ▲ If Mr. Slate instead operates as a sole proprietor and earns $500,000 but does not pay any W-2 wages, his deduction is the lessor of 50% of the W-2 wages (or $0 in this example) or 20% of the $500,000. If he paid out $200,000 in wages and had $300,000 in net business income, his Section 199A deduction would be the lessor of 50% of $200,000 or 20% of $300,000.

  In other words, he would deduct $60,000 ($60,000 is less than $100,000, even in Canada). He would want to create an LLC, tax it as an S corporation and pay out W-2 wages to maximize his Section 199A deduction.

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▲ If Mr. Slate instead operates as a specified service trade as defined previously, he would completely phase out of the Section 199A deduction by exceeding the income limit of $207,500 and $415,000. This is the specified service trade "gotchya."

▲ If Mr. Slate was married and operated a specified service trade, and the taxable income considering all income sources (spouse, investments, etc.) exceeded $315,000 but was less than $415,000, there would be a sliding scale of deduction eligibility. Silly rabbit, tax reform doesn't mean tax simplification.

▲ Fred… yes, we can't neglect Fred… is single and operates an S Corp as an accountant. Days of busting up rocks for Mr. Slate are in the rear-view mirror. He earns $100,000 in net qualified business income after paying $50,000 in W-2 wages to himself.

He is a clearly a specified service trade but because he earns less than $157,500 total ($150,000 in this example) he can take advantage of the full Section 199A deduction of 20% of $100,000. The question of reasonable salary is not being entertained here… focus on the W-2 to income relationship.

▲ Betty becomes a slumlord and earns $500,000 in rental income. No W-2 since she is operating the properties as an individual (and converting passive income into earned income vis a vis a W-2 would be silly). Let's say she purchased the properties for a $1,000,000 (unadjusted basis). The math would go like this-

- 20% x $500,000 is $100,000 (straight calculation).
- 50% of $0 is $0 (W-2 limit calculation).
- 2.5% of $1,000,000 is $25,000 (depreciable asset limit calculation).

Section 199A is limited to the lessor of $100,000 as compared to the greater of $0 (W-2) and $25,000 (depreciable assets).

Takeaways

No entity is penalized under the new tax law. Some entities and situations might not qualify or be limited in some fashion, but the high-water mark in terms of taxation is the old crummy 2017 tax law.

Taxable income becomes a big deal for two reasons! First, $1 over $157,500 or $315,000 starts the specified service business disqualification and W-2 limitation (and there is also a depreciation component that we are glossing over in this summary). Second, the Section 199A deduction is limited by 20% of taxable income from all sources (what would be reported on your tax returns).

W-2 wages include all W-2 wages, not just those paid to the owner(s). Converting a 1099 contractor to a W-2 employee might be beneficial.

S corporations remain a critical tax saving tool for two reasons. First, the usual self-employment tax savings remains intact for all business owners including specified service trades or businesses. Second, a business owner might need to pay W-2 wages to himself or herself to not be limited by income, and only corporations can pay W-2 wages to owners (in other words, an LLC cannot without an S Corp election).

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C Corporations Remain Bad for Most Owners
Thanks to recent tax law changes, corporations now enjoy a 21% income tax rate. But… not all that glitters is gold. Dividends are then taxable to you up to 23.8% (which is 15% to 20% capital gains plus 3.8% of Medicare surtax potentially). Therefore, your effective tax rate for using a C Corp as your entity choice ranges from 36% to 44.8% where the top individual rate is 37%.

We don't run into too many business owners who want to make money but never spend it. Sure, you can enjoy a lasting 21% corporate tax rate given the Tax Cuts and Jobs Act of 2017, but to spend it you need to be taxed again at your dividend rate. Read more in our recent blog post-

www.wcgurl.com/8376

Conclusion

There are several other entity considerations-

▲ The life cycle of an S corporation from startup to operations.

▲ The Nevada fallacy of having an LLC domiciled there.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 2
Customized Entity Structures

Other Formation Considerations

There might be some situations where layering entities or creating a brother-sister or parent-child type of overall structures makes sense.

Holding Company and Operating Company

This is one of the most common situations where you own two entities that do business between themselves. For example, you are a typical poor accounting firm with the usual high maintenance clients, and you feel that everything would be better if you also owned your own office building. You would create an LLC as the holding company which owns the building, and another LLC (and probably taxed as an S Corp) for the operating company.

This allows for some excellent ownership separation. For example, if you and your father-in-law own the building, he doesn't have a stake in your accounting firm, and vise-versa. You might also want to make one of your key employees a business partner in your operations, but he or she should not have a stake in the building. Chinese Wall.

This arrangement can also reduce self-employment taxes or payroll taxes since this conduit changes the color of money. Huh? Your accounting firm's income is earned income, taxed both at the self-employment tax level (or payroll tax level) and the income tax level. However, you reduce this earned income by the amount of rental expense and that subsequent rental income on the other end is considered passive, and only taxed at the income tax level. Beauty. You must have a lease and the rent must be market rates.

Parent-Child Arrangement (Income Flows Up)

You might have two business entities, and you want to combine them but they are also very different. For example, you are a realtor and your spouse is an IT consultant. We could create a holding LLC called Smith Ventures which owns the realtor LLC and the IT consultant LLC. In other words, the realtor LLC and IT consultant LLC have a single member, and that single member is the holding LLC.

The holding LLC would then make the S Corp election, and all the LLC income would flow into the S corporation as wholly owned subsidiaries. Remember, single-member LLCs are disregarded entities and are reported on the sole member's tax return. In this case the sole member is the S corporation.

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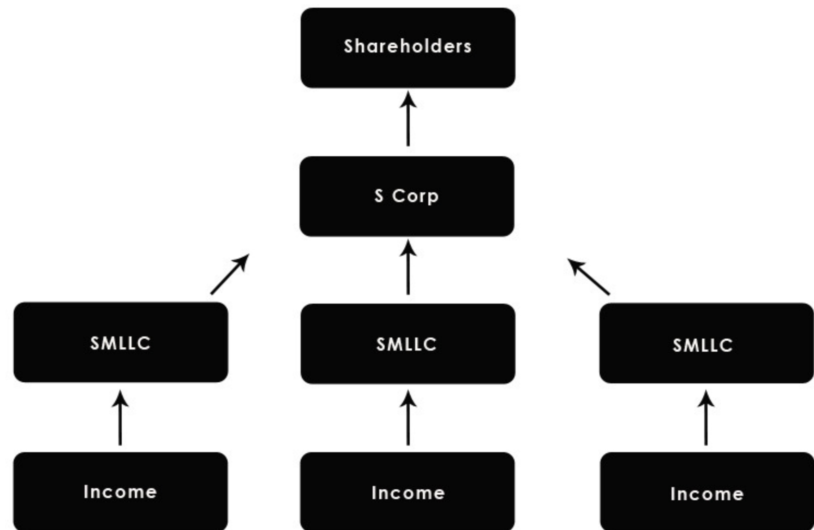
This entity structure solves some big problems yet creates some minor inconveniences. Instead of running multiple S corporations each with payroll processing and tax returns, all the payroll for the shareholders is handled out of a single S Corp. Each single-member LLC (SMLLC) is a disregarded entity and therefore on a singular tax return is required at the S corporation level.



Another benefit is that one of these business units, subsidiaries or whatever you want to call them can be carved away and later sold off. You could also expand ownership in one without expanding ownership in the whole structure (see below).

On to the minor inconveniences. Each entity should have its own checking account and set of books. Common expenses such as an umbrella policy or tax preparation fees would be paid at the S corporation level, while subsidiary-specific expenses such as website hosting would be paid at the LLC level.

Also, if you want to take a distribution out of one of the subsidiaries, truly the S corporation would receive the distribution first, and then make another distribution to you, the shareholder. A double hop. In other words, transfer money from the SMLLC's checking accounting to the S corporation's checking account to your checking account.

Another inconvenience is that each entity might be slapped with high annual fees from the state in the form of filing fees, or franchise taxes (like California) or both. The benefits might still outweigh the costs, but be careful.

This is a common strategy between husband and wife teams where the business entities are completely different, yet the household wants to enjoy the benefits of an S corporation. Plus, one of the spouses can expand ownership in his or her respective entity without upsetting the whole apple cart.

Bonus- one spouse could also have a 401k plan in one entity without affecting the other 401k plan in the other entity. For example, one entity has employees and the 401k plan has elected safe harbor to not fail HCE testing. No problem. The other 401k plan at the S corporation level maxes out each shareholder's contributions. There are certain rules about control groups, but this example gets around it (more information in Chapter 9 – Retirement Planning).

Parent-Child Arrangement (Income Flows Down)

Another thought along these lines involves a multi-member LLC where you and another non-spouse partner are the members. Later in Chapter 3 you'll learn that one of the limitations of an S corporation is that distributions must be made in the same percentage as ownership. So, if you are 50-50 with another shareholder, distributions must also be 50-50.

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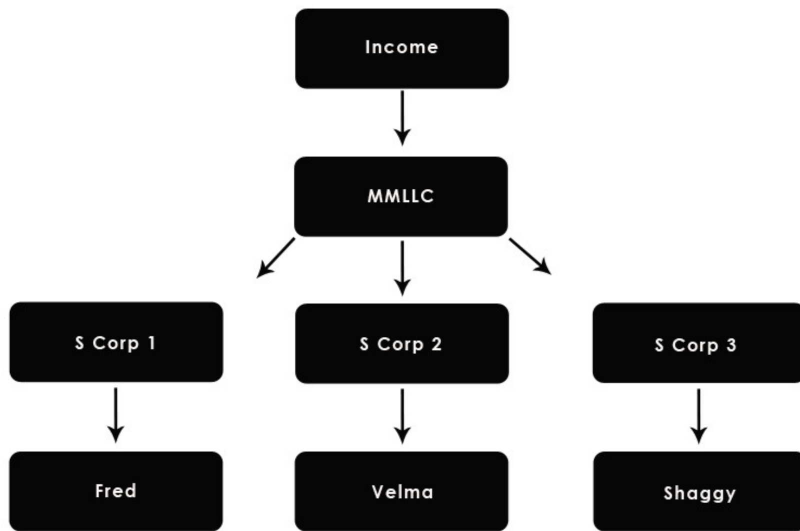
Backup for a moment. If this multi-member LLC was not taxed as an S corporation, the Operating Agreement could dictate a different schedule of distributions. For example, you and another insurance agent team up. But you want an Eat What You Kill revenue model. In this case, you could be 50-50 partners, but have the distributions be tied to the production of each insurance agent. No problem.

You S Corp this thing, and now it blows up. Regardless of production or revenue splitting detailed in your Operating Agreement, or whatever, distributions must be 50-50 since that is the ownership percentage among the two shareholders. But you still want to save on self-employment taxes. What can be done?



We create three entities. A holding company that is a multi-member LLC (MMLLC), with each member being an S corporation. Each S corporation is owned 100% by each principal involved. Stay with us on this one. The following example shows three S corporations as members of the MMLLC, but just ignore one side if you are two-person show.

The MMLLC is really a funnel. All revenue goes in, all common expenses are paid out such as internet, copier lease, admin functions, etc., and an Operating Agreement dictates how the distributions are to be handled. K-1s are issued to the members which happen to be S corporations. And then those S corporations pay a reasonable salary to its respective sole shareholder and distribute the remainder.

There are some excellent benefits with this arrangement beyond the revenue splitting and saving of self-employment taxes. Each S corporation is independent. In using the previous schematic, Fred could buy whatever company car he wanted. Velma could work from home and reimburse herself for a home office. Shaggy could rent an office since his place is… well… a dog house of sorts. Each S corporation can run expenses through as it sees fit without upsetting the other business partners.

We see this arrangement commonly in medical groups (surgery groups, physicians, doctors, anesthesiologists, nurse anesthetists, etc.), insurance agents and financial advisors. It is very common in entities where the revenue is not shared equally, but rather on production.

401k plans in this situation is tough since it is a controlled group. More information can be found in Chapter 10 on controlled groups, and how retirement planning within this scheme works.

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Conclusion

There are several other entity structures and formalities to consider such as-

- ▲ Husband and wife teams (two owners, or just one owner with the other on payroll?).
- ▲ Husband and wife teams that have an outside partner.
- ▲ How to set up an S Corp with varying revenue splits (eat what you kill model).
- ▲ How community property states differ from common law.
- ▲ How to not get double taxed in California with franchise taxes.
- ▲ The Fleischer tax court case for financial advisors.
- ▲ Having your trust own a holding company for your businesses.
- ▲ Operating Agreements to handle death, divorce, incapacitation, corporate waste, forced distributions to cover tax obligations, exit strategies, valuation, etc.
- ▲ The fallacy of liability protection with LLCs and charging orders.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 3
S Corporation Benefits

Avoiding or Reducing Self-Employment (SE) Taxes

A common complaint from those who own their own business is self-employment tax. Can you avoid, reduce, eliminate or lower your self-employment taxes or SE taxes? Yes, to a large extent actually but it takes some effort.

