

Limited Liability Corporations (LLCs), S-Corps

This PDF is compiled with the most popular questions. These questions and answers, in addition to many other business and corporate issues, are also available in our KnowledgeBase-

www.watsoncpagroup.com/kb

Why are LLCs so darn popular?

The power of advertising, the ease and the hype have created this fervor surrounding the limited liability corporation. While there are benefits as explained throughout this article, there are also many misconceptions and some downright pitfalls to forming and operating an LLC.

Should I convert my LLC to an S-Corp (Sub-S Election)?

Perhaps. Reducing your self-employment taxes is the main reason LLC owners want to convert to an S-Corp. There are some issues such as payroll, corporate tax return requirements and passive incomes. But if you have over \$10,000 in net profits, you might want to give it some serious consideration. Please read our tax article on the Sub-S election and becoming an S-Corp at-

www.watsoncpagroup.com/SubS.pdf

How hard is it to form an LLC? S-Corp?

Very easy. We can do all the filings with the Secretary of State (for any state), and our fee is \$50 plus the state filing fees (\$50 to \$125). We'll also obtain your Employer Identification Number (EIN) from the IRS and create an Operating Agreement.

These three documents (Articles of Organization, EIN and Operating Agreement) are required by most banks for a business checking account. The Patriotic Act and Homeland Security want to clamp down on illegitimate business accounts and financial holdings.

Can I be sued if I own an LLC?

Yes. And you can easily lose on a personal level. There are several myths out there regarding the use of an LLC as a shelter from potential lawsuits and litigation. Some of the hype has been created by attorneys who used to charge upwards of \$1,000 to form an LLC. Condos in Maui.

And while consultation with an experienced attorney is strongly recommended for your unique situation, as business owners ourselves we feel the excitement of the LLC has overshadowed the reality of our litigious society. In other words, if your acts, errors or omissions injure someone even though it was under the auspice of your LLC, good chances you will be personally named in the lawsuit and held liable as the owner of the LLC.

For the matter of this discussion, LLCs, S-Corps, C-Corps and limited partnerships are considered the same. No liability protection is asserted for sole proprietorships and general partnerships.

There are three areas where you can be held personally responsible- criminal, contractual and torts. Torts is probably most people's concern, and torts can either be-

- ▲ negligence where you have a general duty to act in a reasonable way and you didn't (like drive your car safely), and
- ▲ intentional torts where there was a purposeful act to harm

There are other tort buzzwords like careless disregard, defamation, etc.

Officers and directors of corporations are routinely held liable for the actions of the corporation. This is called piercing the corporate veil. Can you say Enron?

Piercing the corporate veil typically is most effective with smaller privately held business entities (close corporations) in which the corporation has a small number of shareholders, limited assets, and separating the corporation from its shareholders would promote fraud or an inequitable result. Does that sound like your LLC, and could it happen to you? Yes.

Even a two-member LLC would easily be considered a close corporation. And if those members were negligent in the way they managed the business, separating the corporation from its shareholders would certainly promote unfairness from a liability perspective. This is our opinion of course, but we want to share with you some of the behind-the-scenes perspectives from the courts and law that might not be readily considered when forming an LLC.

Another perspective- if you owned shares of Ford Motor company, you personally were not responsible for the damage caused by the Ford Pinto even if you were an "owner" in the truest sense. However, if you were a corporate officer who ignored (gross negligence) the potential for harm, you could be held responsible, even criminally. In other words, fix that loose railing before your tenant hurts himself (using an LLC owning a rental as an example).

Back to your personal LLC- the general rule across the country is that individuals acting on behalf of a company are personally liable for their tortious conduct even if they did so on behalf of the company. So, to protect your personal assets you need to fund the LLC with enough resources to pay for a lawsuit. This defeats the purpose of not having to pay personally. There might be situations where an investor has a lot to lose personally as compared to his or her smaller co-investors- so perhaps funding the LLC on an equal basis to hedge against potential lawsuits or to have similar language in an Operating Agreement can mitigate some exposures.

Furthermore, if you own multiple investments and LLCs, and you think you can protect the other assets in the event of a lawsuit on one, think again. In our non-legal opinion, if you face a credible lawsuit arising out of your acts there is a chance everything you have is going to be pursued by the injured party's attorney including your personal residence, cars, college funds, LLCs' assets, Snuggly collection, etc.

However, there is one element of protection. If your employee's conduct creates a liability for himself and one for the LLC, the owner of the LLC may be absolved. This can get tricky depending on the conduct, and any instructions the LLC provided to the employee. This is attorney type stuff.

So, what do you do? Securing a decent umbrella policy both at the personal and commercial level is our strong recommendation for liability arising from your acts, errors and omissions. General umbrella policies are \$300-\$500 per year. Errors and omissions insurance varies depending your profession (realtor versus financial advisor versus insurance sales).

