Introduction to Issues Arising From Advising a Small Minority-Owned Business: Tax Considerations

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Topics

- Some of the types of taxes that may apply
- Choice of entity and tax treatment of these types of entities
- Employee/independent contractor issues

Some of the Types of Taxes That May Apply

- Federal income tax, including estimated tax payments
- Federal employment tax (e.g., income tax withholding on wages, Social Security tax, Medicare tax, federal unemployment tax)
- Federal excise taxes
- State and local income tax, including estimated tax payments
- State and local employment tax (e.g., income tax withholding on wages, state unemployment tax)
- State and local sales tax
- State and local property tax
- Other state and local taxes and fees
- Foreign taxes?

- Tax returns and information returns (e.g., Form W-2 for wages to employees and Form 1099 for various payments to non-employees)

Basic Principles of Federal Income Taxation of Individuals

- Individuals file an annual return on Form 1040 (U.S. Individual Income Tax Return) that is due on April 15 each year.
- Married individuals file a joint return.
- The individual reports on his/her return the income, deductions, credits and tax due for the previous calendar year. The income tax return for 2020 is due on April 15, 2021.
  - Income includes, for example, wages, investment income and business income.
  - Deductions include, for example, the standard deduction and business deductions.
  - Credits include, for example, the earned income tax credit and the child tax credit.
- The tax rate structure is progressive. Low-income individuals do not owe income tax. High-income individuals owe tax at a rate of up to 37%. President Biden has proposed to increase the top individual tax rate to 39.6%.

More Basic Principles of Federal Income Taxation of Individuals

- Capital gains (for example from the sale of stock) and dividends earned by individuals are taxed at a lower rate, up to 20%.
- There is an additional 3.8% tax imposed on capital gains and dividends for individuals with income above certain thresholds.
- Capital losses of individuals can offset capital gains, but can only offset ordinary income (such as wage income) up to $3,000. Excess capital losses are carried over to the next year.
- Individuals might also owe state and local income tax.
- Individuals also pay other state and local taxes, such as sales tax and property tax.
- The fact that low-income individuals do not owe federal income tax does not mean they do not pay federal taxes. For example, social security tax (at 6.2%) and Medicare tax (1.45%) is withheld from employee wages.

Choice of Entity

- There are various state corporate law formats in which the business might be conducted, including:
  - Sole proprietorship
  - Corporation
  - Partnership
  - Limited liability company
  - Cooperative
- Each of these formats has its own tax treatment.

Sole Proprietorship

- With respect to a sole proprietorship, there is no state law entity.
- The owner is conducting the business directly.
- The owner is personally liable for the liabilities of the business.
- For tax purposes, all the income and expense items are reported directly by the owner on Schedule C (Profit or Loss From Business (Sole Proprietorship)) of Form 1040.
- The owner is liable for various taxes, including taxes on his or her income from the sole proprietorship (such as income tax, Social Security tax and Medicare tax).

Sole Proprietorship (cont’d)

- The owner of the sole proprietorship will be subject to tax on the earnings of the business at his/her personal income tax rate, which could be as high as 37%, as indicated previously.
- There is a special deduction in the Code for owners of sole proprietorships that can reduce the tax rate to 29.6% on certain earnings from the business.

Corporation

- A corporation is a state law entity separate from its owner(s).
- In general (but not always), use of a corporation provides a liability shield by which the stockholders are not personally liable for the liabilities of the corporation beyond their capital investment.
- For tax purposes, the corporation can be classified as a “C corporation” or as an “S corporation”.

C Corporation

- A C corporation is a taxpayer separate from its shareholders.
- A C corporation files an annual Form 1120 (U.S. Corporation Income Tax Return) with the IRS.
- It is called a “C corporation” because it is taxed under subchapter C of the Internal Revenue Code.
- A C corporation pays tax on its net income at a 21% rate.
  - President Biden has proposed to increase the corporate tax rate to 28%.
- Corporations do not have a preferential rate for capital gains.
- Corporations pay tax at a low rate (or no tax in some cases) on dividends received from other corporations, because those earnings have already been taxed at the corporate level and should not be taxed again at the corporate level.

C Corporation (cont'd)

- A C corporation pays compensation to employees of the corporation, including shareholders who are employees, which gives rise to a deduction at the corporate level, reducing the corporate-level tax.
  - Some corporations pay large amounts of compensation to employee/shareholders to eliminate or mostly eliminate corporate level tax.
  - The IRS might argue that the amount of the compensation to an employee/shareholder is unreasonable and attempt to deny the corporate-level deduction for excessive compensation, thus increasing corporate-level tax. The excess compensation would be taxable to the recipient as a dividend rather than as compensation.