If you own a business as a sole proprietor or as a garden variety single-member LLC (one owner or shareholder) your business income will be reported on your personal tax return under Schedule C and is subject to self-employment tax (currently 15.3%) **and** ordinary income tax. So, you could easily pay an average of 40% (15.3% in SE taxes + 25% in income taxes) on all your net business income in Federal taxes. Wow, that sucks! Similar taxation for partnerships / multi-member LLCs too.

Drive this concept into your head, pretty please. On business income as an LLC or partnership, you are being taxed **twice**. Once at the self-employment tax level and again at the ordinary income tax level. Income taxes are a concern, but they are not the crux of the S Corp election and subsequent tax savings.

We are all humans, and we generally spend what we make. If you are not prepared for 30% to 40% in taxes for your business income, it could be a shocker on April 15.

The recent tax reform and specifically the pass-thru taxation changes in Section 199A do not alter the theory of self-employment tax savings. The additional pass-thru deduction afforded to small business owners complements the benefits of an S corporation. Please bear with us as we go through the mechanics of saving self-employment taxes with an S Corp. In Chapter 6 we will show you several examples of how the Section 199A works with and without an S Corp election.

How SE Tax Is Computed

A bit of disclosure is in order. Self-employment taxes are 15.3% which is derived from the "employer" portion at 7.65% and the "employee" portion of 7.65%. However, a small business gets to deduct its portion of payroll taxes from income before determining the taxable income. Huh?

Think of your last job where you received a W-2. The employer might have paid you $100,000 and withheld your portion of Social Security and Medicare taxes on your behalf. The company also had to pay its portion of Social Security and Medicare taxes, so its total expense was the $100,000 salary plus $7,650. Similar concept with sole proprietorships and LLCs.

Here is an illustrative table-

Net Business Income	100,000
less SE Tax Adjustment at 7.65%	7,650
Taxable Business Income	92,350
SE Tax at 15.3%	14,130
Tax Deductible Portion	7,065

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Do you see the $14,130 or 14.13% of $100,000? That is essentially your effective rate of tax on self-employed business income because of the deductible portion of 7.65%. Probably doesn't make you feel any better but there you go.

Quick Analysis of S Corp Savings

If you own an LLC and have elected to be treated as an S Corp (Subchapter S) for taxation, the business now files a corporate tax return on Form 1120S. What's the big deal? Before we get into that, let's look at some quick numbers. These are based on using a salary of 40% of net business income for incomes up to $500,000 and then decreased incrementally to 30% for the millionaire at $2,500,000 below (real case actually). The 40% / 30% is for illustration.

Income	Total SE Tax	Salary	Total Payroll Tax	Savings $$	Delta %
30,000	4,239	12,000	1,836	2,403	8.0%
50,000	7,065	20,000	3,060	4,005	8.0%
75,000	10,597	30,000	4,590	6,007	8.0%
100,000	14,130	40,000	6,120	8,010	8.0%
150,000	18,711	60,000	9,180	9,531	6.4%
200,000	20,050	80,000	12,240	7,810	3.9%
300,000	22,972	120,000	18,174	4,798	1.6%
500,000	29,991	200,000	20,494	9,497	1.9%
750,000	38,764	262,500	22,307	16,457	2.2%
1,000,000	47,537	350,000	24,844	22,693	2.3%
2,000,000	82,630	600,000	32,094	50,536	2.5%
2,500,000	100,177	750,000	36,444	63,733	2.5%

This also does not include self-employed health insurance premiums which increase your savings.

Chart Notes

Let's review some interesting things about the data on the previous page.

The bulk of payroll taxes are Social Security and Medicare taxes, which are combined to be called FICA taxes. You might have other payroll taxes such as unemployment (Yes, some states require it even for one-person corporations) and state disability insurance (SDI).

As mentioned, salaries started at 40% thru $500,000 and then reduced to 30% at $2M and $2.5M. This is a jumping off point. The IRS standard is "reasonable shareholder salary" which includes all sorts of non-qualitative things such as your expertise, Bureau of Labor Statistics, comparison of salary to distributions, zodiac sign, favorite color, etc.

Medicare taxes of 2.9% continues into perpetuity for LLCs and partnerships who do not elect S corporation status. Not only does this go on into perpetuity, it also goes on forever. This is one of the major component of savings in the upper incomes since Medicare taxes are capped at the amount of salary with S Corps. In other words, if you earn $1M you will pay Medicare taxes on the net income, but if you elect S Corp status and pay yourself a $400,000 salary you only pay Medicare taxes on the $400,000.

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The Medicare surtax starts for those earning $200,000 and filing single, and $250,000 for those filing jointly. This too continues into perpetuity for LLCs and partnerships. In the data, we assumed a joint tax return. For example, at $500,000 net business income there is a $1,906 Medicare surtax. But if this business elects S corporation taxation and pays $200,000 salary, there is not a Medicare surtax. There is not a net investment income (NII) tax on the S corporation ordinary income either (more on that loophole later).

Savings as a percentage of income starts to drop off at $132,900 which makes sense given the Social Security cap for 2019. And those savings bottom out around $300,000 net business income and then begin a decent climb rate. Without getting into excruciating details and mental gymnastics, there is an interesting dynamic at $300,000 between Medicare taxes including the surtax on the LLC / partnership income, the salary being paid within an S Corp election, and Medicare taxes associated with that salary.

The Source of the Savings

The S Corp election of your Partnership, LLC or C corporation changes how the business reports income to the IRS. An S Corp prepares and files a Form 1120S which is a corporate tax return. That in turn generates a K-1 for each shareholder. Remember, shareholder, investor and owner are synonymous terms for our discussions.

As stated earlier, a K-1 is a statement that each shareholder receives, and it is similar to a W-2 since it reports the income that each shareholder is responsible for from a taxation perspective. As we discussed earlier, there are three types of tax returns that generate a K-1.

- ▲ Partnership / MMLLC (Form 1065)
- ▲ S Corporation (Form 1120S), and
- ▲ Estate or Trust (Form 1041)

There are two types of K-1s for the purposes of our self-employment tax conversation- one is generated from a partnership tax return and the other is generated from an S corporation tax return. These K-1s look nearly identical and both are reported on page 2 of Schedule E and your Form 1040. Schedule E is the tax form used for rental properties, royalties and **other investment income** including business income from a partnership or an S Corp.

However, a K-1 generated from a partnership tax return which has ordinary business income in box 1 and / or guaranteed payments in box 4 **will** typically be subjected to self-employment taxes for an active partner or member. Conversely, ordinary business income in box 1 on a K-1 from an S corporation will **not** be taxed with self-employment taxes. The S corporation election changes the color of money (we love this saying).

> **Note:** S Corps do not have guaranteed payments like partnerships might- S Corps would call these payments wages or salary. A partnership (and an LLC for that matter) cannot pay its partners or owners a wage or salary. IRS frowns on this. Any periodic payment that is recurring in a partnership to one of the partners is called a guaranteed payment and is reported separately from partnership income. Both might be subjected to self-employment taxes.

You might hear terms such as pass-through entity or disregarded entity- a disregarded entity is a single-member LLC. As the terms suggests, it is disregarded, and therefore does not have to file its own tax return since the taxable consequence is reported on the owner(s) personal tax returns as a sole proprietorship.

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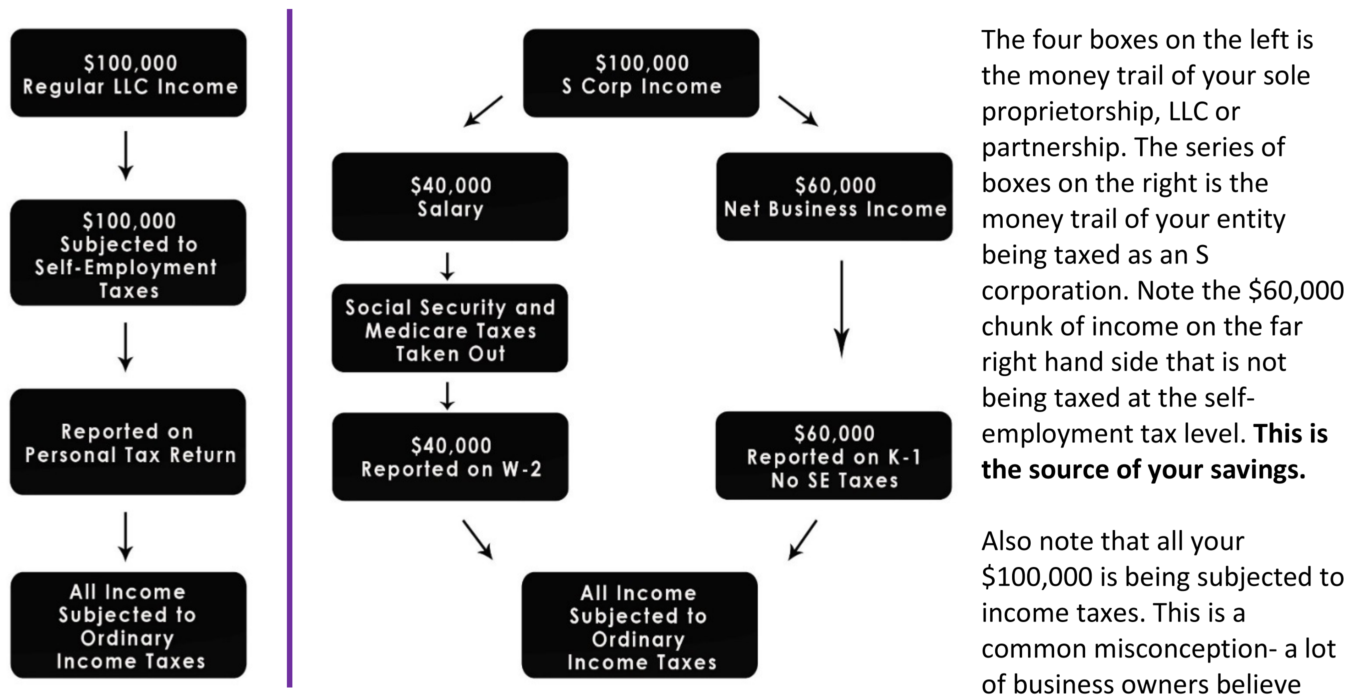
A pass-through entity passes its Federal tax obligation onto the partner of a partnership, the shareholder of an S corporation or the beneficiary of an estate or trust. States might impose a business tax or a franchise tax on the partnership or S Corp directly (they legally cannot impose an income tax… more in Chapter 3 about interstate commerce rules).

Quick Recap, The S Corp Money Trail

So, when your partnership, LLC or corporation is taxed as an S Corp you are considered both an employee and a shareholder (think investor). As an employee, your income is subjected to all the usual taxes that you would see on a paystub- federal taxes, state taxes, Social Security taxes, Medicare taxes, unemployment and disability.

However, as a shareholder or investor, you are simply getting a return on your investment. That income, as the Romneys, Gates and Buffets of the world enjoy, is a form of investment income and therefore is not subjected to self-employment taxes (tiny exception for income over $200,000 (single) or $250,000 (married) where Medicare surtax is charged).

When we say self-employment taxes, we are really talking about Social Security and Medicare taxes. From a sole proprietor perspective, they are self-employment taxes. From an employee perspective, they are Social Security and Medicare taxes. Same thing. Let's look at another visual in terms of how the money travels (yes, picture page!)-



The four boxes on the left is the money trail of your sole proprietorship, LLC or partnership. The series of boxes on the right is the money trail of your entity being taxed as an S corporation. Note the $60,000 chunk of income on the far right hand side that is not being taxed at the self-employment tax level. **This is the source of your savings.**

Also note that all your $100,000 is being subjected to income taxes. This is a common misconception- a lot of business owners believe there is a magical income tax reduction with an S Corp election. Not true. The only reduction is in self-employment taxes. All other tax deductions such as operating expenses, home office expense, mileage, meals and entertainment, etc. are equally deductible with or without an S corporation.

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W-2 Converted to 1099

One of the biggest pushes into the S Corp world is when your employer decides to convert you from W-2 to 1099. To refresh your memory, when you are paid a W-2 salary your employer pays for half of the Social Security and Medicare taxes associated with your income. Conversely when you are paid as a 1099 contractor, you pay both halves of the Social Security and Medicare tax.

