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Employment Taxes & Business Ownership

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As Americans, we are subject to several distinct federal tax schemes. These include: income, capital gains, alternative minimum, gift, generation skipping transfer and estate taxes. Employers collect and remit Social Security and Medicare taxes (“employment taxes”). Self-employed taxpayers pay self-employment tax (“SE Tax”) which is equivalent to Social Security and Medicare taxes.

Employees are well aware that there are three items withheld from their paychecks and paid to the IRS. Those items are federal income tax, Social Security and Medicare taxes. The amount of your wages and the number of dependents you claimed on your W-4 determine the amount to be deducted from your gross earnings. Currently, Social Security tax is withheld only on the first \$90,000 of income and Medicare tax has no upper limit. The amount of Social Security tax withheld is 6.2% of your gross earnings and 1.45% of your gross earnings are withheld for Medicare taxes. The amounts withheld from your paycheck for Social Security and Medicare taxes are only half of the amounts owed. Your employer is required to pay the other half.

Interestingly, the law considers funds withheld from employee paychecks to be held in trust by the employer for the benefit of the federal government. The designation of “trustee” over the funds comes with personal liability for any individual who is ultimately responsible for the collection and remittance of employee funds withheld. This means that if an employer fails to remit \$20,000 withheld from employees, there is a 100% penalty and the amount due balloons to \$40,000 plus interest. Due to personal liability under the law, the IRS can recover the \$40,000 from the person ultimately responsible for the remittance, even if that individual did not personally misappropriate the funds. The treatment of funds withheld from employees is different than the employer’s portion of employment taxes. The employer’s portion is subject to the 100% penalty, however, there is no personal liability for failure to remit since it is not considered to be held in trust.

When you are self-employed, you are responsible for both halves of the Social Security tax and Medicare tax due on your earnings under the Self-Employment Contributions Act of 1954 (“SECA”). Every self-employed person is responsible for what amounts to both the employee’s 7.65% as well as the employer’s 7.65%. Therefore, the total SE tax is 15.3% of your business profit up to \$90,000. Once this threshold has been reached, only the Medicare rate of 2.9% applies. SE tax is in addition to the amount of income tax that you have to pay. Self-employed taxpayers may deduct one-half (1/2) of the self-employment tax due as an adjustment in arriving at Adjusted Gross Income on page one of their tax returns.

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IRS Will Use Private Collection Agencies, Starting 2006





On October 17, 2005, the Internal Revenue Service submitted three Requests for Quotes to retain private debt collection agencies to collect unpaid taxes. The authority to use private debt collection agencies was given under the American Jobs Creation Act, signed into law by President Bush on October 22, 2004. The intent is for the IRS to refer collection cases where the taxpayers know the debt exists, and where the taxpayer has not made efforts to pay the amounts owed. The IRS believes that in many cases, the taxpayer has the ability to pay and will do so if contacted by a private debt collection agency. According to the IRS website (www.irs.gov), "Private collection agencies will be held to the same standards of service and protection of taxpayer rights as the IRS requires of its own employees."

"Many IRS Communications are time sensitive and carry heavy interest and penalties..."



Notes to Self—Address Changes and the IRS

Notify the IRS when you have changed or are changing your permanent address (IRS Tax Tip 2006-15). There are several ways you can notify them:

-  If you move around tax time, you can correct the mailing label the IRS sends to you, or you can reflect your new address on your tax return when it is filed.
-  If you move after you have filed your tax return, or any time outside of tax season, you can go to www.irs.gov, print and file Form 8822, Change of Address. This form is easy to understand and takes only a few minutes to complete.
-  You can, at any time, call the Denver IRS office at (303) 466-1675, or the national customer service hotline at (800) 829-1040, and verbally notify them of your change of address.
-  You can write a letter to the IRS. Specifically, the IRS website states: "In order to process an address change, the IRS will need your full name, old and new addresses, and your social security number or employer identification number, and signatures. If you filed a joint return, you should provide the same information for both spouses. If you filed a joint return and have since established separate residences, you each should notify the IRS of your new addresses."

Why do you want to keep the IRS apprised of your address? The IRS is required to communicate with you at your last known address, and many of the IRS communications are time sensitive and carry heavy interest and penalties if you fail to respond.

Tax Increase Prevention and Reconciliation Act ("TIPRA") of 2005 is Signed Into Law by President Bush

TIPRA provides for changes to several areas of the law. Most notable are the extension of the 15% maximum capital gains and dividends rate established by the Jobs and Growth Tax Relief Reconciliation Act of 2003, an increase in the age of children subject to the "kiddie tax" from 14 years old to 18 years old, and an elimination of the \$100,000 adjusted gross income limit to convert a traditional IRA to a Roth IRA. In addition to extending for one year the \$100,000 deduction under § 179 for depreciable assets to small businesses, TIPRA has expanded Alternative Minimum Tax ("AMT") exemption amounts as well as again allows certain non-refundable credits to offset the AMT liability.