It appears that many credible lawsuits will sue to the limit of coverage to avoid lengthy and expensive trial litigation. Again, please consult your attorney for your unique situation. And no, we don't sell insurance.

Specifically for landlords, keep your rental in proper working order- tight railings, shoveled sidewalks and driveways, cooler hot water temperature settings, newer tempered windows, update smoke detectors, CO2 monitors, etc.

Something to consider- corporations protect the owners from being personally responsible for the corporation's debts and obligations. However, in today's lending climate it will be very difficult to get a business loan in the name of the LLC without having to sign a personal guarantee on the note. Sure, non-recourse loans are available, but they are expensive and require significant equity or collateral.

I heard I can avoid taxes by forming an LLC in Wyoming or Nevada- is that true?

No. Your profits will be allocated to the states in which you operate. There are three steps to the allocation-

Step #1 : One third of your profits are allocated based on payroll. So if you have payroll expenses only in Colorado and California, but are incorporated in Nevada, one third of your LLC's profits are split between Colorado and California. Nothing is allocated to Nevada.

Step #2: The second third of your profits are allocated based on property ownership and where it is located.

Step #3: The last third of your profits are allocated based on sales, but this can get extremely sticky since the definition of where a sale occurs is grey- is it point of sale (seller's location), point of purchase (buyer's location), title transfer, etc.? Where a sale actually occurs is an argument which states and taxpayers can go around and around with- you can only imagine how it will end fighting a state with virtually unlimited resources and time coupled with their presumption of being right.

So, yes, under step 3 perhaps a small portion of your profit can be attributed to Nevada- yet, this is not because you were incorporated in Nevada, it's because you had a presence in a state that does not impose an income tax. Same would be true for all your sales in Wyoming, Washington, etc. where corporate income taxes do not exist. In addition, several states impose a gross sales receipts tax and other forms of alternative minimum tax although their corporate income tax rate is zero.

Moreover, if you are selling software or intellectual property, or something that can be delivered remotely, you might be able to have a virtual office in a tax-free state. This might work for consultants too. More discussion is required.

The bottom line is that Nevada tax laws benefit business owners with a presence in Nevada. You might get a free lunch on consignment, but eventually you'll have to pay. We encourage you to not game the system. You'll lose.

How does an LLC or S-Corp's income affect my taxes?

It depends. Single-member LLCs are taxed similarly to sole proprietorships, and multi-member LLCs are taxed similarly to partnerships. Since a single-member LLC does not file a corporate tax return (Form 1065) there is not a K-1 associated with this business. Therefore the income flows directly onto the owner's personal tax return on Schedule C. This in turn triggers self-employment tax (currently 15.3% for 2013).

Multi-member LLCs (yes, a husband and wife count as two members according to IRS code) must file a corporate tax return on Form 1065 and distribute K-1s to the members (owners). A K-1 is a statement that each owner receives, and it is similar to a W-2 since it shows the income that each owner is responsible for from a taxation perspective.

And if you materially participated in the managing of the business, your K-1 will be subjected to self-employment tax AND income tax. Self-employment tax is current 15.3% for 2013 and income tax can vary between 10% and 39%. You could easily pay 25-54% in taxes on the income produced by an LLC if you elect to be treated as a sole proprietorship or partnership- this is certainly not desirable (keep reading).

And forming an LLC might subject your business to additional state taxes. Certain states (California and New Jersey for instance) subject LLCs to franchise taxes in addition to a typical income tax.

However, there are two caveats with this- an LLC with the S-Corp election can avoid a large portion of the self-employment tax which can offset some of its inherent costs. And income generated from an LLC that owns rental properties is simply not subjected to self-employment tax since it is rental (passive) income.

Please read our tax article on self-employment taxes and the S-Corp election at-

www.watsoncpagroup.com/SubS.pdf

Should I have my LLC or S-Corp own my car?

There are all kinds of issues here, so, buckle up as we go through this stuff. We'll start with the business owning the vehicle.

Company Owned Vehicle

If the company truly owns the car, then it must be titled in the company's name. This might be a challenge with car loans and leases, but for the company to claim it as an asset and subsequent expenses the title needs to be in the LLC or S-Corp's name. And if you buy the car yourself and then transfer it to the business, you might be on the hook for sales tax twice (technically).

Another concern is higher insurance rates. It appears that most auto policies will charge a premium for cars owned by a business for business purposes.

One of the main reasons to have the company own the vehicle is the ability to take Section 179 depreciation. This allows you to get an instant deduction each year. Revenue Procedure 2012-23 states that passenger automobiles can take \$11,160 in depreciation the first year, \$5,100 the second year, \$3,050 the third year and \$1,875 each year thereafter until fully depreciated. Of the first year depreciation, \$8,000 of it is bonus depreciation and the purchase must qualify for bonus depreciation (a new vehicle, not just new to you, for example).

