# The Legal Form of Your Business and Tax Issues

*"It was as true as taxes is. And nothing's truer than them."*

—Charles Dickens (1812–1870), English novelist
Mr. Barkis in *David Copperfield* (1849–1850)

This chapter provides an overview of various types of business entities. It is not intended to substitute or replace the advice of an attorney, accountant, or other similar professional. Before making any critical decisions regarding the setup of your business, you should consult the appropriate licensed professional.

There are five basic legal forms your business can take: sole proprietor, partnership, S corporation, C corporation, and Limited Liability Corporation (LLC). Of these, I will not discuss LLCs because few independent consultants use this form of business and not every state allows them.

This chapter includes discussion of temporary employee status as a contractor, which is not technically a form of business. For many independent consultants, however, this is the first type of contractual relationship they enter into, so you should be aware of its advantages and limitations.

The types of business structures available to you are shaped by two basic factors: liability and taxation. A sole proprietor and partnership assumes more personal liability risk than a corporation. This means that the chances of a lawsuit awarding damages against the personal assets of a sole proprietor or partner is greater than that of a shareholder of a corporation. Taxation is a fact of life for any

type of business. Depending on the type of business, the IRS charges taxes against the business owner's personal income or against the profits of the business. Contract employees, sole proprietors, partnerships, and S corporations pay taxes based on the owner's net income from the business. C corporations pay separate taxes based on the net profits of the business. Each business type has various liability and taxation advantages and disadvantages.

When considering which legal form you will ultimately choose for your business entity—you should consider how the business pays you, how the IRS gets paid, and the effort required to set up the business.

Except in a contract employee arrangement, you must justify the IRS definition of an independent contractor when you work for either a client or an agency, regardless of the legal form of business you choose. If you fail to meet the IRS definition of an independent contractor, the IRS could make your client or agency liable for payroll taxes and disallow your business deductions.

## Contract employee arrangement

When someone hires you as a contract employee, you are not a business but a temporary employee. This is typically the type of relationship you establish when you first start working with agencies. Per your contract, your employer issues you a paycheck which includes your net pay, after taxes, for the pay period.

The IRS gets paid when your employer withholds federal, state, social security, Medicare, and any other taxes typical for employees in your area. You fill out a W-4 and receive a W-2 same as any other employee. The IRS tracks you for tax purposes using your Social Security number entered on the W-4 form.

The only paperwork necessary to set up a contract employee is to fill out a W-4 form for your employer. This registers your Social Security number and establishes the number of allowances you want to set for withholding purposes.

This is the easiest method of employment to set up. As a temporary employee, you may qualify to participate in some employer benefits such as health insurance and retirement plans. However,

you usually have to work for the employer for a minimum number of hours per year before you qualify.

Although your employer withholds payroll taxes from your paycheck, you avoid paying the employer side of Social Security and Medicare taxes. As of this writing, these taxes add up to 7.65 percent of your gross earnings. This includes 6.2 percent of Social Security tax on the first $68,400 of gross earnings and 1.45 percent of Medicare tax on all your earnings. You also avoid paying federal and state unemployment taxes.

Another advantage is limited liability. As a contract employee, you are shielded from liability against the hiring company when you act as an agent for that company.

Disadvantages include the fact you cannot deduct business expenses while you are a temporary employee. This means you typically cannot deduct the cost of your home office, equipment, or any of your health insurance costs. However, there are some exceptions to this restriction. If you file itemized deductions for personal deductible expenses (mortgage payments, real estate taxes, and so forth), you can also deduct the expenses of nonreimbursed items, such as equipment or uniforms, required by your employer.

## Sole proprietor status

If you do not work for someone as a temporary employee and you do not set up a corporation or partnership, your business legally defaults to a sole proprietorship. After you do work for a client as a sole proprietor, the client issues you and the IRS a 1099 statement describing how much the client paid you during the year.

You get paid by withdrawing as little or as much as you want from the profits of your business. The IRS gets paid when you report the net profit of your business on your personal income taxes using Schedule C. You must file a declaration of estimated income tax (Form 1040-ES) each quarter. When you file Form 1040-ES you pay estimated federal income taxes and self-employment taxes for the quarter. The self-employment tax includes both the employer and employee portions of the Social Security and Medicare taxes totaling 15.3 percent. If you do not have employees, the IRS tracks the business for tax purposes using your personal Social Security

number. If you hire employees, you must file for a Federal Employer ID number using form SS-4.