Another nice feature of being paid a W-2 salary is the built-in budgeting since your taxes are taken out before the direct deposit into your checking account. On the other hand, 1099 income is raw- just a big ol' fat check ready to spend.

Regardless, when entertaining being converted from W-2 to 1099, consider the fully burdened labor rate of your employer. If you were making $100,000, you really need to make at least $130,000 or more to come out ahead. You win, they win. Don't forget that as a 1099 contractor you now can rifle a bunch of expenses through your business that were otherwise limited or not allowed… but don't leak that out during negotiations.

Lastly, create an LLC and tax it as an S corporation.

Conclusion

Once again we are short-changing you. Our full version contains additional information on-

▲ The effect of self-employed health insurance premiums, HSA contributions and other company paid fringe benefits on your S corporation savings (**spoiler alert:** they puff up S corporation savings a ton!)

▲ The Net Investment Income Tax (NIIT) and how it effects S Corps (spoiler- it doesn't although some K-1 income might be considered investment income).

▲ The differences between earned, portfolio, passive and non-passive income.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 4
The 185 Reasons to Not Have an S Corp or LLC

Introduction

Not everything that glitters is gold so there are a handful of downsides, some manageable, to the S Corp election or having an LLC. A lot of these examples stand alone, and some of these depend on the net income of the business and other external factors. The Watson CPA Group can help guide you through the decision-making process.

And No, there are not 185 reasons- it was just a self-proclaimed catchy number. Most of these reasons in the beginning of this chapter focus on S corporations. However, there are some general pains with having any type of formalized entity, and those are near the end.

Specific to S corporations, we ask these general questions of each business owner before diving into the nitty-gritty-

- ▲ Does your business earn over $30,000 net income after expenses? Say Yes.
- ▲ Are you located in New York City or Tennessee where S corporation tax rates are egregious and suck up all the federal tax savings? New Hampshire? Say No.
- ▲ Do you have other W-2 income that exceeds or comes close to exceeding the Social Security limits of $132,900 (2019)? Say No. If you say Yes, we need business income to exceed $200,000 in #1 above.
- ▲ Is this a going concern? In other words, is the business going to continue to earn the same income or more each year? Say Yes.
- ▲ Do you have an LLC or some other entity in place that can be elected to taxed as an S Corp? Say Yes. If you say No, we have options just not elegant ones.

Are you still here? Excellent news… then read on!

State Business Taxes (Not Just Income Taxes)

State tax laws might not treat S Corp income and subsequent K-1 income in the same benevolent manner as the IRS. Recall that S corporations do not pay a Federal income tax directly. Rather the income is passed onto the shareholders who are then taxed at their individual tax rates. However, some states impose an additional tax. For example, California imposes a 1.5% franchise tax on S Corp net income with a minimum of $800. Yuck. So your 8% savings in Federal tax turns into 6.5% after you pay California.

Other income tax free states, such as Texas, have similar taxations and various exemptions too. Franchise tax is another buzzword you might come across. Why do they call it a franchise tax, or a business and operating tax as

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they do in Washington State? They can't call it income tax because of the Interstate Income Act of 1959. Yup. Way back when, and it is battled every year in court, in various representations.

Before we get into that, there are two issues at play here and we'll pick on California to illustrate some points. One, if you are an S corporation headquartered in California you will be subjected to the franchise tax. Period. End of story.

But the other side of the coin is state nexus (which was broached earlier) where you are not physically headquartered in California, but have a nexus either physically or economically in California. This too would subject your income sourced from California to the franchise tax.

In some cases you might have nexus in California but not any California sourced income, and you will unfortunately be subjected to the minimum franchise tax of $800 (as of 2019). Nutty. You have nexus, but no taxable income, and you still pay the minimum franchise tax? Yes. This happens when you create an LLC but all your income sources are outside California and they exceed certain thresholds. There are other situations where this can happen.

Conversely, if you are a sole proprietor in California (and not an LLC or corporation), you do not pay a franchise tax. Yes, you will be subjected to Federal self-employment taxes which is why you want to consider an S Corp election. So therein lies the rub. Franchise tax versus self-employment tax.

About half of the states have some sort of franchise, business or excise tax. Back to the Interstate Income Act of 1959- it is against Federal Public Law 86-272 for states to charge an income tax on foreign businesses in certain circumstances. Remember, foreign does not mean domestic and international. Foreign is a business registered in Nevada doing business in California, as an example.

Here is a snippet of Federal Public Law 86-272-

> No state, or political subdivision thereof, shall have power to impose .. a net income tax on the income derived within such state by any person from interstate commerce if the only business activities with in such state by or on behalf of such a person during the taxable year are either, or both, of the following-
>
> 1. The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside of the state; and
>
> 2. The solicitation of orders by such a person, or his representative, in such State in the name of or for the benefit of a prospective customer of such a person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

States are therefore prevented under Public Law 86-272

▲ from taxing out-of-state businesses on income derived from activities within the state

▲ if the activities are limited to mere solicitations of tangible personal property, and

▲ the orders are processed from outside the state.

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Note how this centers on tangible property and not services. Huge distinction! Is internet hosting a service or tangible personal property? How about an eBook? This is discussed more in a later chapter, and the current news is not great. The future isn't good either.

So the wizards at various states came up with a tax that is not based on income or as least not called an income tax. Some states tax your gross receipts, no matter what your expenses are! Amazing. It is also noteworthy that Public Law 86-272 does not protect businesses located in and doing business in the respective state (only interstate activities, not intrastate activities). But it appears that states keep things consistent, and impose a franchise tax, a business tax or an excise tax on local businesses just the same. Genius.

Here are some sample state links-

www.wcgurl.com/1304	California
www.wcgurl.com/1302	Oregon
www.wcgurl.com/1307	New York City
www.wcgurl.com/1311	Tennessee
www.wcgurl.com/1314	Texas

Major New York tax reform was passed in April 2015 which aligned taxation between New York City and New York State. NYC was like Rome, and was off in the weeds as compared to New York State. Regardless, New York S Corp tax rate is 8.85%. Tennessee is 6.5%. Texas is about 1% on gross receipts exceeding $1 million. Washington DC has a tax it imposes on S corporations, but tax is exempt if over 80% of the revenue is from personal service.

Do you want more wrinkles? Here you go- California (we just love to pick on them) has a unique rule to their franchise tax. As a garden-variety LLC, you are taxed on gross receipts in addition to the $800 franchise tax. For example, you could have $1,000,000 in gross receipts and $1,000,000 in expenses. Your franchise tax would be $800 + $6,000 although you do not have any net income. Yuck.

However, if this LLC is taxed as an S corporation then it would pay 1.5% of the net income or $800 whichever is higher. Using the example above California's franchise tax would be $800 versus $6,800. Therefore the lesson is that you might be forced into electing S corporation status in California just to avoid its silly gross receipts tax.

To complicate things even more, you have to apply nexus rules to all this. You might not be subjected to another state's franchise or business tax if you don't have an economic or physical presence in that state.

The issue of state business taxes and nexus is discussed in nauseating detail later in a chapter dedicated to state nexus. More buzzwords such as economic presence, throwback rules, tangible personal property, commerce and due process clauses, etc. Bottom line- talk to your nexus experts at the Watson CPA Group to nail this down.

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Conclusion

If you were keeping track we didn't provide all of the 185 reasons an S corporation can be a problem. Truth be told, there aren't 185. But here are some more considerations detailed in the full version-

- ▲ How trapped appreciating assets inside of an S corporation can be a tax surprise.
- ▲ The differences between unemployment, state disability and workers compensation, including what you can opt out of and the dangers of doing so.
- ▲ The limits of deducting business losses.
- ▲ How shareholder loans are bad news, and how lazy CPA's use it as a plug to balance the dare-we-say balance sheet. Lazy CPA's is not fair. We should say CPA's who normal, and have 10 pounds of crud to work on in a 5-pound day.
- ▲ The problems of fluctuating revenue splits in an S corporation (such as sales teams).
- ▲ The effects of other W-2 income that might affect the savings from your moonlighting.

The dangers of S Corps and other business entities is over 20 pages in our published book. If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 5
State Nexus Problems

This in itself is not a reason to avoid the S corporation election, but there is not a better place for this material. State nexus stuff is getting very complicated so we decided to make this a separate chapter since it will continue to grow over time.

Every year all 50 states plus the District of Columbia and New York City participate in a survey conducted by Bloomberg. Here is the link for the latest results, but a warning is in order first. The 2017 report is 523 pages (yet the table of contents is rich with detail to find your particular area of interest).

www.wcgurl.com/1744

There is also an executive summary for 2018 available from Bloomberg, and it is only 20 pages (nice!)-

www.wcgurl.com/1746

There are several concepts here and a ton of material. Here is the mini table of contents-

- Wayfair Case Part 1
- Disclaimer
- Nexus Theory
- Constitutional and Legislative Standards (*Commerce and Due Process Clause and Public Law 86-272*)
- Sales Tax, Income Tax
- Physical and Economic Presence, Nexus Attached
- Wayfair Case Part 2
- Services and Tangible Personal Property (TPP)
- Costs of Performance, Market-Based Approach
- Allocation and Throwback
- FBA, Drop Shipments, Trailing Nexus Revisited

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Wayfair Case

The United States Supreme Court in a 5-4 decision in South Dakota v. Wayfair changed the sales tax nexus landscape dramatically. Until then, Amazon retailers and other online resellers were partially safe as a result of the 1992 Quill v. North Dakota decision where the Court required nexus through physical presence before states could demand sales tax collection. But with Wayfair, the Court changed this to “substantial nexus.” Here is the U.S. Supreme Court opinion-

www.wcgurl.com/1788

We will explore the significance of this court decision throughout this chapter, and some concepts are moot but remain for legacy and illustrative purposes. Keep referring to our blog posts for updates-

www.watsoncpagroup.com/blog

As mentioned before, the U.S. Supreme Court ruled on June 21, 2018 in favor of a South Dakota statute enacted in 2016 that defined substantial nexus (remember that word from Complete Auto Transit v. Brady in 1977) as-

- ▲ Deliver more than $100,000 of goods and services in a year, or
- ▲ Have 200 or more separate transactions for the delivery of goods or services

Note the Or! Interestingly the suit was brought against Wayfair, Newegg and Overstock collectively. More interestingly, the court noted that other functions of ecommerce like cookies being left behind by browsers and customers downloading retailer apps may be introduced as proof of physical presence. Holy smokes!

Another tidbit was Kennedy, who wrote the majority opinion, admonished Wayfair by stating they could not have a customer base attracted to images of beautifully decorated homes if it weren’t for a stable local and state government. Kennedy was just piling on like the cop giving you a ticket, and a lecture.

Also, we encourage any interstate seller of goods and services to seek the advice of professionals who handle sales tax every day. Our referrals are TaxJar, Avalara and Peisner Johnson.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 6
S Corporation Election

Formation (Election) of an S-Corp

There is a misconception floating around out there that an S-Corp is a standalone entity. Not true. There are several entity types, but the three most common are

- ▲ Limited Liability Companies (LLCs), either as a single member or multi-member
- ▲ Partnerships, including all the variants (LP, LLP, LLLP, etc.), and
- ▲ Corporations (C-Corps), including Professional Corporations (PCs).

Each can elect to be treated as an S-Corp for taxation purposes under subchapter S of the revenue code.

So while we might talk about your "S-Corp", we are truly talking about your LLC, partnership or C-Corp being treated as an S-Corp for taxation. While there are partnerships and C-Corps out there who elect to be treated as an S-Corp, this book generally focuses on the "S-Corp LLC" where the underlying entity is an LLC being taxed as an S corporation. However, the information is valid for each entity type.

Also, the words member and shareholder are synonymous as well from a conversational perspective- the state considers owners to be members but the IRS considers the owners to be shareholders when issues like distributions, basis, etc. Same is true for equity accounts on the balance sheet.

Electing S-Corp Filing Status, Retroactive for Jan 1 2018

Yes, you are able to engage in revisionist history and retro activate your S Corporation election to January 1 and have your income avoid a large chunk of self-employment taxes. Which year? Good question, and Yes, of course, it depends. First things first. You must be eligible to become an S-Corp for taxation purposes-

- ▲ you must have an LLC, partnership or C-Corp already in place,
- ▲ your entity must be domestic,
- ▲ have 100 or fewer shareholders,
- ▲ have shareholders who are individuals, estates or exempt organizations, and not have any non-resident alien shareholders, and
- ▲ have only one class of stock (you are allowed to have voting and non-voting as one class)

There some other devils in the details, but 99% of the LLCs, partnerships and C-Corps out there qualify.

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If you do not have an entity already in place, there are organizations that sell shelf companies. Note the word shelf- not shell. These shelf companies have EINs, file tax returns and all their history sits on a shelf hence the name shelf company. How this works is beyond our book and usually required a conversation.

