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

2021-2022 Edition

(last updated late summer 2021, sorry we are late)

by Jason Watson, CPA
Senior Partner

and

WCG Inc.
Certified Public Accountants
Business Consultants

Introduction

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

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

Time marched on, and more information was added to the first edition such as expanded retirement planning concerns, health care options after the Affordable Care Act and business valuations including exit strategies. Boom, we now had our second edition at over 100 pages. At that point it was suggested by some clients and colleagues to convert the PDF into an eBook as well as paperback. So here we are on our ninth edition which is now called the **2021-2022 edition.**

1. Entity Structures, Custom Multi-Entity Arrangements, Tax Efficiency
2. Deal Structures, Operating Agreements
3. The Fallacy of Nevada Corps
4. State Taxes, Nexus, FBA Problems, and Liability
5. S Corp Benefits, Tax Savings
6. Avoiding Self-Employment Taxes
7. The 185 Reasons an S Corp or LLC Might Stink
8. Forming and Operating an S Corp
9. Late S Corp Election
10. Determining Reasonable S Corp Shareholder Salary
11. Section 199A Business Tax Deduction
12. Tax Deductions, Fringe Benefits, Kids on Payroll and Cars
13. Properly Paying for Health Insurance
14. Small Business Retirement Planning with Your Small Business

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

Here we go…

Shortie Version

This PDF is our teaser of our 430-page monstrosity of a manuscript. We want to show you some of the basic concepts you need to consider when operating an LLC with and without an S Corp election. Throughout this PDF we will bring up additional concerns and solutions including tax court cases that are only available in our purchased print copy from Amazon or downloadable electronic PDF copy.

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

Please visit **www.wcginc.com/book** for more information on purchasing our book in PDF, Kindle and Amazon formats. You can also view the entire contents of our book within our KnowledgeBase at **www.wcginc.com/kb**.

About the Author

Jason Watson, CPA
Senior Partner

Jason Watson is a Senior Partner for WCG Inc., a progressive tax, accounting and consultation firm located in Colorado Springs and Denver.

Jason has owned two small businesses in the past and holds both a Bachelor's and Master's in Business Administration from the University of Wisconsin – Madison.

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

Ask a question and have a dry erase board handy, and you'll see the true passion of a person who not only wants to educate but also wants to see small business owners thrive. While this book on LLCs and S Corporations can be labeled as shameless self-promotion, it truly came from Jason's heart to help small business owners everywhere. And No! He doesn't unnecessarily complicate things; while complication is great cocktail party fodder, most often it is the illusion of precision.

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

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

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

Progressive Updates

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

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

Currently this book is our **2021-2022 Edition** and includes the pertinent and permanent changes to our tax code which came about during the COVID nuttiness. We cannot wait to get back to the days of giving sound business and tax consultation from the comforts of our beach chairs sans laptop. Today with the speed and volume of the changes, we are in a continuous mode of education.

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

wcginc.com/book

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

wcginc.com/blog

> **Note:** As much as we attempt to update our book periodically throughout the year, our blog posts allow us to provide more frequent updates. We encourage you to visit. We are a tax and consultation firm first, and a book-writing firm second; we kindly ask for some patience.

Disclaimer

The information materials and opinions contained on the WCG website and in this book are for general information purposes only, are not intended to constitute legal or other professional advice and should not be relied on or treated as a substitute for specific advice relevant to particular circumstances.

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Please contact us for additional information or seek the advice of other professionals at it pertains to your unique situation.

Shameless Self-Promotion

This book originally was a collection of Knowledge Base articles that were written to help small business owners. And unintended benefit was helping our own small business, WCG, grow and thrive through educational marketing.

Since you probably paid some money for the privilege of being bombarded with shameless self-promotion, we hope you take our comments with a grain of salt (and perhaps some tequila and lime to go with the salt). Our primary focus is to-

- educate you,
- minimize your tax consequence,
- maximize your wealth, and
- keep you out of trouble.

If you read this, arm yourself with knowledge and then ask pointed questions to your current accountant and other professionals, we are completely happy. We have done our job with this book.

Having said that, if you want WCG's assistance in whatever capacity necessary, from quick second opinions to full-time service, we are also happy to provide that. Want more information? The Epilogue in the back of this book has all kinds.

Conversational Tone

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

Testimonials

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

Justin S, CPA

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

Alex J.

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

Britt S., Esq.

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

Tyrone G. says

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

Michael K.

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

Sean D.

My search re: pros & cons of how to own/expense a vehicle used for business purposes dropped me into your KB. Almost a black hole! Hours later, my head throbbing & stuffed with as much as it could absorb in one session--vehicles, entity structures, state tax laws, retirement accounts, and more--I figured maybe I should crawl out & get in touch with the people responsible for assembling all that!

Michael B.

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

Anne M.

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

AJ B.

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

Brett B.

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

Scott G.

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

Josh H.

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

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

Table of Contents

There is a lot of information here. The shortie version is just under 70 pages while our paperback and full PDF versions are over 430 pages of pure reading pleasure.

To see our published book's expanded Table of Contents, please visit-

wcginc.com/toc

Quick Reference 2021

Single 2021

From	To	Rate	Marginal Tax	Total Tax
0	9,950	10%	995	995
9,951	40,525	12%	3,669	4,664
40,526	86,375	22%	10,087	14,751
86,376	164,925	24%	18,852	33,603
164,926*	209,425	32%	14,240	47,843
209,426	523,600	35%	109,961	157,804
523,601	forever	37%		

Married Filing Jointly 2021

From	To	Rate	Marginal Tax	Total Tax
0	19,900	10%	1,990	1,990
19,901	81,050	12%	7,338	9,328
81,051	172,750	22%	20,174	29,502
172,751	329,850	24%	37,704	67,206
329,851*	418,850	32%	28,480	95,686
418,851	628,300	35%	73,308	168,994
628,301	forever	37%		

* Start of Section 199A qualified business income phaseout for small business owners.

Standard Deduction Single	12,550
Standard Deduction Married Filing Joint	25,100
Social Security Wage Limit	142,800
IRA Contribution Limit	6,000 + 1,000 catch up
Roth Income Phaseout Single	125,000
Roth Income Phaseout Married Filing Joint	198,000
401k Employee	19,500 + 6,000 catch up
401k Employer	38,500
Max 401k Total	58,000

Quick Reference 2022 (projected)

Single 2022 (projected)

From	To	Rate	Marginal Tax	Total Tax
0	10,275	10%	1,028	1,028
10,276	41,775	12%	3,780	4,808
41,776	89,075	22%	10,406	15,214
89,076	170,050	24%	19,434	34,648
170,051	215,950	32%	14,688	49,336
215,951	539,900	35%	113,383	162,718
539,901	forever	37%		

Married Filing Jointly 2022 (projected)

From	To	Rate	Marginal Tax	Total Tax
0	20,550	10%	2,055	2,055
20,551	83,550	12%	7,560	9,615
83,551	178,150	22%	20,812	30,427
178,151	340,100	24%	38,868	69,295
340,101	431,900	32%	29,376	98,671
431,901	647,850	35%	75,583	174,254
647,851	forever	37%		

* Start of Section 199A qualified business income phaseout for small business owners.

Standard Deduction Single	12,950
Standard Deduction Married Filing Joint	25,900
Social Security Wage Limit	149,800
IRA Contribution Limit	6,000 + 1,000 catch up
Roth Income Phaseout Single	127,000
Roth Income Phaseout Married Filing Joint	200,000
401k Employee	20,000 + 6,000 catch up
401k Employer	39,000
Max 401k Total	59,000

Chapter 1
Business Entities and LLCs

Basic Business Entities

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

- ▲ Limited Liability Company (LLC), the crowd favorite
- ▲ Limited Liability Partnership (LLP) or General Partnership (GP), the legacy dinosaur
- ▲ C Corporation (for profit)

There is an additional entity subtype with the "Professional" prefix. Some states require certain professionals, such as doctors, attorneys, accountants and engineers, to be a Professional LLC (the PLLC) or a Professional Corporation (the PC). Since you don't see too many LLPs these days, you don't see too many PLLPs either.

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

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

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

S Corporations

This book is mostly about S corporations so we saved the best for last. The benefits include a low audit rate of 0.4% as compared to perhaps 3-5%, yet the big… like elephant big… benefit is the reduction of self-employment taxes. Read that again. There is very little difference between a garden-variety LLC and an LLC with an S corporation election from an income tax perspective; the savings of an S Corp is from the reduction of self-employment taxes which comprise of Social Security and Medicare.

