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Taxes, Business Entities, and Some Basis Business Stuff That Will Help You Stay Focused on What You Do Best!

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Creative Entrepreneurship is, among other things, Business Ownership. Many people who start their own businesses often feel unprepared for the innumerable administrative and managerial tasks that arise once they've struck out on the self-employed path. There are so many topics to discuss, but this presentation will focus primarily on a few: Taxes, Entity Selection, and Basic Business Practices. They are intimately connected and choosing wisely early on can help you stay focused on enjoying your business and helping your clients.

Damn Taxes!

"I've been held responsible for taxes I know nothing about" – James Brown

Taxes are a fact of life, and if you are good at what you do, then you'll likely have a successful business, and that will lead to paying taxes: Employment Taxes, Excise Taxes, Gains Taxes, Income Taxes, Payroll Taxes, Sales Tax, Self-Employment Taxes………

They never seem to end, and the amount and types of taxes you will likely have to pay can be overwhelming, expensive, and at time baffling. Below is a general list of the types of taxes that Business Owners and Individuals often must pay:

- **Employment Taxes**: these are generally taxes incurred by a business owner for paying employees' wages. The most common types fall under Federal and State Unemployment and Paid Family Leave. They vary by state, but most are assessed as a percentage of wages paid per employee up to a certain amount of wages paid. They are almost always paid directly by the business, but some states require that Employees withhold a certain amount from their wages.
- **Excise Taxes**: these are imposed on certain goods, services, and activities. There are Federal and State Excise taxes, and they are an expense of the business. Some states impose Excise Taxes on manufacturers, so while rare, your business may be subject to this tax.
- **Gains Taxes**: these are an income tax mostly related to the sale, exchange, and/or disposition of assets. Some Incorporated Businesses pay their own Gains Tax, while other businesses do not pay these taxes directly and instead the owners pay the tax on their personal tax returns.
- **Income Taxes**: these taxes can be paid directly by the business or by the individual, depending on how the business is organized. Income taxes can be subject to Progressive Tax Rates or a Flat

Tax Rate. Progressive Taxes are taxes that use a 'Tax Table' and charge a different percentage at different levels of income. Some Corporations now pay a Corporate Flat Tax to the IRS (21%) but may pay a Progressive Tax Rate at the state level. Individuals pay Progressive Tax Rates at the federal level while some states have Flat Taxes and Progressive Taxes.

- **Payroll Taxes**: like Employment Taxes, these are taxes incurred by a business owner for paying employees' wages. They generally are Social Security Tax and Medicare Tax. Both are required to be paid by the employer and employee. Social Security Tax is 6.2% of wages up to a certain limit ($142,800 in 2021) and Medicare is 1.45% of wages with no limit. Employers pay half and then Employees pay the other half, so the total paid is 15.3%. There are additional Medicare Taxes withheld from Wages that exceed $200,000 (in 2021) and is 0.9% of those wages. Even though Employers don't pay the full amount of these Payroll Taxes, they are responsible for withholding and paying the amounts to the IRS. Also, some Cities/Counties have additional Payroll Taxes that are required to be withheld from wages. Finally, Employers are responsible for withholding Federal and State income taxes from wages and paying them to the IRS and State agencies.
- **Sales Tax**: these are a state and/or local tax added to the cost of goods and services. They vary from state to state, and there is often confusion around when to charge sales tax and if something is subject to sales tax. State Department of Revenue agencies are the best resource for finding out if you charge sales tax, when they are due to be paid, etc. In general, Sales Tax is not income or an expense to you. It is a consumption tax that you may be responsible for collecting and then paying to the state and/or local government. Also, there are exemptions from collecting sales tax for certain manufacturers, and Sales Taxes you may have to collect and pay to other states, depending on where your clients (the end users) are located. They can be very complicated, and thankfully the internet has simplified some of the rules for interstate commerce. You should be aware though that state agencies are aggressive in enforcing these taxes so you'll likely need to be aware of how they work.
- **Self-Employment Taxes:** these taxes (often just called SE Tax) are Social Security and Medicare Taxes assessed on the net profit of Self-Employed Individuals. If you are Self-Employed, and you show a profit, you are assessed the SE Tax on your net profit as well as Income Taxes. SE Tax is 15.3% of net profit of Self-Employment income. It is the full amount of Social Security and Medicare that was discussed under Payroll Taxes, but when you are Self-Employed, you're responsible for paying all of it.

