

**2010**

**GOING INTO  
BUSINESS**

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**BY**

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# **DISCLAIMER**

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Preparers must be aware that the laws are constantly changing and that the information in this manual may be superceded at any time

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# **INTRODUCTION**

## **THE AMERICAN DREAM TO HAVE YOUR OWN BUSINESS BE YOUR OWN BOSS HAVE INDEPENDENCE AND THE PRIDE OF OWNERSHIP**

This dream can turn into a small success, large success or a nightmare and a failure, depending on preparation, planning and proper implementation of the required operations. The success or failure is dependent, of course, on many things such as the individual's personality and ability to perform the service or promote the product. Unfortunately, the failure of a business all too often is because of failure to consider the practical aspects of management, organization, record keeping and state, local and Federal filing requirements.

This manual is intended as a BASIC guideline for SMALL BUSINESS ventures and is not intended to include the complex aspects of large corporations or dissolutions.

We remind you that the laws are constantly changing and should be considered in any venture.

Before beginning a business, several matters should be given consideration. All too often, you, the tax professional are not consulted until several months AFTER the business has been in operation. It is important to make all client's aware that there is a need to consult with, you, their tax professional PRIOR to start up of a business. It seems we never know who may be thinking of self employment. We hope that this manual will provide the answers to the questions the client needs to have answered and therefore, make the accounting and tax preparation much easier.

It is important to determine, first of all, IF you have a business venture in mind, or if it is just a hobby venture (business or farm). Once you have established that your venture will, truly be considered a business venture, many other general considerations need to be taken into account before an actual business is set up.

## BUSINESS OR HOBBY?

The question of whether an income producing activity constitutes a trade or business is important for determining to what extent and in what manner the expenses attributable to the activity can be deducted. Expenses incurred in a trade or business are fully deductible.

If the activity is not characterized as a trade or business, but as a hobby, the expenses from the activity are generally deductible, only to the extent of earnings from the activity, except in the case of taxes, interest, and casualty losses.

Neither the law nor regulations provide a definition of what is meant by a "trade or business". This is because no one definition can possibly apply to all situations. However, the IRS has defined a trade or business as:

- An activity carried on for livelihood or for profit
- An activity in which a profit MOTIVE is present and where there is some type of economic activity involved.

As to the profit motive, an activity will be considered a business if it is entered into and carried on in good faith for the purpose of making a profit, as opposed to an activity engaged in purely for self-satisfaction.

- An enterprise that is characterized by regularity of activities and transactions and the production of income.

The absence of income, in itself, will not prevent an enterprise from being classified as a trade or business but it could raise a question as to whether a business was carried on in a particular year.

In such a case, taxpayer should be able to show that he or she actually was in business during that year.

## **I.R.S. PRESUMPTION FOR PROFIT RULES**

An activity is presumed to be carried on for profit if it produced a profit in at least 3 of the last 5 tax years including current year. (2 out of 7 for activities that consist primarily of breeding, training, showing, or racing horses).

### **Using presumption at later time:**

If starting out and do not have 3 (or 2) years showing a profit, you may want to take advantage of this presumption at a later time, after you have had the 5 (or 7) years of experience allowed by the test.

### **File Form 5213, Election to Postpone Determination.**

This postpones any determination until 5 (or 7) years have passed since first started. Form 5213 must be filed within 3 years after the due date of your return for the year in which you first started business. (Reproduced form next page)

The benefit gained by making this choice is that IRS will not immediately question whether your activity is engaged in for profit. If you do not meet the presumption test by the end of the 3 (or 2) years, hobby limitations will be applied **RETROACTIVELY** to any year in the 5 (or 7) year period.

Form 5213 automatically **EXTENDS THE STATUTE OF LIMITATIONS** on any year in the 5 (or 7) year period to 2 years after due date of return for the **LAST** year in the period. The statute is extended only for deductions attributable to the activity and any related deductions that might be affected.

**BEFORE**

**YOU**

**OPEN THE DOORS**

## **BEFORE YOU START**

### **BE SURE YOU KNOW WHO IS BOSS**

Being in business for yourself does not mean you are always the boss!!

Effectively, you have many "bosses":

- ✓ The Customer
- ✓ The Creditors
- ✓ The Competitors
- ✓ State, Local, and Federal Government Agencies
- ✓ Any other owners/partners

### **CONSIDER YOURSELF**

- ▶ Are you the kind of person who can get a business started and make it go?
- ▶ WHY do you want your own business? Do you want it badly enough to work long hours without knowing how much money you will end up with?
- ▶ Have you worked in a business like the one you want to start?
- ▶ Have you ever worked as a foreman or manager?
- ▶ Have you had business training/schooling?
- ▶ Have you saved any money?

### **HOW ABOUT MONEY?**

- ▶ How much money will you need to start?
- ▶ How much money of your own do you have to invest in the business?
- ▶ How much credit can you get from suppliers (the people you will be buying from)?
- ▶ Can you borrow the rest of the money you need? From whom? What terms?
- ▶ What NET income do you expect per year?
- ▶ Can you live on LESS than the expected net income so that you can use some of the net to make the business grow?
- ▶ Have you talked to your banker about your plans?

## **BEFORE YOU START**

### **HOW ABOUT PARTNERS OR INVESTORS?**

- ▶ If you need a partner with money or knowledge that you don't have, do you know someone who will fit -- someone you can GET ALONG WITH?
- ▶ Are you aware of good and bad points of sole proprietorships, partnerships, or incorporating?
- ▶ Do you have an attorney to assist you with proper set up and agreements?
- ▶ Have you discussed it with the attorney?

### **HOW ABOUT CUSTOMERS?**

- ▶ Are most businesses in your area doing well?
- ▶ Are businesses like the one you want to start doing well?
- ▶ What kind of people will buy your services/product?
- ▶ How good is the market?
  - Is there a need?
  - Is the need already being met---competition?
  - Is your product an improvement over competitors?
  - Can the market be reached?
    - ◆ Advertising requirements and costs
    - ◆ Distribution requirements and costs (freight/packaging)

SEE MARKETING CHECK-LIST TO FOLLOW

### **HOW ABOUT A BUILDING/LOCATION?**

- ▶ Have you found a suitable location?
- ▶ Will you have enough room when your business grows?
- ▶ Can you modify the building to suit your needs? Cost of same? Permits?
- ▶ Can customers get to building easily? (parking, bus stops)
- ▶ Have you consulted an attorney regarding lease and ZONING?
- ▶ Have you considered operating your business from your home?  
(See special section - office in home)

## **BEFORE YOU START**

### **HOW ABOUT EQUIPMENT?**

- ▶ What equipment and supplies will be needed? Cost of same?
- ▶ Have you considered used equipment costs?

### **HOW ABOUT YOUR MERCHANDISE?**

- ▶ What will you sell?
- ▶ How much product will be needed to open your business? Cost?
- ▶ Have you consulted suppliers who will sell to you at a good price?
- ▶ Have you compared prices and credit terms of different suppliers?

### **HOW ABOUT RECORD-KEEPING?**

- ▶ Have you planned for an adequate record-keeping system?
- ▶ Have you planned for inventory control to be sure you will have enough product on hand to meet demand but not more than you can sell?
- ▶ Have you consulted an accountant regarding:
  - Payroll records and reports
  - Financial statements
  - Tax record-keeping requirements
  - Local, State, and Federal report filing requirements
  - Form of doing business

### **HOW ABOUT LEGAL REQUIREMENTS?**

- ▶ What licenses and permits are needed (state and/or local)?
- ▶ What business laws must be obeyed? Zoning?

## **BEFORE YOU START**

### **HOW ABOUT INSURANCE PROTECTION?**

- ▶ Have you made arrangements for protection against:
  - Shoplifting
  - Robbery
  - Burglary
  - Employee theft
  - Liability - General and Product
  - Fire
  
- ▶ Have you talked to your insurance agent regarding any other types of insurance that may be required?

### **IF YOU ARE BUYING A 'GOING' BUSINESS:**

- ▶ What do you like and dislike about buying a business someone else has started?
  
- ▶ What is the REAL reason the owner wants to sell?
  
- ▶ Have you compared cost of buying a going concern with cost of starting a NEW business?
  
- ▶ Is inventory up to date and in good condition?
  
- ▶ Are building and equipment in good condition.
  
- ▶ Can the lease (if applicable) be transferred?
  
- ▶ What are the ZONING requirements? Can this business be operated by a new owner at this location?

### **CAN YOU MAKE IT "GO"**

#### **ADVERTISING**

- ▶ How will you advertise (and cost of same)?
  - Newspapers
  - Posters
  - Handbills
  - Radio / Television
  - Mail (Bulk permit rates)
  - Internet

## **BEFORE YOU START**

### **PRICES**

- ▶ What will you charge?
- ▶ What do your competitors charge?
- ▶ What is your breakeven point?

### **BUYING**

- ▶ How do you find out what customers want?
- ▶ Will inventory control plan tell you when and what to buy?
- ▶ Do you plan to buy most of stock from a few suppliers rather than a little from many, so that suppliers will want to help you succeed?

### **SELLING**

- ▶ Salesclerks or self service?
- ▶ Do you know how to get customers to buy?
- ▶ Do you know why you like to buy from some clerks and not from others?

### **EMPLOYEES**

- ▶ Do you know where to look for employees?
- ▶ What kind of people do you need?
- ▶ What kind of training do you need to provide?
- ▶ What kind of benefits do you need to provide?

### **CUSTOMER CREDIT**

- ▶ Will you allow purchases on credit?
- ▶ What are the good and bad parts of a credit card plan?
- ▶ Can you tell a deadbeat from a good credit customer?