Recall that Social Security taxes stop at $142,800 (for the 2021 tax year) but Medicare continues into perpetuity. Don't laugh! That 3.8% Medicare tax times a zillion dollars is a lot of money.

> **Spoiler alert:** At $2M in net income, your S Corp tax savings is still above $60,000 even with a $400,000 salary… all because of Medicare taxes.

Other payroll taxes such as Unemployment, State Disability Insurance (SDA), etc. actually increase by electing S Corp taxation, but they are minor compared to the reduction of Social Security and Medicare (self-employment) taxes.

As mentioned earlier, S corporations are pass-through entities and therefore do not pay Federal income taxes directly. However, various states might have different taxes such as a business or franchise tax. Additionally, the shareholders only pay Social Security and Medicare taxes on their salaries, yet do not pay these taxes on the net income after expenses (and shareholder salaries) from an S Corp.

Therefore, you would want a tiny salary and a large distribution from the net income, right? Well, sure, but there is a small little IRS rule called “reasonable shareholder salaries” that we spend an entire chapter on. We’ll also show in a later chapter that S corporations have various sweet spots in terms of income versus payroll tax savings from $30,000 to $2 million, between sole proprietorships, LLCs, partnerships and entities taxed as an S corporation.

S corporations are never formed contrary to popular belief. They are spawned from an entity such as a limited liability company, partnership or C corporation that elects to be taxed as an S corporation. After the election is made on Form 2553, you are treated as an S corporation for taxation purposes only. The underlying entity does not change! A lot of business owners rightfully say, “I have an LLC taxed as an S Corp” but they also say, “I have an S Corp.” Technically the former is more accurate, but both get the point across.

Oddly enough, the equity section in your balance sheet should then have a Capital Stock account and an Additional Paid-In Capital account. Again, while your underlying entity might be an LLC without stock (LLCs have interest not shares), it is being taxed as an S corporation so the balance sheet and tax return should look like a corporation. Yeah, it seems weird to have equity accounts that are for corporations while the underlying entity is a limited liability company. However, this coincides with representing the entity as a corporation for tax purposes, yet the underlying governance might be different. This is the whole S Corp vs LLC conundrum.

We can help with the journal entry to populate these accounts correctly so your equity section resembles that of a corporation. This also helps the tracking of basis in your S corporation. A later chapter has some examples.

To reiterate, you are in a weird limbo with electing to be taxed as an S corporation. You need to walk and talk like a corporation for taxes, but the underlying entity and what the Secretary of State will have on file is going to be an LLC, partnership or C corporation. More on the election, and the behind the scenes stuff in a later chapter plus our thoughts on corporate governance such as Meetings and Minutes.

Again, this book is mostly about S Corps. The last couple of pages were a slamma-jamma description of the basics.

Section 199A Pass-Pass Thru Tax Deduction

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

Defining Terms

Pass-thru entities and structures include-

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

Specified Service Trade or Business is defined as-

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

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

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

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

Income Limits

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

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

- ▲ Single is $157,500 completely phased out by $207,500 (adjusted for inflation).

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

Calculating the Qualified Business Income Deduction

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

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

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

(B) the greater of-

> (i) 50 percent of the W-2 wages with respect to the qualified trade or business, or
>
> (ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

There are some devils in the details of course. The best way is to show some examples of Fred, Wilma, Barney and Mr. Slate. Please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

C Corporations Remain Bad for Most Owners

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

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

wcginc.com/8376

Conclusion

There are several other entity considerations-

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

▲ The Nevada fallacy of having an LLC domiciled there.

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

Chapter 2
Customized Entity Structures

Other Formation Considerations

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

Holding Company and Operating Company

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

This allows for some excellent ownership separation. For example, if you and your father-in-law own the building, he doesn't have a stake in your accounting firm, and vise-versa (didn't we just scare you with this idea, and now we are bringing it up as an example… we're evil). You might also want to make one of your key employees a business partner in your operations, but he or she should not have a stake in the building. Chinese Wall.

Please keep in mind that rental properties including self-rentals are mostly wealth-building strategies and not tax reduction strategies. Yes, depreciation and perhaps even cost segregation can yield some accelerated tax savings, but even that is primarily a wealth-building move.

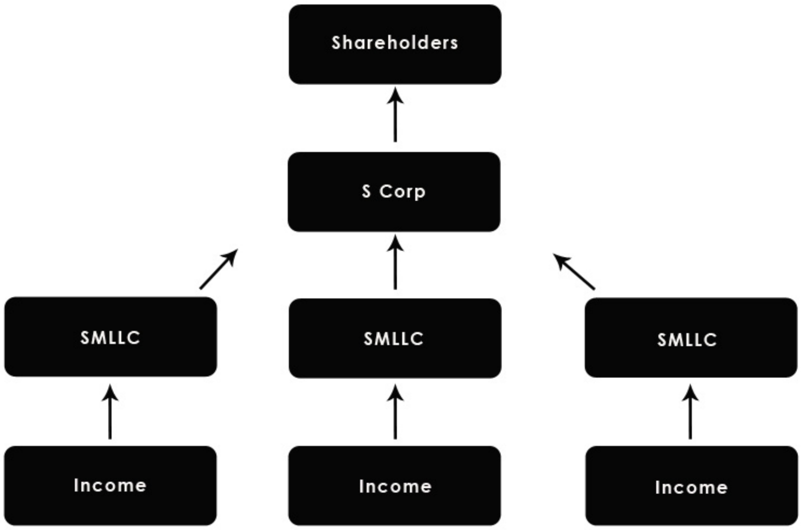
The holding company and operating company arrangement can also reduce self-employment taxes or payroll taxes since this conduit changes the color of money. Huh? As discussed in an earlier chapter, your accounting firm's income is earned income, taxed both at the self-employment tax level (or payroll tax level) and the income tax level. However, you reduce this earned income by the amount of rental expense and that subsequent rental income on the other end is considered passive and only taxed at the income tax level (technically non-passive since it is a self-rental under Section 469, but let's not muddy the waters).

Beauty! You must have a lease and the rent must be market rates; usually a rent appraisal from an independent appraiser will suffice. The rent appraisal is also a good idea in the expansion of ownership. For example, Jason and Tina Watson own the building that WCG leases. As WCG expands its ownership to other partners, the rent payment to Jason and Tina needs to be above reproach; ergo, a rent appraisal. This reduces office politics and hurt feelings.

Parent-Child Arrangement (Income Flows Up)

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

The holding LLC would then make the S Corp election, and all the LLC income would flow into the S corporation as wholly owned subsidiaries. Remember, single-member LLCs are disregarded entities and are reported on the sole member's tax return. In this case the sole member is a sexy and tax-efficient S corporation. Sexy and tax-efficient… probably went to far with that one.



You might be saying, "Yeah, but, why not just have two S Corps?" You can, and in some situations you must (like an attorney and doctor as a married couple). The downside is the additional costs in tax return preparation and payroll processing. Conversely in the arrangement above, all the payroll for the shareholders is handled out of a single S Corp. Each single-member LLC (SMLLC) is a disregarded entity and therefore only a singular tax return is required at the S corporation level.

We rattled that off fairly quickly. Let's break it down with some specifics.. An S corporation tax return preparation fee is generally $1,000 to $1,200, and the cost of processing shareholder payroll is about $800 annually. Let's call this $2,000. By having two S Corps, you added $2,000 to your overall legal and professional services budget perhaps unnecessarily.

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

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

Also, if you want to take a distribution out of one of the subsidiaries, truly the S corporation would receive the distribution first, and then make another distribution to you, the shareholder. A double hop, and what is referred to as a trampoline in the drug trafficking business (fire up Narcos or Snowfall… great shows!). In other words, transfer money from the SMLLC's checking account to the S corporation's checking account to your checking account.

Another inconvenience is that each entity might be slapped with high annual fees from the state in the form of filing fees, or franchise taxes (like California) or both. For example, if this arrangement was in California, there would be a minimum of $800 x 3 in franchise taxes. Nasty! The benefits might still outweigh the costs but be careful.