The numbers are slightly higher for trucks and vans. And these are for the 2012 tax year. The depreciation numbers and revenue procedures are released in April for the current tax year. So, 2013 figures are released sometime in April 2013.

To take Section 179 depreciation the vehicle must have a greater than 50% business use. This is one of the major obstacles for shareholders especially if they do not have another car. Another issue with depreciation is the recapture of depreciation- any gain on the sale of your vehicle (the difference between the original price less depreciation and the sale price) is taxable. The good thing is that most cars depreciate rapidly as they relate to fair market value or resale value.

Work trucks and vans might not depreciate as quickly, so there might some depreciation recapture on your gain when you sell the vehicle.

If your business leases the vehicle, the business portion of the lease amount is expensed. However, there are limits to how much can be expensed, especially for expensive or what the IRS would consider luxury vehicles. The disallowed lease payment is then added back into income and taxed, leaving only the IRS allowed portion as a deductible lease expense.

Lastly, and this is another big deal, any personal use must be considered taxable income if you own more than 2% of the LLC or S-Corp. Personal use is typically determined by taking the personal miles and multiplying them by the Federal mileage rate. And depending on how many miles you drive personally, you might have to claim this on quarterly (versus just Q4) payroll tax filings along with possible estimated tax payments.

Sounds like a lot of work for not that much gain. Jogging a mile for a French fry comes to mind.

You Own The Vehicle, Get Reimbursed

This might be the best option, especially if Section 179 depreciation is not going to benefit you much. You would own the vehicle yourself and turn in expense reports in the form of mileage logs. The company would then reimburse you accordingly. This can be a great option for a lot of reasons.

First, you are reducing the net income of your company, and if you are an S-Corp the lower income could decrease the amount of reasonable salary you must take as a shareholder. Second, most cars operate significantly less than the Federal mileage rate. If you have a car that get 25 miles per gallon and costs about \$3,000 per year in maintenance and depreciation (cheap car), your annual costs at 12,000 business miles per year is \$1,800 in gas plus \$3,000 for a total of \$4,800. But your reimbursement will be 58.5 cents x 12,000 miles or \$7,020. So you just took home \$2,220 tax-free. All legit. All legal.

Third, this is better than simply taking the mileage deduction on your personal tax returns. Any mileage deduction is completed within Form 2106 on Schedule A. So, first you need to be able to itemize your deductions by exceeding the standard deduction. Next, any Form 2106 expenses (such as home office, mileage, cell phone, internet, meals, etc.) must exceed 2% of your income, and only that portion that exceeds 2% is deducted.

So, if you make a \$100,000 as a household, the first \$2,000 in mileage is not deducted. If you get reimbursed from your LLC or S-Corp, all the mileage expense is deducted at the corporate level. This directly improves your tax consequence as a shareholder.

Your company must have an Accountable Plan to take advantage of the You Own The Vehicle, Get Reimbursed scenario. Please see **What is an Accountable Plan?** below.

You Own The Vehicle, Take Mileage Deduction

This might be the easiest option, but it truly can leave money on the table. First, if your LLC is an S-Corp then your reasonable wage figure could unnecessarily be higher if you are not reimbursing yourself through an Accountable Plan, and therefore you are paying more FICA and Medicare taxes.

Second, as mentioned earlier, you have to get over the 2% hump for deducting business mileage. To reiterate, any Form 2106 expenses (such as mileage, cell phone, etc.) must exceed 2% of your income, and only that portion that exceeds 2% is deducted. So, if you make a \$100,000 as a household, the first \$2,000 in mileage is not deducted.

Lastly, you still need to maintain written mileage logs detailing odometer readings, date, business purpose or connection, etc. Why not just turn those in and get reimbursed from your company?

There are situations where you have multiple owners, and some owners are taking advantage of the reimbursement program so the mileage deduction on personal tax returns might be the only way to avoid office politics.

Should I have my LLC or S-Corp pay me rent?

No. Don't do it. Old school. Prior to the IRS making a recommendation to use the Accountable Plan and subsequent reimbursements to the employee (or shareholders), taxpayer would charge their corporation rent and declare the rent as income on Schedule E.

In the garden variety LLC world, the beauty of this was to take money out of the company as passive income, sidestepping self-employment taxes. In the S-Corp world, the beauty of this was to reduce the S-Corp's overall income, and therefore reduce the reasonable salary thresholds for shareholders while still taking money out of the company as passive income (again side-stepping self-employment taxes).

The IRS got sick of this (among other thing of course).

