

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

About This Newsletter

This monthly Newsletter is a free service provided by Gregg Harvey, CPA. It is emailed every month to clients and to select members of the Rochester Regional Chamber of Commerce.

This Month's Contents:

This month's contents include: 1099 information, home office expenses, overview of self-employed retirement plan options, the EFTPS, an MBT update, and Part 2 of Husband-Wife partnerships.

Who Has to Issue a 1099?

I have had this question come up several times recently so here is a clarification on the requirement.

Individuals don't have to issue 1099s. It applies to anyone who pays a person or company \$600 or more in the course of their trade or business.

Any entity (proprietor, partnership or corporation) engaged in a trade or business is required to file 1099's. 1099's are to be filed for any individual or partnership payee (corporate payees are excluded) who receives certain payments from you during the year. You must report on a calendar year regardless of your business fiscal year, as all individuals file income taxes on a calendar year basis. The kinds of payments and minimum dollar limits for reporting are as follows

Interest Paid; 1099-INT; \$10.00
Rents & Royalties; 1099-MISC; \$600.00

Non-employee Compensation; 1099-MISC; \$600.00

One payee who is often overlooked is the landlord. When a business rents space, they must issue a 1099 to the landlord, unless the landlord is incorporated.

Home Office Expense Review

If you plan to run your small business out of your home you may be tempted to "write-off" many of your household expenses. But how do you know what is deductible and what is not?

Generally, expenses related to the rent, purchase, maintenance and repair of a personal residence are not deductible.

However, if you use part of your home for business purposes you may be able to take a home office deduction. Expenses that can be deducted include the business portion of real estate taxes, mortgage interest, rent, utilities, insurance, painting, repairs and depreciation.

In order to claim a business deduction, you must use part of your home:

- Exclusively and regularly as your principal place of business;
- as a place to meet or deal with patients, clients or customers in the normal course of your business;
- or in connection with your trade or business where there is a separate structure not attached to the home;

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- or, on a regular basis for certain storage use such as inventory or product samples;
- or as a home daycare facility.

In addition, if you work as an employee you can claim this deduction only if the regular and exclusive business use of the home is for the convenience of your employer and the portion of the home is not rented by the employer.

“Exclusive use” means a specific area of the home is used only for trade or business. “Regular use” means the area is used regularly for trade or business. Incidental or occasional business use is not regular use.

Non-business profit-seeking endeavors such as investment activities do not qualify for a home office deduction, nor do not-for-profit activities such as hobbies.

Example: An attorney uses the den in his home to write legal briefs or prepare clients’ tax returns. The family also uses the den for recreation. The den is not used exclusively in the attorney’s profession, so a business deduction cannot be claimed for its use.

Self Employed Retirement Plan Options

If you have a small business, you have a number of options for retirement plans. These are great tax shelters. You get a current deduction for your contribution plus you can get compounded tax deferred growth.

Here is a brief summary of some of the rules and regulations that apply to those options.

Simplified Employee Pension Plan (SEP IRA)

This type of plan is very low cost and low maintenance. It is funded with deductible employer contributions and you need to cover all eligible employees. Employees cannot contribute. With a SEP there is no "plan document" and you do not need to file any reports with the IRS. You can set one up in minutes. Also, contributions can vary from year to year. This is an important point since if you hit a dry spell you are not locked in to contributing.

The contribution limit is 25% of compensation if you are an employee of your own corporation, up to \$45,000, or 20% of self-employment income if self-employed, also up to \$45,000. Vesting is immediate. An "eligible employee" is one who has worked for you for 3 of the last 5 years and who earned at least \$500 last year.

Another good thing about a SEP is that they can be opened as late as the extended due date for your tax return.

Saving Incentive Match Plan for Employees (SIMPLE IRA)

These plans allow for employee contributions but they do not allow you to put away as much for yourself as a SEP. The limit is \$10,500 or \$13,000 if you are 50 or older, plus an employer match up to 3%.

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These plans can be used by businesses with up to 100 employees. There are 2 varieties - the 3% match or the 2% non-elective contribution. Eligible employees are those that have earned more than \$5,000 in any 2 years prior and who will earn at least \$5,000 this year.

SIMPLE IRA's are not the same as SIMPLE 401(k)'s. The latter is like a traditional 401(k) however it has higher fees and less flexibility. SIMPLE 401k's are have not been widely adopted for these sorts of reasons.