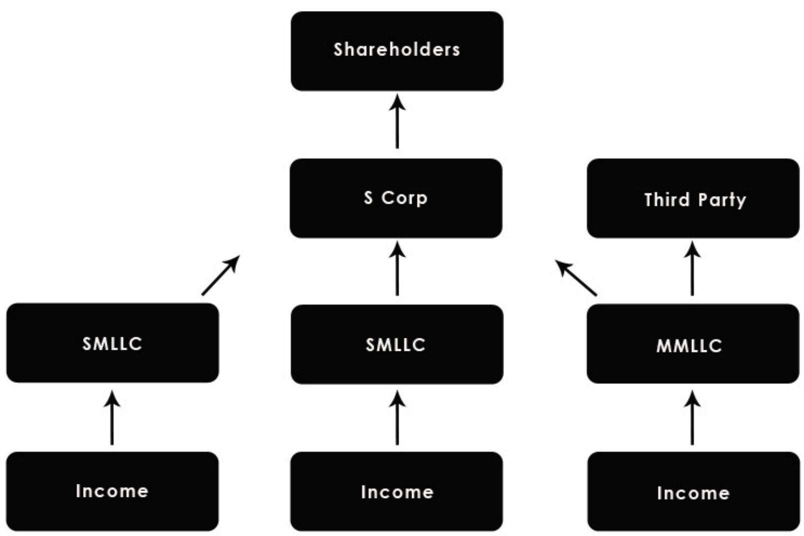
This is a common strategy between husband and wife teams where the business entities are completely different, yet the household wants to enjoy the benefits of an S corporation.

Side Bar: We must analyze limitations in each of the subsidiary LLCs. For example, you cannot have an LLC that would be deemed a hobby tucked under the "protection" of an S Corp. Each LLC must have a profit motive. There might be other limitations at the LLC level, but the hobby loss limitation is a wonderful illustrative point.

Want another? Section 199A Qualified Business Income Deduction has limitations for Specified Service Trades or Businesses (SSTB). Therefore, if one SMLLC is deemed an SSTB and another SMLLC is not, there will be some extra math calculations in determining the Section 199A deduction.

Expanding Ownership

Expanding ownership will be discussed in more detail in a later chapter, but we quickly wanted to add some more reasons for the compartmentalization of your multiple business units into LLCs. Let's say you have a home inspection business and a home remodel business. Similar to the holding company / operating company arrangement, you might want to expand ownership in the remodeling business unit and not the inspection business unit.



For example, you add a partner to the home remodeling LLC and it suddenly becomes a multi-member LLC (the MMLLC above). This entity would have two members; your S corporation and the other guy. The other guy could be an S corporation as well. In this schematic you would need two business entity tax returns; a Form 1120S for the wholly owned S Corp and a Form 1065 for the MMLLC (Partnership Tax Return). Your S Corp would receive a K-1 from the MMLLC.

A Twist

You could also have the SMLLCs remain owned by each spouse individually. The SMLLCs could then pay the S Corp for services rendered, like a management fee, driving the SMLLC income down to a nominal amount, like $500. Why?

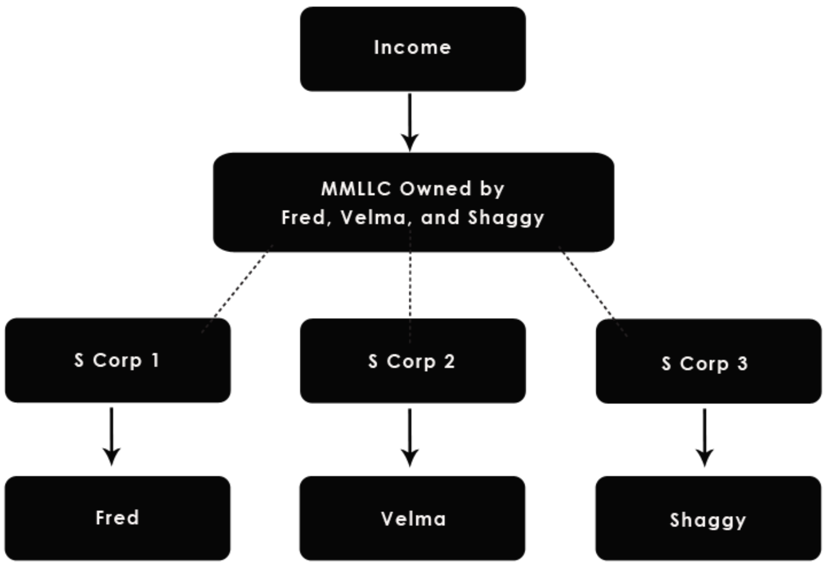
401k plans have all kinds of rules on controlled groups and discrimination rules, and we'll explore more of that later in another chapter. However, if a husband owns SMLLC "A" and wife owns SMLLC "B," each business can have a separate 401k plan. One could be filled with employees, and the other is just a solo 401k plan. This is provided that the spouses don't participate in each other's business (again, more on this narrow exception to controlled group rules in a bit).

Multi-Member LLC That Issues Invoices

A simpler way to accomplish the same thing as above is to create three entities again, but the multi-member LLC is owned by you and the other guys, not the S corporations. While we showed the previous schematic, the following is the preferred arrangement for a host of reasons, especially state apportionment of income and business valuation (more on that in a bit).

The S Corps issue consultation, fee for service or management fee invoices to the multi-member LLC in the amount of the net business income split driving the multi-member LLC income down to zero, or some nominal amount like $500. In other words, the payments from the MMLLC to the S Corp would be recorded as Payments for Services Rendered or Outside Contractor or something similar (see dotted lines below).

Therefore, each human would receive two K-1s. One from the MMLLC or “mothership” for a small amount and another from his or her respective S Corp. Additionally, this still accomplishes the Eat What You Kill income splitting objectives and changes the color of money through distributions from each person’s “baby” S Corp. Flexibility plus tax efficiency. Brilliant!



This would also be beneficial if you didn’t have an Operating Agreement or if you are afraid that an Operating Agreement could be too restrictive from year to year. You would still need some sort of instrument or agreement that dictated how the fees are calculated so there aren’t any hard feelings.

The above schematic is also preferred for regulated industries like financial advisors or real estate agents where entity ownership must be individuals. In some states and certain regulatory agencies, the MMLLC can be owned by S corporations provided the named principals are the licensed / regulated individuals… again, this arrangement avoids that issue.

Having said that, the “baby” S Corps typically must register separately with their regulatory body. For example, if you are band of attorneys wanting the mothership baby S Corp multi-entity arrangement with fee for service agreements, each S Corp would probably need to be registered as a law office with the state bar. This is a minor housekeeping detail, but an important one.

You might also reduce your exposure to state nexus based on revenue or income. If the MMLLC is a California entity issuing a small K-1 to an individual running an S Corp in Illinois, you will reduce the long-reach risk of California. What do we mean here?

Scenario 1 is where your Illinois S Corp owns member interest in a California LLC. The LLC will issue a K-1 to your S Corp and now you instantly have a very visible tax footprint in California.

Scenario 2 is where your Illinois S Corp provides a service to a California LLC in a business to business (B2B) relationship. You might still have a tax footprint in California, but you are in complete control since California does not instantly know about this not-so-visible relationship.

We are not advocating avoiding apportionment (the allocation of taxable income to other states), but at least you are more in control of what California knows and what they don't need to know. They feel like they need to know everything, and they most certainly do not.

Do not issue 1099s in this scenario. First, a 1099 is only required to be sent to non-corporations. Even though you might have created an LLC and then later elected S Corp status, you are now considered a corporation for taxation and your vendors are not required to send you a 1099 (although many do).

> **Side Bar:** Business tax returns such as Form 1065, 1120 and 1120S are usually prepared by tax professionals, and as such the IRS believes revenue has a much higher chance of being recorded properly, and 1099s are not necessary. It would also be ridiculous for Verizon to receive a million 1099s from its customers. Funny, Yes. But ridiculous.

Second, a 1099 has EINs and possibly SSNs. Since these dots can be connected by the IRS, the issuance of a 1099 might invite unnecessary scrutiny. The IRS agent's question becomes "Why did you issue a 1099 to a partner rather than let the income flow through a K-1?" "To avoid taxes and headaches" is probably not going to go well during the audit.

A multi-member LLC with a zero for taxable income (or close to it) is a no harm no foul tax return. In other words, it flies well below the radar but it also above reproach. As stated previously, Fred, Velma and Shaggy would get two K-1s, one from the MMLC and another from their S Corp.

Here is a brief recap of three possibilities given what we've discussed in the previous two schematics-

▲ The MMLLC makes distributions to the S Corp members and issues a K-1, both in accordance with the Operating Agreement's provisions. The S Corps pick up the K-1 as ordinary income plus external income that is earned separately from the MMLLC (moonlighting… or another MMLLC perhaps).