Late S Corp Election, Oops

Form 2553 (the S Corp election form) must be filed with the IRS. It is typically due within 75 days of forming your business entity or March 15 of the following year. However in typical IRS fashion there are 185 exceptions to the rule and the late S corporation election is another example. The IRS provides relief for the late filing of Form 2553. Historically, IRS Revenue Procedures 2003-43 and 2004-48 were the governing rules but the IRS has simplified it (imagine that!).

IRS Revenue Procedure 2013-30, effective September 3 2013, allows an entity to get relief and elect S Corp status within 3 years and 75 days from the date the election was originally intended to be effective. Holy cow. Three years!

The IRS is basically saying that if you walk and smell like an S Corp, then you are an S Corp.

So, if it is November 2018, and you want to go back to January 1, 2018, no problem. If it is March 2019 (tax season) and you are freakin' out because you forgot to make the election earlier, you can still go back to January 1, 2018. No that is not a typo… we are talking about going back to the previous year's January 1!

There are hiccups. Isn't hiccups such a friendly word? Sort of like bumps in the road. Bruises is another word that is about as hollow as hiccups and bumps. No one says pitfalls or disasters anymore, just hiccups. Bottom line is we can engage in some revisionist history on March 1, 2019 and create an Officer Compensation event for December 31, 2018. No worries.

If your current CPA or tax professional says No, we suggest you find a new accountant. The Watson CPA Group has been doing this for over a decade (there was relief provisions prior to the 2013 IRS Rev Proc as well) without major problems. You might incur some late filing penalties which usually can be abated under the First Time Abatement statutory relief program. We will review on a case by case basis.

Once the facts and circumstances are reviewed, and everyone thinks the S Corp election is the way to go, there are three things that happen simultaneously.

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Here is some of that shameless promotion we warned you about-

▲ Fax Late S Corp Election Form 2553 to the IRS

Fee: **$375**

▲ Open Payroll Accounts for 2019

Fee: **$300 to $450** (depending on state, OH and PA are the worst, super yuck)

▲ Issue a 1099-MISC as Officer Compensation (in lieu of a late payroll)

Fee: **$450** (this includes tax planning and estimated tax calculations)

▲ Prepare S Corporation Tax Return on Form 1120S

Fee: **$800 to $1,100**

So about $2,000 give or take a few bucks however you will be saving anywhere from 8% to 10% of your net business income depending in your situation. Also remember that the late S Corp election and payroll account setup is a sunk cost. In other words, you would need these things done regardless of late S Corp election for the previous year or waiting until next year. Bite the bullet now. Get it done.

In the past, to obtain relief with a late S Corp election during the tax season, we would prepare and file Form 1120S (corporate tax return) and attach Form 2553 (S Corp election) to it. Today, there are two paths. If we can file the S Corp tax return (Form 1120S) by March 15, then we send off the Form 2553, wait for the IRS to approve and then efile the tax return. New school.

Conversely, if we cannot file the tax returns in a timely manner, we usually have to paper-file the tax returns along with Form 2553. This is the old school way and there are times it is the only way.

Everyone once in a while the IRS loses its mind and rejects the late S Corp election. We always get it pushed through. Always. Unfortunately the rejection or some other nasty gram of a notice arrives on your doorstep at 5:01PM on a Friday. Briefly freak out, send the documents to us, and then have a Coke and a smile- it'll be OK.

At the very worst we have to obtain a Power of Attorney from you, call the IRS and give them a "see… how it works is…" spiel. The Watson CPA Group has 100% in getting these three events pushed through. Your mileage might vary, but we are also very successful with getting late payment penalties abated with the IRS. Each state is different, and some are unsympathetic. Again, the savings will outweigh the costs (or we wouldn't let you do it).

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Conclusion

Just slapping a Form 2553 together and pushing it through the IRS is not all, there are some other things to bother yourself with-

- Do you run a late payroll to satisfy the reasonable shareholder salary rule?
- If you elect mid-year, what happens to Q1 and Q2 in terms of payroll?
- How does the equity section in your balance sheet look after taking an LLC and taxing it as an S corporation?
- What happens if you need to terminate the S election?
- C Corps look flashy with their 21% tax rate, but be careful! Your effective tax rate could easily be 35.9% which might exceed your individual rate. Huh? Our full book has examples.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 7
Section 199A Deduction Analysis

Section 199A S Corp Considerations

Section 199A deduction also known as the Qualified Business Income Deduction (QBID) arises from the Tax Cuts & Jobs Act of 2017. This is a significant tax break for small business owners but there are rules and limits of course.

As with any major revision to the tax code, there will be modifications and interpretations which will change how Section 199A can be used for pass-through businesses such as S Corps and partnerships. On August 8, 2018, the IRS releases Proposed Regulations 1.199A that introduced new definitions, procedures and restrictions. Here is a quick list links to various things that we've put together for Section 199A enthusiasts-

www.wcgurl.com/8305	Section 199A Main Web Page
www.wcgurl.com/8317	Section 199A Updated (after proposed regs)
www.wcgurl.com/8330	Section 199A FAQs
www.wcgurl.com/8321	Section 199A Proposed Regs (1.199A)
www.wcgurl.com/8313	Section 199A Tax Return Samples
www.wcgurl.com/8320	Section 199A Salary Optimization

Stay tuned to updates as additional guidance is released by visiting our blog-

www.watsoncpagroup.com/blog

Specified Service Trades or Businesses

We already listed out the dirty dozen (actually 13) in a previous chapter and we expand that list in our published book, but we wanted to expand on the reputation or skill "catch all."

Reputation or Skill

This is the hammer. Unlucky number 13! The direct verbiage reads, "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners." This will be heavily litigated and shaped over time. This will also be the catch-all if the IRS challenges your trade or business to deem it a SSTB.

A bit of caution here. Business owners are proud, and for good reasons. As such they think their reputation or skill is the primary source of revenue. Perhaps. Perhaps not. We like to use the example of Dr. James Andrews; he is the go-to guy for the NFL on all knee injuries. Certainly his reputation or skill is known all over the country, and people ask for him by name.

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Sit on the ledge, sure, but don't jump off a bridge just yet. The specified service trade or business problem only comes up when your taxable income exceeds the limits. So, a financial advisor making $150,000 might still enjoy the Section 199A deduction. Please read this again! We have been stuck in a handful of debates with clients about the specified service trade or business designation just to find out they make $100,000 as a household.

Where does the Watson CPA Group land on all this? Quite simple. In matters where it is unclear, like the software consultant who could argue he or she is a software developer, our firm will present both sides of the argument to you. At the end of it all, you decide. Secretly we would rather error on the side of client advocacy in cases where it is not clear. Ultimately it remains your decision (again, in matters where it is unclear or very subjective).

Additionally, the SSTB designation is a direct response to what the IRS and Congress consider disguised W-2 compensation. Their position is that a doctor running an S Corp as an independent surgeon to a hospital is simply a disguised W-2, and as such all his or her income should be subjected to Social Security (up to the limits) and Medicare taxes.

Historically most personal services were performed by employees but the trend is now more independent contractors. In addition, to prevent W-2 converted to 1099 contractor abuse in the future in light of the wonderful Section 199A deduction, Congress created the SSTB designation. Simply, the tax code doesn't want more employees to be converted to contractors.

Again, see all the specified service trades or businesses as expanded in IRS Proposed Regulations 1.199A in our published book.

Section 199A Deduction Decision Tree

Remember that taxable income is all income for the household.

Specified Service Trade or Business (as defined above)-

- ▲ If taxable income is less than $157,500 (single) / $315,000 (married) then the 20% deduction for your pass-through entity is fully available.
- ▲ If taxable income is greater than $157,500 / $315,000 but less than $207,500 / $415,000 then a partial deduction is available. The phase-in of the limit is linear.
- ▲ If taxable income is greater than $207,500 / $415,000 then you are hosed. Sorry. Hosed is a technical term accountants often use to illustrate an untenable situation.

All Others-

- ▲ If taxable income is less than $157,500 / $315,000 then the 20% deduction is fully available.
- ▲ If taxable income is greater than $157,500 / $315,000 but less than $207,500 / $415,000 then a partial deduction is available with the W-2 and depreciable asset limit calculations phase in.
- ▲ If taxable income is greater than $207,500 / $415,000 then the 20% deduction is compared to the full W-2 and depreciable asset limit calculations (see Betty in Chapter 1).

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As mentioned earlier, we will show you examples and side-by-side comparisons in the next chapter. We have Fred, Barney, Hot Shot Surgeon, Goat Herder, and all kinds of nonsense.

Section 199A Pass-Thru Salary Optimization

Speaking of W-2s, there is some optimization that is necessary for a small business owner to get the most from the Section 199A deduction. On one hand we want to reduce W-2 salaries to shareholders to minimize self-employment taxes. This was obvious in an early chapter on the benefits of an S Corp. On the other hand, we want to increase W-2 salaries so they do not limit the amount of Section 199A that is deducted.

You might have seen a number of 28.57% on the internets. This is practically correct, but technically incorrect since it does not factor in employer payroll taxes. We say practically correct since the difference is immaterial.

Let’s look at the data-

Biz Income	100,000	100,000	100,000
Salary	25,000	40,000	27,935
Payroll Tax (Employer)	2,000	3,200	2,235
Net Biz Income	73,000	56,800	69,830
Section 199A W-2 Limit	12,500	20,000	13,968
Section 199A NBI Limit	14,600	11,360	13,966
Salary %	25.0%	40.0%	**27.9%**

We assumed that employer payroll tax portion is 8% of the salary. This includes Social Security, Medicare and unemployment taxes. This might be higher in some states, but let’s play along with 8%.

As you can see, the $25,000 salary (or 25%) results in Section 199A deduction being limited by W-2 amount. Next, the $40,000 salary results in Section 199A deduction being limited by net business income (NBI). Recall that the Section 199A deduction is the lower of these two numbers.

Using Excel’s solver plug-in, or manually changing the salary to bracket the two limits, results in a salary of $27,935 or 27.9%. This magical W-2 optimization for maximizing Section 199A deduction means that both W-2 and net business income limits are the same, and neither is specifically controlling.

Our tax software is very expensive, and it has a wonderful worksheet that sorts through the limits, and we can easily make adjustments of salary based on the limiting factor. However, keep in mind that most S corporations are paying anywhere from 30% to 40%, and sometimes as high as 60%, in salary to the shareholders. So, the 27.9% Section 199A optimization percentage is somewhat theoretical, and primarily reserved for only a handful of S Corps such as retailers.

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Conclusion

Just slamming your net business income and W-2 into a Section 199A calculator, there are some other things to bother yourself with-

- What is the cost of increasing salary?
- How do rentals work?
- Aggregation of several businesses to optimize Section 199A savings.
- What number do I use on the W-2? (**spoiler alert:** Box 1 actually is commonly not correct)
- Where is the SSTB designation made? How is the IRS informed about the SSTB designation or the W-2 / depreciable asset limits?

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 8
Section 199A Examples and Comparisons

Section 199A Basic Comparisons

Joe Public earning $100,000 with and without additional taxable income.

ln		Vanilla No S	Vanilla S Corp	Other Income No S	Other Income S Corp
1	Business Income	100,000	100,000	100,000	100,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	35,000	0	35,000
3	less Payroll Taxes	0	2,678	0	2,678
4	Net Business Income Section 199A	100,000	62,323	100,000	62,323
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	5,726	0	5,726	0
7	less Medicare Tax	1,339	0	1,339	0
8	less SEHI, HSA, etc.	0	0	0	0
9	Other Taxable Income	0	0	60,000	60,000
10	Adjusted Gross Income*	92,935	97,323	152,935	157,323
11	Itemized / Std Deductions	24,000	24,000	24,000	24,000
12	Taxable Income Before Section 199A	68,935	73,323	128,935	133,323
13	Section 199A Net Biz Income	20,000	12,465	20,000	12,465
14	Section 199A W-2 Wage Limit	0	17,500	0	17,500
15	Section 199A Taxable Income Limit	13,787	14,665	25,787	26,665
16	Section 199A Benefit	13,787	12,465	20,000	12,465
17	Marginal Income Tax Rate	12%	12%	22%	22%
18	Income Tax Benefit from Section 199A	-1,654	-1,496	-4,400	-2,742
19	plus Self-Employment Tax	14,130	0	14,130	0
20	plus Tax on Line 12 Delta (above)	0	526	0	965
21	plus Payroll Tax	0	5,355	0	5,355
22	Net Tax After Section 199A Benefit	12,475	4,386	9,730	3,578
23	Net S Corp Benefit $		**8,089**		**6,152**

*includes the S Corp W-2

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There are several notables, takeaways and explanations-

Assumptions are $100,000 in business income prior to $35,000 in reasonable shareholder salary. Married taxpayer with $24,000 as a standard deduction (Line 11), with and without an additional $60,000 in taxable income (Line 9) such as a spouse or pension.