Although you do not have to fill out any paperwork to establish a sole proprietorship, you may need to register with your local government. This may include filing a fictitious name statement or Doing Business As (DBA) name. You may also have to apply for a local business license from your county or municipality.

An advantage to a sole proprietorship is you can deduct your business expenses including at least a portion of your health insurance costs. You apply the deduction to your adjusted gross income, not to the Schedule C for your business.

A disadvantage is a sole proprietorship does not protect your personal assets from damages assessed as the result of a lawsuit against your business.

## Partnerships

Although partnerships are typical for law firms and architectural firms, partnerships are rare for most other independent consultants. A partnership is the only form of business that *requires* multiple owners. Even a corporation can be owned by only one person. As an alternative to a partnership, most consultants create a corporation and distribute shares to other owners when they want to add people to their business.

The way you get paid is determined by a partnership agreement. Typically, the agreement divides profits equally between the partners.

The IRS gets paid by taxing the profits of the individual partners. The IRS requires partnerships to file a partnership income tax return (Form 1065) even though the partnership itself does not pay any taxes. Form 1065 includes an attached form K-1 that shows the changes in each partner's share and the taxable share of the partnership's income or loss. A partnership must also obtain a Federal Employer ID number even if it has no employees.

Other than the IRS forms mentioned above, the government does not require any formal paperwork to set up a partnership. However, though it is not required by law, most partnerships create a written partnership agreement, usually drawn up by an attorney.

One advantage to a partnership is it relieves you from doing everything yourself. If you allocate the work load properly, you can have one partner do marketing full-time while another delivers the service.

Similar to a sole proprietorship, a partnership is legally connected to its owners. This means that a court can order the partners to pay the damages of a lawsuit from the partners' personal assets.

## S corporations

S corporation refers to Subchapter S of the Internal Revenue Code. An S corporation is a cross between a standard corporation and a partnership. It's like a corporation because ownership is vested in shareholders and it provides limited liability protection to the company stockholders. It's like a partnership because it provides for multiple owners and all the profits of the S corporation pass through to the shareholders where the IRS taxes the profits as personal income.

There are two ways to receive money from your S corporation. You can pay yourself as an employee of your corporation complete with payroll deductions and W-2 form at the end of the year. The second method is to withdraw profits in the form of a distribution. The primary advantage of paying yourself a salary (despite the cost of payroll deductions) is that it qualifies you for your company retirement plan and you continue to participate in the federal Social Security program. When you pay yourself a distribution, the IRS taxes it as part of your total income on your personal income taxes. You avoid payroll taxes, but none of the money from the distribution can participate in a retirement program.

As you pay yourself a salary, you withhold taxes from your paycheck the same as any other employer would. When you deposit the withheld funds, you must add the 7.65 percent employer side taxes for Social Security and Medicare. The S corporation must file an income tax return (Form 1120-S). Any taxable income the business earns (in excess of your salary and expenses) pass through to you on your personal income taxes using Schedule E.

Each individual state, not the federal government, registers and licenses corporations. No two corporations can have the same name

within the same state, so you have to reserve your corporate name then file articles of incorporation and pay a licensing fee. Usually the articles of incorporation is a standard form that you fill out. Every year you file an annual report and pay a yearly franchise tax.

The S corporation designation is an IRS issue and as such is not handled by the states. To register your corporation as an S corporation, you have to file Form 2553 with the IRS prior to the taxable year for which it will be effective, or by the fifteenth day of the third month of the current taxable year. Also, you must get a Federal Employer Tax ID number from the IRS (Form SS-4). Finally, you must set up a corporate checking account separate from your personal checking account.

The most often-sited advantage to incorporating (S or C corporation) is the limited liability. If a lawsuit can show that you incorporated for the sole purpose of avoiding liability while acting recklessly, or if you don't maintain your corporate status (such as neglecting to file your annual report and paying the franchise tax), the lawsuit may expose your personal assets. This is known as "piercing the corporate veil." Despite this possibility, incorporating does provide an additional hurdle for someone seeking damages beyond the assets of the corporation itself.