▲ The MMLLC pays guaranteed payments to the S Corp members, which fluctuate according to the Operating Agreement's provisions. The MMLC distributes the remaining cash to the S Corp members and issues a K-1, both in accordance with the Operating Agreement.

▲ The MMLLC makes direct payments to the S Corps and those payments are recorded as fees for services. This can be called a corp to corp or business to business transaction. The individuals are the members of the MMLLC, and the external S Corps are recipients of the fees for services.

Conclusion

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

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

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

Chapter 3
S Corporation Benefits

Avoiding or Reducing Self-Employment (SE) Taxes

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

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

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

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

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

How SE Tax Is Computed

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

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

Here is an illustrative table-

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

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

Quick Analysis of S Corp Savings

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

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

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

Chart Notes

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

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

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

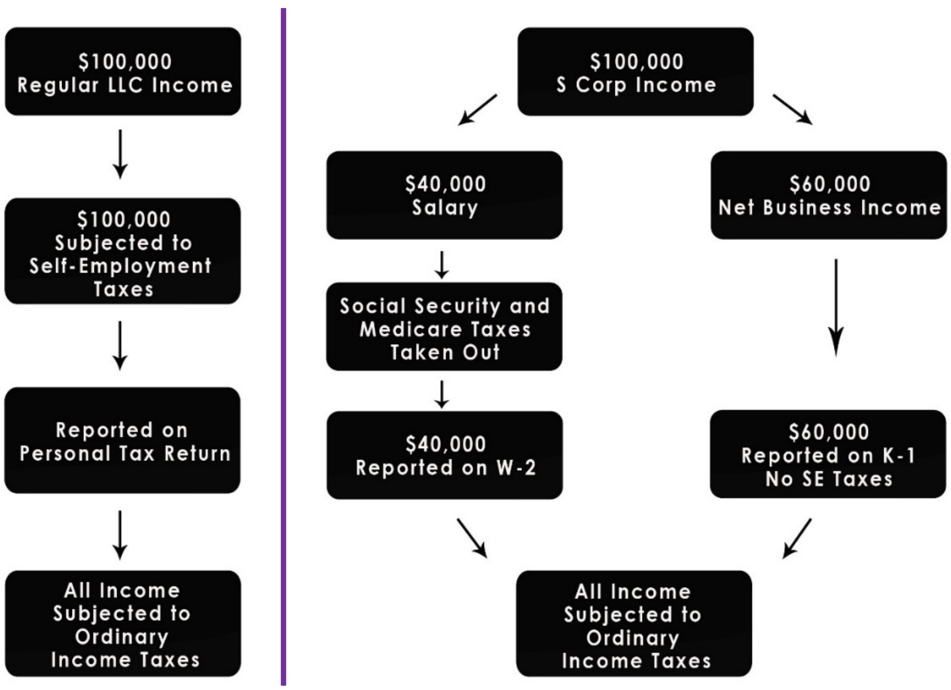
If you want to learn more about these chart notes plus the source of the savings, please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Quick Recap, The S Corp Money Trail

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

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

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



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

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

W-2 Converted to 1099

One of the biggest pushes into the S Corp world is when your employer decides to convert you from W-2 to 1099. You are fired on Friday and brought back on Monday as a contractor. Now what?

To refresh your memory, when you are paid a W-2 salary your employer pays for half of the Social Security and Medicare taxes associated with your income. Conversely when you are paid as a 1099 contractor, you pay both halves of the Social Security and Medicare tax.

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

Businesses like to have contractors versus employees since it cuts down on cost and offers more flexibility. Some businesses can easily exceed a factor of 1.5 for a fully burdened labor rate. For example, if you are being paid a $100,000 salary, the cost to the employer could be $150,000 after you factor in payroll taxes, 401k contributions, pension funding, health insurance, vacations and sick pay, office resources, etc. This would be a factor of 1.5.

Another benefit of deploying contractors is when a business needs to shrink, it simply ends the contract or reduces it dramatically without much hoopla. If Northrop Grumman laid off 10,000 workers there would be congressional hearings. If they cancel 10,000 contracts with sub-contractors, no one pays any attention to it.

Some employers, such as Verizon, have recently gotten in trouble by converting too many W-2 employees into 1099 contractors. The IRS and several states see it as an end-around. Many one-person S corporations are probably disguised W-2 employees so this is a sensitive subject.

Regardless, when entertaining being converted from W-2 to 1099, consider the fully burdened labor rate of your employer. If you were making $100,000, you really need to make at least $130,000 or more to come out ahead. You win, they win.

Don't forget that as a 1099 contractor you now can rifle a bunch of expenses through your business that were otherwise limited or not allowed… wait! What? Let's take mileage as an example. If you are paid as a W-2 employee, you cannot deduct mileage expenses since 2017. But if you are paid as a contractor, your business can either own the car and deduct actual expenses, deduct mileage (Schedule c) or reimburse you for mileage (S Corp).

Being converted from a W-2 employee to a contractor is risky since the connective tissue is reduced dramatically, but generally it is a good thing since it puts you in a better tax position (and you might actually make more money). However, don't leak that out during negotiations.

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

Conclusion

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

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

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

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

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

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

Introduction

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

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

Specifically, in this chapter we will review these disadvantages to having an S corporation-

- ▲ Increased cost (tax preparation, payroll taxes)
- ▲ SEP IRA limitations
- ▲ Trapped assets
- ▲ Disparate distributions
- ▲ Other W-2 income
- ▲ State taxes
- ▲ Among other smaller issues

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

- ▲ Does your business earn over $30,000 net income after expenses? Say Yes.
- ▲ Are you located in New York City or Tennessee where S corporation tax rates are egregious and suck up all the Federal tax savings? New Hampshire? Say No (unless you are being limited by Section 199A for lack of wages).
- ▲ Do you have other W-2 income that exceeds or comes close to exceeding the Social Security limits of $142,800 (for the 2021 tax year)? Say No. If you say Yes, we need net ordinary business income after expenses and deductions to exceed $250,000 in #1 above.

- Is this a going concern? In other words, is the business going to continue to earn the same income or more each year? Say Yes.

- Do you have an LLC or some other entity in place that can be elected to be taxed as an S Corp? Say Yes. If you say No, we have options just not elegant ones.

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

State Business Taxes (Not Just Income Taxes)

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

Other income tax free states, such as Texas, have similar taxations and various exemptions too. Franchise tax is another buzzword you might come across. Why do they call it a franchise tax, or a business and operating tax as they do in Washington State? They can't call it income tax because of the Interstate Income Act of 1959. Yup. Way back when, and it is battled every year in court, in various representations.

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

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

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

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

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

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

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

States are therefore prevented under Public Law 86-272

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

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

▲ the orders are processed from outside the state.

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

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

If you want to learn more about how each state handles interstate commerce and nexus, please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Conclusion

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

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

The dangers of S Corps and other business entities is over 35 pages (pages 119 to 154) in our published book. If you want to learn more about these issues, please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Chapter 5
State Nexus Problems

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

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

wcginc.com/1744

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

wcginc.com/1746

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

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

Wayfair Case

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

wcginc.com/1788

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

wcginc.com/blog

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

▲ Deliver more than $100,000 of goods and services in a year, or

▲ Have 200 or more separate transactions for the delivery of goods or services

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

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

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

If you want to learn more about these issues (they are shifty and changing all the time as well), please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Chapter 6
S Corporation Election

Formation (Election) of an S-Corp

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

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

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

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

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

Electing S-Corp Filing Status, Retroactive for Jan 1 2021

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

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

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

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

Late S Corp Election, Oops

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

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

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

So, if it is November 2021, and you want to go back to January 1, 2021, no problem. If it is March 2022 (tax season) and you are freakin' out because you forgot to make the election earlier, you can still go back to January 1, 2021. No that is not a typo… we are talking about going back to the previous year's January 1!

With the preparation and filing of a late Form 2553 for your S corporation election, a reasonable cause letter must be attached. We have a template that we've used successfully at least 1,200 times, and we can guide you through it. Additionally, your reasonable cause cannot be "hey IRS, I just learned of this S Corp thing, and man, it sounds amazing. I would like to do this retroactively so I can save a bunch of taxes."

