

**Keep It and Protect It!
Tax and Asset Protection Strategies for Small Business Owners
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You Own Your Business - Now What? You have built or purchased your own business. You are good at what you do, and you are successful. But success brings new concerns. Is your business set up the way it should be? Are you paying too many taxes? Are you protected from potential lawsuits? You know how to run your business to make money, but do you know how to keep your hard earned money and protect it?

Consider a Corporation

For most professionals and business owners, incorporating provides many significant benefits. These benefits include a lower audit risk, increased stature and tax savings. Corporations are audited less than sole proprietorships. Sole proprietors file a Schedule C with their 1040 return. The IRS audits Schedule C returns more than any other type of return. Corporate returns are audited much less frequently. Corporations are perceived as more substantial than sole proprietorships. Image and perception is everything when marketing your business and a corporate image alone is worth the cost of incorporating. Potential customers and banks attach more respect and significance to a corporation than to a sole proprietor. Joe Smith DDS, a Professional Corporation, carries more weight than Joe Smith DDS. Most importantly, incorporating can reduce your taxes.

Self-Employment Taxes

The self-employment tax is an unwelcome surprise to most new business owners. The tax can be as much as 15.3% of your net income. The tax includes 12.4% for FICA (government mandated Social Security for retirement benefits) and 2.9% for Medicare. The employee pays one half of this tax and the employer pays the other half. When you received a paycheck, 7.65% of your wages were withheld for FICA and Medicare. Your employer also paid 7.65% of your wages for FICA and Medicare. Now, as a business owner, you are the employer and the employee, so you pay the entire 15.3% FICA and Medicare tax. This is the self-employment tax.

The FICA portion of the tax has a ceiling so it only applies to a certain amount of income. In 2002, the ceiling is \$84,900. Any net income above that amount is not subject to FICA. However, the Medicare portion has no ceiling. It applies to all self-employment income. This means that the self-employment tax on net income up to \$84,900 is 15.3% and 2.9% on any additional amount. As a sole proprietor, all of your income is considered self-employment income. All of your income is subject to the self-employment

tax. The goal is to recharacterize your self-employment income to some other type of income that is not subject to the self-employment tax. In a sole proprietorship there is no distinction between you and the business. You file only one tax return: a 1040 with a Schedule C. When you incorporate, you create a separate business entity. The corporation is the business and you are the employee. The corporation files a corporate tax return and you file a 1040.

Most professionals and small business owners will incorporate as an S corporation. An S corporation, as opposed to the traditional C corporation, is a pass-through entity. There is no separate federal tax on the S corporation. You can be paid a salary and any income retained by the corporation is taxed to you as the owner/shareholder. When the corporation pays you a salary, the corporation pays the employer share of the self-employment tax. The employee share is withheld from your paycheck. Whatever is left in the corporation at the end of the year after paying your salary and other business expenses is not considered self-employment income, and therefore, is not subject to the self-employment tax. This is a loophole for S corporation owners. With an S corporation, the net income of the corporation can be distributed to you as a dividend. S corporation dividends are not self-employment income, therefore they are not subject to the self-employment tax. Here are two examples to make the point.

Example 1

Your business nets \$100,000 and a reasonable salary is \$50,000. If you are a sole proprietor, all the net earnings are subject to self-employment tax. If you operate as a corporation, the corporation could pay you \$50,000 in salary and \$50,000 as a dividend.

- Sole Proprietor: Self-employment income is \$100,000
- Self-employment tax: \$12,648
- S Corporation: \$50,000 Salary and \$50,000 Dividend
- Self-employment tax: \$7,065
- Tax savings is \$5,583

Example 2

Your business nets \$300,000 and a reasonable salary is \$150,000.

- Sole Proprietor: Self-employment income \$300,000
- Self Employment tax: \$18,004
- S Corporation: \$150,000 Salary and \$150,000 Dividend
- Self-employment tax: \$13,987
- Tax savings is \$4,017

You and your accountant can determine what a reasonable salary for your business is. If you pay yourself too little in salary, the IRS could reclassify your dividends as salary. Don't abuse the loophole. Play by the rules and use them to your advantage.

KEY CONCEPT.

The IRS classifies income in three categories: earned income, passive income and portfolio income. Earned income, which includes all self-employment income, is subject to FICA and Medicare taxes. Passive income, which includes rental income from real estate, is not subject to FICA and Medicare taxes. Portfolio income, which is dividends from stock or interest from loans, is not subject to FICA and Medicare taxes. Your strategy should be to recharacterize your earned income to passive or portfolio income to reduce the self-employment tax.

Business Assets and Property

Do you or your business own valuable assets or property? If so, consider another tax- saving technique. Let's say you are a dentist and you own your office building and dental equipment such as chairs, tools and an x-ray machine. Why not lease the building and equipment to your corporation? The lease payments paid by the corporation are a business expense. This expense reduces the corporation's (and your) self-employment income. The lease income you receive is passive income, not self-employment income, so it's not subject to self-employment taxes. Here is an example of this strategy.

Example

Your self-employment income is \$200,000, which is all subject to self-employment tax. You lease your office building and your business equipment to your corporation for \$4,000 per month. In 12 months, the lease expense to the corporation is \$48,000. This amount is a business expense deduction against your self-employment income. $\$200,000 - \$48,000 = \$152,000$. After the deduction, your income subject to self-employment tax is reduced to \$152,000.

Protect Your Business Assets from Liability Claims

People incorporate their businesses for a variety of reasons including tax savings, reduced audit risk, enhanced stature and asset protection. When you operate your business through a corporation, your personal assets are generally not subject to business related lawsuits. Corporations provide a shield limiting the owner's liability to the corporate assets thereby protecting the owner's personal assets.

Unfortunately, professionals such as dentists, doctors, attorneys, accountants and architects cannot shield themselves from professional liability with a corporation. A professional will be personally liable for a malpractice claim whether or not the practice is incorporated. Professional liability is personal liability. Every personal asset is fair game in a malpractice lawsuit.

There is, however, a way to leverage your risk. The first level of defense is malpractice insurance. The second level of defense is to have a separate business own your business assets. For example, if you own your office building and equipment, both are exposed in a malpractice action. You can establish a business entity, such as a limited liability company (LLC), to own the office building and equipment. You own the LLC, and the LLC owns the business assets. A plaintiff in a malpractice action will have a difficult time reaching the business assets because the assets are no longer personal assets. They are owned by the LLC.

You can then integrate this strategy with the lease technique in the previous example. Your LLC can lease the equipment and building to your corporation. This would reduce self-employment taxes and better protect the assets from liability.

Act Now to Keep It and Protect It

Simplicity in your business operations was fine when you began. You may have put off tax planning because you had a business to run and didn't have time. Now that you are successful, tax planning is critical. Now is the time to look at how your business is structured and determine how you can keep more of what you make.

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