Many independent consultants incorporate to add prestige to their business and to access more clients. Having "Inc." or "Corp." after the name of your company reinforces that yours is a "serious" business.

An added advantage of S corporations is in the area of taxes. S corporations do not pay corporation taxes like standard corporations. If your S corporation sustains a loss in the first year of operation, the losses can "fall through" to you offsetting your personal tax burden.

In general, the biggest disadvantage to incorporating is increased paperwork and cost. As noted previously, you have to file annual reports with the state and a corporate tax return with the IRS. Additionally, you have to handle all the employer paperwork to pay yourself a salary.

S corporations also have many specialized restrictions. S corporations are limited to 75 or fewer stockholders and must use the

same tax year as their shareholders, which is January 1 through December 31. More significant, however, are the restrictions on deductions. An S corporation cannot deduct the cost of any employee fringe benefits (health, accident, life, disability insurance, and so forth) for any employees who own 2 percent or more of the company's stock. This excludes most independent consultants who typically own 100 percent of their company's stock.

## C corporations

When you incorporate, if you don't register as an S corporation, the IRS automatically classifies your corporation as a C corporation. The primary difference between S and C type corporations is that C corporations pay corporate income taxes on any profits leftover after salaries and other expenses. If you want to receive a dividend in addition to your salary from the C corporation, you receive income that the IRS already taxed at the corporate level. You must report that dividend as income on your personal taxes where the IRS taxes you again. This double taxation encourages most independent consultants to start with S corporations and then convert to C corporations when they want to take advantage of the added deductions.

Technically, as with S corporations, there are two ways to receive money from your C corporation. You can pay yourself as an employee of your corporation and/or you can pay yourself a distribution in the form of a dividend. As explained previously, if you pay out dividends, you get double-taxed. The advantage of paying yourself a salary is that it qualifies you for any corporate employee benefits based on your salary, including retirement saving benefits.

You handle any employee salaries the same as an S corporation or any company that pays employees on a W-2 basis. The IRS taxes any profits the business earns (in excess of your salary and expenses) at the corporate tax rate. C corporations must also deposit estimated income taxes every quarter.

As discussed above for S corporations, the states register and license corporations. All the standard corporate advantages sited above for S corporations also apply to C corporations including limited liability, increased prestige, and access to more clients. The

biggest additional advantage that C corporations have is the ability to deduct the cost of any employee fringe benefits. This includes items such as health, accident, life, and disability insurance, regardless of the level of employee ownership. Also, C corporations can select what constitutes their tax year. This could provide some advantages when trying to balance the interplay between corporate and shareholder cash flow and taxes.

The biggest disadvantage of C corporations is the double taxation. Also, there's additional paperwork in the form of quarterly estimated taxes.

## Are you an employee?

As an independent consultant, sooner or later you will encounter clients hesitant to hire you for fear the IRS may reclassify you as their employee. If you are reclassified as an employee of one of your clients, they may have to pay IRS penalties and include you in their employee benefits package. If this happens, the primary risk to you is that the IRS disallows your business deductions. This situation is actually rather rare, but several high-profile cases have caused company managers to pause before hiring independent consultants. Some companies even have standing policies not to hire any contractors unless they work for agencies with five or more employees. It is to your advantage to understand how the IRS defines employees and independent contractors.

### *The IRS "20 factors"*

The guiding factor the IRS uses to determine if you are an employee or independent contractor is the famous "20 factors" or "20 questions." The 20 factors expands a common-law test meant to establish who has *control* of your work. In a nutshell, if the person who employs you sets your work hours, provides you with tools, tells you what to do and how to do it, and can fire you, then the IRS is inclined to consider you an employee. It doesn't matter if the employer allows you freedom of action in your work. Just the fact that the employer has the legal right to control the result and method of your work is enough to demonstrate an employer-employee relationship.

