STARTING A BUSINESS

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Starting a business can be one of the most exciting and terrifying experiences in your life. You can make the experience less painful – and more profitable – if you get professional help before you start your business. You can't escape taxation but you can minimize the tax bite by your choice of business entity and through proactive planning.

This booklet explores the different types of business entities, federal taxation of those entities, start-up costs, profit motive, and other events connected with the launching of a business.

CHOOSING A BUSINESS ENTITY

First, and most importantly, you have to decide how your business will be structured. Will it be a corporation, a partnership or another type of business entity?

How much of your money and personal assets are you willing to risk in the business? If the business isn't profitable, creditors, including the IRS, can come after you. This is the reason why the choice of business entity is so important. Depending on how you structure your business, you can shield some or all of your personal assets.

You also have to think about the tax consequences of your choice of business entity.

Different businesses are taxed differently. If you incorporate your business, the corporation pays taxes (unless you elect special "S corp" tax treatment). But if you operate your business as a partnership, you and your other partners pay the taxes.

Here's a look at some common business entities. We all know the names – sole proprietorship, corporation, partnership – but if you're serious about starting a business, you have to know and carefully weigh the pros and cons of each type of business entity.

Sole proprietorships. Where there is only one owner and he or she is willing to risk all of his or her personal assets to satisfy the liabilities of the business, a sole proprietorship may be appropriate. While the business activities of the owner are, for *accounting* purposes, separate from the owner's other income, a sole proprietorship is not an "entity" separate from its owner for *federal income tax* purposes.

Because sole proprietorships are conducted by individuals, the income of the business is taxed just as individuals are taxed.

In 2010, the top individual marginal income tax rate is 35 percent. After 2010, the top rate is scheduled to climb to 39.6 percent. The increase may cause some sole proprietorships to change their choice of business entity.

Sole proprietors also have to think about capital gains tax. Generally, sales of long-term capital assets used in the business will be taxed at the capital gains rate. The maximum capital gains rate, at least through 2010, is 15 percent for individuals. There are lower rates, but they are exceptions reserved for lower-income individuals. After 2010, the capital gains rate is expected to increase for higher-income individuals.

> ***Comment.*** The Obama administration has proposed a maximum capital gains rate of 20 percent for individuals with incomes over \$200,000 and families with incomes over \$250,000. These are just proposals; Congress would need to change the tax rules to enact them into law.

Sole proprietorships also could be subject to the alternative minimum tax (AMT). The AMT is a parallel tax system that was intended to be paid by only the very wealthy. Today, more middle-income taxpayers are paying AMT because it was never indexed for inflation. Calculating AMT liability is complicated and you should get help from a tax professional.

Partnerships. If two or more people are starting a business, a partnership is a simple way to get the business off the ground. A general partnership is a partnership of the "old-fashioned" kind. Each partner is entitled to participate in the management and operation of the business and all are liable for the full amount of any portion of the partnership's debts. The partnership generally does not compute or pay taxes. Rather, income "passes through" to the partners, who report their share of the partnership's profit, loss, deductions, and credits on their individual income tax return, Form 1040. Thus, the tax rate of each partner depends upon his or her own level of income.

Corporations. You don't have to be a million dollar business to be a corporation. Anyone can incorporate a business. Unlike sole proprietorships and partnerships, corporations have to comply with more state laws about the number of shareholders, issuance of stock, holding of meetings, and so on.

Corporations are also taxed differently from sole proprietorships or partnerships. Corporations, except for S corporations, are taxed at the entity level. Income distributed to the owners out of any after-tax profits in the form of dividends is taxable again to the owners.

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Corporations are distinct legal entities. Ownership interest is divided into shares. Corporations have perpetual duration. The shareholders generally are not liable for any debts of the corporation beyond the value of their investments. However, lenders and other creditors sometimes ask owners of small corporations to assume personal liability for loans and other transactions.

C Corporations. Corporations taxed at the entity level are referred to as "C corporations" or regular corporations. The name comes from the title of a subchapter of the Internal Revenue Code.