C Corporation (cont'd)

- The deductions and losses of a C corporation can only be used to offset income of the C corporation. They cannot be used to offset the income of the shareholders.
- Net losses at the corporate level are carried over at the corporate level for use against corporate-level income in later years.
- In general, the transfer of assets by a shareholder to a C corporation is tax-free.
- However, an appreciated asset cannot be disposed of by a C corporation without corporate-level tax on the gain.

C Corporation (cont'd)

- Shareholders are taxable on the receipt of dividends from a C corporation, and shareholders are subject to tax on capital gains from sale of the stock.
- The result is that there can be two taxes on income earned by a profitable C corporation, one at the corporate level and one at the shareholder level.
- As indicated previously, the maximum federal income tax rate on dividends and capital gains of an individual is 23.8%.
- If a C corporation does not pay dividends, the second level of tax is postponed until a shareholder sells his/her shares.
  - Note: There are special rules that in certain instances an individual shareholder can exclude or defer gain on the disposition of stock of a C corporation conducting a qualifying small business.
- When an individual who owns stock dies, the basis in the stock is increased (or decreased) to fair market value at death, so gain (or loss) in the stock disappears. There are legislative proposals to change this rule and tax capital gains at death.

C Corporation (cont'd)

- Here is an example showing the potential double taxation of C corporation earnings.
- A C corporation (C) earns $100 of taxable income. C pays federal income tax of $21 (21%). Note: there might also be state income tax.
- C distributes $79 of after-tax proceeds to the C shareholders as a dividend. Assuming the C shareholders pay tax at the highest federal income tax rate (23.8% for dividends), they pay $18.80 tax on the dividends. Note: there might also be state income tax.
- Consequently, after payment of the two federal income taxes, at the corporate level and at the shareholder level (a total of $39.80), the C shareholders keep $60.20.
- If C does not pay dividends, and C shareholders hold the stock until they die, there is only $21 of federal income tax.
- Contrast the results with later slides about pass-through entities.

C Corporation (cont'd)

- As indicated previously, an appreciated asset cannot be disposed of by a C corporation without corporate-level tax on the gain.
- If a corporation distributes an appreciated asset to a shareholder as a dividend, the corporation will be subject to corporate-level tax on the gain in the asset, and the shareholder will have taxable dividend income in an amount equal to the value of the asset.
- If a corporation liquidates and distributes its assets to its shareholders, the corporation will be subject to corporate-level tax on the gain in its assets, and the shareholders will have taxable capital gain equal to the excess of the value of the assets received over the basis in their stock.

C Corporation (cont'd)

- The potential double tax on C corporations affects transactional planning.
- If a C corporation sells its assets for cash and liquidates, the corporation will be subject to corporate-level tax on the gain/ordinary income on the asset sale, and the shareholders will have taxable capital gain equal to the excess of the cash received over the basis in their stock. The purchaser will take the assets with a basis equal to the purchase price, which would result in a stepped-up basis for the purchaser if the assets were appreciated in the hands of the selling corporation. The stepped-up basis for the purchaser could result in more depreciation deductions (or in some cases more immediate write-off of the cost of the assets) for the purchaser.
- If instead the shareholders of the C corporation sell their stock, they will have capital gain with respect to the gain in their stock, but the purchaser of the shares will not obtain a step-up in basis in the assets of the corporation.
- Consequently, the parties need to understand the tax consequences in negotiating the structure of a transaction.

C Corporation (cont’d)

- C corporations can engage in various types of tax-free reorganizations in which the assets or stock of a C corporation are acquired by another corporation.
- For example, if certain requirements are satisfied, a merger of a C corporation into another corporation pursuant to a state corporate law merger statute, in which the target corporation shareholders receive stock of the acquiring corporation, can be a tax-free transaction both for (i) the target corporation on its transfer of assets to the acquiring corporation, and (ii) the target corporation shareholders on their exchange of target corporation stock for acquiring corporation stock.
- In addition, if certain requirements are satisfied, a C corporation can divide into two corporations.

S Corporation

- If certain requirements are satisfied, shareholders of a corporation can elect to have the corporation treated for tax purposes as an S corporation.
- It is called an “S corporation” because it is taxable under subchapter S of the Internal Revenue Code.
- To qualify for tax treatment as an S corporation, the corporation (1) cannot have more than 100 shareholders, (2) cannot have any shareholders that are not individuals (with certain exceptions), (3) cannot have any foreign shareholders, and (4) can have only a single class of stock.
- An S corporation files an annual Form 1120-S (U.S. Income Tax Return for an S Corporation) with the IRS.