Beyond the reasonable stuff, there might be other hiccups. Isn't hiccups such a friendly word? Sort of like bumps in the road. Bruises is another word that is about as hollow as hiccups and bumps. No one says pitfalls or disasters anymore, just hiccups. The bottom line is that we can engage in some revisionist history on March 1, 2022 to take effect for all of 2021. Boom!

If your current CPA or tax professional says No, we suggest you find a new accountant. WCG has been doing this for over a decade (there was relief provisions prior to the 2013 IRS Rev Proc as well) without major problems. Given the timeline as it compares to the filing deadlines, you might incur some late filing penalties. However, these are usually abated under the First Time Abatement statutory relief program. Aside from that, the late S corporation election is straightforward.

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

▲ Fax Late S Corp Election Form 2553 to the IRS

Fee: **$450** (timely S Corp election is $250)

▲ Open Payroll Accounts for 202<u>2</u> (to be compliant in the future)

Fee: **$300 to $450** (depending on state, CA, CO, TX easier… NY and PA, rough, like a stucco bathtub)

▲ Issue a 1099-MISC as Officer Compensation for 2021 (in lieu of a late payroll)

Fee: **$650** (this includes tax planning and estimated tax calculations)

▲ Prepare 2021 (due spring 2022) S Corporation Tax Return on Form 1120S

Fee: **$1,000 to $1,200**

So, you will spend about $2,500 however you will be saving anywhere from 8% to 10% of your net ordinary business income after expenses and deductions depending in your situation. Also remember that the late S Corp election and payroll account setup is a sunk cost. In other words, you would need these things done regardless of late S Corp election for the previous year or waiting until next year. Bite the bullet now. Get it done.

Said differently; if we isolate 2021 only, your costs are about $1,750. If you have $50,000 in net business operating income after expenses you will still save well over $2,000 after our fee.

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

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

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

At the very worst we have to obtain a Power of Attorney from you, call the IRS and give them a "see… how it works is…" spiel. We have a 100% success rate in getting these late S Corp elections pushed through. While your mileage might vary, we are also very successful with getting late payment penalties abated with the IRS. Each state is different, and some are unsympathetic. Again, the savings will outweigh the costs (or we wouldn't let you do it).

Conclusion

Just slapping a Form 2553 together and pushing it through the IRS is not all you need to do. There are some other things to bother yourself with-

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

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

Chapter 7
Section 199A Deduction Analysis

Section 199A S Corp Considerations

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

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

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

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

www.wcginc.com/blog

Specified Service Trades or Businesses

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

Reputation or Skill

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

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

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

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

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

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

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

Section 199A Deduction Decision Tree

Remember that taxable income is all income for the household (these numbers represent the 24% marginal tax bracket and are indexed annually).

Specified Service Trade or Business (as defined above)-

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

All Others-

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

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

Section 199A Pass-Thru Salary Optimization

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

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

Let's look at the data-

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

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

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

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

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

Conclusion

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

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

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

Chapter 8
Section 199A Examples and Comparisons

Section 199A Basic Comparisons

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

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

*includes the S Corp W-2

There are several notables, takeaways and explanations-

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

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

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

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

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

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

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

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

Fun! Moving on…

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

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

wcginc.com/8313

Section 199A Comparison Recap

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

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

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

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

Conclusion

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

- ▲ The phaseout for a specified service trade or business.
- ▲ How does a mixture of rental income and SSTB income work?

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

Chapter 9
Reasonable Shareholder Salary

IRS S Corp Stats

Let's jump right into some numbers first before going through reasonable S Corp salary theory developed from IRS revenue rules and Tax Court cases. The following table is a summary generated from IRS statistics on S corporation tax returns for the 2017 tax year. Yes, this is the most current. No, we do not know why a room full of servers can't crunch this in real-time. So here we are-

Annual Receipts	Gross Receipts Per Return	Net Income Per Return	Officer Comp Per Return	Officer Comp % of Net Income
$25,000 to $99,999	63,669	7,967	9,096	53%
$100,000 to $249,999	170,884	24,796	24,405	50%
$250,000 to $499,999	365,715	43,505	43,917	50%
$500,000 to $999,999	718,876	67,243	68,015	45%
$1M to $2.5M	1,581,150	130,244	106,072	45%

First some quick observations. Officer compensation is added back to net income to determine officer comp as a percentage of net income. Next, this is all industries from capital intensive manufacturing to personal services business such as attorneys, doctors, consultants, engineers and accountants. More data to follow in a bit.

Also, this includes S Corps who lost money, and whether they lost money and continued to pay a reasonable shareholder salary (Officer Compensation) is unclear. In other words, if losses were teased out would Officer Compensation be reduced as a percentage of net income? We cannot quickly determine from the IRS data.

If you want to see more IRS stats and analysis, please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Reasonable S Corp Salary Theory

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

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

Therefore, a $10,000 shareholder salary costs you $1,5300 in additional taxes beyond income taxes. Said in a different way, if you pay yourself $50,000 when $40,000 could have been a reasonable shareholder salary, you just wasted $1,530. Even a $5,000 delta equates to $765.

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

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

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

Consider this-

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

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

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

Take this one step further. What would an investor be willing to pay a person other than you, yet who is also capable of running the business? Perhaps your contribution to the business was developing procedures and workflows to make it hum, and someone with less skill and experience can do the same work and produce the same results. Just a thought as we head into all this.

Naturally, a lower salary to you results in a higher rate of return for the investor. We could also look at the earnings generated from capital investments such as machinery or internally generated assets, and other non-owner employees versus shareholder labor. Think of that software developer from the previous table. We digress here but explore this more in a bit.

Risk Analysis to Reasonable Shareholder Salary

We raise the risk issue throughout our chapter on reasonable shareholder salary, but let's touch on it some more. Please recall that shareholder distributions are financial rewards to the investor. While the detached abstract investor and the employee are the same person (you), it doesn't change the theoretical demands of an investor. When a business valuation is calculated, discretionary cash flow is determined and then a risk premium is assigned to it. Simply stated, cash flow divided by risk equals value.

Assembled Workforce or Developed Process Effect

As alluded to earlier, the business's ability to earn revenue without the direct involvement of the owner(s) can be huge. Consider an actor or an on-air personality (WCG has a handful of these clients). Would revenue continue after the owner stopped working?

For example, you start off as a one-person engineering firm earning $150,000 net ordinary business income after expenses and deductions but before shareholder salary. You pay yourself $65,000 and pocket $85,000 as shareholder distributions. Done.

Time moves along, and you've hired eight other engineers and they are paid $90,000 each but contribute $60,000 to the bottom line of the business (using the $150,000 number above as a proxy). Even if you increase your salary to $150,000, you still have $480,000 ($60,000 x 8) available for shareholder distributions.

If you want to learn more about risk analysis and other business valuation perspectives to reasonable shareholder salary, please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

RCReports

For several years now, WCG has leveraged RCReports or Reasonable Compensation Reports which is a consulting firm out of Denver, Colorado. They send out a survey to you which asks a bunch of questions about qualifications, time spent on various tasks, regional data, etc. From there, and in their words, "RCReports synthesizes a proprietary blend of IRS criteria, Court Rulings, geographic data and our EXCLUSIVE database of wages to accurately assess Reasonable Compensation for S Corp, Small & Closely Held Business Owners." Cool!

You can view a sample here-

wcginc.com/8257

The other consideration is that just because RCReports comes up with a salary does not mean you must pay that salary. There might be circumstances which would drive down a reasonable salary such as rapid growth, unsteady earnings, etc. There might be circumstances, such as 401k and other external reasons, to increase your salary.

Conclusion

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

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

This is a wonderful chapter and is an excellent summary of the various issues for reasonable salary calculation and testing. If you want to learn more about these issues, please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Chapter 10
Operating Your S Corp

Costs of Operating an S Corporation

People want to know costs and while this might seem like more shameless self-promotion, you still need to understand what you are getting into. **Sales pitch alert!** WCG specializes in small businesses which have a small number of owners, and often just a one-person show. Did you know that 95% of all S Corps have only one shareholder, and 99% of all S Corps have three or fewer shareholders?

Common S Corp candidates and current clients for WCG are consultants, attorneys, financial advisors, insurance agents, physicians, chiropractors, doctors, surgeons, anesthesiologists, nurse anesthetists, real estate agents, contractors, photographers (the profitable ones), online retailers, FBA retailers and good ol' fashion widget makers, among several others. We also have several medical groups and financial advisor teams operating multi-tiered entity structures.