Profit Sharing Plans

As the name implies, contributions from these plans vary with profits. The contribution limits are the same as with a SEP. Vesting is determined by the plan document, it is totally up to the employer. You will probably need to hire a professional with this sort of plan because they can become complex.

401(k)

Setting up a 401(k) program is getting cheaper all the time, due to competition. You can do it for less than \$2,000 a year plus there is going to be a per-employee charge as well. Total contribution limit follows the SEP (\$45,000 or \$50,000).

Defined Benefit Plan

These have become less popular in recent years, as they are largely being replaced by the various defined contribution plans that are available. The possible attraction here though is a scenario where you may be in your 50's and have not saved enough for retirement yet. You can set up a plan

that pays you up to \$180,000 a year or 100% of your highest 3 consecutive years pay. The contribution needed to create a fund like that is deductible.

You will definitely need a professional for these plans, and they tend to draw the attention of the IRS especially if your plan document changes with any frequency.

Roth IRAs

Say you have set up your SEP or other plan. But say you still want a larger tax break. You can get one by adding a Roth IRA on top of your plan. Contributions are not deductible but earnings build up tax free and you can make withdrawals without owing any tax. Contributions are phased out at higher adjusted gross incomes, but they are high enough so that they do not affect most taxpayers.

Please contact your investment advisor or other professional for further information on Roths.

Getting Started

To get started, you can contact any of the big no-load mutual fund companies such as Fidelity or T. Rowe Price. Or, you can work with a small business consultant, or your banker. Please contact me if you have any questions or would like any further information.

Paying Federal Tax Obligations Electronically

If you owe federal taxes, consider paying through EFTPS, the Electronic Federal Tax Payment System. EFTPS is

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a fast, easy, convenient and secure service provided free by the Department of Treasury.

EFTPS is available to both individual and business taxpayers. With EFTPS, you can pay all your federal tax payments through the internet or by telephone. These payments include corporate, excise and employment taxes as well as your 1040 quarterly estimated tax payments.

EFTPS is convenient and flexible. It allows individual taxpayers to schedule payments up to 365 days—and businesses up to 120 days—in advance of the payment due date. With the ability to schedule payments in advance, you can avoid missing deadlines and incurring penalties. Scheduled payments can be cancelled up to 48 hours before the scheduled payment due date.

EFTPS is available around-the clock. The electronic payment system and a live Customer Service representative are available 24 hours a day, 7 days a week. Other features include an immediate, printable acknowledgement number, which acts as a receipt for your payment.

After you enroll in EFTPS, you will receive a confirmation package by mail. In a separate mailing you will receive an EFTPS Personal Identification Number (PIN) with instructions for activating your enrollment. Employers who apply for and receive a new Employer Identification Number and have a federal tax obligation are automatically enrolled in EFTPS Express Enrollment to make their Federal Tax Deposits.

For more information you can visit IRS.gov. Click on the e-file logo and look for "Electronic Payment Options" and the EFTPS

Michigan Has A New Business Tax

Here is an overview of the new Michigan Business Tax (MBT) structure.

Business Income Tax

Federal taxable income is your MI business taxable income times 4.95%

Modified Gross Receipts Tax

Gross receipts, less payments to other firms, times 0.80%

Less Credits

Section 403 for in-state employee compensation and in state asset additions

Section 405 for in-state R&D

Section 417 for small business credit

Section 407 - eligible contributions

Section 409 motor sports entertainment complex

Section 410 - stadium credit

Section 411 - gross receipts phase out

Section 413 - certain property tax credits

Section 415 - start up credits (complex)

Section 421 - non refundable credits (list – e.g. colleges)

Section 423 - disability comp payments

Section 425 - endowment and foundation payments

Section 427 - homeless shelters and food banks

Section 429 - Renaissance Zone activities

Section 431 - new jobs credit

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Section 433 - Renaissance Zone activities

Section 435 - rehabilitation credit

Section 437 - economic growth (complex)

Section 439 - low grade hermatite credit

Section 441 - entrepreneural credit

Section 445 - motor vehicle dealer

Section 447 - certain retailers (e.g. Meijer)

Section 449 - retailers again for 2208 and 2009 only, unused credit carryover from the 2007 MI SBT

Net MBT

As you can see, the new business tax is complex.