## **BEFORE YOU START**

### **AND FINALLY, IN GENERAL**

**COULD YOU MAKE MORE MONEY WORKING FOR SOMEONE ELSE?**

**DOES YOUR FAMILY AGREE WITH YOUR PLAN TO START YOUR OWN BUSINESS?**

**DO YOU KNOW WHERE TO FIND OUT ABOUT NEW IDEAS/PRODUCTS?**

**STARTING AND OPERATING YOUR OWN BUSINESS WILL BE A FULL TIME JOB.**

**YOU WILL WANT TO DO ALL YOU CAN FOR YOURSELF BUT DON'T BE AFRAID TO ASK FOR HELP FROM PEOPLE WHO CAN TELL YOU WHAT YOU NEED TO KNOW.**

**AN ATTEMPT TO KEEP YOUR OWN RECORDS CAN BE MORE COSTLY IN ACCOUNTING FEES TO STRAIGHTEN OUT YOUR ERRORS, PENALTIES FOR FAILURE TO FILE PROPER REPORTS, ETC, THAN THE ACCOUNTING FEE TO DO IT RIGHT THE FIRST TIME!**

**INADEQUATE SUPPLY OF CASH AT START UP MAY DOOM A BUSINESS BEFORE IT BEGINS.**

**IT MAY PAY TO OVERESTIMATE COSTS.**

**LACK OF CASH MAY MEAN LOSS OF EMPLOYEES, EQUIPMENT, INVENTORY AND CREDIT CUSTOMERS -- IN SHORT, LOSS OF THE BUSINESS.**

**THE FOLLOWING WORKSHEETS WILL AID IN PLANNING FOR PROPER CASH FLOW**

**WORKSHEET**  
**CASH REQUIRED FOR FURNITURE AND EQUIPMENT**

<u>Item</u>	<u>Cash Price</u> <u>(If paying in full)</u> <u>Enter only if plan</u> <u>To pay cash and</u> <u>also enter in last</u> <u>Column</u>	<u>Installment Purchase</u>			<u>Estimated</u> <u>Cash Required</u>
		<u>Full</u> <u>price</u> <u>(Enter</u> <u>installment in last</u>	<u>Down</u> <u>Paymt</u> <u>down payment</u>	<u>Installment</u> <u>Payment</u> <u>and one</u> <u>column)</u>	
Counters					
Storage Shelves					
Display stands, shelves, tables					
Cash registers					
Safe					
Window Displays					
Special lighting					
Outside signs					
Delivery Equip					
<u>Office Equip</u>					
Desks					
Calculators					
File cabinets					
Chairs					
Computers					
Printers					
Copy Mach.					
Fax Machine					
Telephone Syst					
Building Security					
OTHER					
TOTAL OF LAST COLUMN (Enter this amount in next worksheet under "Starting Costs You Only Have to Pay Once" .....					\$

## WORKSHEET - ESTIMATE INITIAL EXPENSES

	Estimated Monthly Expense Based on Sales Of \$_____	How Much Cash Needed to Start (See Column #3)	What to Put in Column #2 (Typical, but May require Adjustment)
Salary of owner/mgr			2 times col. 1
Other salaries/wages			3 times col. 1
Payroll taxes			4 times col. 1
Rent			3 times col. 1
Advertising			3 times col. 1
Delivery Expense			3 times col. 1
Supplies			3 times col. 1
Telephone			3 times col. 1
Other utilities			3 times col. 1
Insurance			Payment required By Ins. Co.
Interest			3 times col. 1
Maintenance			3 times col. 1
Legal and Prof			3 times col. 1
Starting costs you have to pay only once (Leave col. 1 blank on this line)			
Fixtures and Equipment			From Worksheet
Decorating and Remodel			Talk to Contractor
Installing Fixtures and Equipment			From Equip Supplier
Starting Inventory			From suppliers
Deposits Utilities			Utility Co
Legal and Prof. Set Up			Attorney/Accountant
Licenses and Permits			City, State, Federal
Advertising/Promotional Opening			Your own est.
Accounts Rec.			Needed to buy more stock until customers pay
Cash			Unexpected reserve
Other (make a list)			Total from list
<b>TOTAL ESTIMATED</b>	<b>CASH NEEDED TO START</b>	<b>TOTAL ALL COL. 2</b>	

## **START UP COSTS VS. EXPANSION COSTS**

### **NOT ALL EXPENSES ARE CURRENTLY DEDUCTIBLE**

#### **AMERICAN JOBS CREATION ACT OF 2004:**

The American Jobs Creation Act of 2004 changes the treatment of start-up expenses incurred after October 22, 2004, so that taxpayers may elect to deduct up to \$5,000, reduced by the amount by which the start-up expenditures exceeds \$50,000, of start-up expenditures in the tax year in which the trade or business begins. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins must be amortized over a 15-year period. Code §195, amended by Pub. L. 108-357, American Jobs Creation Act of 2004, Section 902.

Be aware that some of the expenses of starting a new business will not be fully deductible in the first year.

#### **START UP COSTS**

- Amortizable over 60 months beginning with the month business begins.  
IRC 195
  - ◆ Must be made in connection with investigating creation of a trade or business or creating the trade or business.
- AND
- ◆ Trade or business must be actually begun
- AND
- ◆ Must be expenses that would be deductible if incurred in connection with OPERATION of an existing trade or business.

Examples: Market research, product research, site selection costs, advertising, wages, professional fees, necessary travel.

- NOT amortizable:
  - ◆ Activities and investigations relating to INVESTMENTS
  - ◆ Start up expenses for INTEREST, TAXES AND RESEARCH AND DEVELOPMENT costs (deductible when paid or incurred)
  - ◆ Cost of acquisition of depreciable property- These are added to basis of the property and depreciable but not considered start up costs for amortization.
  - ◆ Costs of organizing a partnership or corporation. These are not considered "start up" costs but may be Amortizable as Organization costs.

## **START UP COSTS (continued)**

### **PLANNING FOR START UP COSTS**

- Associate expenditures properly to purchase of depreciable assets instead of to start up costs.
- If corporation, incorporate BEFORE incurring investigation and start up costs.
  - 60 months begins when business begins
  - if 1244 stock and business attempt is abandoned, loss is an ordinary loss (not capital loss)

### **START UP COSTS ONLY DEDUCTIBLE BY TAXPAYER WHO INCURS THEM**

- Sole proprietorship - no problem
- Partnerships - individual PARTNER may deduct qualified expenses by amortization PERSONALLY (not by the partnership)

### **EXPANSION COSTS ARE GENERALLY A CURRENT DEDUCTION, NOT A START UP COST**

## **SPECIFIC BUSINESS - RETAILERS**

### **RETAILERS CHECKLIST**

#### **CUSTOMERS**

- ✓ Who are your customers and what do they want from you?
- ✓ What is the total market you share with competitors?
- ✓ Will you appeal to the entire market or only a segment?
- ✓ If only a segment, is it large enough to be profitable?
- ✓ Are incomes in community stable?
- ✓ Is community population subject to fluctuation?
- ✓ Will you have special appeal:
  - lower prices
  - better quality
  - wider selection
  - convenient location
  - convenient hours
- ✓ Will you ask customers for suggestions?
- ✓ Should you belong to a trade association?
- ✓ Should you subscribe to trade subscriptions/publications?
- ✓ Should you attend market shows?
- ✓ Do most of the customers buy on weekends?
- ✓ Do sales increase in evenings?
- ✓ Do most customers prefer to buy on credit?

## **RETAILERS CHECKLIST**

### **BUYING**

- ✓ Do you have a merchandise budget for each season?
- ✓ Do you have a formal plan for deciding what to buy and from whom?
- ✓ Do you need to keep track of success of buying decisions in prior years to aid you in next year's buying?

### **PRICING**

- ✓ Have you established a set of pricing policies?
- ✓ Do you set specific markups for each product?
- ✓ Will you use a one-price method rather than bargain with customers?
- ✓ Will you offer discounts for quantity purchases or special groups?
- ✓ Will the prices you have established earn a planned gross margin of profit?
- ✓ Do you clearly understand the market forces affecting your pricing methods?
- ✓ Do you know which products are slow movers and which are fast?
- ✓ Do you know which products draw customers when put on sale?
- ✓ Do you know the maximum price customers will pay for certain products?
- ✓ Is there a specific time of year when competitors have sales?
- ✓ Do customers expect sales at certain times of the year?
- ✓ Is a series of sales better than one annual clearance sale?
- ✓ Are you influenced by competitors' price changes?
- ✓ Are there restrictions regarding prices you can charge?
  - minimum standard set by suppliers
  - State "fair trade practice acts"
  - State regulations on how long "close-out" sales can be advertised?
  - Regulations affecting two-for-one sales?
  - Can you issue "rainchecks" on sale items?

## **RETAILERS CHECKLIST**

### **SALE PRICE OF PRODUCT**

Setting the sales price of your product or services should be considered from the viewpoint of WHAT THE REQUIRED GROSS PROFIT IS, as well as whether or not it is competitive.

#### **Will the sales price cover costs and produce required GROSS profit?**

- ✓ Material costs
- ✓ Shipping costs
- ✓ Labor to manufacture (if applicable)
- ✓ Owner's required salary including income taxes
- ✓ Fringe benefits and payroll taxes on mfg. labor

#### **Will the required gross profit meet operating and overhead expenses?**

Use column #1 of worksheet used for estimating start up expenses

Compute estimated monthly gross profit and deduct estimated monthly expenses

## **RETAIL MARKETING**

### **PROMOTION**

- ✓ Which items can be successfully advertised?
- ✓ Which items can be sold best by demonstration?
- ✓ Which of the media can most effectively reach target group?  
radio, t.v., newspapers, yellow pages, handbills, internet?
- ✓ What can and cannot be said in ads? (Truth in Advertising requirements)
- ✓ Can you make use of direct mail?
- ✓ Is a good mailing list available?
- ✓ Should you concentrate on certain seasons?
- ✓ Are certain days of the week better than others?
- ✓ Are cooperative advertising funds available from suppliers?
- ✓ Are there supplier's national programs you should tie to?
- ✓ What are the other firms spending on promotion?
- ✓ HOW are the successful firms advertising?
- ✓ Can you measure the success of the promotional programs you use?
- ✓ Are your products displayed to maximize appeal in the store?
  - Which items have unusual eye appeal?
  - Best location in the store for display?
  - Making use of window displays?
  - Which shelves are best?
  - Schedule for changing displays?
  - Display "attention getting" items where they will call attention to other items as well?
  - Which items are bought on "impulse" and should be placed in high traffic areas?
  - Are price tags easy to read?
- ✓ Do suppliers offer financing of accounts receivable or inventory?