The tax savings of an S corporation is not in dispute. But what does it cost to have tax preparation, payroll, tax planning and consultation done? Because small businesses are a core competency for us, we have created Business Advisory Services packages that includes the following-

2022 Tax Planning and Preparation	**Vail**	**Telluride**	**Aspen**
Tax Planning, Tax Projection Worksheets	✓	✓	✓
Small Business Tax Deductions Optimization	✓	✓	✓
Section 199A QBI Tax and Salary Optimization	✓	✓	✓
Estimated Tax Payments (done thru payroll)	✓	✓	✓
2022 Business Entity Tax Prep	✓	✓	✓
2022 Individual Tax Prep, One Owner	✓	✓	✓
Expat / Foreign Income Calcs, Forms	Add-On	Add-On	Add-On
IRS Audit Defense	✓	✓	✓
Situational Tax Law Research (up to 3 hours)			✓

2022 Payroll	**Vail**	**Telluride**	**Aspen**
Reasonable Shareholder Salary Calculation	✓	✓	✓
Shareholder Payroll Processing (up to 3 owners)	✓	✓	✓
Employee Payroll Processing (25 employees)	Add-On	✓	✓
Annual Payroll Processing (includes five 1099s)	✓	✓	✓

Continued…

Business Advisory Services	Vail	Telluride	Aspen
Consulting			
Consultation, Periodic Business Reviews (PBR)	Quarterly	Unlimited	Unlimited
Complimentary Quick Chats (CQC)	Unlimited	Unlimited	Unlimited
Interfacing with Other Professionals		Unlimited	Unlimited
Financial Analysis			
QuickBooks, Xero Consulting		✓	✓
Accounting (bookkeeping + analysis)	Add-On	Add-On	Add-On
Fractional Controller	Add-On	Add-On	Add-On
Financial Statements Analysis, Comparisons		Quarterly	Quarterly
Cash Flow Management and Analysis			✓
First Research, Industry-Focused Consulting			✓
National and Metro Economic Reports			✓
KPI Analysis, Benchmarking, Trend Analysis			✓
Budgeting, Forecasting, Goal-Setting			✓
Strategy and Maintenance			
C-Level Financial Advice and Strategic Planning			✓
Succession Planning, Exit Consultation			✓
Annual Business Valuation			✓
Annual Corporate Governance, Meetings		✓	✓
Annual Fee*	**$3,420**	**$5,760**	**$8,160**
Monthly Fee*	**$285**	**$480**	**$680**
	(prorated based on onboarding date)		

Custom! Unlike the modern-day new car packages where you have to spend $8,000 for the moonroof, our Business Advisory Service plans can be customized specifically for you. The service array above is simply a starting point. If you need more from us, let's chat about it!

Tax Patrol Services
We also have Tax Patrol! This is a wonderful tax service for those who don't need all the business advisory bells and whistles above, but from time to time want some love from an experienced tax consultant and business advisor. Have a quick tax question? Need to know the depreciation rules as you buy that new car? Wondering what your April tax bill is going to be in August? Tax Patrol is like ski patrol... you might not use it, but you sleep better knowing you have it.

Tax Patrol	Keystone	Copper	Breck
2022 Individual Tax Prep)	✓		✓
2022 Business Entity Tax Prep		✓	✓
Tax Planning, Tax Projection Worksheets	✓	✓	✓
Estimated Tax Payments Calcs	✓	✓	✓
IRS Audit Defense	✓	✓	✓
Complimentary Quick Chats (CQC)	Unlimited	Unlimited	Unlimited
Annual Fee	**$1,080**	**$1,500**	**$1,980**
Monthly Fee	**$90**	**$125**	**$165**
	(prorated based on onboarding date)		

Accounting and Payroll Services

Accounting fees are based on 2 bank account with less than 250 monthly transactions and include the QBO fee from Intuit. Custom quote is available if you have a lot going on such as third-party integrations (POS, time billing system), accrual accounting method, extensive benefits packages and / or industry specific issues (e.g, job costing in construction).

Employee payroll can be added to shareholder payroll for $75 per month if already using our Business Advisory Service plans above (e.g, Vail), or $160 for standalone. Custom quote for more than 5 employees and a referral to therapy.

Accounting, Payroll	
Monthly Accounting (bookkeeping + analysis)	starting at $400 / month
Bi-Monthly Accounting (bookkeeping + analysis every 2 months)	starting at $250 / month
QuadMonth Accounting (bookkeeping + analysis every 4 months)	starting at $175 / month
Sales Tax, Personal Property Tax	typically $75 / month,$150 / quarter
Employee Payroll (up to 5, bi-weekly)	$75 or $160 / month

Prorated Fees

Some more things to consider- when a partial year remains, our usual annual fee is pro-rated to not charge you for services you didn't use (like payroll and consultation). However, a large chunk of our annual fee is tax preparation which is typically a built-in fixed amount of $1,600 (both business entity and individual tax returns). Whether we onboard you in January, July or December, we have to prepare a full year tax return. This increases the monthly fee for the remaining months of 2021 but the monthly fee will later decrease in January of 2022 to reflect the amounts above. Yeah, we make it sound like 2022 is just around the corner.

Payroll Processing

We make very little profits on payroll processing… we offer it as a convenience to our clients. One throat to choke with a single call can be reassuring but if you want to run your payroll, go for it! Everyone thinks payroll is a piece of cake; write a check and done. Nope… we see a lot of mistakes being made by clients especially the handling of health insurance and HSA contributions since there are special rules for greater than 2% S Corp shareholders. Then again, we don't mind fixing what was broken.

Tax Returns

You can prepare your own individual tax return as well… but the benefit WCG preparing both individual and business tax returns is that we slide things around depending on income limitations and phaseouts.

> **Note:** An individual tax return is what the IRS calls Form 1040 and refers to the entity filing the tax return (you, the individual, are the entity). However, a married couple are deemed to be one entity for the sake of an individual tax return. So, when we say we will prepare your individual tax return, it is meant to include your spouse in a jointly filed tax return.

Break-Even Analysis (does an S Corp make sense?)
Break-even analysis is based on our annual fee of $3,420. If an S corporation saves you 8% to 10% (on average) in taxes over the garden-variety LLC, then $3,420 divided by 9% equals $38,000 of net ordinary business income after expenses and deductions.

More sales pitch! Keep in mind that our fee of $3,420 includes your individual tax return which you might already be paying another tax professional to prepare. WCG has a handful of clients who are right at the break-even point of $38,000 but leverage an S Corp and our services to get tax preparation, tax planning and consultation.

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

wcginc.com/PBR

We also have written a webpage on end of year tax planning-

wcginc.com/EOY

And, to see our entire fee structure (transparency)-

wcginc.com/fee

No more shameless promotion… at least for a while.

1099-NEC Issued to Your SSN

Let's back up and talk about the 1099-NEC versus 1099-MISC. The 1099-NEC which stands for non-employee compensation was last used in 1982 until the IRS revived it for the 2020 tax year. Why? No one really knows, but the IRS pawned off the excuse of varying filing deadlines within the 1099-MISC, and to simplify, they spun off the 1099-NEC again.

Take Money Out of the S Corp

Remember, payroll taxes (Social Security and Medicare taxes) are the same as self-employment taxes. But they also include unemployment taxes, state disability insurance (such as California's state disability insurance) and other odd-duck local taxes. We discussed this in Chapter 4 (Additional Payroll Taxes, page **Error! Bookmark not defined.**).

As an S Corp shareholder, you are taking money out of the business in various ways-

Source	Payroll Taxes	Income Taxes
Reasonable S Corp Salary	Yes	Yes
Shareholder Distributions	No	No
Reimbursements (Accountable Plan)	No	No
Funding Retirement Accounts	No	Deferred
Self-Rental (not home office)	No	Maybe
Adding Children to Payroll	Yes	No
Shareholder Loans	No	No

Taking money out of your S corporation and dealing with 1099s issued to your SSN have their own nuances. Please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Tax Planning and Withholdings

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

Here is some more WCG elegance (yeah, we're bragging a bit)- we calculate and pay your quarterly estimated tax payments through your payroll withholdings. No more writing separate checks or using online payment portals, and tracking due dates. We do this by manually entering your federal and state withholdings accordingly to reflect the tax liability for your W-2 income and your K-1 income, plus other household sources. Beauty!

For example, let's say you have a net ordinary business income after expenses and deductions before shareholder salaries of $150,000 and a reasonable salary of $60,000. From there, we look at all household income sources such as your spouse's income and withholdings, rental income, pension income and anything else that is material to your tax world.