Husband and Wife Partnerships, Part 2

When married couples run unincorporated small businesses, they can really get nailed by the federal self-employment tax (SE tax). In fact, these small-business owners often face SE tax bills that exceed their federal income tax bills.

There are two strategies for reducing this problem. A couple ideas for managing this problem follow but first some notes on why the problem occurs in the first place.

Here's the problem in a nutshell: If you operate your husband-wife business as a partnership or as a husband-wife Limited Liability Company (LLC) that's treated as a partnership for federal tax purposes, you must file an annual Form 1065 (U.S. Return of Partnership Income) with the

IRS. Each year, you and your spouse will also receive separate Schedule K-1s. These schedules split the business income and deduction items between you and your spouse. You then file your joint Form 1040 by recombining the Schedule K-1 amounts and mixing in your non-business tax items (personal exemptions, itemized deductions, and so forth).

With your joint Form 1040, you must include one Schedule SE to calculate the SE tax on your share of SE income passed through to you by the husband-wife partnership or LLC. You must also include a separate Schedule SE to calculate the SE tax on your spouse's share of SE income passed through to her by the husband-wife partnership or LLC.

On your separate Schedule SE, your share of partnership SE income equals the amount shown on your separate Schedule K-1 multiplied by a factor of 0.9235. For 2007, you must pay 15.3% SE tax on the first \$97,500 of SE income. That 15.3% rate comprises 12.4% for Social Security tax plus 2.9% for Medicare tax. On any SE income above the \$97,500 threshold (for 2007), you only pay the 2.9% rate, because the Social Security tax component cuts out.

Your spouse must go through the same drill all over again when filling out her separate Schedule SE. As the following example illustrates, this can produce a whopping combined SE tax liability:

Example 1: Say your husband-wife partnership produces \$200,000 of SE income in 2007 (after applying the 0.9235 factor). The \$200,000 is split

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50/50 between you and your spouse. In this situation, you and your spouse each will owe \$14,990 of SE tax for a combined total of \$29,980.

The problem with the husband-wife partnership scenario is you get charged the maximum 15.3% SE tax rate on \$97,500 worth of SE income not just once but twice (once on your Schedule SE and once again on your spouse's separate Schedule SE).

So how do you avoid this double hit? There are at least 2 basic solutions.

Consider Strategy 1 if you're an aggressive taxpayer who doesn't mind going out on a limb as long as that limb has solid support in the Internal Revenue Code. Consider Strategy 2 if you're not the aggressive type.

Strategy 1

Create a Husband-Wife LLC With Modest Guaranteed Payments
Step 1 in this SE-tax-saving strategy is to start operating as a husband-wife LLC and stop operating as a husband-wife partnership. (If you already operate as a husband-wife LLC, proceed directly to Step 2 below.)

To convert an existing husband-wife partnership into a husband-wife LLC, simply register the LLC with the appropriate state authority (usually the Secretary of State) and pay the required registration fee (usually nominal). Then transfer any assets that are now owned by the partnership to the new LLC. (You probably have only a few assets or maybe none to transfer.) For federal income tax purposes, this conversion of

the existing husband-wife partnership into the new husband-wife LLC is a tax-free transaction. Why? Because the new husband-wife LLC is still treated as a husband-wife partnership under the federal income tax rules. In the eyes of the IRS, nothing has changed. However, you'll also need to check on the state income tax consequences, if any, of converting.

Even though the new husband-wife LLC is still considered a husband-wife partnership for most federal tax purposes, there are some key differences. The most important difference is that the members, or owners, of an LLC are generally protected from liabilities related to the LLC's business activities. In other words, the new husband-wife LLC will protect your personal assets and your spouse's personal assets from most business-related liabilities. For this reason, you and your spouse now look a lot like limited partners. In fact, you want to be classified as limited partners for SE tax purposes. By claiming this classification, you can take the following SE-tax-saving steps.

Step 2: Have the LLC pay you and your spouse modest but reasonable guaranteed payments. Guaranteed payments are fixed amounts (paid monthly, quarterly, or whatever) that don't depend on the level of business income. The key point is that LLC members who can be classified as limited partners for SE tax purposes only owe SE tax on guaranteed payments, if any, that they receive from the LLC for services rendered to the LLC. Source: Internal Code Section 1402(a)(13).