Notice how under an S corporation scenario (the second and fourth columns) the adjusted gross income (Line 10) is higher than a garden variety LLC or sole proprietorship. This is because issuing a W-2 is limiting the amount of Social Security and Medicare taxes paid, and subsequently deducted to ultimately determine taxable income. This has always been the case before and after the Tax Cuts & Jobs Act of 2017. No change.

Taxable Income Before Section 199A Deduction (Line 12) is used for illustration purposes only. The Section 199A deduction will eventually reduce adjusted gross income to arrive at taxable income for income tax purposes (a deduction from AGI). Our illustration is purely for the difference between a non-S Corp and an S Corp. It is not an income tax calculation.

Lines 13, 14 and 15 compute the various Section 199A calculations and will be used to determine any limitations. In this example, since taxable income is below $315,000 the only two limits are Section 199A based on business income (Line 13) and Section 199A based on taxable income (Line 15). The Section 199A based on W-2 limitation is not used.

Line 16 is the selected Section 199A benefit depending on the calculation and income limitation rules.

Notice that under a non-S Corp scenario the limiting factor (or as nerdy military types say, limfac) is Section 199A based on taxable income whereas the S corporation scenario the limiting factor is Section 199A based on net business income. This should make sense.

Line 18 is the income tax benefit based on the Section 199A calculation. Remember we are thinking in terms of taxes, so the Section 199A calculation must be put into an income tax savings context based on marginal tax rates.

Next, we add self-employment taxes to the non-S Corp (Line 19), and income taxes and payroll taxes to the S Corp (Lines 20 and 21) to arrive at the cash in your pocket difference by being taxed as an S corporation. In this example, an S corporation is saving $8,089 for no additional household income and $6,152 with $60,000 in additional income. Of this savings, the bulk remains because of self-employment tax savings.

Fun! Moving on…

We have several more examples in our published book, but here is a recap on the following page of all our examples. You will see that S Corp savings is still a great tax savings tool in conjunction with Section 199A.

We also have side by side tax returns showing comparisons from 2017 to 2018 for Fred Flintstone. Visit our link-

www.wcgurl.com/8313

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Section 199A Comparison Recap

Hopefully you are still with us and not in the fetal position sucking your thumb. To hammer these points home, the Section 199A won't help everyone and the S corporation still has some shine (although perhaps less in some situations) as an overall tax reduction mechanism.

Here is a summary of the previous Section 199A side-by-side comparisons-

Business	Status*	Biz Income	Other Income	Health Ins.	199A Benefit	S Corp Savings
Consultant	Married	100,000			1,496	8,089
Consultant	Married	100,000	60,000		2,742	6,152
Consultant	Married	100,000			1,496	7,518
Consultant	Married	100,000		10,000	1,514	9,786
Retailer	Married	200,000			5,983	7,379
Retailer	Married	200,000	100,000		5,983	5,715
Retailer	Single	250,000			10,906	18,551
Retailer	Married	250,000			7,479	5,329
Retailer	Single	250,000			10,906	18,551
Attorney	Single	250,000			0	7,645
Surgeon	Single	600,000			0	8,133
Goat Herder	Single	600,000			28,044	36,177

The far right column, S Corp Savings, is your net savings after forfeiting a part of the Section 199A deduction. The deduction reduction if you will.

Conclusion

There are some other calculations to be aware of with the Section 199A deduction. For example-

▲ The phaseout for a specified service trade or business.

▲ How does a mixture of rental income and SSTB income work?

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 9
Reasonable Shareholder Salary

Reasonable S Corp Salary Theory

Determining a reasonable salary is the hardest part of running an S corporation. What the heck do I pay myself? Before we get into that, let's discuss why shareholder salary needs to be just above bar napkin quality and just below NASA precision.

Scattered throughout this book we've stressed that the only tax savings an S Corp provides is the reduction of self-employment taxes, and in the case of shareholder wages we are talking about Social Security and Medicare taxes (payroll taxes). When your business pays you $10,000 in shareholder wages, 7.65% is withheld from your pay check for the employee's portion of payroll taxes. This is broken down into 6.2% Social Security tax and 1.45% Medicare tax. The business also must pay 7.65% for a combined percentage of 15.3%. Since the business deducts its portion of payroll taxes, the effective tax rate is 14.1%.

Therefore, a $10,000 shareholder salary costs you $1,410 in additional taxes beyond income taxes. Said in a different way, if you pay yourself $50,000 when $40,000 could have been a reasonable shareholder salary, you just wasted $1,410. Even a $5,000 delta equates to $705.

Truth be told there is some philosophical issues with the reasonable salary element where your labor is the only material income-producing factor for the business. Some would argue that all the S Corp's income should then be considered shareholder wages and subjected to Social Security and Medicare taxes, since if you died the business would die. Do we see this "loophole" being re-defined and shrinking over the next several years? Yes. But at the same time, we say let it ride until we can't use it. The IRS and Congress move at glacial speeds- let's worry about next time, next time.

Conversely, there might be times where your business would continue without you. When the Watson CPA Group does business valuations, especially in divorce proceedings, we assign a value to goodwill. We do this by taking a number called seller's discretionary cash flow (SDCF) and we subtract the cash flow that is derived from tangible assets (cash, equipment, etc.). This leaves us with a theoretical number that is considered goodwill which can be used as a proxy to determine your "value" to the business.

We further tease out personal goodwill and enterprise goodwill since in some jurisdictions personal goodwill is not marital property. This might seem like an odd tangent, but a similar argument can be made for a business that does not rely on you. One great example is a financial advisor that has a small team supporting him or her- typically the fee income continues well into the future without the direct involvement of the advisor (enterprise goodwill). In this situation, an argument for a smaller salary could be warranted since enterprise goodwill exceeds personal goodwill.

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Consider this-

Business Type	Owner Participation
Software developer who has gone to market	10%
Amazon retailer, a lot of drop shipments, no inventory	20%
Financial advisor with small team	30%
Doctor who is a partner in an emergency clinic	40%
Consultant, Attorney, Accountant	90%
Actor with no endorsements or couch-jumping events	100%

Of course, this is all theoretical and is open to debate, but you get the idea.

Not to go too far into the weeds, but when performing business valuations we also consider investor value. What rate of return would an investor need to earn after paying you a reasonable salary? In other words, what would someone be willing to pay you to continue running the business after they acquired it from you?

Naturally, a lower salary to you results in a higher rate of return for the investor. We also look at the earnings generated from capital investments such as machinery and other non-owner employees versus shareholder labor. We digress…

Conclusion

Reasonable shareholder salary is the hardest thing. On one hand it must be low enough to get the S corporation savings and on the other hand, it cannot be unreasonable nor limit your Section 199A deduction . There are all kinds of considerations with setting officer compensation-

- IRS Revenue Rulings and Fact Sheet 2008-25.
- Tax Court cases.
- Risk Management Association (RMA), Bureau of Labor Statistics (BLS), RCReports and Salary.com. The data!
- Rules of Thumb, Jumping Off Point.
- How to split the payroll baby with your spouse.
- The competing interests like 401k and Social Security benefits.
- How to use payroll as a conduit for tax planning and effective tax budgeting putting you in a tax neutral situation next April.
- Some other tricks such as putting kids on payroll or making Mom an inactive shareholder.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 10
Operating Your S Corp

The S Corp Grind, Operational Hassles

You're probably thinking that running an S-Corp adds all kinds of burdens. Not true. When we ask the appropriate questions and recommend an S Corp election, some clients will say, "Sounds like a lot of work." There are very few additional hassles with an S corporation as compared to other entities. All the things you do now to maintain your financial records remain the same. Determining your business income and expenses remains the same. Whether you compile data to put on a Form 1040 Schedule C or Form 1120S (corporate tax return), the effort from you is identical. Additionally, the things you do in terms of corporate governance such as meetings, minutes and voting, also remain the same.

The two other requirements are paying a reasonable salary to S Corp shareholders through payroll and preparing a corporate tax return. If you use the Watson CPA Group (and you should), then this hassle is ours not yours. Well, not entirely true- we are attached at the hip if we prepare your tax returns, and while we can be demanding for a comprehensive tax return the hassle is mostly ours.

S Corp Salary

The bulk of this chapter is devoted to reasonable S corporation salary theory and calculation. We only mention it here since calculating a reasonable salary and processing payroll is a hassle as a business owner.

Corporate Tax Return

An S Corp must file a corporate tax return by **March 15** and there are additional financial reporting requirements. Since an S corporation is a pass-thru entity whereby the tax consequences are passed through to the shareholders, the personal tax returns of the shareholders cannot be completed until the S Corp tax return is completed (both can be filed simultaneously). However, if you use the Watson CPA Group to prepare your tax returns, we'll make it seamless and pain free. Ok, taxes and pain free don't really go together, but you get the idea.

S corporations file a Form 1120S and this in turn creates K-1s for all the shareholders. Unlike many other tax professionals, we always create a balance sheet and we always reconcile equity accounts (capital stock, additional paid in capital, retained earnings, shareholder distributions and basis). This can be challenging for us, but we feel it is important for you, the client, and for long-term reporting accuracy.

When you own an S corporation, you are both employee and investor. If you invested $100 into Google, you could only lose $100. Nothing more. The same with your S Corp as an investor. For example, if you invested $10,000 into your company, but your company lost $20,000, your K-1 will show a $20,000 loss but you are only allowed to deduct your basis which is $10,000. Without tracking this information, you could be incorrectly deducting losses in the current year instead of carrying them forward to future years.

More importantly, without shareholder basis information, there is no way to determine the gain on your future business sale. Just like stock sales, when you sell your company for a zillion dollars the IRS will consider all that to be capital gain unless you can prove otherwise.

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Creating a balance sheet is also just good accounting practice, and it contributes to the overall tracking of your company's worth. Lenders and investors will also want to see this information if you need leveraged financial assistance for company growth. Recently, a business owner was gifting away chunks of her business to her sons, and her basis needed to be calculated and transferred for gift tax filings. Her balance sheet information was a mess and needed fixing. We are retained frequently to put humpty dumpty back together and build historical balance sheet information.

Business succession, exit strategies, asset sales, business valuation, buy-sell agreements, etc. are topics rarely considered by most small business owners, and that is Ok. But as accountants and business consultants, it is our job to keep you out of future trouble by putting things on the right track today. That starts with your corporate tax returns being comprehensively and accurately prepared, which includes Schedule L (the balance sheet). While we don't look for ways to complicate the heck out of things, demand that your tax professional prepare a balance sheet with your tax returns.

S Corp Costs

People want to know costs and while this might seem like more shameless self-promotion, you still need to understand what you are getting into. The Watson CPA Group specializes in S corporations which have a small number of shareholders, and often just a one-person show. This is all we do.

Because it is a core competency for us, we have created an S Corp package that includes the following-

	Aspen	Vail	Breck	Keystone
S Corp Reasonable Salary Calculation	Yes	Yes	Yes	Yes
Section 199A Pass-Thru Optimization	Yes	Yes	Yes	Yes
S Corp Payroll Filings and Deposits	Yes	Yes		
Annual Processing (W-2s, up to five 1099's)	Yes	Yes		
S Corporation Tax Prep (Form 1120S)	Yes	Yes	Yes	Yes
Individual Tax Prep (Form 1040), One Owner	Yes		Yes	
Estimated Tax Payments	Yes	Yes	Yes	Yes
2019 Tax Planning, Mock Tax Returns	Yes	Yes	Yes	Yes
Unlimited Consultation, PBRs	Yes	Yes	Yes	Yes
First Research Industry Reports	Yes	Yes	Yes	Yes
Small Business Tax Deductions Optimization	Yes	Yes	Yes	Yes
IRS Audit Defense	Yes		Yes	
Annual Fee	**$2,940**	**$2,640**	**$2,460**	**$2,160**
Monthly Fee	**$245**	**$220**	**$205**	**$180**

Couple of things to keep in mind- we make very little profits on payroll processing… we offer it as a convenience to our clients. One throat to choke with a single call can be reassuring but if you want to run your payroll, go for it! And… the benefit of the Watson CPA Group preparing both tax returns is that we slide things around depending on income limitations, phaseouts, alternative minimum tax (AMT), etc. Having our arms around both can yield some good tax savings!

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Some more things to consider- Since only a partial year remains, our usual annual fee is pro-rated to not charge you for services you didn't use (like payroll and consultation). However, a large chunk of our annual fee is tax preparation which is typically a fixed amount of $1,300 (both corporate and personal). Whether we onboard you in January, July or December, we have to prepare a full year tax return. This increases the monthly fee for the remaining months of 2018 but the monthly fee will later decrease in January of 2019 to reflect the amounts above.