Then we create a mock tax return (the tax plan). That's right! We extrapolate all this data, pump it into a tax return and determine your tax obligations. We do this periodically throughout the year. Nothing is as accurate as a mock tax return. Yes, you can use Excel or other online estimators, but a tax return is the best tool.

Taking Shareholder Distributions

The IRS and Tax Court do not like to see you use your business as an ATM machine. This is not because you just said automated teller machine machine. This is because the spirit of a shareholder distribution is to be a return on investment, and if it is magically tied to personal living expenses it looks bad. Think of it this way- you wouldn't call up Google and demand a dividend because baby needs new shoes, or the boat payment is due. Same thing here.

Another perspective- Apple shareholders are routinely upset because of the cash that Apple hoards. There are two ways to get a return on investment- capital appreciation (and subsequent sale) and dividends. If there are piles of cash and there aren't immediate or mid-term needs for the cash, shouldn't that be returned to investors who helped build the cash to begin with?

What do you do? One option is to take systematic shareholder distributions throughout the year, and flush out the remainder once a quarter or annually. Another option is simply distribute large chunks periodically without any cadence or basis that can be tied to personal living expenses. WCG prefers the first option. Looks clean. Defensible.

Accountable Plan Expense Reimbursements

An Accountable Plan, under IRC Section 1.62-2(C)(2), allows a business to reimburse an employee for expenses incurred in connected with the performance of duties for the business provided proper substantiation is followed.

The typical reimbursed expenses through an Accountable Plan are home office use including depreciation, mileage or business-use portion of automobile expenses, cell phone and internet. All these expenses have one thing in common- they are mixed used, both personally and business. Mixed-use expenses should be paid by the employee and later reimbursed. Conversely, anything that is 100% business use should be paid directly by the business.

Conclusion

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

- ▲ “I just got a new S Corp puppy. What do I do now?”
- ▲ Reclassifying shareholder distributions as Accountable Plan reimbursements.
- ▲ How shareholder distributions might accidentally exceed basis and trigger taxes.
- ▲ How other tricks of trade such as income shifting, putting kids on payroll and making Mom or Dad a shareholder can reduce taxes.
- ▲ The upsides and downsides of adding your spouse to payroll. Yes, it can save taxes but there are several cautions you need to be aware of.
- ▲ Do you want to maximize value or minimize taxes?

Chapter 10 has a ton of good information spread across pages 253 to 292… 40 pages of operational considerations. Please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Chapter 11
Tax Deductions, Fringe Benefits

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

Four Basics to Warm Up To

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

Marginal Tax Rate

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

Cash Savings or Tax Savings

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

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

Building Wealth

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

The Trick

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

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

185 Business Deductions You Cannot Take

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

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

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

Deductions the IRS Cannot Stand

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

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

Here we go-

- ▲ Meals and Entertainment (shocker)
- ▲ Car and Truck Expenses, Mileage Logs (another shocker)
- ▲ Travel
- ▲ Home Office (unless reimbursed through an Accountable Plan)

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

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

Automobiles and LLCs, S Corps

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

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

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

Two rules to live by-

▲ Cash is King (keep it!)

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

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

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

▲ Business Owned Automobile (mixed bag)

▲ You Own the Automobile, Get Reimbursed By The Mile (clean and elegant)

▲ You Own the Automobile, Take a Mileage Deduction (silly in an S Corp… oh and by the way, gone with the Tax Cuts and Jobs Act of 2017)

▲ You Own the Automobile, Lease it Back to Your Business (exotic)

Which was do I choose?

Automobile Decision Tree

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

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

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

We discuss automobiles including examples to the decision tree above in our book. Please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Sutter Rule

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

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

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

Cohan Rule

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

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

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

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

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

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

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

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

Summary of Small Business Tax Deductions

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

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

We discuss several small business tax deductions plus provide a summary table in our book. Please visit **www.wcginc.com/book** for more information or visit our KnowledgeBase at **www.wcginc.com/kb**.

Reducing Taxes

One of our primary focuses at WCG is ensuring you are paying the least amount of taxes allowed by law. Some of our other primary focuses are helping you build wealth and leverage the most of your financial worlds for you and your family. However, these focuses or objectives are not isolated; they are very much related to each other and intertwined.

Before we run through several tax reduction and tax avoidance ideas, let's talk about some basic concepts-

There is not a secret tax deduction club that only a few people know about. If there were, it would be like fight club, right? But trust us when we say no one is intentionally not talking about a tax deduction club.

Most people are interested in saving cash when they say they want to reduce or avoid taxes, but saving cash and reducing taxes are not necessarily the same.

Two households, making the exact same income, might have wildly different tax liabilities based on the myriad of variables such as children, mortgage interest, charitable donations, available tax credits, and, Yes, the proficiency of the tax professionals involved. So, just because your neighbor or produce clerk pays x does not mean you will too.

As household incomes travel through the ranges, a lot of things happen. The first $100,000 in income for most households is well-sheltered with itemized deductions and low tax brackets. The next $100,000 in income sees certain tax credits go away, higher tax brackets and fewer available tax deductions such as IRAs and other things (what we call income phase-outs).

In other words, if you go from $100,000 to $200,000 in household income, you will pay way more than double in taxes (you could easily see 2.5 to 3.0 times more). Yuck! The next $100,000 and beyond is completely naked, and is generally purely taxable (unless some tax reduction tactics are deployed). Super yuck!

Tax deductions and tax deferrals are not the same. Tax deferrals are tax bombs later in life; little IOU's to the IRS and they will eventually call in the chit. But if you use the immediate tax savings to build wealth, then a tax deferral is worth it. Deferring taxes to pay for a cruise vacation might not always be the best approach (then again, live a little!).

You want to match the highest tax deduction to the high income. Let's say it's December and you are considering buying a piece of equipment. If next year's income is going to be significantly higher, wouldn't it make sense to wait until January to complete the purchase? Probably.

Tax deductions commonly need separation with cash. For example, you can save $2,500 (for example) in taxes right now if you write a check for $10,000 to a charity. That might not make sense if you are more interested in cash than taxes, right? Tax deferrals commonly need separation with cash as well, but at least you get it back. IRA's and 401k plans (among others) come to mind.

Ok, here we go on those tax reduction and tax avoidance headlines-

- ▲ Sell Stock Losers to Offset Gains
- ▲ Budget Review
- ▲ 401k, SEP IRAs, and IRAs
- ▲ Profit Sharing, Defined Benefits Pensions (Cash Balance)
- ▲ Advanced Tax Planning for IRA's, Roth IRAs and Roth Conversions
- ▲ Medical C Corp
- ▲ Cost Segregation on Real Estate
- ▲ Switching to Accrual Accounting
- ▲ Adding Spouse to Payroll
- ▲ Adding Children to S Corp Payroll
- ▲ Adding Children to Payroll Family Management LLC
- ▲ Tax Free Rental of Your Home
- ▲ Donor Advised Fund
- ▲ Conservation Easement
- ▲ Captive Insurance
- ▲ 1031 Exchanges (Like-Kind) on Real Estate Transactions
- ▲ Permanent Life Insurance Plans

▲ Family Limited Partnerships (FLP) and LLCs

▲ Discounted Roth Conversions

▲ GRATs, GRITs, and Private Annuities

If you want to know about these bulleted items, please visit-

wcginc.com/6177

Conclusion

In the full version of Taxpayer's Comprehensive Guide to LLC's and S Corps, Chapter 11 is nearly 60 pages long. In the shortie version here, it is a mere 6 pages. What the heck is in the other 54 pages? Lots! Deeper explanations on-

▲ Tax home and how your home office has a 50-mile rule.

▲ Home offices when you have another work location (spoiler- You can have another work location and still have a home office deduction).

▲ Section 179 and 100% bonus depreciation. Hummer rule is back!

▲ How depreciation can be an ugly tax problem at the wrong time.

▲ Small business tax deduction themes such as ordinary and necessary, paid or recognized, directly related to your business and reasonable (board meetings in Fiji for a two-person board probably not reasonable).

▲ The automobile decision tree on whether to own and get reimbursed versus having the company own the automobile.

▲ Mixing business with pleasure when it comes to business travel, and how to leverage your business in paying for your spouse's travels.