### **CREDIT PROGRAMS (IF ANY)**

- ✓ What type?
- ✓ Does nature of operation require a type of customer credit program?
- ✓ Would a credit program be a sales tool?
- ✓ Use of credit cards - cost to you?
- ✓ Your own credit program - cost to you?
- ✓ Will interest charged pay for costs?
- ✓ Do you know about Fair Credit Reporting Act?
- ✓ Are you familiar with Truth in Lending legislation?
- ✓ What is a SAFE percentage of your business you can have on credit that will not jeopardize paying your own bills?
- ✓ Discuss credit programs with accountant or attorney

## **RETAILER MARKETING**

### **SPECIAL SERVICES**

- Delivery service offered:
  - Own vehicles?
  - Driver Licensing Requirements
  - Considered leasing instead of buying?
  - Considered using commercial delivery service?
  - Do you charge for delivery?
  - If no charge for delivery, have you considered this cost in pricing
- Do you have a policy for handling merchandise returns?
- Will you contribute to community such as donations for school functions and advertising in year books -- how much?
- Should you participate in local chamber of commerce, merchant's association better business bureau or other civic organizations --how much?

## **PROVIDING FOR TAXES**

Every business is subject to federal, state, and local taxes of various kinds and in various amounts. Be sure to plan for those applicable to your business.

### **FEDERAL TAXES**

- ★ Individual income tax
  - What is taxable to the owner, partner, corporate officer
- ★ Corporate income tax
- ★ Social Security and Medicare tax
  - Self employment tax for sole prop. and partners
  - FICA & medicare tax for employees and corporate officers
- ★ Excise taxes
- ★ Federal Unemployment tax for employees and corporate officers
- ★ Withholding requirements

### **STATE TAXES**

- ★ State income tax on individual and corporate earnings
- ★ Sales and use taxes
- ★ Personal Property taxes
- ★ Franchise or capital stock tax
- ★ Occupation or business license tax
- ★ Unincorporated business tax
- ★ Unemployment compensation tax - employees
- ★ Worker's Benefit fund taxes - employees
- ★ Corporation annual fees
- ★ Assumed business name fees

### **LOCAL TAXES**

- ★ Income
- ★ Sales and Use
- ★ Property tax
- ★ Personal Property tax
- ★ Local business license taxes and fees
- ★ Local payroll tax items

**FAILURE TO PLAN FOR TAXES IS A MAJOR CAUSE OF FAILURE OF BUSINESSES OF ALL KINDS.**

## **OTHER CONSIDERATIONS**

### **LICENSING**

Covered in the NON-PAYROLL TAX COURSE.

### **CONSUMER PROTECTION**

Food  
Drug  
Cosmetic  
Flammable Fabrics  
Truth in Lending

### **TRADE PRACTICE (FEDERAL TRADE COMMISSION)**

Advertising  
Sales practice  
Product Safety

### **LABOR RELATIONS**

Workers Compensation Insurance  
Labor Disputes  
Wage and Hour - BOLI  
Working Conditions - OSHA  
Employment Practices  
Economic Security

### **ENVIRONMENT**

Air pollution  
Water pollution

### **PATENTS, TRADEMARKS, COPYRIGHTS**

Application forms and information regarding the above licensing and regulations are covered in the NON-PAYROLL TAX Course.

### **FEDERAL EMPLOYER'S I.D. NUMBER (EIN)**

With new requirements to furnish EIN number when performing services or renting in the course of trade or business, it is advisable to apply for the Federal ID number as soon as your business plans are finalized and before you start your new business. This number is also required on your income tax returns.

## **ARE YOU ORGANIZED**

- ✓ Do you have a set of plans for a year's operations?
- ✓ Are they realistic?
- ✓ Are your plans stated so you will know when they have been achieved?
- ✓ Do you have a formal plan for setting aside money to meet quarterly tax payments?
- ✓ Are job descriptions and authority for responsibilities clearly stated?
- ✓ Do employees understand how they will be rated for promotion and salary increases?
- ✓ Does wage schedule meet local rate for similar work?
- ✓ Would you, or employees, benefit by taking business education courses at local schools?
- ✓ Will training help employees achieve better results?
- ✓ Are working conditions good?
- ✓ Do you use POSITIVE personal attitudes - impartial, words of encouragement, and congratulations, listening to complaints?
- ✓ Are you familiar with Fair Labor Standards Act as it applies to minimum wages, overtime payments, child labor?
- ✓ Do you avoid all forms of discrimination?
- ✓ Do you have a formal program for motivating employees?
- ✓ Have you protected against shoplifting and internal theft?
- ✓ Do you hold regular personnel meetings?
- ✓ Have "rules and regulations" been explained to each employee?  
Does each employee have a written copy?

## **ANALYSIS AND CONTROL**

### **ACCOUNTING SYSTEM**

- ✓ Meet minimum record keeping for good control?
- ✓ Set up systems to create “checks and balances”.
- ✓ Meet requirements for tax reporting timely?
- ✓ Do sales records give key information needed to make sound decisions?
- ✓ Do inventory records give key information to make sound decisions?
- ✓ Do expense records give key information to make sound decisions?
  - Can you tell where the money goes?
  - Can you detect unnecessary expenses?
- ✓ Can you analyze and USE monthly financial statements?

### **INSURANCE**

- ✓ Up to date fire coverage on buildings, equipment AND INVENTORY?
- ✓ Does liability insurance cover, product failure, bodily injuries, libel, slander
- ✓ Met all obligations to employees under applicable law (Worker’s Comp)
- ✓ Considered business interruption insurance?
- ✓ Fringe benefits for employees (group life, medical, retirement) and cost of same.

**FORM**

**of**

**DOING BUSINESS**

# FORM OF DOING BUSINESS

Once you have decided to start a business and have determined that it will work, you must decide what type of business ENTITY to use. There are legal and tax consequences that will enter into this decision.

## GENERAL CHOICES INCLUDE

- Sole proprietorship
- Partnership
- "S" Corporation (Small Business Corporation)
- "C" Corporation - Regular corporation
- Limited Liability Partnership (LLP) or Limited Liability Corporation (LLC)

## GENERAL CONSIDERATIONS

- Risk Factor:

If there is a substantial risk involved, the corporate structure may be necessary to provide the shield of protection against suit in order to protect the INDIVIDUAL parties INDIVIDUAL assets.

- ▶ This is more important if the INDIVIDUALS have substantial wealth outside the business.
- ▶ Risk industries include:
  - Food business
  - Beverage business
  - Entertainment facility where accidents can occur
  - Any manufactured product which could result in injury to purchaser
- ▶ If the business is relatively risk free and owners have few assets the relatively informal sole proprietorship or general partnership seem more attractive.
- ▶ Limited liability is often illusory under a corporation since lenders usually require owners of small closely held corporations to guarantee payment of corporate notes, thus making the corporate "shield" less protective of personal assets.

# FORM OF DOING BUSINESS

## GENERAL CONSIDERATIONS CONTINUED

- **Cost of establishing and maintaining the type of organization**

- ▶ Legal

"Red tape" involved in original incorporation

- ▶ Accounting and Record keeping

Partnerships, Corporations and LLCs require written agreements before actions can be taken (Partnership agreements, Corporate minutes, Operating Agreement etc.) whereas sole proprietor controls the decisions.

Accounting for partnerships, llcs, and corporations must be kept separate for separate tax return filings, whereas a sole proprietorship tax return is filed with the individual return

- ▶ Dissolution

Dissolution and termination of a partnership is much easier than the comparable process for a corporation.

- **Requirements to raise capital**

- ▶ From loans

- ▶ From sale of corporate stock

All businesses need to raise and manage money. A LARGE corporation often finds it easier than an unincorporated business to borrow, to attract and retain talented employees and to accumulate goodwill. HOWEVER, smaller corporations will experience the same kinds of problems raising capital and attracting staff as do smaller unincorporated entities.

# FORM OF DOING BUSINESS

## GENERAL CONSIDERATIONS CONTINUED

- **Tax Factors**

Because the goal is to maximize after-tax income, tax factors play an important part in the choice of business form. A common strategy is to begin the business in unincorporated form, so that business losses can shelter the proprietor's or partners' other income.

The S Corporation is an alternative since the shareholders of an S Corporation also get a loss pass-through treatment. However, loss absorption for Partnerships and S Corporation is limited to the basis of their stock, plus debt owed them by the partnership/corporation.

### **IN ALL CASES LOSS DEDUCTIONS AGAINST OTHER INCOME ARE GOVERNED BY PASSIVE LOSS RULES.**

A regular "C" Corporation faces double taxation because the profit is taxed to the corporation and the after-tax income passed on to shareholders is taxed to the shareholders as dividend income.

### **CHART FOLLOWING FOR COMPARABLE TAX TREATMENT**

### **CORPORATE ACCUMULATED EXCESSIVE EARNINGS AND PROFITS PENALTY TAX**

A corporation must distribute earnings and profits to stockholders as dividends, rather than accumulate the excess UNLESS there is a sound business reason for such accumulation. (Over \$150,000 for personal service corporations and over \$250,000 for others). Excess such accumulations, without a sound business reason are subject to a penalty tax on the accumulation.

### **TAX RATES:**

Individual tax rates are GENERALLY lower than the TOP corporate rates.

# FORM OF DOING BUSINESS

## GENERAL CONSIDERATIONS CONTINUED

- **Control**

- ▶ Sole Proprietorship - sole proprietor controls.
- ▶ Partnership- partners must decide how authority will be shared among the partners, who will make decisions, and what will be done if partners disagree.
- ▶ Corporation- is managed by a board of directors and serious conflicts can result over control of the board. Also, each decision must be made at a meeting of the board and recorded in well kept minutes of the meeting.

- **Continuity**

- ▶ Sole proprietorship- dies with the owner
- ▶ Partnership - death of a partner dissolves the partnership unless a well drafted partnership agreement and buy-sell agreement has been initiated and then the surviving partners can continue the business.
- ▶ Corporation C or S has perpetual existence and stock can be sold or bequeathed freely.

Shares of a public corporation are relatively easy to sell and easy to value.

Shares in a closely held corporation are less liquid and provisions should be made for redemption of shares.

## **SOLE PROPRIETORSHIP**

Sole proprietorship is the most basic, least formal form of conducting a business.

Offers greatest degree of privacy.

No one's permission is needed to start the business.

Records showing income and expenses minimal as required for Federal and State income tax purposes.

Sole proprietor may ask or hire anyone to provide advice, but is not obliged to take any advice.

Sole proprietor is personally liable for all business debts.

All personal assets can be reached by creditors.