The new school way is to use an Accountable Plan and reimburse the shareholder for expenses associated with the home office. Your company must have an Accountable Plan to take advantage of this scenario. Please see **What is an Accountable Plan?** below.

The expense report should detail the space used as a home office or storage of business items (inventory, supplies, etc.) as a percentage of overall square footage of the home. This percentage is then applied against rent, mortgage interest, property tax, utilities, home phone, insurance and repairs to determine the expense amount to be reimbursed. The reimbursement can be monthly or quarterly or annually- your choice.

No depreciation or mortgage principal payments can be expensed and reimbursed. Depreciation would normally be allowed under the traditional home office deduction on your individual tax return. However, please recall that this would be subject to the 2% income threshold, so it shouldn't be a major factor on your tax returns.

Should my LLC or S-Corp pay my health insurance premiums?

Yes. For now, we'll only focus on S-Corps since LLCs are much more straightforward when it comes to paying health insurance premiums. In **IRS Notice 2008-1** premiums paid under individual medical and health insurance plans may be deductible on your personal tax return (the usual Form 1040) if the following conditions are met:

- ▲ The S-Corp must establish an **Accountable Plan** for the payment of health insurance premiums on behalf of the shareholder. Please see **What is an Accountable Plan?** Below.
- ▲ The S-Corp must either directly pay the premiums for the plan or reimburse the shareholder for the premiums paid. Proper recordkeeping habits must be followed.
- ▲ Here's the kicker- premiums paid or reimbursed must be included in Box 1 of the shareholder's W-2. The health insurance premiums are not included in Box 3 Social Security Wages and Box 5 Medicare Wages (thus they are exempt from employment taxes). This might take some payroll coordination, but it certainly is worthwhile.

By including it as wages in Box 1, the S-Corp gets a "wage expense" deduction, which in turn reduces the K-1 income for all shareholders (but each shareholder gets comparable a bump in W-2 income as a part of his or her reasonable salary). On your personal tax return, you will get a deduction for health insurance premiums paid. This directly reduces your adjusted gross income, and is not a Schedule A itemized deduction (which is good). If this procedure is not followed, the premiums can only be deducted on Schedule A subject to the 7.5% or 10.0% income thresholds (which is not good).

What is an Accountable Plan?

An Accountable Plan is system of reimbursing employee expenses without having to consider the reimbursements income. A typical response by taxpayers is that he or she doesn't care since they deduct unreimbursed expenses on their personal tax returns, offsetting the income. This is not a good idea for two reasons.

First, you must be able to itemize your deductions to deduct job-related expenses. Second, the expenses must exceed 2% of your adjusted gross income, and only that portion that exceeds 2% if deducted. Before we go into the plan provisions, let's examine the reasons why. Here are some numbers-

	<u>No Plan</u>	<u>A Plan</u>	<u>No Plan</u>	<u>A Plan</u>
Income	50,000	50,000	50,000	50,000
Company Reimbursements	3,000	3,000	3,000	3,000
Adjusted Gross Income	53,000	50,000	53,000	50,000
Deductions Before Expenses	8,000	8,000	12,000	12,000
Work-Related Expenses	3,000	0	3,000	0
Less 2% of AGI	1,060	0	1,060	0
Total Deduction	9,940	8,000	13,940	12,000
Recognized Deduction	11,600	11,600	13,940	12,000
Taxable Income	41,400	38,400	39,060	38,000
Taxes @ 15%	6,210	5,760	5,859	5,700

So, there are two scenarios- **No Plan** which is where company reimbursements are considered taxable income and **A Plan** where the company has an Accountable Plan for expense reimbursements. Each column assumes the same salary of \$50,000 and the same work-related expenses of \$3,000.

At \$8,000 in deductions such as home mortgage, property taxes, charity, etc. your work-related expenses go towards your standard deduction of \$11,600 for married, filing joint. By moving to an Accountable Plan under the same conditions, you would be saving \$450 in taxes. Not a lot, but it's better than \$0.

And at \$12,000 in deductions, the savings is only \$159. For arguments sake, if you had \$100,000 in income and \$10,000 in expenses such as home office, cell phone, internet, mileage and meals, the savings is about \$550. So the net-net is that if you already itemize your deductions, then the savings is not as large. However, we still encourage the creation and use of an Accountable Plan. It's easy. It puts money back into your pocket.

The plan is usually drafted as a company policy that satisfies three basic requirements: a business connection; substantiation; and return of excess amounts-

- ▲ **Business Connection:** The expense must have a business connection. Typically expenses incurred by an employee while doing his or her job usually have a business connection. It might be a good idea to list some examples of such as home office, cell phone, internet, mileage and meals. Don't forget per diem allowances and other travel type expenses. Health insurance premiums should also be detailed (see **Should my LLC or S-Corp pay my health insurance premiums?** above).