Break-even analysis is based on our annual fee of $2,940. If an S corporation saves you 8% to 10% (on average) in taxes over the garden variety LLC, then $2,940 divided by 9% equals $32,667 of net business income after expenses.

You can always find someone to do it for less- we know that. At the same time, we have a vested interest in your success and provide sound tax and business consultation as a part of our service. Here are links to our Periodic Business Review agenda and End of Year Tax Planning that we cover throughout the year so our consultation to you is comprehensive-

www.wcgurl.com/PBR

www.wcgurl.com/EOY

These general fees will cover most situations. However, depending on the number of transactions, accounts and employees, these fees might have to be adjusted to reflect additional complexities. The Watson CPA Group is not out to gouge anyone or do a quick money grab- we want to build relationships by doing things right for a reasonable fee. Check out our fee structure here-

www.watsoncpagroup.com/fee

No more shameless promotion… at least for a while.

Take Money Out of the S Corp

Remember, payroll taxes (Social Security and Medicare taxes) are the same as self-employment taxes. But they also include unemployment taxes, state disability insurance (such as California's state disability insurance-CASDI) and other odd-duck local taxes. We discussed this in previous sections. As an S Corp shareholder, you are taking money out of the business in four ways-

	Source	Payroll Taxes	Income Taxes
1.	Reasonable S Corp Salary	Yes	Yes
2.	Shareholder Distributions	No	No*
3.	Self-Rental (not home office)	No	Yes
4.	Reimbursements (Accountable Plan, health expenses, education assistance)	No	No

Let's talk about everything except a reasonable salary for your S corporation first. When you write a check to yourself or transfer money from your business checking account to your personal checking account, you are taking a shareholder distribution. However you are not taxed on shareholder distributions nor are they a deduction to the business- you are taxed on income.

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Let's say your S Corporation earns $100,000 after shareholder wages and expenses, and you magically also have $100,000 in the business checking account. You transfer $60,000 to your personal checking account as a shareholder distribution. $40,000 is left behind in the business checking account.

What is your taxable income? $100,000. Good.

Next year, your business is a bit slower and you only earn $50,000 and therefore you have $90,000 ($40,000 + $50,000) in the business checking account. You transfer $80,000 to your personal account leaving $10,000 in the business account.

What is your taxable income? $50,000 even though you transferred $80,000 from the business to you. Cash is cash and income is income. Over time, aggregated historical cash should be very close to aggregated historical incomes but don't get too caught up on that. Same with accrual versus cash accounting- in looking back 20 years both accounting methods should converge in net incomes. We digress…

Estimated Tax Payments, Withholdings Issues

Estimated tax payments change as well when you have an S Corp, especially the first year. Generally speaking, you are required to pay at least 100% of your prior year tax liability or 90% of your current year tax liability whichever is lower. If you earn over $150,000, you must pay 110% of your current year tax liability. How do you keep that straight?

Here is some more Watson CPA Group elegance- we calculate and pay your quarterly estimated payments through payroll. No more writing separate checks and tracking due dates. We do this by manually entering your Federal and State withholdings accordingly to reflect the tax liability for your W-2 income and your K-1 income. Beauty!

Conclusion

Operating your S Corp can be tricky and time consuming. We only touched on some of the issues here in our shortie version. Here are some additional considerations-

- ▲ How to make payroll a minimal cash outlay compared to garden-variety payroll.
- ▲ How other tricks of trade such as income shifting, putting kids on payroll and making Mom or Dad a shareholder can reduce taxes.
- ▲ The upsides and downsides of adding your spouse to payroll. Yes, it can save taxes but there are several cautions you need to be aware of.
- ▲ How to pull money out of your business through an Accountable Plan reimbursement and how it lowers taxes.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 11
Tax Deductions, Fringe Benefits

Ahh.. the good stuff. Yes, you work hard. Yes, you want to be able to get a little extra from your hard work and your business. Yes, you want this to be tax-advantaged. We get it. This chapter will discuss the 185 tax deductions you cannot take, explain how to position yourself on allowable small business tax deductions, and then get into hot topics such as automobiles, home offices, deducting MBAs, Cohan rule and other fun things.

Chapter 6 and Accountable Plans was a snap. Chapter 7 and Tax Deductions, Fringe Benefits is long.

Four Basics to Warm Up To

Before we get into which tax deductions and tax moves you can take, there are some basic concepts to help formulate your thinking.

Marginal Tax Rate

Quick lesson on small business tax deductions. When you write a check and it has a tax savings element (office expense, 401k, IRA, charity, etc.) it is not a dollar for dollar savings. For example, if you are in the 22% marginal tax bracket, you must write a check for $4,000 just to save $880 in taxes. Keep this in mind as you read this information on tax deductions. Also keep in mind that cash is king, and that perhaps paying a few more taxes today with the added flexibility of cash in the bank can be comforting. More on this later in the chapter.

Cash Savings or Tax Savings

You can save $50,000 today! Yes, today! You just need to write a $150,000 check to your church. Huh? That might not sound like the best idea to a lot of people since so much cash is leaving. Another way to look at this is this- most people say “I want to save taxes” but really what they are saying is “I want to save cash.”

In other words, most people are in the cash-saving business not the tax-saving business. If we can do both, great. However, most tax-savings moves take cash, and cash is what you want to keep. So keep this concept in mind as you review business deductions below.

Building Wealth

At the end of your life, you’ll measure your financial success on the wealth you built not the tax you saved. We agree that a part of wealth building includes tax savings, but be careful not to sacrifice wealth for the thrill of a tax deduction (or deferral). Here is an example- let’s say you stuff all your available cash into a tax-advantaged retirement account such a 401k. A few years go by and a great rental comes on the market but your cash is all tied up in a 401k. So, you sacrificed potential building of wealth by not having an intermediate investment strategy for the sake of tax deferrals.

The Trick

Here’s the trick. The Holy Grail if you will. You need to find a way to deduct money you are already spending. Read that again. For example, if you have a travel budget then you are already comfortable with a certain amount of money leaving your person. Let’s find a way to deduct it through your business.

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Automobile depreciation? Same thing. You are already comfortable with automobiles losing thousands of dollars in value especially in the early years, so let's a find a way to make this degradation in value a tax windfall.

The remainder of this chapter is written to help educate yourself so the money you are already spending can be positioned in such a fashion that it becomes a legitimate small business tax deduction. Remember that the greatest trick the devil ever pulled was convincing the world he didn't exist. The second greatest trick was finding a way to deduct the expense. You gotta love The Usual Suspects. Classic!

185 Business Deductions You Cannot Take

Similarly to the 185 reasons to not elect S corporation taxation, there aren't 185 small business deductions that you cannot take. However, we want to start with the crazy things small business owners try to do since it is such a good springboard for discussion. Here is the list-

- 100% cell phone
- Mileage and gas for your automobile
- Home office improvements
- Food (unless with a business purpose)
- Per diem
- Country club dues
- Client gifts (limited to $25)
- Professional attire (unless you do it correctly)

There are others of course, but these are the ones we routinely see business owners trying to slide across our desk while we focus on a shiny object. Further explanations and tax code references can be found in the full version of our book.

Deductions the IRS Cannot Stand

Here is a quick list of the small business tax deductions that the IRS cannot stand. That isn't phrased correctly. The IRS actually likes these tax deductions since most business owners either incorrectly deduct them or cannot substantiate an otherwise qualified deduction for lack of proper record keeping.

The IRS plays pot odds on the following business deductions since the recovery of taxes is probable and therefore profitable for the government. In poker, if it costs you $10 to bet and there is $100 in the pot, then you can be wrong 90% of the time and still break even. This is the essence of the pot odds: You're paying a fraction to win a larger sum, and the IRS is no different.

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Here we go-

▲ Meals and Entertainment (shocker)

▲ Car and Truck Expenses, Mileage Logs (another shocker)

▲ Travel

▲ Home Office (unless reimbursed through an Accountable Plan)

There are others, but these are the biggies. We don't want you to have a chilling effect on these expenses. You should not be afraid of an audit. You should not be afraid of losing an audit. You should only be afraid of having an unreasonable or indefensible position. Sure, easy for us to say.

At the same time, if you have legitimate expenses and you can back them up with proof, then happily deduct them. Like Muhammad Ali once said, "It's not bragging if you can back it up." Well, the same can be said of small business tax deductions that are at higher risk of audit. If you can back it up then deduct it!

Automobiles and LLCs, S Corps

A question we entertain almost daily is "I want to save taxes. Should I have the business buy me a car?" Our auto-attendant replies with, "Do you need a car?" If you answer with "Yes" the auto-attendant replies with, "Hold please." If your "Yes" is not quick or mumbled, or if there is any recognition of hesitation, the auto-attendant is unhappy.

We digress. There are only a few questions you need to ask yourself when considering a car purchase. Are you the type of person who buys new? How long do you typically keep your cars? Is the car 100% business use? How many miles do you plan to drive? There is a decision tree at the end of the automobile section.

Back up for a bit. Remember our previous discussions about tax deductions, and how only a fraction of the money you spend is returned to you? So, back to our auto-attendant, "Do you need a car?" If the answer is "Yes" because your bucket of bolts is getting exceedingly dangerous, then Yes, buy a much-needed car out of a sense of safety. If the answer is "Not really, but I want to save taxes," then don't.

Two rules to live by-

▲ Cash is King (keep it!)

▲ Depreciation is a tax deferral not a tax avoidance system (typically)

There might be some other external forces at play. For example, if you need a car next year but your income is ridiculously and unusually high in the current tax year, then reducing your income now makes sense. Again, tax modeling and planning is critical.

Ok, you've chatted with your car-loving buddies at the Watson CPA Group and we've determined that a car purchase should be in your near future, now what? There are all kinds of issues here, so, buckle up as we go through this stuff. There are four scenarios-

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- ▲ Business Owned Automobile (mixed bag)
- ▲ You Own the Automobile, Get Reimbursed By The Mile (clean and elegant)
- ▲ You Own the Automobile, Take a Mileage Deduction (silly in an S Corp… oh and by the way, gone with the Tax Cuts and Jobs Act of 2017)
- ▲ You Own the Automobile, Lease it Back to Your Business (exotic)

Which was do I choose?

Automobile Decision Tree

In deciding whether to own the automobile personally or through your S corporation, here is a set of examples to help you make a decision. It is not a hard and fast set of rules, but will provide some guidance.

First, let's establish the bookends. On one end is the $80,000 luxury auto that you barely drive, and you recycle automobiles every 2-3 years. This is clearly business owned.

On the other end is the $30,000 modest automobile that you drive a tone of miles, and you keep automobiles for at least 5 years. This is clearly individually owned and reimbursed.

Armed with that information, here we go-

Example 1

You like big fancy cars that cost $80,000 and you only drive 5,000 miles for the business. Degradation of value is a way of life simply based on time so this automobile will go down in value, and as such you might as well get a tax deduction for it. Ergo, have the business own it. In other words, if you have already budgeted for the degradation of automobile value you might as well get a tax deduction for it, right?

Example 2

You are frugal and therefore you like to buy used Subaru's costing around $20,000… and, you drive the wheels off the thing because you are a real estate agent. Degradation in value is not as severe as example 1, so in this example the small business owner should own the automobile personally and get a mileage reimbursement from the business.

Example 3

You like big heavy trucks that cost $80,000 and you drive 12,000 miles for the business. You would like to save some taxes this year as well (shocking). This is a great example of using Section 179 plus 100% Bonus Depreciation to deduct the full amount of the truck.

Example 4

Same as example 3, but you expect your income to dramatically increase next year versus this year. In this case, have some patience and purchase the truck next year to match the excellent tax deduction against the higher income. We know, patience stinks. Our job is to build your wealth, and save taxes over your lifetime… not just today.

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Example 5
You buy a lightly used SUV that weighs over 6,000 pounds for $50,000 and you drive it 6,000 miles per year. Yuck. This is right in the middle of "no man's land" where the decision is not obvious. Yes, you can deduct the full amount of $50,000 since the Section 179 deduction is not based on a new automobile, just new to you. Same with 100% Bonus Depreciation with the new tax law.

But recall that depreciation is a tax deferral… if you sell your business automobile for $40,000 a few years later, you will have depreciation recapture on the $40,000 taxed at ordinary income tax rates (with some limits). And… Section 1031 Like-Kind Exchanges no longer apply to automobiles since the recent tax reform so you can't trade it in to kick this depreciation recapture can down the road.

