TaxTips

small business owners summer 2019

Reasonable compensation

Is your S corp paying you enough?

Entrepreneurs often struggle with the question of how much to pay themselves. The underlying rule is that individuals who own and operate their business through an S corp need to pay themselves a "reasonable" salary. This rule also applies to any family members hired to help with the business, such as a spouse, parent, child, and even your grandchildren.

S corp shareholders are often tempted to pay themselves less because salaries are subject not only to federal and state income tax, but also to Social Security and Medicare taxes, federal and state unemployment insurance, and other various state and local payroll taxes. However, S corp profits passed through to the shareholder are not subject to these extra payroll taxes.

The IRS is aware of the tendency for S corp shareholders to underpay certain employees, and sometimes raises this issue when auditing closely held businesses. If the IRS determines that a shareholder's salary is unreasonably low, the S corp may be on the hook for unpaid payroll taxes. To limit this risk, S corp shareholders should be proactive in documenting that their salaries meet the "reasonable" salary requirement.

Here's a quick way to tell if your salary is reasonable. Suppose you sold your S corp to an outside investor, and the new owner hired you to continue running the business. How much would this outside investor be willing to pay you for the work you do? In other words, a reasonable salary is an amount that similar businesses, under similar circumstances, would pay you for the same services. To document this, S corp shareholders should record their decisions regarding shareholder compensation in the corporate meeting minutes. And they should mention the factors that went into deciding the salary amounts for each shareholder. For example, shareholders should make note of the current financial condition of the S corp, how many hours the shareholder works, and the type of work that the shareholder performs.

Qualified Small Employer Health Reimbursement Arrangements

What to look for and how to protect yourself

Under the right circumstances, sole proprietors and other small businesses can reimburse employees for legitimate out-of-pocket medical expenses up to the annual limits.

By implementing a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA), employers can report these reimbursed medical expenses as a business deduction. If all the formalities are met, the reimbursements are not subject to income tax or payroll taxes.

The annual limits for year 2019 are $5,150 for self-only coverage and $10,450 for family coverage.

A QSEHRA can reimburse qualified medical expenses for the employee or the employee's family members. These expenses include:

- Insurance premiums for individual health plans
- Fees for doctors, dentists, hospitals, and lab testing
- Long-term care insurance premiums
- Transportation to and from medical care facilities
- Prescribed medication

Your business is eligible to set up a QSEHRA if:

- Your business has at least one and fewer than 50 full-time employees.
- Your business does not offer group health insurance to any employees.
- You agree to offer the QSEHRA benefits on the same terms to all eligible employees.
- Before reimbursing health insurance premiums, you verify that the employee or the employee's family member is covered by health insurance.

Hiring family members

Tax-saving strategies

Sole proprietors may be able to reduce their tax burden by hiring their children, spouse, or parents to work as bona fide employees.

There are three ways to save tax dollars for the business owner. First, sole proprietors may be able to avoid some payroll taxes on wages paid to their sons, daughters, spouses, and parents. Secondly, they are shifting income to persons who might be in a lower tax bracket. Thirdly, sole proprietors can deduct other employee benefits to amplify their tax savings.

1. **Reducing payroll taxes.** Sole proprietors don't have to pay federal unemployment insurance (FUTA tax) on wages paid to parents, spouses, or children under age 21. Many states also exempt family members from state-level unemployment insurance (SUTA tax). Sole proprietors don't have to pay Social Security and Medicare tax (FICA) on wages paid to their sons and daughters under age 18. That means the child doesn't have the 7.65% FICA tax withheld from his/her wages, and the sole proprietor doesn't have to pay the employer's portion of FICA either.
2. **Shifting income into lower tax brackets.** By paying wages to family members in lower-income tax brackets, you end up deducting the wages paid on your tax return with its potentially higher tax rates, and the income gets taxed at a lower rate on your family member's tax return.
3. **Deducting employee benefits.** As a sole proprietor, you can offer pre-tax benefits to your employees, such as group health insurance, term life insurance, and employer contributions to their retirement plans. This opens the opportunity, for example, to deduct health insurance premiums for the family as an employee benefit on Schedule C, instead of as a deduction on Form 1040, Schedule 1. This helps reduce the sole proprietor's self-employment tax.

Following are the do's and don'ts of hiring family members:

- Do have them fill out Form W-4.
- Do pay a reasonable salary for services performed.
- Do report their pay on Form W-2.
- Do withhold federal and state income tax.
- Do file quarterly and annual payroll forms.
- Do provide your family members with the same benefits you offer to other employees.
- Don't pay unreasonably high salaries.
- Don't pay them for doing nothing.

Choosing the right retirement plan

Ask yourself three simple questions

Entrepreneurs who want to set up a retirement plan for their business have three options: SIMPLE IRA, SEP IRA, and solo 401(k) plans.

Each of these retirement plans enables business owners to save money for retirement. The earnings on the investments are tax-deferred until retirement, and contributions can be tax deductible.