You could also list conditions and parameters for reimbursement. Must answer phone calls outside the office to claim reimbursement. Or only mileage to and from client meetings, delivering product, running errands for supplies, etc. The more comprehensive the allowable business connections, the safer your plan will be.

- ▲ **Proper substantiation:** The employee must adequately account to the company for expenses within a reasonable time. Adequate accounting means completing expense reports and providing the company with receipts, invoices, and other documentary evidence of the expenses. Using a separate credit card and requesting credit card statements is a great recordkeeping technique. For more information on recordkeeping, substantiation and documentary evidence, read our tax article at-

www.watsoncpagroup.com/Recordkeeping.pdf

There are special substantiation rules for meals, entertainment, business gifts and anything considered "listed property." We can help you these situations if necessary.

- ▲ **Return of the Excess Reimbursement:** The employee must return to the company any excess reimbursements within a reasonable time. While this is not an issue if you are reimbursed only for what you request, you should still detail this policy in your Accountable Plan. Many companies provide a monthly stipend to cover expenses, and employees are required to return unused portions.

Here is a timeline according to the IRS-

1. An advance may be received within 30 days of the time of the expense.
2. The employee furnishes an adequate account of expenses within 60 days after they were paid or incurred.
3. The employee returns any excess reimbursement within 120 days after it was paid or incurred.

The Accountable Plan should address the above issues, and it should be drafted as company policy for all employees. While different employee groups and individual employees can have different plans, you should draft this policy while distancing it from any favoritism towards the shareholders.

Meals and entertainment pose an interesting scenario. They are 100% reimbursable to you, but only 50% deductible to the company. If you are an S-Corp LLC then this 50% rule on meals and entertainment will increase your taxable income. Either way, the Accountable Plan is still the best option. Read more about S-Corps at-

www.watsoncpagroup.com/SubS.pdf

Should I put my children on the payroll?

Perhaps. While most parents can't get their kids to clean a counter or put away dishes, perhaps putting kids to work at the office is a good option.

Tax Advantages

There are some minor tax advantages to paying your children- for example, you can pay your child \$5,900 in wages, and since the standard deduction is currently \$5,900 the child will have not have any taxable income. And you could still claim the exemption if the child qualifies normally. If you pay yourself this income through a shareholder distribution and you are in the 15% tax bracket, you will unnecessarily pay about \$885 in income taxes.

You could also pay your child more money since their tax bracket is probably lower than yours. They can gift up to \$13,000 per year back to you. Almost hard to say with a straight face.

For regular LLCs, if your child is under 18, the company does not have to pay employment taxes such as Social Security, Medicare and Workers' Compensation Insurance. You can also avoid Unemployment taxes until the child turns 21. But for S-Corps and C-Corps, Social Security and Medicare taxes are paid regardless of age.

Retirement Accounts

Your child can contribute to a retirement account and reduce your taxes. Seriously? Seriously!

For example, a 14 year-old can have an IRA or a Roth IRA and contribute 100% of earned wages up to \$5500 in 2013. This type of individual plan, however, is not a direct business deduction for the company even if it contributes to the account. Of course the salary to the child is a business expense, and you can increase the salary enough for the child to fund these individual accounts directly. However you'll pay additional taxes, but there might be situations where the benefits outweigh the tax consequence.

In order for a company to take advantage of making those direct contributions and getting a business deduction for them, the plan would need to be a SIMPLE, SEP or 401k type of plan. The usual age for these types of plans is 21, so if you hire your 14 year-old and you also have a 19 year-old working for the company, that 19-year old suddenly becomes eligible.

But setting up the plan correctly allows your child to contribute \$17,500 to a 401k or the maximum limits on SIMPLE's and SEP's which can be significant. In turn the business gets an instant deduction and the kid gets your money albeit a bit early. As an aside, SIMPLE's and SEP's are easy to set up and have very low annual maintenance costs in comparison to 401k type plans. Talk to us or your financial advisor.

IRS Concerns

You must be mindful of child labor laws, and as far as the IRS is concerned there are some rules too.

First, the child must actually perform work. Some argue that cleaning bathrooms and stuffing envelopes are different since cleaning bathrooms is non-essential and therefore not qualifying. Our advice is to be as legitimate as possible- create a job description, list of expectations, etc. Ensure that the work they do has a business connection.

Also, the pay must be consistent and the pay must be reasonable relative to what you pay others for similar work. Basically you need to treat them like any other employee to avoid troubles. Lastly, you need to keep detailed records (of course you do!).

Should I put my rentals into an LLC?

Sure. Why not? Everyone else does. The real answer is Perhaps. There are several myths out there regarding the use of an LLC as a shelter from potential lawsuits and litigation. Some of the hype has been created by attorneys who used to charge upwards of \$1,000 to form an LLC.

