CHAPTER ONE

Business Entity

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The entity you choose for your business determines several things about the way you process payroll. There are four standard entities for businesses, and we will examine each one of them and their unique attributes in relation to payroll. If you have already chosen your entity type, then you can read only that section. The remaining sections may become useful if you change your entity type.

This is by no means a complete analysis of each type of entity. If you have not chosen the entity type for your business I suggest that you consult with a certified public accountant (CPA) who specializes in small business as well as an attorney who also specializes in small business to discuss not only the cost but also the legal, tax, accounting, and liability aspects of all types of entities in relationship to your particular needs and circumstances.

CORPORATION

Corporations are creatures of the state; that is, you must set up a corporation through a state government. A corporation is a business entity that is owned by a shareholder(s), people who own shares of stock. The shareholder(s) elect a board of directors to oversee the corporation's actions and hire executives to run the day-to-day operation. In many cases in small business corporations the shareholders, the board of directors, and the officers are the same people. The corporation is liable for the actions and finances of the business, but the shareholders are not.

There are two standard classifications of corporations: Subchapter C (C-Corp) corporations, which pay taxes as an entity, and Subchapter S corporations (S-Corp), which are pass-through entities. The S-Corp pays no federal income taxes. The gains and/or losses are "passed through" to the shareholders. Form 1120S, which is the federal corporation tax return for S-Corps, will have a form K1 for each shareholder. The K1 will be used to report the corporation's earnings/losses on the shareholders' personal tax returns. Many small business owners use S-Corps because they can reduce employment taxes, including Social Security and Medicare taxes, for the shareholders.

For employment tax purposes, an S-Corp shareholder who works in the corporation (other than minor services) is an employee. He remains a shareholder as well. This allows for savings on Social Security and Medicare taxes because such taxes need not be paid on distributions of earnings and profits from the corporation to its shareholders. Thus, to the extent they pay themselves shareholder distributions instead of employee salaries, S-Corp shareholders/employees can save money on payroll taxes. The downside is that it may also reduce their Social Security benefits when (if) they are eligible to draw them.

It's up to the people who run an S-Corp, its officers and directors, to decide how much salary to pay the corporation's employees. When you are employed by an S corporation that you own (alone or with others), you may be the one making this decision. In fact, 70% of all S corporations are owned by just one person, so the owner has complete discretion to decide on his or her salary.

However, the Internal Revenue Service (IRS) insists that the employee/shareholder must be paid reasonable compensation, that employment tax is withheld and paid (see Chapter 5) for the work the employee/shareholder does. Only after reasonable compensation is paid can the corporation pay distributions to the employee/shareholder. Distributions are not subject to employment tax but will be reported as income on the employee's/shareholder's personal tax return.

A lot of S-Corp owners go too far and pay distributions pay to avoid any employment tax at all on what the employee/shareholder takes out of the corporation as compensation.

J. Russell George, Inspector General for Tax Administration, testified to the Senate Committee on Finance that "In tax year 2000, the owners of 36,000 single-shareholder S corporations received no salaries at all from their corporations, even though the operating profits of each of these corporations exceeded $100,000. This resulted in employment taxes not being paid on $13.2 billion in profits."

If the IRS feels that an employee/shareholder has taken too little in wages and too much in distributions, the IRS will "recharacterize" the distributions as wages and require payment of the employment taxes, plus penalties that can equal 100% of the taxes then due.

A CPA who incorporated his accounting practice as an S-Corp took a salary of $24,000 and distributions of $220,000. The IRS said that his salary was not reasonable compensation and that $175,000 of the distributions should be treated as wages subject to employment taxes, and assessed almost $50,000 of taxes plus penalties. The court upheld the IRS's power to recharacterize the distributions as wages subject to employment tax. (*Watson v. United States* (DC IA 05/27/2010), 105 AFTR 2d)

In my years of tax practice, my firm used a rule of thumb that distributions should never exceed wages for an employee/shareholder. We never had a problem with "reasonable compensation" for any audit.

PARTNERSHIP

The standard general partnership is an entity where two or more people combine money, assets, skills, and other resources. The partners then share the profits and/or losses in accordance with the agreement between the partners. If

there is no agreement, then the assumption is that the partners share equally. General partners as opposed to limited partners are personally responsible for all the liabilities that the partnership incurs.

A partnership pays no income tax directly. The gains and/or losses are "passed through" to the partners. Form 1065, which is the federal partnership tax return, will have a form K1 for each partner. The K1 will be used to report the partnership earnings/losses on the shareholders personal tax returns.

General partners are never employees for payroll purposes. The partnership may have employees that the partnership will have on payroll and withhold as well as pay taxes on. The partners will pay self-employment tax on the profits reported by the partnership on their personal tax returns.

There are other forms of partnerships where there are limited partners who share based on the partnership agreement in the profits and/or losses but are not liable for the liabilities that the partnership may incur. They have "limited" liability.

SOLE PROPRIETORSHIP

The sole proprietorship is the simplest entity in which to operate a business. A sole proprietorship is not a separate legal entity. It just denotes an individual who owns and operates a business. A sole proprietor is personally responsible for all of the liabilities of the business they operate.

The sole proprietorship is a popular entity in that it is simple, cheap, and easy to setup. An entrepreneur can simply go into business, in many cases without any planning other than doing business.

Since a sole proprietorship is only its owner, taxation is simple. The sole proprietor reports all of their income and expenses on a Schedule C of their Form 1040. Self-employment taxes are calculated on any gain and are equivalent to employment taxes that they would pay, if on payroll.

A sole proprietor is never on payroll in their own business. No employment taxes are withheld from distributions the sole proprietor takes. The sole proprietor pays self-employment tax, which is Social Security and Medicare taxes, on their individual Form 1040 every year.

LIMITED LIABILITY COMPANY (LLC)

An LLC is a hybrid entity. Like a corporation, it is a creature of the state – you must set up an LLC through a state government office. If you do nothing, and are the only member of the LLC, the LLC is treated as a disregarded entity for federal tax purposes. If there is one member (owner) it is treated as a sole proprietor for tax and payroll purposes; see the Sole Proprietorship section. If there is more than one member it is treated as a partnership for tax and payroll purposes; see the Partnership section.

An LLC, however, can elect to be treated as a S-Corp or a S-corporation for tax and payroll purposes, discussed earlier in this chapter. The election is made on IRS Form 8832 – Entity Classification Election.

The LLC has some advantages and disadvantages over the S-Corp structure. The advantages include:

- Creditor protection.
- Flexibility in organizational control.
- Fewer documents and fewer formalities.
- Built-in transfer restrictions.
- Disproportionate distributions.

The disadvantages include:

- Additional transaction costs to create.
- Built-in transfer restrictions.

Your legal and financial advisors can walk you through all of the complexities and help you select the best entity for your needs.