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

Chapter 12
Retirement Planning

Retirement Planning Within Your Small Business

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

Reasons for Small Business Financial Planning

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

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

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

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

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

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

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

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

These federal exemption amounts are indexed each year, and while Congress can always vote to repeal, this estate tax exemption was written in stone with passing of the American Taxpayer Relief Act of 2012. However, various states have much lower exemptions. Oregon for example is $1M and New Jersey is $600,000. Nebraska has a sliding scale. So, just because you are out of woods federally, doesn't mean the transfer your wealth is free of taxation. Get a plan.

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

The reason for financial planning are-

Goals and Objectives

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

The Plan

Financial plans also create a blueprint and chart a course on how to get reach goals and objectives while managing risk. Again, this sounds simple. But even the most basic house needs a blueprint for framers, plumbers, electricians and even inspectors to review and implement. And in the case of a financial plan, these same players are your financial advisors, tax professionals, attorneys and insurance specialists.

Accountability

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

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

Small Business Retirement Plans Comparison

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

wcginc.com/6103

We took a handful of salaries (for corporations including S corporations) and net incomes (for sole proprietors and partners in partnerships) and plugged them into Pacific Life's calculator, and came up with the following table based on the 2021 tax year limits-

Salary/Income	Entity	Max 401k	Max SEP IRA	Max SIMPLE
40,000	Sole Prop / Partner	26,935	7,435	14,583
40,000	Corporation	29,500	10,000	14,700
60,000	Sole Prop / Partner	30,652	11,152	15,124
60,000	Corporation	34,500	15,000	15,300
80,000	Sole Prop / Partner	34,370	14,870	15,665
80,000	Corporation	39,500	20,000	15,900
154,000	Sole Prop / Partner	48,124	28,624	17,669
154,000	Corporation	**58,000**	38,500	18,120
175,000	Sole Prop / Partner	52,324	32,824	18,280
175,000	Corporation	58,000	43,750	18,750
205,000	Sole Prop / Partner	**58,000**	38,680	19,133
205,000	Corporation	58,000	51,250	19,650
232,000	Sole Prop / Partner	58,000	44,008	19,909
232,000	Corporation	58,000	**58,000**	20,460
303,000	Sole Prop / Partner	58,000	**58,000**	21,949
303,000	Corporation	58,000	58,000	22,200

Note the bolded **$58,000** number. This is the maximum defined contribution amount permitted in 2021 per plan (and Yes you can have two plans- we'll talk about Greg and his two plans in an example later).

Crazy! The following are some quick observations-

- In 2021, the maximum you can contribute to a qualified retirement plan is $58,000. You can go above this with a defined benefits pension (cash balance)- more on that later.
- Partnerships (those required to file Form 1065) follow the same limits as Sole Prop above.
- $154,000 in W-2 salary from your C Corp or S Corp is the magic number for maximizing your 401k. After that, any increase in salary does not help. **Your fastest way to reach your contribution limit is through a 401k plan.**
- $232,000 in W-2 income from your S Corp is the minimum salary for a max SEP IRA contribution.

- ▲ $303,000 from your small business or K-1 partnership income from your Schedule E as reported on your individual tax return is the magic number for maximizing your SEP IRA contribution. SEPs are old school and used for crisis management rather than planning (more on that too).

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

- ▲ 401k max is computed by taking $19,500 employee (you) contribution, plus 25% of your W-2 or earned income (as adjusted).

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

- ▲ Max SIMPLE 401k is basically $13,500 plus 3% of your W-2 or earned income (as adjusted). Don't spend too much time thinking about SIMPLE 401k plans.

- ▲ You can add $6,500 for catch-up contributions if you are 50 years old or older.

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

Turbo Charged 401k Plans

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

Profit-Sharing Plan

Let's look at a real-life example that the WCG worked on to see how this works first. The following is a husband and wife business with over $600,000 in net profits from 2016. Yeah, it is a bit old but the illustration remains meaningful.

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

Tilt. Here are some observations and clarifications-

- ▲ NEC refers to non-elective contributions, and in this example these are the contributions required under the safe harbor 401k plan provisions.
- ▲ Profit sharing is based on salary and age. Note the subtle differences for everyone except Mike and Susie.
- ▲ $53,000 is the maximum allowed under a 401k plan with tiered profit sharing for 2016.
- ▲ In this real case, the owners kept 75% of all monies put into the plan. Not shabby.
- ▲ The annual cost in 2016 to administer this plan was $2,500.
- ▲ The tax deferral savings was over $53,000 for these business owners including state income taxes too (based on 39.6% federal rate and 11% state rate). This was California, and the couple plan to retire in Nevada- instant 11% tax savings.
- ▲ Yes, those salaries for Mike and Susie are ridiculously high. So the increase in payroll taxes must be weighed against the savings and benefits. After $132,900 (for the 2019 tax year) only Medicare taxes are being "unnecessarily" paid at 2.9%. The benefits could outweigh this 2.9%.

Defined Benefits Pension / Cash Balance Plan

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

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

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

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

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

Here is a quick list of the **2021 amounts** that can be contributed into a cash balance plan based on age-

Age	401(k) only	401(k) with Profit Sharing	Cash Balance	Total	Tax Savings
70	26,000	64,500	343,000	407,500	183,375
65	26,000	64,500	276,000	340,500	153,225
60	26,000	64,500	266,000	330,500	148,725
55	26,000	64,500	207,000	271,500	122,175
50	26,000	64,500	162,000	226,500	101,925
45	19,500	58,000	126,000	184,000	82,800
40	19,500	58,000	98,000	156,000	70,200
35	19,500	58,000	77,000	135,000	60,750
30	19,500	58,000	60,000	118,000	53,100

Before you lose your mind on the tax savings (which is assumed to be at 45% total between federal and state), you need the cash to do so. To save $101,925 at age 50 you need to part ways with $226,500 in cash. And if your spouse is on the payroll, you can double it. We only showed ages in chunks of 5.

Conclusion

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

▲ Investing without a plan is dangerous. Define your objectives and design a plan to meet those objectives.

▲ Tax savings versus tax deferrals, and how the tax bomb that could potentially go off could put a dent into your retirement plans.

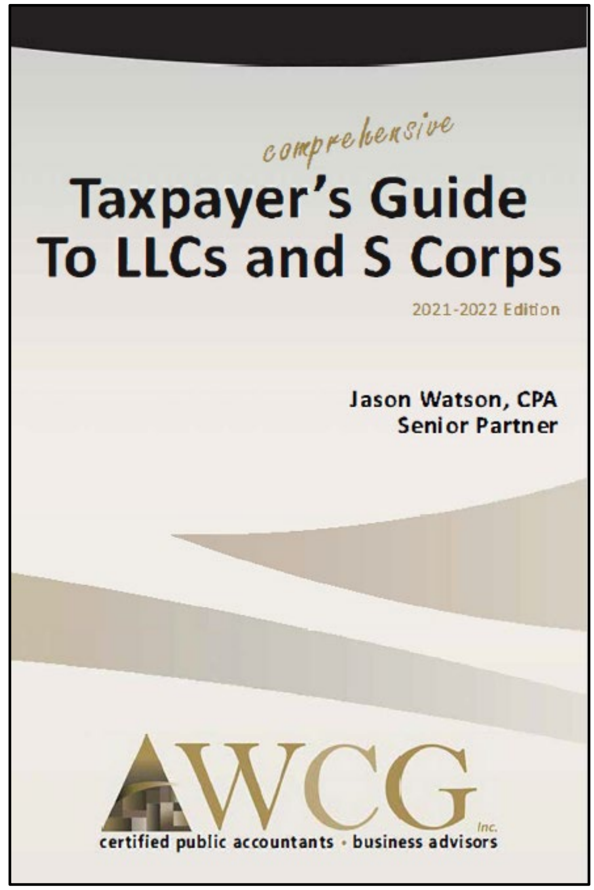
▲ Why 401k plans are preferred, and SEP IRAs should only be used as crisis management (versus proper planning).

▲ How having a staff dramatically alters 401k plans, profit sharing and defined benefits / cash balance plans.

▲ Controlled groups or affiliated services group, and how that might force you to cross-test all 401k plans in a multiple entity structure or implement a 401k plan that is adopted by all affiliated entities.

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

Thank You!



We hope you enjoyed reading our shortie version for the **2021-2022 Edition** of Taxpayer's Comprehensive Guide to LLCs and S Corps.

If you purchase our book from Amazon in paper, or one of the various electronic formats, and you believe it did not help you with your small business, please let us know. We never want you to feel like you wasted your money. $40 or $40,000… wasting money never makes people feel good. We will make it right, right away.

Thanks again!

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