And while consultation with an experienced attorney is strongly recommended for your unique situation, as rental property owners ourselves we feel the excitement of the LLC has overshadowed the reality of our litigious society. In other words, if someone gets hurt and you fail to maintain your rental in a proper and safe condition, you will likely be personally named in the lawsuit and held liable as the owner of the LLC.

This question and answer was expanded on in a previous FAQ. See **Can I be sued if I own an LLC?** above.

So, what do you do? Securing a decent umbrella policy both at the personal and commercial level is our strong recommendation for liability arising from your acts, errors and omissions. General umbrella policies are \$300-\$500 per year. The floor of many umbrellas is around \$500,000 so you might have to raise the limits of each rental to meet the floor (so there's no break in coverage).

It appears that many credible lawsuits will sue to the limit of coverage to avoid lengthy and expensive trial litigation. Again, please consult your attorney for your unique situation. And no, we don't sell insurance.

Specifically for landlords, keep your rental in proper working order- tight railings, shoveled sidewalks and driveways, cooler hot water temperature settings, newer tempered windows, update smoke detectors, CO2 monitors, etc.

Moving on, corporations protect the owners from being personally responsible for the corporation's debts and obligations. However, in today's lending climate it will be very difficult to get a mortgage loan on a rental property in the name of the LLC without having to sign a personal guarantee of the mortgage note. Sure, non-recourse loans are available, but they are expensive and require 60% loan to value at best.

If you think you're clever and quit-claim the title / deed to the LLC after you close on the loan be careful. The lender might catch wind of it through routine title checks that they now perform, and the lender might call the loan. Not good.

Having said all that, it is not a bad idea to have an LLC own your rental property if you can. You might also consider having your tenants sign Hold Harmless Agreements. Essentially you are adding layers to your liability onion.

Additionally, if you are investing with partners an LLC with a solid operating agreement might be the only way to properly handle the ownership. A common situation is where two family members invest together and need ways to affect ownership changes, such as a parent and child. Of course the Watson CPA Group can assist you in creating the LLC.

On small side note- real estate professionals might also be creating a mess with the material participation definitions within a partnership LLC. If you are considering to claim the real estate professional designation, we encourage you to read our recent tax article on the subject-

www.watsoncpagroup.com/REP.pdf

Lastly, there are some potential tax issues regarding LLCs and rentals (see **What are the tax issues with an LLC owning a rental property?** below).

What are tax issues with an LLC owning a rental property?

None. However, if you elect to treat your LLC as an S-Corp you might run into another level of unnecessary taxation. Here's why- rental properties are considered passive income even if you actively or materially participate in the rental activity. Passive income by definition is not subjected to self-employment tax.

However, if you elect to have your LLC be treated as an S-Corp for taxation purposes you could potentially have to pay yourself a reasonable wage for the management of the LLC which in turn is subjected to FICA and Medicare taxes (15.3%). This is the same as paying self-employment tax. Save yourself the potential grief and headache by having your rental property LLCs be regular LLCs and your business LLCs be LLCs with the S-Corp election. Please read our tax article on the S-Corp election at-

www.watsoncpagroup.com/SubS.pdf

As a one-person show, should I still form an LLC? An S-Corp?

Yes. Admittedly we shot down the liability protection argument. We also shot down the LLC in Nevada argument. So what's left? Lots, actually.

An LLC will give you credibility. Vendors and banks will take you more seriously with an LLC.

An LLC can be quickly expanded to multiple owners, and make ownership transfer much easier.

An LLC (and in some cases an S-Corp) can expand your options for health insurance coverage and other benefits. This varies by the state, so more discussion is required, but it is an important consideration given our current benefits landscape.

There are Revenue Procedures allowing an LLC to retro-actively be converted to an S-Corp (Sub-S Election) which allows you to avoid some of the self-employment taxes. However, and this is a big however, without the LLC in place you cannot retro-actively create an LLC AND be an S-Corp. For example, you start a business on January 1. On July 1 you create an LLC. On March 1 the following year you discover that you are going to pay a ton in self-employment taxes. Unfortunately, you can only go back to July 1 with the S-Corp status and not the inception date of January 1. Make sense?

Read are full tax article on S-Corps at-

www.watsoncpagroup.com/SubS.pdf

So, get the LLC in place now so your options are not so cramped. Just understand that an LLC is not all the hype.

If the S-Corp taxation is what I ultimately want, should I form an LLC or C-Corp?

Good question. Each state is different with its requirements for LLCs and C-Corps. C-Corps generally have more red tape and filing requirements than LLCs, but each case is unique. Typically, however, an LLC with the S-Corp election is going to be our advice. Please contact us for more discussion.