This list covers most of the taxes you may be responsible for as a business owner, but there may be other esoteric taxes that you come across as your business flourishes. No matter what revenue agencies throw at you for their piece of the business pie, your best basic resources for learning about taxes is the Internal Revenue Service website (www.irs.gov) as well as the revenue websites in the state or states you will operate in. So, before you hire an expensive CPA or Attorney, look at the websites first to see if you are subject to a tax and how they work. Most of the info is easy to find, and the people who work at the agencies can be very helpful and will walk you through some of the basics. If things get more complicated, than it is important to know when to hire someone to help you navigate the tax landscape (more on that later).

Entity Selection: Cause That's My Business

"Even if you don't have the perfect idea to begin with, you can likely adapt"

- Victoria Ransom

Owning a business can be incredibly simple with very little organization or can involve setting up a legal structure. The type of business owner you want to be and how you organize your business often depends on a few things:

- What kind of income am I likely to earn?
- Do I need to worry about protecting my personal assets?
- Do I want to have partners or stay by myself?

Sole Proprietor: The simplest form of Business Structure, and likely the most common, is just being you and charging for your products and services. You are not required to do anything beyond this simple formation. This is also known as being Self-Employed or an Independent Contractor. Sole Proprietors report all their Income and Expenses on the Schedule C of their Form 1040 tax return, and they are taxed on their Net Income (Profit). Their Net Income is subject to both Income and Self-Employment Taxes.

There is no legal distinction between the individual and the business. You are the business. You are allowed to obtain a 'Doing Business As' certificate and operate under a different name. You can also get a Federal Tax Identification Number (EIN) for your business (required if you hire employees), but unless you formally set up a separate entity, you are still a Sole Proprietor. A Sole Proprietor is responsible for recording all his/her income and expenses and is not permitted to pay him/herself through wages. Instead, the owner pays taxes on his/her profit and can take funds out of the business account as needed. But, regardless of how much money you take out of the business, you are still taxed on your Profit.

While this is the simplest and least expensive form of business structure, it has very little business protection for the owner and due to Self-Employment Taxes (SE Tax), usually pays the highest tax rates. It also is statistically the most likely form of business to be audited by the IRS and state agencies because all the activity is self-reported. However, one major benefit of the Sole Proprietor, other than the ease and low cost, is that you can deduct your losses on your personal tax returns, and that can be advantageous for people. Another benefit is that there is one legal tax shelter that involves paying your children and not having to contribute to Employment, Payroll, and some other taxes.

Corporation: these are separate legal structures organized at the state level**.** Most states have you form the corporation with the Secretary of State by filling out some documents and paying a fee. Once the state accepts your documents and formation, you would then obtain an EIN for your corporation.

All corporations begin as a C Corporation. C Corporations pay their own income tax and issue shares to the shareholders (owners). Other than Wages and possibly dividends paid to the shareholders, all the income and taxes are reported and paid at the entity level. C Corporations have some advantages, the most popular being its relatively low tax rate (21% Federal Flat Tax) and its separate legal structure. However, the C Corporation has many disadvantages, the biggest being that it's difficult to take money from the company without having to report additional income on your personal tax returns. Therefore, If you choose to be a corporation, and you'd like more flexibility related to withdrawing funds from the corporation, you can elect to be an S Corporation by filing one additional form with the IRS (Form 2553). S Corporations do not generally pay federal income tax, but they pay Income and sometimes Excise taxes in some states.

The S Corporation is called a "Flow Through" entity because the profits or losses from an S Corporation "flow through" to the shareholders based on their percentage of ownership. So, if you own 33% of the Corporation, you would each report 33% of the profits/losses on your personal tax returns from a form called a Form K-1. The Form K-1 shows profits, losses, and other types of income and expenses that are generated from the S Corporation that must be reported on the shareholder's personal tax return. It also shows the shareholder's "Basis", or Equity, in the S Corporation. The Basis is a record of each shareholder's value in the corporation, and is essentially an aggregate of the profits, losses, shareholder contributions, and shareholder distributions taken since the corporation's inception. This amount is updated at the end of each year once the financials and tax returns have been finalized.