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Table 1 is an illustration of the effect of SE Tax on income. It presumes the taxpayers filed Form 1040 for 2005, as Married Filing Joint. The amount of income on the return kept the taxpayers in the lowest income tax bracket (10%).

Table 1		No SE Income	Tax Attributed To SE Income
Business Income (Schedule C)			
	Gross Receipts	\$ 20,000.00	\$ -
	Business Deductions	\$ (10,800.00)	\$ -
	Net Profit	\$ 9,200.00	\$ -
	SE Tax %	15.30%	15.30%
	SE Tax On Profit	\$ 1,407.60	\$ -
Form 1040			
Income			
Line 7	Wages (W-2)	\$ 22,500.00	\$ 22,500.00
Line 12	Business Income	\$ 9,200.00	\$ -
Line 22	Total Income	\$ 31,700.00	\$ 22,500.00
Adjustments			
Line 27	1/2 SE Tax (Above)	\$ (703.80)	\$ -
Line 37	AGI	\$ 30,996.20	\$ 22,500.00
Line 40	Standard Deduction	\$ (10,000.00)	\$ (10,000.00)
Line 42	Personal Exemptions	\$ (6,400.00)	\$ (6,400.00)
Line 43	Taxable Income	\$ 14,596.20	\$ 6,100.00
Line 44	Income Tax %	10.00%	10.00%
	Income Tax	\$ 1,459.62	\$ 610.00
	Total Tax	\$ 2,867.22	\$ 610.00
			\$ 2,257.22

As illustrated in Table 1, the tax effect in terms of a percentage of tax (income and SE) paid on self-employment income, is equal to 24.53% (\$2,257.22 difference / \$9,200 business profit).

Choice of Entity

Self-employment tax is often overlooked in new businesses. We have worked with educated professionals, as well as people with small home businesses, that have been surprised at tax time because they failed to plan for SE tax. Planning for SE tax should begin before you choose what type of entity you will set up to run your business.

The most common forms of business entity structures are sole proprietorship, partnership, limited liability company and S corporation. Each of these entities present the business owners with significant advantages and disadvantages with regard to civil liability protection. Although a significant consideration in choosing an entity form, liability protection is beyond the scope of this article, and for that reason is not discussed.

Sole-Proprietorship. Generally speaking, a sole-proprietorship is created when an individual undertakes a business activity without creating a separate legal entity. When the individual files an individual income tax return, the business activity is reported on a Schedule C (“Profit or Loss from Business”) and attached to the Form 1040 (“U.S. Individual Income Tax Return”). The sole-proprietor must pay SE Tax on the profit from the business subject to the Social Security limitation.

Partnership. If you have two or more persons involved in a business, a general partnership may be formed under state law. In this scenario, each of the partners are liable for SE Tax on their allocated shares of the net business profit in much the same way as a sole-proprietor. Some partnerships can be set up as limited partnerships. In a limited partnership, the limited

“...the sole-proprietor must pay SE Tax on the profit from the business...”

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partner possibly *may not* be subject to SE Tax on the allocated share of profit. This depends upon the details of the limited partner's investment and involvement in the business.

Limited Liability Company. Limited liability companies are business entities created under state law. Federal tax law does not recognize the existence of a limited liability company ("LLC") as a separate legal entity from the members. For that reason, a single-member LLC reports its business income and expenses on a Schedule C attached to a Form 1040, just as a sole-proprietor reports earnings. If an LLC has two or more members, it reports the business income in the same way as a partnership, by filing a partnership tax return. In both of these cases, the LLC members report and pay SE Tax on the profit from the business.

An LLC may also be structured so that some of the members would be considered "limited partners," (members with restricted rights and involvement). This limited partner treatment includes the ability to avoid paying SE Tax on the limited partner's distributive share of net profit. Typically, this structure works best for businesses that have marginal cash flow and appreciating assets in the business name. Under most circumstances members are able to remove appreciated assets without triggering capital gains tax.

S Corporation. An S corporation is created by setting up a regular corporation and then filing a Form 2553 ("Election by a Small Business Corporation"). This designation allows the corporate profits to be taxed at the shareholder level. The major advantage of the S corporation is that the shareholders are not required to pay SE Tax on dividend distributions from the company. This is an immediate tax savings of 15.3% on dividend distributions through choice of entity. This savings is illustrated in Table 2.