Should I form an LLC with my spouse?

No. Don't you see enough of each other at the house? All kidding aside, this is not the best idea- as a multi-member LLC you will be required to file a corporate tax return on Form 1065. If you are starting a new business our suggestion is to form the LLC as a single-member. If you expect to be profitable, then elect to be treated as an S-Corp for taxation purposes. If you expect to lose the first two or three years, the S-Corp election becomes a bit more complicated and more discussion is required- it is generally better to delay the S-Corp election so you can avoid performing payroll and filing a corporate tax return.

And if you are concerned about ownership transfer in case of death, we suggest taking care of this issue within your will and estate planning. Transfer of assets between spouses during death is generally seamless in most states. Contact a wills, trusts and estates attorney for more comprehensive analysis and advice.

What is your fee structure for an LLC or S-Corp tax return?

Most people don't buy anything without knowing the price ahead of time. So, we offer a narrow fee range for your corporate tax return preparation - you know upfront what you will be charged.

A single-owner (single-member) LLC's income or loss will flow onto the owner's Schedule C within their personal tax return. Therefore, a corporate tax return is not required. The fee for this situation is incorporated in the fee for your personal tax return (either \$150 or \$225). However bookkeeping services in conjunction with the tax preparation is available and might be required.

A multi-owner (multi-member) LLC requires a corporate tax return on Form 1065 and our base fee is \$325. This includes 2 hours of year-end journal entries, generating annual financial statements, creating K-1 statements for each owner / member, and preparing the LLC's corporate tax return. And Yes, a husband and wife count as two in the eyes of the IRS- sorry.

The base fee for an S-Corp or C-Corp tax return (Form 1120 or 1120S) is \$375 which also includes 2 hours of year-end journal entries, generating annual financial statements, etc. An LLC that elects to be treated as an S-Corp for taxation purposes is considered an S-Corp, and therefore the base fee is \$375.

Note: If you maintain your own financial records or accounting books, our past experience has suggested that an extra 3-5 hours will be required to properly prepare your corporate tax return. Specifically most errors center on general balance sheet issues, retained earnings and payroll. And these areas of your corporation's financial records are critical in terms of accuracy.

<u>Entity</u>	<u>Tax Return</u>	<u>Base Fee</u>	<u>Fee NTE</u>
LLC Single-Member	Schedule C	NA	NA
LLC Multi-Member	Form 1065	\$325	\$725
LLC Electing S-Corp Status	Form 1120S	\$375	\$775
C-Corp	Form 1120	\$375	\$775
C-Corp Electing S-Corp Status	Form 1120S	\$375	\$775

Base Fee / Fee NTE

If we maintain your accounting books (see **Bookkeeping Services** below) we guarantee that your corporate tax return will be prepared for either \$175 (Form 1065) or \$250 (Form 1120 or 1120S). However, if you or a third-party maintains your accounting books, your tax preparation fee will be a not-to-exceed (NTE) fee range.

For example, the fee for an S-Corp requiring a Form 1120S who maintains their own accounting books will be a base fee of \$375 not to exceed \$775. The actual fee will depend on the time spent reconciling the accounting records with the corporate tax return.

Prior Year Bookkeeping, Tax Prep

If you need prior year bookkeeping plus a corporate tax return, we typically offer a discount for those combined services. Depending on the number of transactions and the overall complexity of the bookkeeping, we offer a fee range of \$950 to \$1,450. Additional factors that are considered are number of bank accounts, credit cards, personal versus business use of funds and how quickly we can translate the statements into accounting records.

Additional Fees

We also have a short list of additional fees that might be incurred depending on your situation-

Any corporate tax returns that require paper filing	\$35
Copying and returning of original tax documents	\$25
QuickBooks help, reconstructing financial statements	\$100 / hr
Business owners who introduce significant changes or additions after a preliminary tax return is prepared	\$100 / hr
Corporate tax consultation and audit assistance, coordinating with attorneys, business consultation, writing correspondence	\$150 / hr

Note: some of these additional fees may be waived depending on the circumstances. For example, extensive research is charged at \$150 per hour, however since we are expanding our scope of knowledge in the process we tend to heavily discount this fee. Please keep in mind that we pride ourselves in **not being** the nickel and dime type of tax preparation firm. At the same time, there is not enough fluff in our tax preparation fees to subsidize additional services.

In other unicorn-type cases, we have also reduced our fee below the base fee for extremely simple corporate tax returns or for “no activity” filings. Please contact us if you think this might be your situation.

Knowing that the fee for our tax preparation service is fixed and will not change is a comfort to our clients. If you have any questions about our fees or if you are unsure which tier you qualify for please contact us.