C corporations compute and pay taxes based on their own operations, with no reference to the income or losses of the shareholders. Corporate federal tax rates are as follows:

(1) 15 percent on the first $50,000 of income;
(2) 25 percent on $50,001-$75,000;
(3) 34 percent on $75,001-$10 million; and
(4) 35 percent over $10 million.

Code Sec. 199 manufacturing deduction. Created by Congress in 2004, the manufacturing deduction under Code Sec. 199 provides a lucrative benefit to more than just traditional manufacturers like auto and steel makers. The deduction is widely available to many U.S. businesses, including the construction, architecture, farming, software development, motion picture production, and music recording industries, among others. There are also special rules that make it easier for small businesses to qualify for the deduction. However, there is one important exception: restaurants generally do not qualify.

For 2010, the Code Sec. 199 deduction is equal to nine percent of the lesser of:

- The taxpayer's qualified production activities income for the tax year; or
- The taxpayer's taxable income for the tax year without regard to the Code Sec. 199 deduction (or in the case of individuals, adjusted gross income).

Importantly, the deduction cannot exceed 50 percent of the W-2 wages paid by the taxpayer during the tax year. Only wages allocable to domestic production gross receipts are included for purposes of computing this Code Sec. 199 deduction limitation. There are special rules for oil and gas companies.

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The manufacturing deduction is allowed against alternative minimum taxable income (AMTI) for purposes of calculating the alternative minimum tax (AMT). However, a corporation, including an exempt corporation subject to tax on unrelated business taxable income, must use its AMTI, not its taxable income, when calculating the income limit on the amount of the deduction.

Hybrid C corporations. Hybrid C corporations are C corporations, but they do not have all of the rights of C corporations. Frequently, these corporations are taxed at the maximum individual tax rate. Examples are:

- ***Personal holding companies:*** A personal holding company is a corporation that (1) has at least 60 percent of adjusted ordinary gross income for the tax year characterized as personal holding company income, and (2) at any time during the last half of the tax year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by a maximum of five individuals.
- ***Personal service corporations:*** A personal service corporation is one that furnishes personal services performed by employee-owners. Employee-owners are those who own, directly or indirectly, more than 10 percent of the outstanding stock of the corporation on any day during the company's tax year.
- ***Qualified personal service corporations:*** A qualified personal service corporation is exempt from the general prohibition against use of the cash method of accounting by corporations. However, a qualified personal service corporation is not entitled to utilize the graduated tax rates available to other corporations.
- ***Passthrough entities:*** A business entity (other than a general partnership) that insulates the owners from most liability, yet pays no tax (or very little) is called a passthrough entity. All income and deductions are "passed through" to the owner and taxed on the owner's individual income tax return each year.

> ***Caution:*** The IRS can recast transactions that attempt to use the passthrough rules for tax avoidance purposes.

Examples of passthrough entities are:

- ***S corporations:*** S corporations are popular because income is taxed at the shareholder level. The shareholders have the same protection from liability as shareholders of a C corporation. An S corporation passes most of its income and loss items to its shareholders. Thus, the corporate tax rates do not apply, and each shareholder is subject to taxation at

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his or her individual tax rate. The S corporation itself is liable for a small number of taxes.

- ***Limited partnerships:*** These are partnerships that have two classes of partners. One or more general partners run the business operations and are fully liable for any partnership debts. Limited partners are discouraged by law from running the partnership's business and are liable only for the amount they invested in the partnership. Income generally passes through to the partners.
- ***Limited liability partnerships (LLPs):*** These operate like a traditional limited partnership, but the general partner also has limited liability.
- ***Limited liability companies (LLCs):*** These resemble both limited partnerships and corporations. They provide limited liability to members, but also permit members to conduct the business affairs of the LLC. Like a partnership, an LLC passes income through to its members.

Planning Tip. A business may start as a C corporation and then decide to become an S corporation. Special rules govern the recognition of built-in gains to prevent tax evasion.

Trusts: Although usually formed to protect assets for a child or other dependent, beneficiary trusts also are used for

business purposes. The donors of the trust place business assets "in trust," and the trust operates a business or owns an investment. This form generally provides limited liability for the donors and the beneficiaries. Trusts, however, do not pay the same tax rates that apply to individuals. Trusts are also subject to the AMT. One exception: If the trust is set up as a passthrough or grantor trust, income will be taxed to the owner at the owner's rate and the trust entity will be ignored.