What makes the application of the 20 factors so difficult is that the IRS does not consistently apply all the factors. In certain circumstances, you could technically answer more than half the questions as an employee, but still be an independent contractor because of the way the IRS weighs the questions for a particular situation. Check the IRS Web site at http://www.irs.ustreas.gov for the latest information on the IRS 20 factors.

***Safe harbor***

Over the past couple of decades, the IRS has steadily increased its enforcement of the employment tax laws with regard to employee classification. However, the 20 factors used by the IRS raised some problems. One of the stronger indications of client control is the necessity for an independent contractor to work at the client's premises. There are, however, many situations where legitimate independent contractors have to work at the client's premises because that's where the object of the work is located. A lawn care company *must* work on its client's premises because that's where the lawn is located. Likewise, the government could hardly expect mainframe programmer consultants to purchase a mainframe just so they can complete client work on their own premises.

Because of these vagaries and the increased attention brought by the IRS, the government enacted Section 530 of the 1978 Tax Reform Act to include what is now called a Safe Harbor clause. This legislation was originally intended as a temporary relief measure and was scheduled to terminate at the end of 1979, but instead, congress decided to extend it indefinitely. The clause exempted certain workers from having to meet all 20 factors to qualify as independent contractors. It allowed a client to treat an individual as a contractor, regardless of the 20 factors, if the client consistently treated the worker and similar workers as independent contractors, filed all required forms such as 1099s, *and* had a reasonable basis for treating the worker as an independent contractor. This includes similar rulings or court cases that upheld the independent contractor status, longstanding industry-wide practice, or failure of prior IRS tax auditors to question the status of the independent contractors.

***Section 1706***

If you plan to do consulting in what the IRS considers the "technical service" sector and you will be working through agencies, you should know about Section 1706. Section 1706(a) of the 1986 Tax Reform Act added a new subsection (d) to Section 530 of the 1978 Act. Even though you have to look in Section 530(d) to find the code, most people refer to Section 1706 when discussing this issue.

Section 1706 removes the Safe Harbor protection for agencies that hire independent contractors in the technical services industry. The section is poorly written and was so confusing that the IRS issued a clarification which confirmed that the new law would apply only to three-party relationships between an agency, contractor, and client. The *actual wording* of the section is as follows:

"Section 530 shall not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work."

Huh? You can see why organizations like the Independent Computer Consultants Association (ICCA) have tried to get Congress to repeal this legislation since it was passed in 1986. Janet Ruhl, in her book *The Computer Consultant's Guide*, provides an excellent description of the history of Section 1706. Apparently, the legislation was inserted into the tax code due to lobbying efforts by the National Technical Services Association (NTSA), an organization dominated by large technical service agencies. NTSA stated that its goal was to force temporary technical workers to work as salaried employees to tip the competitive edge to the larger firms who made up its membership.

NTSA lobbied for the legislation on the basis of their competitive disadvantage against smaller agencies who could attract more skilled technical contractors because the smaller agencies were willing to treat them as independent contractors and as a result share with them a much larger part of the client billings. In addition to NTSA's lobbying, IRS studies at the time *seemed* to indicate independent contractors were more likely to under report income and claim

unwarranted deductions. Based on these factors, Congress decided to restrict Section 1706 to technical service workers, and the legislation was quietly slipped into the larger Tax Reform Act of 1986 without any public debate.

If you are a technical services independent consultant, you face two basic problems related to Section 1706. The first is that because of the confusing wording of the section, some direct clients think they do not qualify for the Safe Harbor clause when they hire you directly as an independent consultant. In this case, you can try to educate your client as to the real application of the section in three-party arrangements. This is also a good reason to incorporate, because many clients who are worried about Section 1706 feel more protected when you are incorporated.

The second problem you face occurs when you do work through an agency. In this situation, incorporation by itself does not protect the agency from Section 1706, although many believe it does. When doing work through an agency, as much as possible, you should try to reinforce your status as an independent consultant as defined in the IRS 20 factors. Some agencies don't want to risk being burned, so they only hire consultants as temporary employees on a W-2 basis. If you encounter an agency with this policy, you could take the W-2 work; however, you should be aware that if you mix W-2 and independent consultant work the IRS could redefine all your work as W-2. The simplest way to avoid this is to turn down any work that requires you to work on a W-2 basis.