Financial Statements

Many CPAs will prepare a corporate tax return without a **balance sheet**- for certain situations a balance sheet is not required by the IRS. However, we feel that it is sound tax preparation practice to create this financial document in conjunction with your tax return regardless. A small business can have a unique way of becoming bigger, and replicating poor accounting practices as you grow can create a much larger problem later- we prefer to lay the groundwork today for an easier transition. This is to your advantage.

Tax Consultation

Watson CPA Group is not just tax preparers or number crunchers- we are tax consultants, and our firm will take you through the cycles of your personal and business lives. Many accountants are only compliance oriented- and while IRS compliance is critical, being proactive is equally important.

And, we are a resource that is **always available** throughout the year. Have a question? Need advice? Received a notice from the IRS just before Happy Hour on a Friday? You can contact us anytime, day or night.

Moreover, our goal is to always prepare a comprehensive and accurate tax return but equally important is your understanding of how a tax return “works”- to the extent necessary, we want you to be comfortable with your tax consequences so together we can successfully plan for your future.

Continuous Client Support

Our engagement with you is not just tax preparation- our fees are more of an investment since we offer the continuous peace and mind of knowing that you are not alone in your tax world. Most questions throughout the year are answered free of charge since our relationship with you is viewed as long-term.

Unfortunately IRS notices and correspondence (mail) audits are a way of tax life. Over 75% of the IRS audits are conducted via mail, and usually require the taxpayer to send proof or evidence of a deduction (charities, medical expenses, tuition bills are the most common) to the IRS. We typically help clients with the initial response to these issues free of charge.

In addition, our fees are purposely kept low since 99% of all taxpayers will not require additional assistance or consultation- we don't charge for services you might not ever need or receive. However, if your particular situation requires extensive consultation including writing correspondence on your behalf, our fee is \$90 per hour. A firm quote will be provided upfront.

Copies, Please

The ability to maintain our competitive fees relies on receiving soft copies (faxes, scans, emails) or hard copies of your originals. If you send us original documents and do not want them returned to you we will maintain them in our office indefinitely. All mailed documents are scanned and electronically available to you via our client portal.

If you want originals or tax returns sent back to you, we must charge a \$25 fee for the costs of copying and mailing. Please understand that until mid-April we do not have any extra resources- **we can only return originals in May.**

Do you offer bookkeeping services?

The strongest reason for using a professional bookkeeping service is- you do what you do best with your time; let us do what we do best with our time. QuickBooks is good but it does not prevent you from entering erroneous or incomplete data. Business owners can quickly waste valuable time trying to make it work correctly.

Also, banks, investors and IRS agents prefer a CPA-prepared set of accounting records. Remember, these groups review financial records every day, and they can quickly spot accidental inconsistencies and errors. Let us help you avoid the bookkeeping pitfalls so you can focus on growing your business.

Rates

Our bookkeeping rates are listed below. However, the sheer number of transactions will also influence which rate we charge.

	<u>Quarterly</u>	<u>Monthly</u>
Bookkeeping Only	\$200	\$100
Payroll Only	\$100	\$75
Bookkeeping and Payroll	\$250	\$150

Reduced Tax Preparation Fees

When we prepare your books throughout the year, our tax preparation fees are reduced to one flat rate fee-

<u>Entity</u>	<u>Tax Return</u>	<u>Flat Fee</u>
LLC Multi-Member	Form 1065	\$175
LLC Electing S-Corp Status	Form 1120S	\$250
C-Corp	Form 1120	\$250
C-Corp Electing S-Corp Status	Form 1120S	\$250

How It Works

With our bookkeeping service, we make all the entries in QuickBooks, perform bank reconciliations, provide preliminary financial statements and give business consulting as necessary.

Exchanging Documentation

The Watson CPA Group has been assisting clients since 1997, providing nationwide accounting and tax preparation service from our offices in Colorado Springs. By utilizing a secure **Client Portal** to exchange your financial information, accounting records, tax documents and tax returns, we can save you valuable time and resources. You can scan, fax or mail your documentation, all in your PJs on a lazy morning!

However, most clients give us direct access to their bank accounts (checking and business credit cards) to make the process seamless. We also upload the QuickBooks data file to our Client Portal for your review. Interestingly, several banks now have “read-only” account logins specifically designed to give accountants direct access yet provide safety and security for the client. Having said that, if this type of access makes you uncomfortable we will work with you to find a solution that fits for everyone.

The Watson CPA Group are Colorado Springs accountants, and we can also exchange information and discuss your bookkeeping needs through appointments if you are local to the area.

Payroll

Our bookkeeping services do not include payroll or sales tax filings.

Sales Tax Filings Since these situations can vary between clients, your specific needs will be analyzed and quoted accordingly.

Please call or email us anytime with your questions and concerns. Thank you in advance, and we look forward to working with you!

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