It might behoove you then to own this automobile personally and get a mileage reimbursement from the business. Then again, if you have an unusually high income this year perhaps deducting it in full today makes sense. Again, "no man's land" since the decision now has a ton of variables and what-ifs.

Example 6
Same as example 5 but you keep the automobile for 10 years and drive 15,000 miles. This changes the narrative. Since you will be owning it for so long with so many miles, the mileage reimbursement option is the way to go. In other words, own it personally and get reimbursed for the business miles you drive.

We have a questionnaire that you can complete, and we can review together to find the best course of action. Here is the link-

www.wcgurl.com/8120

Sutter Rule

The Sutter rule allows the IRS to disallow a portion of your business meals when they consume a large part of your normal living expenses. In other words, if every meal you eat is a justifiable business meal, it might not matter under the Sutter rule. This rule was created in Richard Sutter v. Commissioner, 21 Tax Court 170 (1953), where Sutter expensed his lunch every day but the court found that "the deduction for the cost of lunches was apparently almost entirely payment for petitioner's own meals when he attended such functions as meetings of the Chamber of Commerce. There is no evidence that these costs were any greater than expenditures which petitioner would have been required to make in any event for his own personal purposes. They must consequently be disallowed."

Sutter was audacious- he deducted everything he could think of. It is a great read.

Again be careful. Business meals are low hanging fruit for the IRS. We've seen thousands of dollars in tax savings disappear before our eyes during an examination because the client could not demonstrate the business purpose. To not lose an audit, make sure you keep receipts beyond relying on the credit card statement. In addition, keep a log or journal of the person(s) you met with and the topics of discussion. Be very specific. Memories fade, so if you intend to reconstruct this evidence upon receipt of your examination notice from the IRS, think twice. IRS agents are no dummies on meals.

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Cohan Rule

Let's briefly discuss record keeping, and then jump into a famous New York entertainer named Cohan who ultimately provided a nifty rule that can be used during an IRS audit. To be able to demonstrate a business deduction you need to show the date, the amount and the person or business you paid. A bank or credit card statement, or canceled check, satisfies this. The second element is the business purpose must be documented either through a logbook, planner or accounting software. Proof of payment plus business purpose equals tax deduction.

Do you need receipts? Yes and no. For travel, gifts, meals and entertainment, if the amount is under $75 then you only need to document the event and business purpose in a logbook or planner. However, if you spend $10 at Costco for some paper, then you need proof of payment plus business purpose documentation. Seems a bit onerous and even contradictory, but it is true.

Enter **Cohan vs. Commissioner, 39 F. 2d 540 (2d Cir. 1930)**. Yes, 1930 and we still use it today. George Cohan gave us "Yankee Doodle Dandy" and "Give My Regards to Broadway", and he gave us a tax deduction rule. His rule is simple- you can approximate your business expenses and ultimately your business tax deduction. What?! No, it is not that simple.

You must have corroborating evidence that demonstrates your expense. For example, as a Colorado Springs CPA firm, the Watson CPA Group can demonstrate that we prepare so many tax returns which are so many pages in length, and therefore we can approximate our paper costs. **Temp. Regs. Sec. 1.274-5T(c)(3)** also gives latitude to the IRS to allow substantiation of a business expense by other means.

The Watson CPA Group has successfully used the Cohan rule in IRS examinations. We have also implemented it during tax preparation when records are incomplete or missing (i.e., one hot mess). Having said that, using estimates and approximations looks bad. Keep good records, please. Do not rely on the Cohan rule or some treasury regulation to save your butt.

The Cohan rule or any type of estimation cannot be used for travel, business gifts, meals and entertainment. All the good stuff need strict record keeping habits. **Section 274(d) of the U.S. Tax Code** also states that listed property must be substantiated with proper documentation. Listed property includes vehicles, equipment generally used in entertainment such as cameras and stereo equipment, and computers. Seems a bit out dated, but there you go. So, if you are a photographer who drives a car for business while entertaining guests, you will be a master at record keeping.

A logbook or planner is very influential during an audit. When a client can show contemporaneous records in a planner that coincides with travel, meals and home office use, the audit lasts about 90 minutes as opposed to four hours with a deficiency notice at the end. Contemporaneous comes from Latin, and means existing or happening during the same period. In other words, as things happen in your world, write them down in a logbook or planner.

Girls are better at this than boys because of purses which is why we now have European shoulder bags for boys. Yet boys still stink at record keeping. If you are a boy, keep in mind that your DNA precludes you from multitasking. You might be doing two things at once, but that in no way is multitasking. Your contemporaneous record keeping might be more sequential.

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Summary of Small Business Tax Deductions

This chapter is huge, and has a ton of information in it and perhaps it is overwhelming. To reiterate information from the beginning of this chapter there are some over-arching themes and concepts for all small business deductions. The business expense must be-

- Ordinary and necessary (IRS Publication 334), **and**
- Paid or recognized in the current tax year, **and**
- Directly related to your business, **and**
- Reasonable, and not lavish or extravagant (IRC Section 162 and IRS Publication 463).

We want to give you this table to help summarize the business deductions that are clearly not allowed (black), the ones that clearly are allowed (white), and the gaggle of exceptions (grey).

Business Expense	Deduction?
401k Plan	Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.
Advertising	Yes.
Automobiles	Business use only. Use decision tree to see if you should own it or the business. Depends on price, turnover, miles driven, business use and marginal tax rates. Personal use added to W-2 Box 1, 3 and 5 using Lease Value rates in IRS Pub 15-B.
Business Travel	All kinds of rules. Mix pleasure with business under some circumstances.
Business Meals	50% if business discussion with client, prospect or associate. 50% if traveling away from your tax home on business. 100% for business social gatherings or convenience of the employer (lunch).
Cell Phone	Business use only. Never 100% unless you have second phone. Reimbursed through Accountable Plan.
Client Gifts	Max $25 per recipient per year.
Commissions	Yes.
Commuting Expenses	No. If you have a home office, then commuting becomes business travel and subsequently Yes.
Copier Lease	If the lease can be considered a capital lease, then No. If the lease is an operational lease, then Yes. Depends on the facts and circumstances.
Country Club Dues	No. Don't throw the book. Not our fault.
Defined Benefits Plan	Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.
Education	Only if improves your current work skills or necessary for professional credentials (see Tax Court cases above).

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Food	50% if business discussion with client, prospect or associate. 50% if traveling away from your tax home on business. 100% for business social gatherings or convenience of the employer (lunch).
Golf Outing	No. Seriously. Let it go.
Guard Dogs	If you are a high risk defense attorney on the East Coast and need a security detail, then Maybe. Must be a bona fide occupational qualification.
Health Reimbursement Arrangement (HRA)	Yes. Need a HRA plan. There are rules. Added to your W-2 Box 1.
Health Savings Accounts (HSA)	Business contributions, Yes. Added to your W-2 Box 1.
Home Office	If regularly and exclusively used for business then Yes. Multiple locations OK provided home office is primarily used for substantial administrative activities. Reimbursed through Accountable Plan.
Insurance	Business liability insurance, Yes. Auto insurance, Yes if the business owns the car. Health insurance, Yes and added to W-2 Box 1. Dental insurance, Yes and added to W-2 Box 1. Eye insurance, Yes and added to W-2 Box 1. Long Term Care insurance, Yes but limited. Disability insurance, No. Otherwise your benefits become taxable income. Life insurance, No. Only in C corporations where the corporation is the owner and beneficiary (no S Corp election!).
Kids On Payroll	Great way of reducing tax liability for the same amount of cash. Must do it correctly and follow state child labor laws.
Legal, Professional Fees	Yes.
Merchant Card Fees	Yes.
Per Diem	Maybe. If employees own more than 10% of a corporation, then No. Sole proprietors and single member LLCs including partners in partnerships, Yes.
Professional Attire	If the clothing is suitable for everyday use then No. If the clothing is a uniform then Yes. Possible advertising expense. No dry cleaning unless clothing otherwise qualifies.
Profit Sharing Plan	Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.
Retirement Plan	Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.
Taxes	Sales tax, Yes. Payroll tax, Yes for business portion. Estimated tax payments, No. Nice try.
Utilities	No, unless you have a separate office location. If using home office, utilities is a part of the deductible basis.
Website	Yes.

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There you go. There are tons of variations, exceptions, rules to follow, interpretations, positioning, and many more modifiers that we can't think of right now. Please contact us if you have any questions or concerns- we love to run through small business tax deductions with owners. And like a good parent, we try to find ways to say Yes. Yes, you can go to Johnny's house right after you clean your room. Yes, you can deduct that expense provided you document it this way.

Conclusion

In the full version of Taxpayer's Comprehensive Guide to LLC's and S Corps, Chapter 8 is 55 pages long. In the shortie version here, it is a mere 7 pages. What the heck is in the other 48 pages? Lots! Deeper explanations on-

- ▲ Tax home and how your home office has a 50-mile rule.
- ▲ Home offices when you have another work location (spoiler- You can have another work location and still have a home office deduction).
- ▲ Section 179 and 100% bonus depreciation. Hummer rule is back!
- ▲ How depreciation can be an ugly tax problem at the wrong time.
- ▲ Small business tax deduction themes such as ordinary and necessary, paid or recognized, directly related to your business and reasonable (board meetings in Fiji for a two-person board probably not reasonable).
- ▲ The automobile decision tree on whether to own and get reimbursed versus having the company own the automobile.
- ▲ Mixing business with pleasure when it comes to business travel, and how to leverage your business in paying for your spouse's travels.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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Chapter 12
Retirement Planning

Retirement Planning Within Your Small Business

Most people have a pretty good handle on personal finance and basic retirement savings, and while the principles are generally the same in the small business world, a lot of business owners have a deer caught in your headlights at 2:00AM look when it comes to leveraging their business for retirement. And there is good reason- retirement planning within your small business carries a bunch more options and potential pitfalls (sounds like life in general, doesn't it?).

Reasons for Small Business Financial Planning

There are three major wealth considerations for small business owners (or anyone for that matter)-

- ▲ Accumulation (fun and exciting part)
- ▲ Preservation (the tricky part)
- ▲ Transfer (the necessary evil part)

Each of these major wealth considerations are interwoven, and need comprehensive focus to ensure the necessary dots are connected, and no gaps or holes exist during transitions. That is where financial planning comes into play.

Accumulation is easy. Most people think if they toss some money at a mutual fund they are planning for retirement. Nope.

Preservation gets tricky since we need to have our money outlast our lives. And with people living well into their 90s, this can be tough. Let's put it another way- if you work for 40 years, from age 25 to 65, you need to save enough to live for another 25-30 years. That is incredible. If you are spending $100,000 at age 55, you better be making $180,000 and putting the $80,000 into a moderate growth retirement vehicle.

Preservation also includes proper insurance, asset protection through trusts, pro-active maneuvering and other tools in the toolbox.

Transfer of wealth is automatic. We have yet to see a hearse with a trailer hitch. Or, said in a completely more stark way, every life come with a death sentence. How it is executed is partially up to you. Did we just ruin your appetite? Sorry.

Transfer of wealth can also be tricky. Current federal estate tax exemption is $5.43M per person, and a passed spouse can posthumously port his or her exemption to the surviving spouse. Not bad. And most people don't have over $11.86M in estate value. Rich people problems (now referred to as high net worth).

These federal exemption amounts are indexed each year, and while Congress can always vote to repeal, this estate tax exemption was written in stone with passing of the American Taxpayer Relief Act of 2012. However,

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various states have much lower exemptions. Oregon for example is $1M and New Jersey is $600,000. Nebraska has a sliding scale. So, just because you are out of woods federally, doesn't mean the transfer your wealth is free of taxation. Get a plan.

What about your business? Does it have an exit strategy or wealth transfer strategy? Add this to the plan.

The reason for financial planning are-

Goals and Objectives

Define your goals and objectives, determine your current position and discover unmanaged risks. This sounds simple and makes sense, but defining goals and objectives is a fluid concept. They change. And as they change, the plan needs to be malleable enough to adopt. Financial plans are modified annually or whenever a major life change as occurred, whichever is more frequent. This is important.

The Plan

Financial plans also create a blueprint and chart a course on how to get reach goals and objectives while managing risk. Again, this sounds simple. But even the most basic house needs a blueprint for framers, plumbers, electricians and even inspectors to review and implement. And in the case of a financial plan, these same players are your financial advisors, tax professionals, attorneys and insurance specialists.
A financial plan brings these people together to work in concert. This is why the Watson CPA Group is a part of The One Call Team-

www.watsoncpagroup.com/toc

Accountability

Financial plans also provide confidence, measure success and hold everyone accountable. If everyone agrees that your financial plan will ensure financial security in your life, then it becomes a measuring stick for determining success along the way. Anyone can throw some money at an investment, but what does it mean? And does it fit the plan? And is the selection of that investment meet the plan's objectives.