S Corporation (cont'd)

- An S corporation provides the same state-law liability shield as a C corporation.
- Unlike a C corporation, in general an S corporation is a flow-through for tax purposes. The income and deduction items of an S corporation flow through onto the tax returns of the shareholders (by way of a Schedule K-1) in proportion to the shareholders' stock ownership. When the items flow through to the S corporation shareholders, they retain their character as ordinary income/loss or capital gain/loss.
- Consequently, there is no corporate-level tax on an S corporation. Only one level of tax is imposed on the income of an S corporation, at the shareholder level.
  - However, there are some limited situations where tax is imposed on an S corporation if it was formerly a C corporation and converted to S status.
- There are limitations that can apply to the use by shareholders of deductions that flow through to them from an S corporation.

S Corporation (cont’d)

- Earnings of an S corporation that have already flowed through to the shareholders for tax purposes and have been subject to tax at the shareholder level are not taxed again when the S corporation distributes the earnings to the shareholders.
- In general, the transfer of assets by a shareholder to an S corporation is tax-free.
- However, an appreciated asset cannot be extracted from an S corporation without recognition of gain that flows through to the shareholders.

S Corporation (cont'd)

- Here is an example showing the taxation of S corporation earnings.
- An S corporation (S) earns $100 of ordinary income (and no capital gain or loss). S pays no federal income tax on the earnings.
- The income flows through to the S shareholders who pay tax on the earnings. Assuming the S shareholders pay tax at the highest federal income tax rate, they pay tax of $37 (37% rate). Note: there might also be state income tax.
- S distributes $100 to the S shareholders. The S shareholders do not pay tax on the distribution.
- After taxes paid at the shareholder level on the S corporation's earnings ($37), the S shareholders keep $63.
- There is a special deduction in the Code for owners of S corporations that can reduce the tax rate to 29.6% on certain earnings from an S corporation, so in some cases the S corporation shareholders can keep as much as $70.40.

S Corporation (cont'd)

- The tax treatment of S corporations affects transactional planning.
- If an S corporation sells its assets for cash and liquidates, the corporation will not be subject to corporate-level tax on the gain on the sale. The capital gain/ordinary income or capital loss/ordinary loss from the asset sale will flow through to the S corporation shareholders. The S corporation shareholders will receive a step-up (or step-down) in stock basis reflecting the income or loss that flows through from the S corporation, which will affect the shareholders' capital gain or loss upon receipt of the sales proceeds upon liquidation of the S corporation. The purchaser will take the assets with a basis equal to the purchase price, which would result in a stepped-up basis for the purchaser if the assets were appreciated in the hands of the selling corporation. The stepped-up basis for the purchaser could result in more depreciation deductions (or in some cases more immediate write-off of the cost of the assets) for the purchaser.

S Corporation (cont'd)

- If instead of an asset sale by the S corporation, the shareholders of the S corporation sell their stock, they will have capital gain (or loss) with respect to the gain (or loss) in their stock, but the purchaser of the shares will not obtain a step-up in basis in the assets of the S corporation.
- Consequently, the parties need to understand the tax consequences in negotiating the structure of a transaction.
- Similar to C corporations, S corporations can engage in various types of tax-free reorganizations in which the assets or stock of an S corporation are acquired by another corporation.
- Also similar to C corporations, if certain requirements are satisfied an S corporation can divide into two corporations.

Partnership

- In general, there are two types of state-law partnerships, general partnerships and limited partnerships.
- In a general partnership, all the partners are personally liable for the liabilities of the partnership.
  - A limited liability partnership (LLP) is a general partnership that provides some limited liability for each partner depending on the governing state law. This form is generally used by providers of professional services.
- In a limited partnership, there is a general partner (or partners) and limited partners. The general partner (which can be a corporation) is personally liable for the liabilities of the partnership, but the limited partners normally are not liable beyond their capital investment.

Partnership (cont'd)

- A partnership is governed by a partnership agreement, which is a contract in which the partners agree on their responsibilities (e.g., capital obligations and management duties) and their economic sharing of profits and losses.
- Because the partnership agreement is a contract, the partners have substantial flexibility in dividing up their responsibilities and their economic shares.

Partnership (cont'd)

- A partnership is a flow-through for tax purposes. A partnership files an annual Form 1065 (U.S. Return of Partnership Income) with the IRS.
- Because a partnership is a flow-through for tax purposes, there is only one level of tax imposed on the income of a partnership, at the partner level.
- The income and deduction items of a partnership flow through onto the tax returns of the owners (by way of a Schedule K-1). When the items flow through to the partners, they retain their character as ordinary income/loss or capital gain/loss.
- In general, the tax items must be allocated among and the partners in a manner consistent with the sharing of economic profits and losses set forth in the partnership agreement.