Proprietors are not common law employees and are therefore not eligible for employee benefits (unemployment etc)

Sole proprietors with earned income from a business or profession can set up a qualified plan covering himself and employees (Pension plan 401(c)(1)). This is true even if the proprietor does not have net profits in taxable year in question.

Proprietors without qualified plans can maintain deductible Individual Retirement Accounts (IRAs) and they do NOT have to cover common law employees under these plans.

A proprietorship does not have continuity of existence - when the owner dies or becomes disabled, the business cannot continue unless it is reorganized, or unless it becomes the creature of another sole proprietorship.

Sole proprietorships can not be transferred easily: There is no ready market, with agreed on values, for sole proprietorships.

If the business is, in essence, a one-person business, sole proprietorship is the least cumbersome method for launching a business. If the business crashes, it is the simplest method of burying it. The proprietor is responsible for paying all the business debts.

Proprietor can allow for unlimited liability by:

- ◆ Avoiding situations in which business is overextended beyond the ability to pay business debts out of business assets.
- ◆ Protection against tort liability through liability insurance.

If risks are unacceptable, financing to open or operate is a problem, if there are several active participants, or numerous potential investors who are not interested in management responsibilities, another form of organization may be necessary or preferable.

## SOLE PROPRIETORSHIPS CONTINUED

### CREATION

- Doing business under owner's name only - no formalities to begin
- Doing business under "artificial" or "assumed" business name:  
(Example: City Domestic Laundry)
  - Must file DBA (doing business as) registration
  - Name must not be deceptive
  - Generally filed with county in which business will be located.  
Oregon: Filed with Corporation Commission, Salem, Oregon  
Annual fee to renew.
- Sole proprietorships do not need authorization to do business in a foreign state. If they satisfy a "minimum CONTACTS" test in the foreign state (employees in the foreign state, a business location in the foreign state, or a warehouse as opposed to transient or mail order activity in the state), they may be required to collect sales tax in the foreign state.

### SALES TAX

Sole proprietorships must collect sales taxes in their HOME states.

**ONE OF FIRST BUSINESS ACTIVITIES IS TO OBTAIN A SALES TAX NUMBER if the home state of business or 'Minimum Contacts' (above) tests are met.**

## SOLE PROPRIETORSHIPS CONTINUED

### TAXABLE INCOME

Sole proprietor's taxable income includes all of the business profits (Regardless of whether the owner withdraws the profits or puts them back into the business)

Business profits also constitute Self Employment Income for purposes of Self employment tax. As there is no employer to share the burden, the sole proprietor pays Soc. Sec. tax at a higher, self-employed rate. This is often the "Make or Break" Point of self employed business.

Although the sole proprietor may have enough PERSONAL itemized deductions or other deductions (capital losses etc) from other sources to offset income from the business for INCOME TAX purposes, they may still owe considerable Self Employment tax if none of the other deductions are from HIS or HER OWN business activities.

#### Tax Returns:

Summarized income and expenses - Sch. C of Individual Return 1040.  
Sch. SE (Self Employment) of Individual Return form 1040.

A SOLE PROPRIETOR'S 'SALARY' (Withdrawals from the business) IS NOT a deductible business expense.

### CAPITAL LOSSES

A sole proprietor may deduct capital losses to the amount of capital gains plus the lower of \$3,000 or the amount of capital loss in excess of capital gains.

Note:  
Capital losses of a corporation can be deducted ONLY to the extent of capital gains.

### EMPLOYEES

Sole proprietor is required to maintain proper records, file proper reports, withhold and pay withholdings plus employer's payroll taxes in the same manner as partnerships and corporations. See EMPLOYEES section.

**Principal Business or Professional Activity Codes**

These codes for the Principal Business or Professional Activity classify sole proprietorships by the type of activity they are engaged in to facilitate the administration of the Internal Revenue Code. These six-digit codes are based on the North American Industry Classification System (NAICS).	Select the category that best describes your primary business activity (for example, Real Estate). Then select the activity that best identifies the principal source of your sales or receipts (for example, real estate agent). Now find the six-digit code assigned to this activity (for example, 531210, the code for offices	of real estate agents and brokers) and enter it on Schedule C or C-EZ, line B. <b>Note.</b> If your principal source of income is from farming activities, you should file Schedule F.	
<p><b>Accommodation, Food Services, &amp; Drinking Places</b></p> <p><b>Accommodation</b></p> <p>721310 Rooming &amp; boarding houses</p> <p>721210 RV (recreational vehicle) parks &amp; recreational camps</p> <p>721100 Traveler accommodation (including hotels, motels, &amp; bed &amp; breakfast inns)</p> <p><b>Food Services &amp; Drinking Places</b></p> <p>722410 Drinking places (alcoholic beverages)</p> <p>722110 Full-service restaurants</p> <p>722210 Limited-service eating places</p> <p>722300 Special food services (including food service contractors &amp; caterers)</p>	<p>561490 Other business support services (including repossession services, court reporting, &amp; stenotype services)</p> <p>561790 Other services to buildings &amp; dwellings</p> <p>561900 Other support services (including packaging &amp; labeling services, &amp; convention &amp; trade show organizers)</p> <p><b>Waste Management &amp; Remediation Services</b></p> <p>562000 Waste management &amp; remediation services</p>	<p><b>Museums, Historical Sites, &amp; Similar Institutions</b></p> <p>712100 Museums, historical sites, &amp; similar institutions</p> <p><b>Performing Arts, Spectator Sports, &amp; Related Industries</b></p> <p>711410 Agents &amp; managers for artists, athletes, entertainers, &amp; other public figures</p> <p>711510 Independent artists, writers, &amp; performers</p> <p>711100 Performing arts companies</p> <p>711300 Promoters of performing arts, sports, &amp; similar events</p> <p>711210 Spectator sports (including professional sports clubs &amp; racetrack operations)</p>	<p>238170 Siding contractors</p> <p>238910 Site preparation contractors</p> <p>238120 Structural steel &amp; precast concrete construction contractors</p> <p>238340 Tile &amp; terrazzo contractors</p> <p>238290 Other building equipment contractors</p> <p>238390 Other building finishing contractors</p> <p>238190 Other foundation, structure, &amp; building exterior contractors</p> <p>238990 All other specialty trade contractors</p>
<p><b>Administrative &amp; Support and Waste Management &amp; Remediation Services</b></p> <p><b>Administrative &amp; Support Services</b></p> <p>561430 Business service centers (including private mail centers &amp; copy shops)</p> <p>561740 Carpet &amp; upholstery cleaning services</p> <p>561440 Collection agencies</p> <p>561450 Credit bureaus</p> <p>561410 Document preparation services</p> <p>561300 Employment services</p> <p>561710 Extenuating &amp; pest control services</p> <p>561210 Facilities support (management) services</p> <p>561600 Investigation &amp; security services</p> <p>561720 Janitorial services</p> <p>561730 Landscaping services</p> <p>561110 Office administrative services</p> <p>561420 Telephone call centers (including telephone answering services &amp; telemarketing bureaus)</p> <p>561500 Travel arrangement &amp; reservation services</p>	<p><b>Agriculture, Forestry, Hunting, &amp; Fishing</b></p> <p>112900 Animal production (including breeding of cats and dogs)</p> <p>114110 Fishing</p> <p>113000 Forestry &amp; logging (including forest nurseries &amp; timber tracts)</p> <p>114210 Hunting &amp; trapping</p> <p><b>Support Activities for Agriculture &amp; Forestry</b></p> <p>115210 Support activities for animal production (including farmers)</p> <p>115110 Support activities for crop production (including cotton ginning, soil preparation, planting, &amp; cultivating)</p> <p>115310 Support activities for forestry</p>	<p><b>Construction of Buildings</b></p> <p>236200 Nonresidential building construction</p> <p>236100 Residential building construction</p> <p><b>Heavy and Civil Engineering Construction</b></p> <p>237310 Highway, street, &amp; bridge construction</p> <p>237210 Land subdivision</p> <p>237100 Utility system construction</p> <p>237990 Other heavy &amp; civil engineering construction</p> <p><b>Specialty Trade Contractors</b></p> <p>238310 Drywall &amp; insulation contractors</p> <p>238210 Electrical contractors</p> <p>238350 Finish carpentry contractors</p> <p>238330 Flooring contractors</p> <p>238130 Framing carpentry contractors</p> <p>238150 Glass &amp; glazing contractors</p> <p>238140 Masonry contractors</p> <p>238320 Painting &amp; wall covering contractors</p> <p>238220 Plumbing, heating &amp; air-conditioning contractors</p> <p>238110 Poured concrete foundation &amp; structure contractors</p> <p>238160 Roofing contractors</p>	<p><b>Educational Services</b></p> <p>611000 Educational services (including schools, colleges, &amp; universities)</p> <p><b>Finance &amp; Insurance Credit Intermediation &amp; Related Activities</b></p> <p>522100 Depository credit intermediation (including commercial banking, savings institutions, &amp; credit unions)</p> <p>522200 Nondepository credit intermediation (including sales financing &amp; consumer lending)</p> <p>522300 Activities related to credit intermediation (including loan brokers)</p> <p><b>Insurance Agents, Brokers, &amp; Related Activities</b></p> <p>524210 Insurance agencies &amp; brokerages</p> <p>524290 Other insurance related activities</p> <p><b>Securities, Commodity Contracts, &amp; Other Financial Investments &amp; Related Activities</b></p> <p>523140 Commodity contracts brokers</p> <p>523130 Commodity contracts dealers</p> <p>523110 Investment bankers &amp; securities dealers</p>
	<p><b>Arts, Entertainment, &amp; Recreation</b></p> <p><b>Amusement, Gambling, &amp; Recreation Industries</b></p> <p>713100 Amusement parks &amp; arcades</p> <p>713200 Gambling industries</p> <p>713900 Other amusement &amp; recreation services (including golf courses, skiing facilities, fitness, fitness centers, bowling centers, skating rinks, miniature golf courses)</p>		