FACTORS AFFECTING ENTITY CHOICE

There is no blanket rule that determines what entity is right for your business. However, identifying the existence or absence of certain key factors can go a long way in helping you make the right decision.

Factor #1: Contribution of property and services to the entity

One of the most important considerations in entity choice is the tax treatment of your contribution of property and services to the new business.

- ***Corporations:*** Contributions of property to a corporation (S or C) need not be a taxable event. When a corporation is organized, the value of the issued stock is usually the same as the value of the property transferred to the corporation. The tax law calls this non-recognition of gain or loss.

  Caution. Non-recognition is not provided for the contribution of services for an equity position in a corporation. Therefore, if one of the shareholders provides the money and the other provides the labor in exchange for an equity interest, the contribution of money will be a tax-free event, while the shareholder who contributes his or her labor will recognize compensation income in the value of the stock received in return.

  Comment. For entrepreneurs who need to attract capital to their fledgling business (or want to protect some of their own capital while investing in the business), using a C corporation has a distinct advantage. The *American Recovery and Reinvestment Act of 2009* temporarily allows investors to exclude 75 percent of the gain from the sale of certain small business stock acquired and held for more than five years. There are proposals in Congress to make this temporary treatment permanent or expand it to a 100 percent exclusion. The exclusion had been 50 percent for many years.

- ***Partnerships and passthrough entities:*** The contribution of cash or property to a partnership or other type of passthrough entity is generally a nontaxable event. The partnership rules prevent the transfer of gain or loss between partners when property with a "built-in" gain or loss is contributed.

  Caution. The contribution of services to a partnership or other passthrough entity can be tax-free, but not always. The tax rules are complicated and the IRS doesn't always apply them consistently, especially if your business is a limited liability company.

Factor #2: Limitations on investors' and owners' rights to participate in management

Who is going to manage your business? Do you want centralized management; that is, will a few key people be charged with the day-to-day conduct of affairs, while the rest of the investors remain "silent?" Will everyone who invests want a say in the operation of the business?

Corporations (both S and C), have centralized management. Investors' rights are governed by state law. The conduct of the business is divided between the officers and the directors of the corporation.

Centralized management is possible in a partnership or passthrough entity. For example, a limited liability company can have centralized management

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if the members appoint certain members to run it or if they hire managers. Generally, however, there are no specific restrictions on management of passthrough entities.

Factor #3: Restrictions on investors

The S corporation, unlike the other business entities, has restrictions on who may invest. These restrictions limit the utility of S corporations.

Shareholders. Not everyone can be an S corporation shareholder. Only the following individuals, estates and trusts are eligible S corporation shareholders:

(1) Individuals other than nonresident aliens;
(2) Estates, including the estate of an individual in bankruptcy;
(3) A qualified Subchapter S trust (QSST);
(4) A voting trust that is a subpart E trust and is created primarily to exercise the voting power of stock transferred to it;
(5) A trust to which stock is transferred according to the terms of a will;
(6) An electing small business trust; and
(7) Retirement trusts and charitable organizations.

Caution. The maximum number of S corporation shareholders is 100. Even an accidental or temporary excess in the allowable number of shareholders can terminate your S corporation. However, there are special rules for family members. In some cases, the special rules allow large family businesses (especially those that have a number of generations) to retain S corporation status.

Factor #4: Types of stock interests

C and S corporations have different restrictions on the types of stock permitted. Generally, C corporations can have a variety of interests attached to various classes of shares. An S corporation binds all investors to the same enterprise. Therefore, it is difficult to direct specific items of income or loss to specific shareholders. The outstanding shares must be identical regarding the rights of the holders in the profits and assets of the corporation. In other words, each share must confer identical rights to distribution and liquidation proceeds. Differences in voting rights, however, are permitted.

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Factor #5: Debt and equity

Because S corporations and pass-through entities allocate the entity's debt to its owners under the partnership rules, both debt and equity can be used to capitalize the venture. An owner's contribution to the entity, whether debt or equity, becomes part of the owner's basis in the entity.