Partnership (cont'd)

- Here is an example showing the taxation of partnership earnings.
- A partnership (P) earns $100 of ordinary income (and no capital gain or loss). P pays no federal income tax on the earnings.
- The income flows through to the partners who pay tax on the earnings. Assuming the partners pay tax at the highest federal income tax rate, they pay tax of $37 (37% rate). Note: there might also be state income tax.
- P distributes $100 to the partners. The partners do not pay tax on the distribution.
- After taxes paid at the partner level on the partnership's earnings ($37), the partners keep $63.
- There is a special deduction in the Code for partners that can reduce the tax rate to 29.6% on certain earnings from a partnership, so in some cases the partners can keep as much as $70.40.

Partnership (cont’d)

- In contrast to an S corporation where there can be only a single class of stock and all tax items are shared in proportion to stock ownership, a partnership allows for a more flexible and more complicated economic arrangement and sharing of tax items.
- Similar to an S corporation, there are limitations that can apply to the use of partnership deductions by the partners.
- In general, a transfer of property to a partnership by partners is tax-free.
- In general, a partnership can distribute property to its partners tax-free.

Partnership (cont’d)

- The tax treatment of partnerships affects transactional planning.
- If a partnership sells its assets for cash and liquidates, the partnership will not be subject to partnership-level tax on the gain on the sale. The capital gain/ordinary income or capital loss/ordinary loss from the asset sale will flow through to the partners. The partners will receive a step-up (or step-down) in the basis of their partnership interests reflecting the income or loss that flows through from the partnership, which will affect the partners’ capital gain or loss upon receipt of the sales proceeds upon liquidation of the partnership. The purchaser will take the assets with a basis equal to the purchase price, which would result in a stepped-up basis for the purchaser if the assets were appreciated in the hands of the selling partnership. The stepped-up basis for the purchaser could result in more depreciation deductions (or in some cases more immediate write-off of the cost of the assets) for the purchaser.

Partnership (cont'd)

- If instead of an asset sale by the partnership, the partners sell their partnership interests, they will have capital gain (or loss) with respect to the gain (or loss) in their partnership interests, subject to certain exceptions. Unlike an S corporation, the purchaser of the partnership interests can obtain a step-up in basis in the assets of the partnership if the purchaser makes a particular election.
- Consequently, the parties need to understand the tax consequences in negotiating the structure of a transaction.
- A partnership cannot participate in the various types of tax-free reorganizations and divisions allowed for C corporations and S corporations.
- However, in certain situations a partnership can combine tax-free with another partnership and in certain situations a partnership can divide tax-free into two partnerships.

Limited Liability Company

- A limited liability company (LLC) is a state-law entity that, in general, provides a liability shield to all of its owners.
- An LLC has members, not shareholders or partners.
- An LLC is governed by an LLC agreement, which is similar to a partnership agreement.
- An LLC with a single member is treated as an entity disregarded for tax purposes, which means that the member is treated for tax purposes as the direct owner and operator of the business.
  - An LLC with a single member can, however, elect to be taxed like a corporation.
- An LLC with multiple members is taxed like a partnership.
  - An LLC with multiple members can, however, elect to be taxed like a corporation.

Cooperative

- A cooperative is a state-law entity owned and controlled by the people who use the products or services the business produces.
- Cooperatives operate for the benefit of members, rather than to earn profits for investors.
- Cooperatives may include businesses owned and managed by the people who use their services (a consumer cooperative) or organizations managed by employees (worker cooperatives).
- Economic benefits of a cooperative are distributed in proportion to each member’s level of participation in the activity of the cooperative, rather than according to capital invested.

Cooperative (cont'd)

- Cooperatives are democratic - each member has one vote. All members have the same voting power regardless of their respective capital investments.
- In general, members of a cooperative are not personally liable for the liabilities of the cooperative beyond their capital investment.
- Income earned by a cooperative is generally taxed once at the member level.
- A cooperative files Form 1120-C (U.S. Income Tax Return for Cooperative Associations) with the IRS.

Employee/Independent Contractor Issues

- Business owners must determine whether the individuals providing services to the business are employees or independent contractors.
- Generally, a business must withhold income taxes, withhold and pay Social Security taxes and Medicare taxes, and pay unemployment tax on wages paid to employees.
- Federal and state employment and labor laws also apply with respect to employees.

Employee/Independent Contractor Issues (cont'd)

- The obligations described on the previous slide do not apply with respect to independent contractors.
- Penalties can apply for incorrect classification of workers as independent contractors rather than employees.
- To determine the status of a worker, various factors are considered, in particular the extent to which the business controls or has the right to control what the worker does and how the worker does his or her job.