The S Corporation is a very popular corporate entity because of the tax savings and the ease with which shareholders can withdrawal funds from the corporation without incurring additional tax. The profits from an S Corp are considered "Passive" income and are therefore not subject to Self-Employment Taxes. Additionally, shareholder's report the profits (or losses) each year, and these amounts increase (or decrease) the shareholder basis in the corporation. Withdrawals from the corporation (called 'shareholder distributions') are not taxable, so as a shareholder increases his/her basis in the corporation, he/she can withdrawal funds from the corporation without incurring additional tax liabilities. Shareholders only report income from the corporation's profit and from wages (though if the company earns interest, dividends, and capital gains, those income items are reported on the shareholder's personal returns based on the percentage of ownership, too). If the corporation has a loss, the shareholders can deduct the loss personally if he/she has basis available. The loss will reduce a shareholder's basis, and if the loss is greater than the amount of basis a shareholder has, then the loss is "Suspended" and is carried forward until basis is restored, or earned, again.

Because the profits from an S Corporation are not subject to Self-Employment Taxes, many business owners choose this option to reduce their tax liabilities. Self-Employment Taxes are Social Security and Medicare taxes that Self-Employed individuals pay based on their net profit from their businesses. This tax is essentially 15.3% of your net profit and added to your total Income Tax on your personal tax return. It is also applied near the end of your personal tax return, so it cannot be reduced by personal deductions, exemptions, and credits. Because the S Corporation profit is passive income, shareholders do not pay SE Tax on their share of S Corp profits. However, the IRS requires shareholders who perform services for the S Corporation to pay themselves a reasonable salary. The IRS does not specify what the reasonable salary should be, so the S Corporation shareholders have flexibility in terms of how much and how often they pay themselves. Many S Corporation shareholders pay themselves a minimum salary to report more passive income. The shareholder salary can be an effective tax planning tool and can be used solely for contributing to the shareholder's personal tax liability.

LLC/Partnership (LP): The LLC and LP function the exact same way in terms of how income and expenses are reported to the partners. Both entities have partners who own a percentage of the LLC/LP, and both entities are flow through entities. So, like the S Corporation, the partners report their share of the LLC/LP profit or loss on his/her personal tax return based on his/her percentage of ownership. Also like the S Corporation, each partner has an equity account (called a 'Capital Account') that tracks the partner's share of profits, losses, contributions, and distributions. Partners report as income their share of profit (or losses) on a Form K-1, and not the funds withdrawn from the LLC/LP. Instead, like the S Corporation, the withdrawals (and losses) reduce the partner's capital account, and profits and contributions increase the partner's capital account.

Partners of LLC/LPs do not pay themselves wages, so there is no payroll for Partners (with one exception, explained below). However, the LLC/LP can 'pay' a partner a 'Guaranteed Payment' for services performed. This is a business deduction, and reduces the profit for the LLC/LP, and is also income to the partner receiving guaranteed payment. This is often used to compensate one partner for additional services performed for the LLC/LP, or for commissions, or for managing the entity for the other two partners. It is not required, but it is an option if the need to compensate one partner separately ever arises. A guaranteed payment is reported as income to the partner receiving it and is listed on the partner's Form K-1 along with his/her share of the profits (losses).

Apart from payroll, the other major difference between the LLC/LP and the S Corporation is that the earnings from an LLC/LP are subject to Self-Employment taxes (including Guaranteed Payments). So, income from the partner's Form K-1 will be taxed the 15.3% of SE Tax plus the tax for Ordinary Income. The one advantage the LLC has over the LP is that it can choose to be taxed as a corporation by filing some forms with the IRS in the beginning of the year. If this is done, the LLC acts just like an S Corporation (or C Corp) and the partners would put themselves on payroll and report the profits (or losses) as passive income instead of income subject to SE Tax.

Finally, many people have heard of LLCs, and an individual can set up an LLC and be what is called a 'Single Member LLC'. These are easy and inexpensive to form and have the legal protection of a separate entity. However, a Single Member LLC does not file a separate tax return and, like a Sole Proprietor, reports all the activity on the Schedule C of a Form 1040.

As you can see, there are many options for organizing your business, and how you organize can involve extensive tax planning and a review of your legal liability. In general, a separate legal entity will protect your personal assets, but, depending on the type of entity, it may not help you reduce your tax liability. Working with a CPA or tax planner is important for setting up your business, so I highly recommend you talk to someone in advance to see what would work best for you and your unique tax situation.