The capitalization flexibility provided under the partnership rules comes at a price. The accounting for S corporations and passthrough entities is complex and technical. This complexity also may lead to valuation problems on the sale of the owners' interests.

TAX COMPLIANCE

Yet another consideration for your newly-formed business is how you are going to bring the enterprise into compliance with the applicable tax laws. All businesses, except for partnerships and multiple-member LLCs, must file an annual income tax return. These excepted flow-through entities must file an information return instead because they do not pay any tax. Partnerships and multiple-member LLCs have an information return entitled Form 1065, U.S. Return of Partnership Income. The tax consequences of a single-member LLC is reported on either an individual's Form 1040, U.S. Individual Income Tax Return, or a corporation's Form 1120, U.S. Corporation Income Tax Return.

Income tax. Similar to the income tax on wages, the federal income tax on business income is a pay-as-you-go tax. Before you even consider which income tax form you have to file, you must withhold and pay the income tax due on your revenue as you are currently earning it. As a result, most businesses must make income tax payments to the IRS throughout the year, based on their estimated income tax liability. Sole proprietorships, partners and S corporation shareholders must make these estimated tax payments if they expect to owe $1,000 or more when filing a return. Corporations generally make estimated tax payments if expected to owe $500 or more when filing a return.

> **Comment.** The *American Recovery and Reinvestment Act of 2009* temporarily allows investors to exclude 75 percent of the gain from the sale of certain small business stock acquired and held for more than five years. There are proposals in Congress to make this temporary treatment permanent or expand it to a 100 percent exclusion.

Employment tax. When paying employees of your new business, you must withhold employment tax on their wages. The term "employment tax" is somewhat of a misnomer, as it actually includes Social Security and Medicare taxes, federal unemployment (FUTA) tax, and federal income tax withholding. The amount of federal income tax you withhold from an employee's paycheck is guided by information reported to you on the employee's Form W-4, *Employee's Withholding Allowance Certificate.* Social Security and Medicare taxes pay for benefits that workers and their families receive under the *Federal Insurance Contributions Act* (FICA) in terms of old-age, survivors, and disability insurance (OASDI), as well as hospital insurance. You, as the employer, must withhold these taxes from an employee's wages, as well as pay a matching amount.

> ***Caution.*** The IRS takes very seriously the responsibility of employers to pay federal payroll taxes. When times are tough, it may be tempting to miss a payroll tax deposit. The consequences can be severe. The IRS will not only recover any missed payments, it will sanction the business and its owner(s). In some cases, business owners have served jail time for egregious payroll tax evasion.

Self-employment tax. Although you may be your own boss, this does not shield you from the withholding requirement for employment tax. The law generally requires sole proprietorships and partners to withhold 12.4 percent of their related income for the OASDI and 2.9 percent of their income for the hospital insurance portions of the employment tax. This is required for those with net earnings from self-employment of $400 or more and for church employees with $100 or more.

> ***Comment.*** U.S. citizens working abroad and subject to the social security laws of a foreign country are generally exempt from the U.S. Social Security tax.

Excise tax. Finally, depending upon the nature of your business, you may be subject to the federal excise tax. This tax is basically a selective sales tax affecting manufacturers of certain products, companies using certain kinds of equipment and those receiving payment for certain services. A couple of examples include:

- Environmental taxes;
- Communications and air transportation taxes;
- Fuel taxes; and
- Retail sales tax on heavy trucks, trailers and tractors.

While most excise taxes are reported on Form 720, Quarterly Federal Excise Tax Return, there are several exceptions requiring additional forms. You should be sure to consult a tax professional about all the forms that may be necessary for your industry and your particular business model.

START-UP COSTS

Researching a new business and getting it off the ground are very costly endeavors. Generally, you cannot deduct these expenses but there are some exceptions. If the start-up expenses actually result in a running business, you can elect to amortize some costs (that is, deduct them in equal installments) over a period of at least 60 months, beginning with the month in which your business opens.

Qualified start-up expenses may include expenses associated with:

- Investigating the creation or acquisition of an active trade or business; and
- Creating an active trade or business.