LIST CONTINUED ON NEXT PAGE

**Principal Business or Professional Activity Codes (continued)**

523210 Securities & commodity exchanges	335000 Electrical equipment, appliance, & component mfg.	<b>Other Services</b> <b>Personal &amp; Laundry Services</b>	<b>Other Professional, Scientific, &amp; Technical Services</b>	
523120 Securities brokers	332000 Fabricated metal product mfg.			
523900 Other financial investment activities (including investment advice)	337000 Furniture & related product mfg.	812111 Barber shops	541800 Advertising & related services	
<b>Health Care &amp; Social Assistance</b> <b>Ambulatory Health Care Services</b>	339110 Machinery mfg.	812112 Beauty salons	541600 Management, scientific, & technical consulting services	
	339110 Medical equipment & supplies mfg.	812220 Cemeteries & crematories	541910 Market research & public opinion polling	
	322000 Paper mfg.	812310 Coin-operated laundries & drycleaners	541920 Photographic services	
	324100 Petroleum & coal products mfg.	812320 Drycleaning & laundry services (except coin-operated) (including laundry & drycleaning dropoff & pickup sites)	541700 Scientific research & development services	
	326000 Plastics & rubber products mfg.	812210 Funeral homes & funeral services	541930 Translation & interpretation services	
	331000 Primary metal mfg.	812330 Linen & uniform supply	541940 Veterinary services	
	323100 Printing & related support activities	812113 Nail salons	541990 All other professional, scientific, & technical services	
	313000 Textile mills	812930 Parking lots & garages	<b>Real Estate &amp; Rental &amp; Leasing</b> <b>Real Estate</b>	
	314000 Textile product mills	812910 Pet care (except veterinary) services		531100 Lessors of real estate (including miniwarehouses & self-storage units)
	336000 Transportation equipment mfg.	812920 Photofinishing		531210 Offices of real estate agents & brokers
321000 Wood product mfg.	812190 Other personal care services (including diet & weight reducing centers)	531320 Offices of real estate appraisers		
339900 Other miscellaneous mfg.	812990 All other personal services	531310 Real estate property managers		
<b>Chemical Manufacturing</b>		<b>Repair &amp; Maintenance</b>		531390 Other activities related to real estate
325100 Basic chemical mfg.	811120 Automotive body, paint, interior, & glass repair	532100 Automotive equipment rental & leasing		532400 Commercial & industrial machinery & equipment rental & leasing
325500 Paint, coating, & adhesive mfg.	811110 Automotive mechanical & electrical repair & maintenance	532210 Consumer electronics & appliances rental		532220 Formal wear & costume rental
325300 Pesticide, fertilizer, & other agricultural chemical mfg.	811190 Other automotive repair & maintenance (including oil change & lubrication shops & car washes)	532310 General rental centers		532230 Video tape & disc rental
325410 Pharmaceutical & medicine mfg.	811310 Commercial & industrial machinery & equipment (except automotive & electronic) repair & maintenance	532290 Other consumer goods rental		<b>Religious, Grantmaking, Civic, Professional, &amp; Similar Organizations</b>
325600 Soap, cleaning compound, & toilet preparation mfg.	811210 Electronic & precision equipment repair & maintenance	813000 Religious, grantmaking, civic, professional, & similar organizations		
325900 Other chemical product & preparation mfg.	811430 Footwear & leather goods repair	<b>Retail Trade</b> <b>Building Material &amp; Garden Equipment &amp; Supplies Dealers</b>		
<b>Food Manufacturing</b>			444130 Hardware stores	
311110 Animal food mfg.	811210 Electronic & precision equipment repair & maintenance		444110 Home centers	
311800 Bakeries & tortilla mfg.	811410 Home & garden equipment & appliance repair & maintenance		444200 Lawn & garden equipment & supplies stores	
311500 Dairy product mfg.	811420 Upholstery & furniture repair		444120 Paint & wallpaper stores	
311400 Fruit & vegetable preserving & speciality food mfg.	811490 Other personal & household goods repair & maintenance		444190 Other building materials dealers	
311200 Grain & oilseed milling	<b>Professional, Scientific, &amp; Technical Services</b>		<b>Clothing &amp; Accessories Stores</b>	
311610 Animal slaughtering & processing			541100 Legal services	
311710 Seafood product preparation & packaging			541211 Offices of certified public accountants	448150 Clothing accessories stores
311300 Sugar & confectionery product mfg.			541214 Payroll services	448140 Family clothing stores
311900 Other food mfg. (including coffee, tea, flavorings, & seasonings)		541213 Tax preparation services	448310 Jewelry stores	
<b>Leather &amp; Allied Product Manufacturing</b>		541219 Other accounting services	448320 Luggage & leather goods stores	
316210 Footwear mfg. (including leather, rubber, & plastics)		<b>Architectural, Engineering, &amp; Related Services</b>	541310 Architectural services	448110 Men's clothing stores
316110 Leather & hide tanning & finishing		541350 Building inspection services	541340 Drafting services	448210 Shoe stores
316990 Other leather & allied product mfg.		541330 Engineering services	541360 Geophysical surveying & mapping services	448120 Women's clothing stores
<b>Nonmetallic Mineral Product Manufacturing</b>		541320 Landscape architecture services	448190 Other clothing stores	
327300 Cement & concrete product mfg.	541370 Surveying & mapping (except geophysical) services	541380 Testing laboratories	<b>Electronic &amp; Appliance Stores</b>	
327100 Clay product & refractory mfg.	541380 Testing laboratories	541510 Computer systems design & related services	443130 Camera & photographic supplies stores	
327210 Glass & glass product mfg.	<b>Computer Systems Design &amp; Related Services</b>	<b>Specialized Design Services</b>	443120 Computer & software stores	
327400 Lime & gypsum product mfg.	541400 Specialized design services (including interior, industrial, graphic, & fashion design)		443111 Household appliance stores	
327900 Other nonmetallic mineral product mfg.			443112 Radio, television, & other electronics stores	
<b>Mining</b>				
212110 Coal mining				
212200 Metal ore mining				
212300 Nonmetallic mineral mining & quarrying				
211110 Oil & gas extraction				
213110 Support activities for mining				

LIST CONTINUED ON NEXT PAGE

**Principal Business or Professional Activity Codes (Continued)**

<b>Food &amp; Beverage Stores</b>	451212 News dealers & newsstands	486000 Pipeline transportation	423100 Motor vehicle & motor vehicle parts & supplies
445310 Beer, wine, & liquor stores	451220 Prerecorded tape, compact disc, & record stores	482110 Rail transportation	423400 Professional & commercial equipment & supplies
445220 Fish & seafood markets	451130 Sewing, needlework, & piece goods stores	487000 Scenic & sightseeing transportation	423930 Recyclable materials
445230 Fruit & vegetable markets	451110 Sporting goods stores	485410 School & employee bus transportation	423910 Sporting & recreational goods & supplies
445100 Grocery stores (including supermarkets & convenience stores without gas)	<b>Miscellaneous Store Retailers</b>	484200 Specialized freight trucking (including household moving vans)	423920 Toy & hobby goods & supplies
445210 Meat markets	453920 Art dealers	485300 Taxi & limousine service	423990 Other miscellaneous durable goods
445290 Other specialty food stores	453110 Florists	485110 Urban transit systems	<b>Merchant Wholesalers, Nondurable Goods</b>
<b>Furniture &amp; Home Furnishing Stores</b>	453220 Gift, novelty, & souvenir stores	483000 Water transportation	424300 Apparel, piece goods, & notions
442110 Furniture stores	453930 Manufactured (mobile) home dealers	485990 Other transit & ground passenger transportation	424800 Beer, wine, & distilled alcoholic beverage
442200 Home furnishings stores	453210 Office supplies & stationery stores	488000 Support activities for transportation (including motor vehicle towing)	424920 Books, periodicals, & newspapers
<b>Gasoline Stations</b>	453910 Pet & pet supplies stores	<b>Couriers &amp; Messengers</b>	424600 Chemical & allied products
447100 Gasoline stations (including convenience stores with gas)	453310 Used merchandise stores	492000 Couriers & messengers	424210 Drugs & druggists' sundries
<b>General Merchandise Stores</b>	453990 All other miscellaneous store retailers (including tobacco, candle, & trophy shops)	<b>Warehousing &amp; Storage Facilities</b>	424500 Farm product raw materials
<b>Health &amp; Personal Care Stores</b>	<b>Nonstore Retailers</b>	493100 Warehousing & storage (except leases of miniwarehouses & self-storage units)	424910 Farm supplies
446120 Cosmetics, beauty supplies, & perfume stores	454112 Electronic auctions	<b>Utilities</b>	424930 Flower, nursery stock, & florists' supplies
446130 Optical goods stores	454111 Electronic shopping	221000 Utilities	424400 Grocery & related products
446110 Pharmacies & drug stores	454310 Fuel dealers	<b>Wholesale Trade</b>	424950 Paint, varnish, & supplies
446190 Other health & personal care stores	454113 Mail-order houses	<b>Merchant Wholesalers, Durable Goods</b>	424100 Paper & paper products
<b>Motor Vehicle &amp; Parts Dealers</b>	454210 Vending machine operators	423600 Electrical & electronic goods	424700 Petroleum & petroleum products
441300 Automotive parts, accessories, & tire stores	454390 Other direct selling establishments (including door-to-door retailing, frozen food plan providers, party plan merchandisers, & coffee-break service providers)	423200 Furniture & home furnishing	424940 Tobacco & tobacco products
441222 Boat dealers	<b>Transportation &amp; Warehousing</b>	423700 Hardware, & plumbing & heating equipment & supplies	424990 Other miscellaneous nondurable goods
441221 Motorcycle dealers	481000 Air transportation	423940 Jewelry, watch, precious stone, & precious metals	<b>Wholesale Electronic Markets and Agents &amp; Brokers</b>
441110 New car dealers	485510 Charter bus industry	423300 Lumber & other construction materials	425110 Business to business electronic markets
441210 Recreational vehicle dealers (including motor home & travel trailer dealers)	484110 General freight trucking, local distance	423800 Machinery, equipment, & supplies	425120 Wholesale trade agents & brokers
441120 Used car dealers	484120 General freight trucking, long distance	423500 Metal & mineral (except petroleum)	999999 Unclassified establishments (unable to classify)
441229 All other motor vehicle dealers	485210 Interurban & rural bus transportation		
<b>Sporting Goods, Hobby, Book, &amp; Music Stores</b>			
451211 Book stores			
451120 Hobby, toy, & game stores			
451140 Musical instrument & supplies stores			

**END OF LIST**

## **PARTNERSHIPS**

### **DEFINITION OF PARTNERSHIP**

Relationship existing between two or more persons who join together to carry on a trade or business.