Better Business Practices: Know Thyself

“There is nothing more beautiful than someone who goes out of their way to make life beautiful for others” – Mandy Hale

Owning and operating one’s own business can be rewarding, but it can also consume all aspects of your life as well, and that may not always be a good thing. Many people are good at what they do, but often these same people are not good at running a business. However, there are some basic, better business practices that new business owners can adopt early on to help them enjoy business ownership and not have the growth surpass your level of preparedness:

Know what you can handle and when you should hire: Probably one of the biggest mistakes that new business owner make early on is trying to do everything for the sake of saving money. While doing your bookkeeping, invoicing clients, updating your software, paying your employees, ordering office supplies, and writing contracts are great skills to learn, they will get in the way of your main business activity very quickly, and will also take valuable time away from your personal life and take attention away from your clients. It is so important to know when to hire people to take over the administrative tasks so you can focus on your clients and your business. Most new business owners will try to do as much as they can early on, but effective business owners begin to separate portions of their business and pass those segments on to other more qualified people. Hiring a bookkeeper, a payroll company, and an Accountant early on will save you a lot of headaches. If you are working more than eight hours a day, and working seven days a week, that is a sign that you are doing too much and need help. Take an inventory of your weekly tasks and decide what can be passed on to someone else.

Know your worth and when to say No: When just starting out, many business owners feel that they will not survive financially and will work for a discounted rate to keep the client. While it is important to be aware of what the market can afford in terms of your services and products, it is also ill advised to work for cheap for fear of losing business. This is a common mistake new business owners make, and the most common side effect of this is resentment towards the work itself and the client. When that happens, your work and reputation will suffer. So, know what you’re worth and what the market pays for your services and products. If a client won’t pay that amount, they are not worth your time or energy.

Know your business through your client’s eyes: While clients will hire you because you’re talented, they will not stay with you or darken your doorway again if you are difficult to work with, can’t deliver projects on time, are too costly, don’t answer emails and phone calls, and are inconsistent with your work. Quite simply, they won’t do business with you again if you behave in a way that makes it difficult for them. So, review yourself objectively often, and see where you can improve. Clients are running their own businesses, and they want someone they can depend on and trust. Having someone whose opinion you trust is usually very helpful when assessing your own business. This can be a client who you know personally, an employee, or anyone who can give you the straight truth about your business practices. Find that person or those people early on and listen to them when you ask, ‘How am I doing’?

Know your limits and know when to ask for help: Other common mistakes that new business owners make is taking on too much work and not delegating. If you provide a good service or product at a price supported by the market, you will be busy and may not realize that you've become so busy that you may not be able to deliver on time and/or may not be able to produce with the best quality that you can provide. If you cannot accommodate your clients, then you need to decline work until such time that you've hired help or your current workload diminishes. Also, you should evaluate your work practices to see that you are working efficiently and not being distracted by other secondary or tertiary tasks. If you are, it's time to delegate, and if there's nobody to delegate to, then hire someone to help.

Know who to cultivate and who to avoid: Business owners will collect clients who are satisfied with your work and will actively refer to you and promote your business. These people are your best form of advertising and recognizing them and cultivating them is extremely important. However, businesses also attract many people who will waste your time. They can be other businesses aggressively and regularly trying to sell you goods and services, clients who spend a lot of your time (without paying you), and employees who are wonderful people but not productive. Your time is your most valuable asset, and each minute your attention is directed elsewhere is costing you. Knowing the people avoid and being firm about what you want (or don't want) from them is very important.

You Need Professional Help

As mentioned above, hiring people to help with some administrative and managerial tasks is an important move and one that many people wait too long to do. But, how do you decide who to hire? I recommend three simple criteria: Experience, Availability, and Value. I also recommend that you interview at least three people or organizations in each service that you need help with, and if you can, get recommendations.

Experience: whether it's an attorney, bookkeeper, CPA, payroll company, financial advisor, or business coach, find professionals who have experience working with businesses in your industry. This is important because you are hiring them for their skills but also for their knowledge in your industry, and the right professional can save you time, money and angst by providing valuable information on how you operate your business, how others operate their businesses, what works, and what doesn't. They often have contacts that would be helpful to you and can advise in many areas of business administration.