Each plan has slightly different features, and you'll need to choose one that meets your specific needs.

Consider these three questions when choosing your plan:

1. **What is your age?** If you're at least age 50, consider a SIMPLE IRA or solo 401(k). Both offer catch-up contributions, allowing you to contribute an additional $3,000 (SIMPLE) or $6,000 [401(k)].
2. **Do you want to make after-tax Roth contributions?** Only solo 401(k) plans can be set up to receive designated Roth contributions that are not limited by income level. This makes solo 401(k) plans a uniquely compelling fit for entrepreneurs who want to save taxes on their retirement contributions. For 2019, entrepreneurs can contribute up to $19,000 of after-tax elective deferrals to their Roth 401(k), or $25,000 if age 50 or older.
3. **Do you want to catch up on the previous year's contribution?** A SEP IRA can be set up retroactively. Sometimes we have a situation where a sole proprietor or business owner doesn't have a retirement plan, and they want to put some of their earnings towards retirement. The solution is to file an extension and set up a SEP IRA. You have until the extended due date of your tax return to set up and contribute to a SEP IRA to deduct the contributions on that year's tax return. This means that entrepreneurs with a valid extension who set up a SEP account by the October 15 deadline can deduct any contributions on that year's tax return.

Tax-free reimbursements of business expenses

Accountable plan basics

Businesses can reimburse owners and employees for out-of-pocket expenses under an accountable plan, a set of rules and processes that allow tax-free reimbursements of certain business expenses. To qualify,

an accountable plan must contain the following three terms and conditions:

1. Employees must substantiate their expenses by providing the business with a written statement of expenses they paid, along with receipts and any other documents needed to prove the expense is legitimate. The documentation must show the amount paid and the business purpose for the expense. Employees also need to document the time and place of any travel or meal. For gifts given to clients or vendors, employees should also describe what was given and how the recipient of a gift is related to the business.
2. The company can only reimburse employees for tax-deductible expenses related to the business. Expenses should be approved for reimbursement only if the expense relates to the business.
3. The company must require employees to return any excess advances in a timely manner.

Your accountable plan should detail when employees need to provide you with substantiating documents and to return any funds paid out in advance that were not spent on legitimate business expenses.

The IRS provides two safe-harbor methods for preserving the advance as a tax-free reimbursement. We highlight just one method—the fixed date method—to illustrate what we mean by the time constraint. Using this method:

- The business advances funds only within 30 days of when the expense is paid;
- The employee requests reimbursement and provides substantiating documents within 60 days of paying the expense; and
- The employee returns any excess advances within 120 days after the expense is paid.

The best time to set up an accountable plan is now. We can advise you on how to set up expense reports and reimbursement processes that will pass IRS muster.

Working in the gig economy

Tax tips for ride-sharing drivers

Working in shared economy marketplaces like DoorDash, Lyft, or Uber has certain advantages for earning extra income. Some people even make a decent living at it.

If you are working in a gig economy, it's important to remember that these companies don't withhold taxes from the money you earn, but that doesn't mean you're off the hook from paying them. To avoid owing tax at the end of the year, we recommend you pay estimated taxes throughout the year. Alternatively, you could have additional tax deducted from your salary at your day job. The estimated tax calculation can get a little tricky, so just give us a call and we'll help you out.

It's also important that you track how many miles you drive. For 2019, you can deduct 58 cents for every mile you drive your car for business purposes. Every 1,000 miles you drive for Uber or DoorDash amounts to a $580 deduction.

The only way you'll know how many miles you drive is if you keep track of them using a mileage log, either on paper or via a smartphone app. Also, take a picture of your odometer reading on January 1 and December 31. This helps you track how many total miles you drive for the year.

Also track your out-of-pocket expenses. You might offer bottles of water to your passengers, or gift baskets to your Airbnb guests. You can deduct these out-of-pocket expenses on your tax return. Examples of other deductible business-related expenses include:

- Hands-free smartphone mounts for the car
- Smart phone and monthly service
- Parking, bridge tolls, and road tolls
- Linens and soaps utilized by Airbnb guests
- Security cameras and home protection services
- Commissions and fees paid to Uber, Lyft, Airbnb and other networks

If you've purchased any big-ticket items, remember to tell us about them. Maybe you replaced the roof or installed a solar panel in your Airbnb home. Or perhaps you installed a video security system in your Uber car. We can help you decide if these are expenses that need to be spread out over several years through depreciation, or if you can deduct some or all of them right away.

In addition to mileage logs and expense records, keep your 1099 forms and other tax documents. Gig economy companies report income paid to you on a Form 1099. Some companies will send you Form 1099-MISC, while others will send you a Form 1099-K. Some might even send you both, or none at all. The important thing is to keep copies of any tax documents and all the income you earn.

Send us copies of the year-end reports and statements you receive. Uber and Lyft, for example, detail their fees and provide an estimate of your mileage on their year-end reports.