- ***Planning Tip.*** Business owners can deduct up to $5,000 in start-up expenses in the year in which the business begins. This helps smaller businesses. The remainder of any start-up expenses, however, will have to be amortized.

Who owns the deduction? Another complication with start-up expenses is that they are amortizable only by the person who incurs them. If your new business is going to be a sole proprietorship, that won't be a problem. However, if the venture is to be a corporation, you can't personally deduct the costs you incur before incorporation. Those costs are part of your investment in the corporation's stock. You may want to contribute the funds to the corporation and let the corporation incur the expenses so that it can amortize them.

HOBBY LOSS RULES

When you start a business, you are not expecting to lose money. But, depending upon the type of business, you may have losses over the first few years of operation until things start humming. One danger in starting a business is that the IRS will invoke the "hobby loss" rule.

Deductions attributable to an activity not engaged in for profit, like a hobby, are limited to the amount of gross income derived from the activity. That means that income that you have from other sources can't be offset by your new business's losses. This can make or break your fledgling business. The best way to avoid these harsh "hobby-loss" rules is to start collecting proof simultaneously with starting your business.

Profit-motive. Most businesses start out small, so small that the IRS may question whether you are really serious about making money. In IRS-speak, an activity not engaged in for-profit is any activity that does not constitute a trade or business, or an activity that is not engaged in for the production or collection of income. What this really comes down to is a determination based on the presence or absence of a profit motive. You must have a good faith expectation of making a profit and you must be prepared to prove it. Otherwise, the IRS may determine that your business is a hobby and it will deny your claimed tax benefits.

No one says that you can't enjoy your business. And you can still have a qualifying profit motive for an activity that has little chance of making a profit. But in determining your intent for tax purposes, more weight is given to objective facts than to your subjective testimony of business intent.

"For-profit" factors. Courts often use nine factors to test if an activity is engaged in for-profit:

(1) Manner in which the taxpayer carries on the activity;
(2) Expertise or experience of the taxpayer's advisors;
(3) Time and effort the taxpayer expends on the activity;
(4) Expectation that the assets used in the activity may appreciate in value;
(5) Success of the taxpayer in carrying on other similar or dissimilar activities;
(6) Taxpayer's history of losses from the activity;
(7) Amount of occasional profits earned from the activity;
(8) Taxpayer's financial status; and
(9) Elements of personal pleasure or recreation derived from the activity.

An activity is presumed to be for-profit if it is profitable for three or more years in a period of five consecutive years. If the activity involves breeding, training, showing, or racing horses, the presumption applies if profits arise in two or more years within seven consecutive years. The IRS can rebut the presumption.

BUSINESS USE OF A HOME

Many individuals start their businesses out of their homes. Not only must you be aware of local zoning rules and state laws that govern home-based businesses, the IRS also takes an interest in home-based businesses. If you use part of your home for business purposes you may be able to take a home office deduction. However, you must meet both of the following requirements:

You use the business part of your home exclusively and regularly for conducting trade or business; and

The business part of your home is either the principal place of business, the place where you meet with customers in the normal course of business or a separate

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structure used in connection with the trade or business.

Exclusive use. Taxpayers exclusively use a portion of their home for business use if there is a room or separately identifiable space that is only used for business. Generally, no mixing between business and personal use is allowed. However, space used for storage of inventory or product samples or as a daycare facility are notable exceptions to this rule.

Principal place of business. A taxpayer's home is generally considered the principal place of business if it is used regularly and exclusively for the administrative or management activities of the business or you do not conduct these activities at any other location. If you fail to meet either of these requirements because you have several places of business, the IRS will look to the relative importance of the activities performed at each location, as well as the time you spend there.

Caution. Personal, family and living expenses are not deductible under any circumstances.

Planning Tip. Non-business profit-seeking endeavors such as investment activities do not qualify for a home office deduction.

CONCLUSION

Every factor that should be considered when selecting the proper entity for your venture, is beyond the scope of this booklet. However, you are now acquainted with some of the major considerations. This familiarity will help make the first meetings with your tax advisor more productive and your business more profitable.

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