The Watson CPA Group can always assist you with retirement and financial planning as it relates to your small business and taxation. And if you need a referral for a financial advisor we can offer that too.

Small Business Retirement Plans Comparison

We are going to put the carriage in front of the horse, and show you a comparison of basic small business retirement plans before explaining each plan. We cheated, and used Yahoo! Finance's online calculator to demonstrate these differences. Why re-invent the wheel? And frankly, Yahoo! Finance does a fantastic job at this type of stuff. Here is their link-

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We took a handful of salaries (for corporations) and net incomes (for sole proprietors and partners in partnerships) and plugged them into Bankrate's calculator, and came up with the following table based on 2019 limits-

Salary/Income	Entity	Max 401k	Max SEP IRA	Max SIMPLE
40,000	Sole Prop	26,435	7,435	14,083
40,000	Corporation	29,000	10,000	14,200
60,000	Sole Prop	19,000	11,152	14,624
60,000	Corporation	34,000	15,000	14,800
80,000	Sole Prop	33,870	14,870	15,165
80,000	Corporation	39,000	20,000	15,400
148,000	Sole Prop	46,556	27,556	17,013
148,000	Corporation	**56,000**	37,000	17,440
175,000	Sole Prop	51,884	32,883	17,789
175,000	Corporation	55,000	43,750	18,250
196,000	Sole Prop	**56,000**	37,027	18,392
196,000	Corporation	56,000	49,000	18,880
224,000	Sole Prop	56,000	42,552	19,197
224,000	Corporation	56,000	**56,000**	19,720
293,000	Sole Prop	56,000	**56,000**	21,155
293,000	Corporation	56,000	56,000	21,400

Note the bolded $56,000 number. This is the maximum defined contribution amount permitted in 2019 per plan (and Yes you can have two plans- we'll talk about Greg and his two plans in an example later).

Crazy! Some quick observations-

- In 2019, the maximum you can contribute to a qualified retirement plan is $56,000. You can go above this with a defined benefits pension (cash balance)- more on that later.
- Partnerships (those required to file Form 1065) follow the same limits as Sole Prop above.
- $148,000 in W-2 salary from your C Corp or S Corp is the magic number for maximizing your 401k. After that, any increase in salary does not help. Your fastest way to reach your contribution limit is through a 401k plan.

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▲ $224,000 in W-2 income from your S Corp is the minimum salary for a max SEP IRA contribution.

▲ $293,000 from your small business or K-1 partnership income from your Schedule E as reported on your individual tax return is the magic number for maximizing your SEP IRA contribution. SEPs are old school and used for crisis management rather than planning (more on that too).

▲ Earned income from a sole proprietor is net profit minus 50% of your self-employment tax minus your contribution. Since the contribution actually adjusts the maximum contribution, this can be a circular reference. And No, 401k or SEP contributions do not reduce SE tax.

▲ 401k max is computed by taking $19,000 employee (you) contribution, plus 25% of your W-2 or earned income (as adjusted).

▲ SEP IRA max is computed by taking 25% of your W-2 or earned income (as adjusted).

▲ Max SIMPLE 401k is basically $13,000 plus 3% of your W-2 or earned income (as adjusted). Don't spend too much time thinking about SIMPLE 401k plans.

▲ You can add $6,000 for catchup contributions if you are 50 years old or older.

Let's talk about each of these qualified plans in turn, starting with the 401k. Out of the box, or non-traditional retirement plans will follow (profit sharing plans, defined benefits pensions, cash balance plans, Section 79 plans, etc.). Exciting!

Turbo Charged 401k Plans

Oftentimes business owners want to put away a ton of money in a small business 401k plan, but cannot due to inherit limitations within the plan. Or business owners want to keep most of the plan money for themselves, which is shocking yet natural. For example, to have the company make a 10% profit sharing contribution, every eligible employee will also receive a 10% contribution which is usually undesirable. You only thought having a staff was a pain because of drama and turnover. Add this dilemma to the list.

You work hard to make money, and you shouldn't have to work too hard to keep most of it. There are turbocharger kits you can add to your normally aspirated 401k plan. These usually work best with an underlying safe harbor 401k plan. Here we go-

▲ Age-Weighted / New Comparability Profit Sharing Plan, and

▲ Defined Benefits Pension / Cash Balance Plan

Age-Weighted

A profit sharing plan based on age allows older employees to receive more of the profits than younger employees (hence the tricky name of age-weighted). Another way to look at this is to consider those closer to retirement possibly needing the most assistance in saving for retirement. This also makes sense since older employees are usually more valuable, and therefore profit sharing plans can be used to discriminate in their favor.

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Age-weighted profit sharing plans are designed to be top heavy, and two people earning the same salary can have very different profit sharing contributions simply based on age which is perfectly acceptable. No, there is a not a weight-weighted formula where older employees are usually heavier and therefore get more of the profit sharing. That would be fun though. Brings a whole new meaning to a top heavy plan. There are probably some more jokes in there, yet we digress.

How the formula works is beyond this book, but an age-weighted profit sharing plan allows a company to contribute more to those employees who are older **including owners**.

New Comparability

The new comparability profit sharing formulas take age-weighted formulas one step further by grouping certain employees together such as officers, executives, clerical, etc. Officers are given a higher portion of the profit sharing, and within the officer group the older employees are given a higher portion. A double shot. For example, a crusty officer will have a much larger contribution than a new administrative assistant.

The new comparability method is also referred to as cross-tested, and will normally have underlying actuary consulting defending the plan's provisions and discrimination. Remember, discrimination is not bad as long as it can be justified and supported. Yes, this adds to the cost. But let's look at a real life example that the Watson CPA Group worked on to see how this works first.

The following is a husband and wife business with over $600,000 in net profits from 2016.

Employee	Age	Salary	Deferral	NEC	Profit Sharing	Total
Mike	43	265,000	18,000	7,950	27,050	53,000
Susie	43	212,000	18,000	6,360	28,640	53,000
Linda	35	62,155	2,486	1,865	876	5,227
Aaron	29	39,868	1,595	1,196	562	3,353
Timothy	32	24,611	0	738	347	1,085
Blake	25	33,452	0	1,004	472	1,475
Jacqueline	31	34,411	1,376	1,032	485	2,894
Denise	23	27,529	0	826	388	1,214
Nate	32	22,104	0	663	312	975
Tony	26	22,086	0	663	311	974

Tilt. Here are some observations and clarifications-

- NEC refers to non-elective contributions, and in this example these are the contributions required under the safe harbor 401k plan provisions.

- Profit sharing is based on salary and age. Note the subtle differences for everyone except Mike and Susie.

- $53,000 is the maximum allowed under a 401k plan with tiered profit sharing for 2016.

- In this real case, the owners kept 75% of all monies put into the plan. Not shabby.

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- ▲ The annual cost in 2016 to administer this plan was $2,500.
- ▲ The tax deferral savings was over $53,000 for these business owners including state income taxes too (based on 39.6% federal rate and 11% state rate). This was California, and the couple plan to retire in Nevada- instant 11% tax savings.
- ▲ Yes, those salaries for Mike and Susie are ridiculously high. So the increase in payroll taxes must be weighed against the savings and benefits. After $132,900 (for the 2019 tax year) only Medicare taxes are being "unnecessarily" paid at 2.9%. The benefits could outweigh this 2.9%.

Defined Benefits Pension / Cash Balance Plan

If the age-weighted or new comparability profit sharing plans supercharge a 401k plan, the defined benefits pension and cash balance plan turbocharges it. We can hear gear heads moaning all over the country above turbo and super charging your engine. Regardless, the defined benefits pension and cash balance plan adds a ton of meat to your 401k platter. Here we go.

A defined benefit is in contrast to a 401k plan since a 401k plan is a defined contribution. A defined contribution plan specifies the amount going into the plan and has nothing to do with how much will be available when you start taking withdrawals. It could be $0 or millions. A defined benefit is a calculus where some future benefit is defined, and is usually a stream of payments similar to an annuity.

A cash balance plan is a form of a defined benefits pension, with one major difference. The participant can see his or her account balance grow over time similarly to an IRA or 401k plan. A cash balance plan can be considered a hybrid since it does not rely on formulas and salary histories although it falls under a defined benefits umbrella by definition.

A cash balance plan is usually piggybacked onto a safe harbor 401k plan, and it truly is a separate plan (the latter is a defined contribution and the former is a defined benefit). So why would a small business want a cash balance plan in addition to a 401k plan? The usual reason- put more money into a self-employed retirement plan for the owners' personal retirement and defer taxes.

Similar to age-weighted and new comparability profit sharing plans, cash balance plans use a person's age to determine the amount that can be contributed and use actuary consultation to defend the plan's discrimination.

Here is a quick list of the **2017 amounts** that can be contributed into a cash balance plan based on age-

Age	401k Plan	401k Plan w/ Profit Sharing	Cash Balance	Total	Tax Savings @45%
70	24,500	61,000	329,000	390,000	175,500
65	24,500	61,000	266,000	327,000	147,150
60	24,500	61,000	254,000	315,000	141,750
55	24,500	61,000	194,000	255,000	114,750
50	24,500	61,000	148,000	209,000	94,050
45	18,500	55,000	113,000	168,000	75,600
40	18,500	55,000	87,000	142,000	63,900
35	18,500	55,000	66,000	121,000	54,450
30	18,500	55,000	51,000	106,000	47,700

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Before you lose your mind on the tax savings (which is assumed to be at 45% total between Federal and state), you need the cash to do so. To save $94,050 at age 50 you need to part ways with $209,000 in cash. And if your spouse is on the payroll, you can double it. We only showed ages in chunks of 5.

Conclusion

We are not just tax accountants. We are business consultants and financial planners. We can guide you in leveraging more from your business to help you build wealth and minimize taxes along the way. Some other things we discuss in this chapter our book-

- Investing without a plan is dangerous. Define your objectives and design a plan to meet those objectives.
- Tax savings versus tax deferrals, and how the tax bomb that could potentially go off could put a dent into your retirement plans.
- Why 401k plans are preferred, and SEP IRAs should only be used as crisis management (versus proper planning).
- How having a staff dramatically alters 401k plans, profit sharing and defined benefits / cash balance plans.
- Controlled groups or affiliated services group, and how that might force you to cross-test all 401k plans in a multiple entity structure or implement a 401k plan that is adopted by all affiliated entities.

If you want to learn more about these issues, please visit **www.watsoncpagroup.com/book** for more information or visit our KnowledgeBase at **www.watsoncpagroup.com/kb/**.

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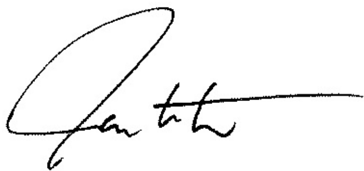
Thank You!

We hope you enjoyed reading our shortie version for the 2019 Edition of Taxpayer's Comprehensive Guide to LLCs and S Corps.

If you purchase our book from Amazon in paper, or one of the various electronic formats, and you believe it did not help you with your small business, please let us know. We never want you to feel like you wasted your money. $13 or $13,000… wasting money never makes people feel good. We will make it right, right away.

Thanks again!



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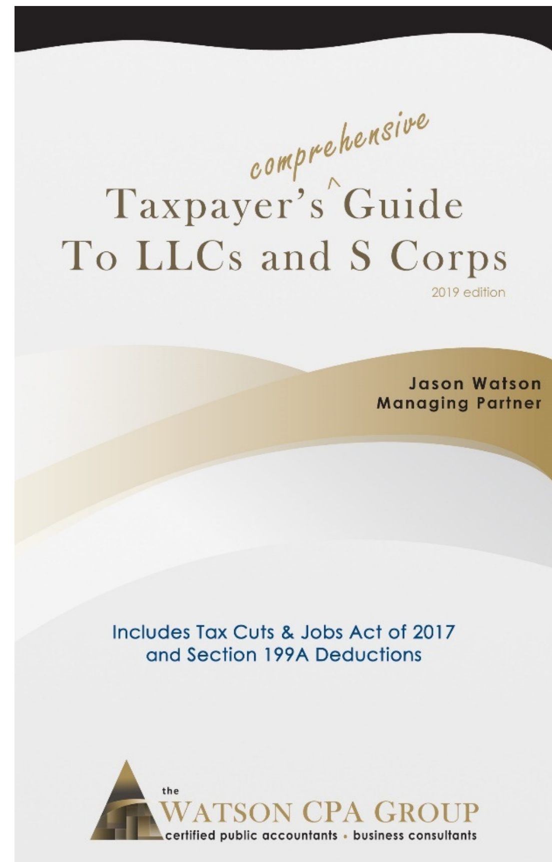

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