Availability: a professional who is flexible and can work within your schedule is very important, so look for a professional who can work when you need him/her, not the other way around. Additionally, make sure that this person can accommodate your business by being clear about what you're looking for and what you need. Communicating your needs in terms of time, budget and tasks that need completed is crucial to the right hire.

Value: finding the right person means that you are getting your money's worth, of course, but the services you are receiving are improving your business. If you are spending your hard-earned cash on a professional service, it should be creating value for you. That value should be measurable, as in it gives you more time to pursue new business, it provides better information to pricing and marketing your work, it demonstrates clear methods to cut costs in your business so you're more profitable, etc. If the professional service does these things effectively, then you will feel that the cost is worth it. If you feel that you are wasting money or don't understand what you're receiving, then it's not working for your business.

Record Keeping: Put Your Records On

Business Documents To Keep For One Year

- Correspondence with Customers and Vendors
- Duplicate Deposit Slips
- Purchase Orders (other than Purchasing Department copy)
- Receiving Sheets
- Requisitions
- Stenographer's Notebooks
- Stockroom Withdrawal Forms

Business Documents To Keep For Three Years

- Employee Personnel Records (after termination)
- Employment Applications
- Expired Insurance Policies
- General Correspondence
- Internal Audit Reports
- Internal Reports
- Petty Cash Vouchers
- Physical Inventory Tags
- Savings Bond Registration Records of Employees
- Time Cards For Hourly Employees

Business Documents To Keep For Six Years

- Accident Reports, Claims
- Accounts Payable Ledgers and Schedules
- Accounts Receivable Ledgers and Schedules
- Bank Statements and Reconciliations
- Cancelled Checks
- Cancelled Stock and Bond Certificates
- Employment Tax Records
- Expense Analysis and Expense Distribution Schedules
- Expired Contracts, Leases
- Expired Option Records
- Inventories of Products, Materials, Supplies
- Invoices to Customers
- Notes Receivable Ledgers, Schedules
- Payroll Records and Summaries, including payment to pensioners
- Plant Cost Ledgers
- Purchasing Department Copies of Purchase Orders

- Sales Records
- Subsidiary Ledgers
- Time Books
- Travel and Entertainment Records
- Vouchers for Payments to Vendors, Employees, etc.
- Voucher Register, Schedules

Business Records To Keep Forever

While federal guidelines do not require you to keep tax records "forever," in many cases there will be other reasons you'll want to retain these documents indefinitely.

- Audit Reports from CPAs/Accountants
- Cancelled Checks for Important Payments (especially tax payments)
- Cash Books, Charts of Accounts
- Contracts, Leases Currently in Effect
- Corporate Documents (incorporation, charter, by-laws, etc.)
- Documents substantiating fixed asset additions
- Deeds
- Depreciation Schedules
- Financial Statements (Year End)
- General and Private Ledgers, Year End Trial Balances
- Insurance Records, Current Accident Reports, Claims, Policies
- Investment Trade Confirmations
- IRS Revenue Agent Reports
- Journals
- Legal Records, Correspondence and Other Important Matters
- Minutes Books of Directors and Stockholders
- Mortgages, Bills of Sale
- Property Appraisals by Outside Appraisers
- Property Records
- Retirement and Pension Records
- Tax Returns and Worksheets
- Trademark and Patent Registrations

Personal Documents To Keep For One Year

While it's important to keep year-end mutual fund and IRA contribution statements forever, you don't have to save monthly and quarterly statements once the year-end statement has arrived.

Personal Documents To Keep For Three Years

- Credit Card Statements
- Medical Bills (in case of insurance disputes)
- Utility Records
- Expired Insurance Policies

Personal Documents To Keep For Six Years

- Supporting Documents For Tax Returns
- Accident Reports and Claims
- Medical Bills (if tax-related)
- Sales Receipts
- Wage Garnishments
- Other Tax-Related Bills

Personal Records To Keep Forever

- CPA Audit Reports
- Legal Records
- Important Correspondence
- Income Tax Returns
- Income Tax Payment Checks
- Property Records / Improvement Receipts (or six years after property sold)
- Investment Trade Confirmations
- Retirement and Pension Records (Forms 5448, 1099-R and 8606 until all distributions are made from your IRA or other qualified plan)