Each person contributes money, property, labor, or skill and expects to share in the profits and losses of the business.

Include: syndicate, group, pool, joint venture, or other unincorporated venture that is carrying on a business and may not be classified as a trust, estate, or corporation.

### **Factors used to determine if parties intend to be partnership**

- ✓ Parties' conduct in carrying out the provisions of the partnership agreement
- ✓ Testimony of disinterested persons
- ✓ Relationship of parties
- ✓ Control each has over income and purpose for which income is used

### **A JOINT UNDERTAKING MERELY TO SHARE EXPENSES IS NOT A PARTNERSHIP**

(Example: Neighbors agree to share expense of fence)

### **MERE CO-OWNERSHIP OF PROPERTY THAT IS MAINTAINED AND LEASED OR RENTED**

Does NOT necessarily constitute a partnership.  
If co-owners provide SERVICES to tenants, partnership exists.

### **PITFALLS OF PARTNERSHIP**

- ◆ Liability: General partners liability is unlimited whereas limited partners are only liable to extent of their investment.
- ◆ Management Responsibilities - allocating and settling disputes between partners
- ◆ Continuity of business at death or disability of one of the partners.

## **PARTNERSHIPS**

### **TAXATION**

**A partnership pays no income tax**

**Must file separate form 1065 return and ALL required attachments**

**Failure to file or failure to file a COMPLETE return is subject to penalty of \$50 PER MO PER PARTNER!! Penalty to partnership.**

**All income and deductions are passed through to partners to be reflected on their individual returns in appropriate places.**

### **TAX YEAR**

**A partnership generally is required to adopt the same taxable year as that of the partners owning a majority of the interest in the partnership capital or profits.**

**If partners owning a majority do not have same tax year, partnership must adopt tax year of the principal partners.**

**If majority or principal rules above do not apply, the partnership MUST use a calendar year (Year ending 12-31)**

# CORPORATE STRUCTURE

## GENERAL ATTRIBUTES OF CORPORATION

- ✓ Unlimited life
- ✓ Shares fully transferable (generally)
- ✓ Shareholders limited liability and cannot lose more than investment
- ✓ Managed by Board of Directors, not stockholders, so can raise money by selling stock without fear of interference in management.
- ✓ Reasonable salary paid to employee-shareholder is deductible by Corp.
- ✓ Retirement and employee benefits can be more generous to corporate employee than sole proprietor or partner.
- ✓ Corporation IS a taxpayer - an entity in itself. Profits, losses and credits are NOT passed through to stockholders. (Unless S Corp)
- ✓ Requires consent of State in which incorporating
- ✓ Requires certain records to be kept.
- ✓ Requires meetings to be held at certain times.
- ✓ Must pay State and Federal income tax (except S Corp)
- ✓ Quarterly estimated tax payments required.
- ✓ After tax earnings:
  - Retained - appreciated stock values taxed to shareholders later
  - Paid to Stockholders as dividends -cash dividend up to accumulated earnings and profits.
- ✓ Distributions if no earnings and profits are tax free distributions to extent of basis of stockholder - balance is capital gain
- ✓ Penalty tax on excess accumulated earnings.  
15% for balance of accumulated

Unreasonable accumulated earnings if exceed \$250,000 (\$150,000 for personal service corporations) unless there is a valid business reason.

## **CORPORATE STRUCTURE**

**Corporation must have reasonable business need and definite plan for use it is suggested that all items be noted in the minutes as it is accumulated**

- ✓ **business expansion plans**
- ✓ **plant replacement**
- ✓ **business acquisitions**
- ✓ **product liability loss reserves**
- ✓ **stock redemption plans**
- ✓ **working capital needs**
- ✓ **retirement of debt**
- ✓ **funding for non-qualified retirement plan**

## CORPORATE TAX RATES

### BASIC FEDERAL RATES

- 15% on taxable income up to \$50,000 +\$0.
- 25% on taxable income \$50,001 up to \$75,000 +\$ 7,500.
- 34% on taxable income \$75,001 up to \$100,000 + \$13,750.
- 39% on taxable income \$100,001 up to \$335,000 + \$22,250.
- 34% on taxable income \$335,001 up to \$10,000,000 + \$113,900.
- 35% on taxable income \$10,000,001 up to \$15,000,000 + \$3,400,000.
- 38% on taxable income \$15,000,001 up to \$18,333,333 + \$5,150,000.
- 35% on taxable income over 18,333,333 + \$0.

### PERSONAL SERVICE CORPORATIONS

**DO NOT BENEFIT FROM GRADUATED RATES.**

**THEIR INCOME IS TAXED AT A FLAT 35%.**

Personal Service Corp. is one that is substantially (at least 95%) owned by its employees, retired employees, or their estates

**and**

whose substantial activities involve the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.)

## PERSONAL HOLDING COMPANY (PHC)

At least 60% of corporation's adjusted gross income consists of PHC income and at any time during last half of tax year, more than 50% in value of the corporation's outstanding stock is owned, directly or indirectly by five or fewer individuals.

### Exceptions:

- Tax Exempt corporations
- Banks
- Domestic building and loan associations
- Life insurance companies
- Surety companies
- Certain lending or finance companies
- Certain foreign companies
- Certain small business investment companies operating under the Small Business Investment Act of 1958
- Corporations under jurisdiction of the court in a Title 11 or similar case.

### PHC INCOME (In general - investment income)

- Dividends
- Interest minus certain amounts excluded
- Royalties minus certain expenses allowed
- Annuities
- Rents minus certain expenses allowed
- Compensation received for use of corporation property from shareholders who own at least 25% of the corporation
- Amounts received under personal service contract if someone other than the corporation designates the individual who is to perform the services and that performing individual owns at least 25% of corporation
- Income from estates and trusts

### PHC ADJUSTED ORDINARY GROSS INCOME

Corporation's gross income minus:

- Gains from sale or disposition of capital assets
- Gains under IRC 1231 (b)
- Certain foreign corporation income
- Certain expenses allowed against rental income
- Certain expenses allowed against royalty income
- Certain interest income

### PHC TAX

Flat 15% tax on undistributed PHC income - in addition to other corporate taxes on income.

## **CORPORATIONS**

### **SPECIAL TAXES OR RATES ON CORPORATIONS**

#### **ALTERNATIVE MINIMUM TAX**

**Corporations may also be subject to AMT tax of 20% of its Alternative Minimum taxable income if this is higher than its regular tax liability.**

#### **ENVIRONMENTAL TAX**

**For tax years beginning before 1996**

**Tax in addition to any other tax**

**Not applicable to S corporations**

**Rate of 0.12% of modified AMT income for the year over \$2 million**

#### **ACCUMULATED EARNINGS TAX**

**This is a penalty tax of 15% of subject earnings not distributed for the purpose of avoiding taxable distributions.**

## CORPORATE “DOUBLE TAXATION”

### CAUTION:

Consideration should be given to comparison of personal income tax rates for small business with one or two owners. Although at first glance it appears that the corporate tax rates are lower than the individual rates, the EFFECTIVE rates are HIGHER for the corporation tax.

<u>A single individual tax rate for 2010:</u>			
If Taxable Income is:			
Over –	But not over –	The tax is	of the amount over –
\$0	\$8,375	\$0 + 10%	\$ -0-
\$8,376	\$34,000	\$837.50. + 15%	\$8,375
\$34,000	\$82,400	\$4,681.25. + 25%	\$34,000
\$82,400	\$171,850	\$16,781.25. + 28%	\$82,400
\$171,850	\$373,650	\$41,827.25 + 33%	\$171,850
\$373,650	.and over	\$108,421.25 + 35%	\$373,650

Keep in mind that the personal rates are effective for TAXABLE income after itemized, standard, and personal exemptions.

The Corporate rates are based on PROFIT of the corporation (no std. deduction, itemized, or exemptions).

### CORPORATE TAX RESULTS IN DOUBLE TAXATION

Corporate tax is applied to profits of the corporation.

When the profits are distributed as dividend (to avoid accumulated earnings penalty tax) the dividends are AGAIN taxed to the shareholders. However, with the Tax Act of 2003, these dividends are eligible for the capital gains rates if the proper holding periods are met and the dividends are Qualified Dividends.

If shareholders are in a bracket of 35%, which means their capital gains rate would be 15% and Corporation is in top bracket of 35% this means a total of 50% tax on the profits of the corporation. (Plus applicable State corp tax and State individual tax)

If profits are not to be left in the corporation for a business reason, and therefore avoiding the penalty tax, consideration should be given to declaring salaries and bonuses to decrease the corporate income subject to double taxation.

## 7EXAMPLE OF DOUBLE TAXATION

If closely held corporation (husband and wife sole shareholders) generates a net profit of \$150,000 after payment of salaries to EACH shareholder, officer, in the amount of \$35,000 each (Joint \$70,000).

$$\text{Corporate tax } \$22,250 + 39\% \text{ of } \$50,000 = \underline{\$41,750}$$

If the \$150,000 is then distributed as Qualified dividends to the shareholders, it may qualify as long term capital gain and given that they are in the 15% tax bracket - their long term capital gain tax is 15%.

Shareholder's tax on wages

$$(\$70,000 \text{ wages} - (\text{Std Ded and Exemptions } \$18,700)) = \$51,300$$

$$\text{Taxable Amount at joint rates} \quad \$9,013 \text{ Tax}$$

Shareholder's long term capital gain tax

$$(\$150,000 \times 15\%) \quad \underline{\$22,500}$$

**Option 1: Total Tax** **\$73,263**

If the \$150,000 distribution is not a Qualified dividend it would be an ordinary dividend added to the \$70,000 resulting in \$220,000 ordinary income. Assuming standard deduction for joint under 65 at \$11,400 and two exemptions @ \$3,650 each, the TAXABLE balance would be \$201,300.

$$\text{Tax on } \$201,300 \text{ at joint rates} = \underline{\$51,573}$$

**Option 2: Total Tax** **\$51,573**

### ALTERNATIVE

**If the dividend does not qualify as long term capital gain, declaring additional salary (bonus) in the amount of \$150,000 to the two shareholders would be the next best option.**

Corporate tax would be -0-

Tax to shareholders is still (generally) \$51,573.