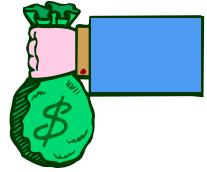
Table 2	No Dividend Distributions	With Dividend Distributions	Tax Savings
Business Income (Schedule C)			
Gross Receipts	\$ 100,000.00	\$ 100,000.00	
Business Deductions	\$ (25,000.00)	\$ (25,000.00)	
Net Profit (On K-1)	\$ 75,000.00	\$ 75,000.00	
Dividend Distributions	\$ -	\$ (30,000.00)	
Income Subj. to SE Tax	\$ 75,000.00	\$ 45,000.00	
SE Tax %	15.30%	15.30%	
SE Tax On Profit	\$ 11,475.00	\$ 6,885.00	\$ 4,590.00
Form 1040			
Income*			
Line 7 Wages (W-2)	\$ -	\$ -	
Line 17 K-1 Income (S-Corp)	\$ 75,000.00	\$ 75,000.00	
Line 22 Total Income	\$ 75,000.00	\$ 75,000.00	
Adjustments			
Line 27 1/2 SE Tax (Above)	\$ (5,737.50)	\$ (3,442.50)	
Line 37 AGI	\$ 69,262.50	\$ 71,557.50	
Line 40 Standard Deduction	\$ (10,000.00)	\$ (10,000.00)	
Line 42 Personal Exemptions	\$ (6,400.00)	\$ (6,400.00)	
Line 43 Taxable Income	\$ 52,862.50	\$ 55,157.50	
Line 44 Total Income Tax			
15% Bracket	\$7,199	\$7,544	(\$344.25)
Income Tax	\$7,199	\$7,544	
Total Tax	\$ 18,674.38	\$ 14,428.63	\$ 4,245.75

*Table assumes a married couple filing jointly

One significant disadvantage that should be carefully contemplated is the "reasonable compensation" issue for shareholder-employees. The IRS has successfully argued in court that when no

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Charitable Planning Corner



If you are charitably inclined and own highly appreciated capital assets, you may want to consider creating a charitable remainder trust ("CRT"). The following is an example of how a CRT might be structured:

- The donor creates the trust and funds it with the desired assets (such as highly appreciated stock, for example);
- The donor receives an immediate income tax charitable deduction based on the present value of that portion of the contributed assets projected to pass to charity at the end of the trust term;
- The CRT pays an income stream, typically calculated either as a fixed annuity or as a fixed percentage of the value of the CRT assets, to the donor no less often than annually;
- Taxable income realized by the CRT on its assets, including capital gains on assets sold during the trust term, are allocated between the donor's retained income interest and charity's remainder interest;
- The CRT receives a charitable deduction for income attributable to the charity's remainder interest;
- Although the donor must pay income taxes on income attributable to the donor's deemed portion of the CRT assets, this tax liability is deferred until the tax year when the corresponding income distributions are made to the donor.

Various types of assets can be contributed to a CRT, even a closely-held business interest. In the case of land or business interests, however, it is important that the interests be transferred to the CRT well in advance of any negotiations to sell the interest.

Who's Who at Mallgren & Ferrell, P.C.

Paul Chmielewski, J.D., LL.M.



Paul Chmielewski grew up in Florida. He received an undergraduate degree in Finance from Florida State University in 1991. After graduation, Paul worked for the Federal Reserve Bank in Dallas, Texas. Eventually, he decided to further his education and returned to the Florida State University College of Law where he obtained his law degree in 1995. He then worked as a tax attorney for the Florida Department of Revenue. In 1997, Mr. Chmielewski was accepted to the Master of Laws In Taxation Program at the University of Florida College of Law, where he received his LL.M. in 1998. Thereafter, he formed his own law firm in Florida.

After moving to Colorado in 2000, Mr. Chmielewski was employed as the Manager for the Investment Management and Trust Department of Wells Fargo in Northern Colorado. In this capacity, he implemented tax and estate plans for his clients as well as assisted in the probate of estates and the administration of trusts. In 2004, Paul resumed the private practice of law with Stinar & Zendejas, LLC, in Colorado Springs. He joined Mallgren & Ferrell, P.C., in May, 2006. Mr. Chmielewski concentrates his practice in the areas of tax and estate planning, entity selection, asset protection, general business law, real estate, probate, Medicaid, and trademarks.

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salary or an understated salary exists, distributions should be re-characterized as wages. The result of re-characterization is an underpayment of employment taxes with a 100% penalty and interest. Thus, shareholders who work for their corporations should carefully document a salary that reflects reasonable compensation for the services provided to the S corporation to minimize this issue under audit.

The Treasury Inspector General for Tax Administration issued a report (Ref. No. 2002-30-125, Audit # 200130027) where 84 S corporations with officer compensation of less than \$10,000 and ordinary income in excess of \$50,000 were randomly selected for audit. The examinations revealed that the average W-2 wages paid to shareholder-employees was \$5,300 and the average dividend distribution (not subject to SE Tax) was \$349,323. To further study this non-compliance issue, the IRS has announced (News Release No. IR-2005-76) that it will randomly select 5,000 S corporation tax returns for 2003 and 2004 for examination, beginning in late 2005. In short, S corporations will experience an increased rate of audit over the next few years while the IRS gathers compliance data.

SE Tax is a significant expense that is often overlooked by the new entrepreneur. The effects of an employment tax or SE Tax error can be financially devastating and create personal liability for the owner(s) of a business. If you are considering starting a business please contact us to discuss what form of entity best suits your goals and needs.