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Step 3: Report only those reasonable guaranteed payment amounts that you receive from your husband-wife LLC as SE income on: (a) the separate Schedules K-1 issued by the LLC to you and your spouse and (b) the separate Schedules SE that you and your spouse file with your joint Form 1040.

Step 4: Take out as much of the remaining cash flow from your husband-wife LLC as you wish in the form of random cash draws when cash is available and when circumstances permit. Just make sure your cash draws are not so regular and predictable that the IRS can claim they are actually disguised guaranteed payments. That would foil this whole SE-tax-saving plan.

Example 2: As in Example 1, your husband-wife business would produce \$200,000 of SE income in 2007 if you ran the show as a husband-wife partnership. If the \$200,000 was split 50/50 between you and your spouse, you would each owe \$14,990 of SE tax for a combined total of \$29,980.

This time, however, let's assume you convert your operation into a husband-wife LLC on Jan. 1, 2007. You and your spouse then collect 2007 guaranteed payments of \$45,000 each (say \$3,750 per month), which we assume represents reasonable compensation for your efforts in the business (albeit on the low side of reasonable). Under the husband-wife LLC structure, you and your spouse would each owe only \$6,885 of SE tax ($15.3\% \times \$45,000 = \$6,885$) for a combined total of only \$13,770. Compare \$13,770 to the \$29,980 of SE tax you would owe if you continue

operating your business as a garden-variety husband-wife partnership. The LLC arrangement reduces the SE tax bite by \$16,210.

By using this strategy, you can potentially save thousands in SE tax. You can collect similar SE tax savings every year as long as your overall business situation remains about the same. This can really add up over the years. So it's not too surprising that the IRS doesn't like it very much

The IRS could audit your business and claim your guaranteed payments were set way too low. The government could then attempt to assess back SE taxes, interest and penalties. Minimize this threat by doing some research to show you could hire outsiders and pay them the amount that you've paid yourselves to perform the work that you and your spouse do for the business.

The IRS could also simply say you and your spouse can't classify yourselves as limited partners for SE tax purposes. This is a weak argument, because the IRS has a history of claiming LLC members should be classified as limited partners for other tax-law purposes. So the IRS would be hard-pressed to claim that LLC members cannot also treat themselves as limited partners for SE tax purposes.

Strategy 2

Hire Your Spouse as an Employee
If you're uncomfortable with the aggressive strategy explained above, here's one that's tamer but will still generate some nice tax savings.

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Step 1: Unwind your existing husband-wife partnership or husband-wife LLC treated as a partnership for federal tax purposes, and start running the operation as a sole proprietorship or single-member LLC treated as a sole proprietorship for federal tax purposes. Even if your husband-wife partnership (LLC) owns assets and has liabilities, this step is generally a tax-free partnership liquidation transaction.

Step 2: Have your new proprietorship (single-member LLC) hire your spouse as an employee. Pay your spouse a modest (but reasonable) cash salary, say \$45,000, out of the proprietorship's checking account. Withhold 7.65% from your spouse's salary checks to cover the employee's half of Social Security and Medicare taxes. As the employer, your proprietorship must pay another 7.65% to cover the employer's half of Social Security and Medicare taxes. So there's a combined 15.3% rate for Social Security and Medicare taxes on your spouse's modest cash salary. However, since her salary is modest, the Social Security and Medicare tax hit is modest, too.

Step 3: On your sole proprietorship Schedule C (filed with your joint Form 1040), deduct as business expenses your spouse's cash salary, and the employer's half of Social Security and Medicare taxes on that salary. These deductions also reduce your SE income and thus your SE tax bill.

Step 4: With your joint Form 1040, include only one Schedule SE showing you as the sole proprietor. This minimizes your SE tax bill because you pay the maximum 15.3% SE tax rate on no more than \$97,500 worth of 2007 SE

income — vs. up to \$195,000 for 2007 if you continue operating your business as a husband-wife partnership or LLC (2 x \$97,500 = \$195,000).

When all is said and done, this strategy should substantially reduce the total amount you pay for Social Security and Medicare taxes.

For More Information

For more information on anything covered in this Newsletter, please contact me. I provide tax, accounting, consulting, and other business services such as payroll and medical billing.

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