***Savings of cash results in the amount of \$21,690.***

NOTE: Since the shareholders have already received a substantial salary, the payroll tax effects are reduced to a minimum. Watch that salaries are commensurate with duties. **REMEMBER, OWNERS AND OFFICERS MUST NOT TAKE THIS ACTION UNLESS APPROVED BY THE BOARD OF DIRECTORS. IT MUST BE APPROVED AT A MEETING AND REFLECTED IN CORPORATE MINUTES**

# **STATE TAX RATES FOR CORPORATIONS**

## **CALIFORNIA**

**Corporations in California must file EITHER:**

**Franchise tax return**

**or     Income tax return**

### **FRANCHISE TAX:**

**Imposed on all corporations "doing business"  
OR incorporated in California**

**Prepaid for the PRIVILEGE of doing business**

**Measured by income of preceding year (income year)  
for privilege of doing business in the following  
year (taxable year)**

**Doing business: actively engaging in any transaction  
for the purpose of financial gain.**

### **SUBJECT ENTITIES:**

**All corporations incorporated in California  
All corporations doing business in Calif. whether or  
not incorporated or qualified under Calif. law.  
Banks doing business in California.**

### **MINIMUM FRANCHISE TAX**

**If subject to the above franchise tax - minimum is \$800  
Except:  
Qualified INACTIVE gold or quicksilver mining corp \$25**

### **TAX RATE:**

**8.84% for all EXCEPT banking corporations or S Corp.**

**BANKING rate is 10.84% for calendar year banks and  
financial corporations that are not S corporations.**

## **STATE TAX RATES FOR CORPORATIONS**

### **CALIFORNIA**

#### **CORPORATION INCOME TAX:**

**Imposed on all corporations that derive income from sources within California but are NOT doing business in California.**

#### **INCLUDES:**

- **Associations**
- **Massachusetts trusts**
- **Business trusts**
- **Real Estate Investment Trusts**
- **Political organizations that have political TAXABLE income in excess of \$100**

**DOES NOT INCLUDE BANKS**

### **OREGON**

**Tax Rate 6.6%**  
**Minimum tax is \$10**

### **WASHINGTON**

**No State tax**

## **STATE TAX RATES FOR CORPORATIONS**

### **OTHER STATE TAXES APPLY IN THE FOLLOWING STATES: PLEASE BE SURE TO VERIFY CURRENT RATES!**

Alabama - 5%  
Alaska (graduated rates)- 1% to 9.4%  
Arizona (graduated rates)- 8% (\$50 minimum)  
Arkansas (graduated rates)- 1% to 6% (6.5% of excess over \$100,000)  
Colorado - 5%  
Connecticut 9.5%  
Delaware 8.7%  
Dist of Columbia -9.975%  
Florida 5.5%  
Georgia 6% + net worth tax  
Hawaii graduated rates 4.4 - 6.4% and separate capital gain 4%  
Idaho 8%, Min. \$20  
Illinois 4.8% plus additional 2.5% personal property replacement tax  
Indiana 1.2% to 3.0 %  
Iowa graduated rates 6% - 12% plus financial institution tax 5%  
Kansas 4.% plus 3.25% surtax on taxable income excess of \$50,000  
Kentucky graduated rates 4% - 8.25% plus license tax  
Louisiana graduated rates - 4% to 8%  
Maine graduated rates 3.5% to 8.93%  
Maryland 7%  
Massachusetts 5.95% plus surtax 12%  
Michigan 2.3%  
Minnesota 9.8%  
Mississippi graduated rates 3% to 5%  
Missouri 6.25% (financial institutions different treatment)  
Montana 6.75% with adjustments and surtax Min.\$50  
    except small business corporations minimum is \$10  
Nebraska graduated rates 5.58% to 7.81%  
New Hampshire -Business profits tax 7%  
New Jersey 9% plus additional tax on net worth and other adjustments  
New Mexico graduated rates 4.8% to 7.6%  
New York 3.25% - 3.5% (\$100 minimum to \$325 minimum)  
North Carolina 7.25%  
North Dakota Graduated rates 3% to 10.5%.  
Ohio graduated rates 5.1% plus 8.5% of excess over \$50,000 (net income basis)  
    Or 4.0 net worth basis (greater of)  
Oklahoma 6%  
Pennsylvania 7.5% plus  
Rhode Island 9% with minimum of \$250  
So Carolina 5%  
Tennessee 6% plus tax on interest and dividends  
Utah 5%, Min. \$100  
Vermont graduated rates 7% to 9.75%  
Virginia 6%  
West Virginia 9%  
Wisconsin 7.9%

## **SUBCHAPTER S CORPORATIONS**

Internal Revenue Code Section 1371 to 1379 govern “Subchapter S” corporations.

Provides a means to avoid the double taxation of a regular “C” corporation

Under Subchapter S a corporation does NOT pay taxes on profits

Profits and losses are “passed through” to shareholder in much the same manner as with a partnership.

The tax advantages should be carefully “weighed” based on the income/loss situation and whether the profits must remain in the corporation rather than be distributed.

**Careful consideration should be given to actual distribution of enough cash to the Sub S shareholders to fund the tax liability they will incur.**

## ELIGIBILITY TO ELECT SUB CHAPTER "S"

Must be a "small business" corporation and meet the following conditions:

- ✓ Must be a DOMESTIC corporation
- ✓ Must not have more than **75 shareholders** (was 35 prior to 1997)
- ✓ Shareholders must be individuals, estates, and certain trusts ONLY (Another corporation, a partnership or a non-qualified trust can NOT be a shareholder)
- ✓ Must have only ONE class of stock.  
Generally all shares must be common shares  
Common stock that differs only with respect to voting rights is treated as One class of stock (Code sec. 1361(b)(1)(D) and ©) (4)
- ✓ May not have any nonresident alien shareholders
- ✓ May not be a member of an "affiliated group"
- ✓ Must have a permitted tax year as required by sec. 1378 or make an election to have a tax year other than a permitted tax year. A permitted tax year is December 31 or any other tax year for which a corporation establishes a business purpose to IRS's satisfaction.
- ✓ Must make the proper S Corporation election
  - All shareholders must sign consent form 2553
  - Filed with Internal Revenue
  - Filed Timely -  
Either:
    - At any time during that portion of the first tax year the election is to take effect which occurs before the 16<sup>th</sup> day of the third month of that tax year.----- Or
    - In the tax year before the first tax year it is to take effect

**An election made after the 15<sup>th</sup> day of the third month but before the end of the tax year is treated as made for the NEXT year**

- **IRS must approve the election**  
**DO NOT FILE TAX RETURNS AS SUB S**

**(FORM 1120S)**

**UNTIL ELECTION IS APPROVED BY IRS**

**NEW SHAREHOLDERS DO NOT HAVE TO FILE A CONSENT IN ORDER FOR A CORPORATION TO MAINTAIN S CORPORATION STATUS**

## **S CORPORATION ADVANTAGE CHECKLIST**

### **Reasons to chose the S corporation form of doing business include:**

- ✓ Limited liability
- ✓ Benefit of lower tax rate on individuals
- ✓ No separate tax on corporate income
- ✓ Deductibility of business start up losses available to individuals
- ✓ Individual shareholder can deduct its share of net operating losses
- ✓ Capital gains generally not taxed at corporate level
- ✓ No accumulated earnings tax
- ✓ No corporate alternative minimum tax
- ✓ More flexibility in choosing accrual or cash method of accounting
- ✓ Family member may be able to split income among other family members.

## **S CORPORATION DISADVANTAGES**

### **Reasons NOT to chose the S corporation status:**

- ✓ Rules that govern election are inflexible
- ✓ More perks (fringe benefits) subject to tax
- ✓ Employee stock ownership plans are not available
- ✓ Passive activity losses and credits are sometimes limited
- ✓ Some states do not recognize S corporations for state income tax purposes

## **LIMITED LIABILITY COMPANY (LLC)**

### **DEFINITION OF L.L.C.**

Organization formed under STATE law  
Shields owners of the LLC (known as “members” and management (may be members or “managers”) from personal liability for debts and liabilities of the LLC **entity**

### **STATE OPERATIONS**

As a general rule, LLC statutes authorize the LLC to conduct business in the state in which it is formed, in other states and internationally.

Generally, the LLC statutes provide that the law of the place where the LLC was organized governs the organization, internal affairs and liabilities of the members of the LLC.

### **BASIC ATTRIBUTES OF L L C**

- ✓ No limit on number of members (owners)
- ✓ LLC can have a corporate subsidiary - LLC may own any or all of the stock of a corporation.
- ✓ Generally, any legally recognized “person” may own an interest in an LLC.
- ✓ A non-resident alien or foreign country business organization may own an interest in an LLC
- ✓ LLC formed in the U S is not necessarily treated as a partnership in foreign countries (Canada for instance treats LLC as corporation)

## LIMITED LIABILITY COMPANY (LLC)

### TERMINOLOGY OF L L C

- ✓ **Members** - owner of an interest in LLC  
Can not be a member unless prerequisite approval of the other members
- ✓ **Articles** - Articles of organization must be filed with Secretary of State or similar official containing basic information.
- ✓ **Operating Agreement** - adopted to provide details about the operation of the company and relationship of members to each other. (Similar to a partnership agreement)
- ✓ **Interests** - Members have “interests” in an LLC (as partners have “interests” in a partnership. **LLCs do not issue shares of stock**)
- ✓ **Capital Account** - Members in LLC taxed as partnership have “capital account” representing a member’s equity interest in the company. Equal to:
  - Capital contributions to the company (cash and FMV property)
  - Member’s allocable share of company’s income and gain each year (including tax exempt income)
  - Less distributions to member of cash or FMV property
  - Less member’s share of allocable tax losses, deductions and expenditures.
- ✓ **Management** - Members can either designate “managers” or reserve management to themselves. Unless otherwise agreed, members manage in accord with the proportionate interests in the LLC. Managers may function in a manner similar to a general partners.

## LIMITED LIABILITY COMPANY (LLC)

### CHOOSING THE RIGHT BUSINESS FORM

Choice depends upon many factors. No single “right” answer.

#### TEN MAJOR QUESTIONS TO BE ANSWERED:

- ▶ **Where will the business of the organization be conducted**  
(Will a LLC be recognized in the foreign state or country?)
  
- ▶ **Who will own the organization?**  
U. S. Residents, foreign citizens, individuals, corporations?  
If corporations, LLCs or nonresident aliens will be owners - S corporation is not an option.
  
- ▶ **How many owners will there be?**  
If only one owner - an LLC is not an option at this time, unless taxation as a corporation is desired.  
If more than 75 owners - can not be an S corporation.
  
- ▶ **How do owners expect to finance venture?**  
If with debt - LLC may be preferable over S corporation because LLC members may more often include a portion of the LLC’s debt in basis of their interest  
C or S corporation shareholders cannot include entity’s debt in basis of their stock even if they guarantee the debt.  
If business will need to **retain a lot of earnings** for future capital needs, a C corporation may be preferable to LLC or S corporation if it’s tax bracket is significantly lower than that of its owners. (Be sure the accumulated earnings have reasonable necessity to avoid the accumulated earnings tax.) Since LLC members and S corporation shareholders pay tax on earnings whether or not distributed to them, they could be paying tax on income never received if the business can not or does not distribute the earnings.
  
- ▶ **Do the owners desire flow-through (pass through) taxation?**  
(Currently, the excess “flow through” is taxed to members of an LLC/partnership/ or S corporation. Partnership and LLC “pass through” may be subject to SE tax whereas S corporation “pass through” is not currently subject to SE tax.)

## LIMITED LIABILITY COMPANY (LLC)

### CHOOSING THE RIGHT BUSINESS FORM

#### TEN MAJOR QUESTIONS TO BE ANSWERED: (Continued)

- ▶ **Do organizers of the business expect to incur net losses?**  
Heavy start up costs, front loaded tax depreciation, overhead in excess of revenues? If owners have income from other sources, participate actively in the business of the entity, or have passive income from other sources, - LLC or S corporation may be best choice of entity. **Regular Corporation losses do not pass through and are carried either back or forward to years when there are profits.**

**Note: Since LLC members have more basis against which losses may be used in their LLC interest than S corporation shareholders because LLC members can include their share of LLCs debt in their basis.**

- ▶ **Do owners of the organization want to create various classes of equity interests or specially allocate the business income, losses, or other tax attributes to different owners?**

S Corporations may only have one class of stock

C Corporations may have any number of classes of stock but all

Of the holders of the same class of stock generally must be treated the same under state corporate law

LLC treated as a partnership for tax purposes can allocate the Income, gains, losses, deductions, credits, or other item among the members in almost any method desired and may be inconsistent from one member to the next so long as the allocations have “substantial economic effect”.

- ▶ **Are the owners concerned about limited liability?**
- ▶ **Do the owners of the business plan to offer employee benefits to those owners who provide services?**

Significant advantage to C Corporation

- ▶ **Is the particular business regulated in a manner that dictates the form of business entity that must be used.**

Professional rules (law, medical, accounting professions?)

## **LIMITED LIABILITY COMPANY (LLC)**

### **GENERAL TAXATION**

An LLC can be taxed as a “**C**” Corporation under the IRC or as a pass-through **Partnership** for federal income tax purposes. (LLC can not be taxed as S Corp)

### **FRINGE BENEFIT TAXATION**

Generally, a C Corporation can deduct fully the cost of health insurance and other qualified fringe benefits for all shareholder-employees and they do not have taxable income attributable to those economic benefits.

LLC taxed as a partnership rules similar to rules for S corporation 2 percent shareholders apply to all of the members of the LLC , regardless of the amount of their capital or profits interest in the LLC

A partner is not considered an “employee” under IRC so various tax free employee benefits including group term life insurance, employee death benefits, accident and health plans, and meals and lodging and not tax free to partner.

Members in LLC can not participate in a cafeteria plan sponsored by the LLC.

### **TRANSFERABILITY OF INTEREST**

LLC (taxed as a partnership) must have lack of free transferability of ownership interests. LLCs usually restrict the transfer and most provide that members must approve any transfer of interest or admission of new members.

Corporations (except professional corporations) generally do not restrict the sale or transfer of stock by shareholders.

## **LIMITED LIABILITY COMPANY (LLC)**

### **DIFFERENCE BETWEEN LLC AND GENERAL PARTNERSHIP**

**Formation** - LLCs are formed by filing Articles of Organization or similar document.

- General partnerships are formed by an agreement, which may be oral, and no State law requires filing of “organizational documents”. (Note: Oregon law requires a copy of the “partnership agreement” to be filed with the Dept of Revenue when partnership first organized – very seldom enforced!)

### **Liability - Principal advantage of LLC over general partnership**

LLC - no member is liable personally for debts or obligations of LLC other than those specifically guaranteed or assumed by the member unless the veil of liability protection can be pierced.

Partnership - Each general partner is subject to joint and several **personal** liability for all of the partnerships’ liabilities.

### **Management and Authority**

Generally management is about the same for LLC and partnership.

General partners or members have statutory authority to represent and act on behalf of the entity.

LLCs can designated managers and often provide that only the named managers have authority and power to bind the LLC to contract.

### **State Taxation**

LLC, in some states impose an entity-level income tax

LLC, in some states are treated same as partnerships

### **Allocation of Income and Distributions**

Partnership, generally each partner shares equally in the profit, losses and distributions of partnership, unless otherwise agreed.

LLC, in many states, the members share in those items in proportion to the value of their capital contributions to the LLC.

## LIMITED LIABILITY COMPANY (LLC)

### LIMITED LIABILITY COMPANY VS LIMITED PARTNERSHIP

Very similar - Both must be structured and operated carefully to ensure that they are taxed as partnerships for federal income tax purposes.

#### Several significant distinctions

- ◆ **General partner liability** - A limited partnership must have at least one general partner who is liable for all debts of the partnership. All of the members of an LLC normally are protected from personal liability (as are limited partners in limited partnership)
- ◆ **Participation in Management** - Participation of limited partners in management of a limited partnership can result in loss of limited liability protection for that limited partner. No similar restriction exists on ability of LLC members to participate in management and control of the LLC.

### LLC VS. LIMITED LIABILITY PARTNERSHIP (LLP)

Principal difference is level of limited liability protection for owners of the entity.

LLP statutes only shield each partner from LLP liabilities for the malpractice of another partner in the LLP. Each LLP partner thus remains liable for his or her own malpractice, the malpractice of people they directly control or supervise, and the LLP general debts, including trade payables, loans lease obligations and other contracted liabilities.

## **BUSINESS CREDITS AVAILABLE**

A taxpayer who is planning to go into business should be aware of business incentives that have been provided to promote certain business ventures:

**Alcohol fuels credit** - applies to alcohol sold or used as fuel. (Form 6478)

**Community Development Corporations** (Form 8847)

**Credit for taxes paid on certain employee tips** (Form 8846)

**Disabled access credit** (Form 8826)                      Non-refundable tax credit

For eligible small business that pays or incurs expenses to provide access to persons who have disabilities.

Must pay or incur the expenses to enable business to comply with Americans with Disabilities Act of 1990.

**Electric Vehicle Credit** (Form 8834)

Available to original owner only and for a vehicle that has not been a non electric vehicle.

**Employer Provided Child Care Credit** (Form 8882)

**Empowerment zone employment credit** (Form 8844)

Must have employees

Must be engaged in business in an empowerment zone for which credit is available

**Enhanced oil recovery credit** (Form 8830)

**Indian employment credit** (Form 8845)

Applies to PART of the qualified wages and health insurance costs (up to \$20,000 per employee) you paid or incurred during a tax year **that is more than** the sum of the comparable costs you (or your predecessor) paid or incurred during the calendar year 1993.

Employee must be an enrolled member, or the spouse of an enrolled member, of an Indian tribe and not employed in gambling activities.

Employee must perform substantially all of his or her services within an Indian reservation while living on or near the reservation.

**Investment credit** (Form 3468)

**Reforestation credit** - expenses incurred to forest or reforest property you hold for growing trees for sale or use in the commercial production of timber products.

**Rehabilitation credit** - expenses incurred to rehabilitate certain buildings

**Energy credit** - applies to certain expenses for solar or geothermal energy property you placed in service during the year.

**Low income housing credit** (Form 8586)

Applies to low income housing buildings placed in service after 1986.

## **BUSINESS CREDITS AVAILABLE - Continued**

### **New Markets Tax Credit** (Form 8874)

For investments made after 12/31/00 in low-income or economically disadvantaged communities. Applies to the amount invested in a qualified community development entity.

### **Orphan drug credit** (Form 8820)

Applies to qualified expenses incurred in testing certain drugs, known as “orphan drugs for rare diseases and conditions.

### **Renewable electricity production credit** (form 8835)

Applies to sellers of electricity.

For example:

Wind, a renewable source, expenses incurred to purchase equipment and expenses to bring it on line,.

### **Research credit** (Form 6765)

Designed to encourage businesses to increase the amounts they spend on research and experimental activities. Available through 6/30/04

### **Small Employer Pension Plan Start-Up Costs** (Form 8881)

50% of eligible costs up to maximum credit of \$500

### **Work opportunity credit** (Form 5884)

Provides an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs.

State certification required.

For employees who began work for you after 2006.

### **Welfare-to-work credit** (Form 8861)

Credit for qualified wages paid to qualified long-term family assistance recipients who start work after December 31, 1997 and before January 1, 2007

Only during first two years of work

1<sup>st</sup> year - 35% of the first \$10,000 of qualified wages paid an employee

2<sup>nd</sup> year - 50% of the first \$10,000 of qualified wages paid to that employee

Special rules for agricultural and railroad employees.

More than half the wages must be in trade or business.

Qualified wages include amounts that are normally excluded from employees gross income:

Amounts received for medical care under accident and health plans

Employer contributions to accident and health plans

Amounts excludable under an educational assistance plan

Amounts excludable under a dependent care assistance program

## **BUSINESS CREDITS AVAILABLE - Continued**

Qualified wages do not include:

Wages paid to an employee during a period when received payments for that employee from a federally funded on the job training program

Wages for which work supplemental payments are received under the Social Security act.

Wages for services of replacement workers during a strike or lockout.

**Must receive certification from your SESA before claiming the credit.**

(State Employment Security Agency)

**IF TAXPAYER TAKES THE WELFARE TO WORK CREDIT FOR AN EMPLOYEE DURING THE TAX YEAR, YOU CANNOT TAKE THE WORK OPPORTUNITY CREDIT FOR THAT EMPLOYEE DURING THAT TAX YEAR.**

The above credits are individually computed on Form 3800.

Form 6251, Alternative Minimum Tax Credits, must be computed even if not required to file.

2010