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Newsletter

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INDIVIDUALS

Ownership of the Family Business: His, Hers, or Both?

In recent years, the use of a Limited Liability Company (LLC) has become the entity of choice for small, family-owned enterprises. The LLC or similar limited partnership entity generally provides important liability protection, and yet from a tax standpoint, a one-member LLC is an “ignored entity” and does not require separate tax return filing. All of the income, deductions, gains and losses of the entity are reported in the Form 1040 of the owner. The intent is to achieve the best of both worlds: liability protection similar to the corporate structure, but without the hassles of a separate tax return.

The Husband-Wife LLC

If a business is placed in a one-owner LLC, the entity is ignored for income tax purposes and a proprietorship schedule is included within the Form 1040 of that owner to report the business activity income and expenses. But what if the small business is placed in an LLC that has two members, a husband and wife?

In a community property state, there is great flexibility. The IRS has indicated that a husband and wife may treat the LLC as a one owner, ignored entity, reporting all activity within the 1040 as a proprietorship. On the other hand, if the husband and wife treat the entity as a partnership and file a partnership income tax return, the IRS will also accept that position.

But in any location other than a community property state, even though the only members might be a husband and wife, the tax regulations require the filing of a partnership income tax return for a business if it has two or more owners. The tax return preparation costs in this case can be significantly greater due to the complexity of partnership reporting (a balance sheet is often required as part of the tax return, and there are book-to-tax reconciliations required, detailed Schedule K-1 income and deduction reporting to each partner, etc.). In general, in a non-community property state where a small business has previously reported as a proprietorship, the taxpayer is often better served to have a single member LLC entity rather than having both the husband and wife included in the ownership.

Self-employment Tax Issues

In the formation of an LLC, an often overlooked issue is the consequence of the self-employed Social Security tax (SE tax). If an LLC member has management authority, the IRS position is that the member is subject to SE tax on his or her share of business net income. This assumes that the LLC is conducting an active business rather than merely investing in rental real estate or holding portfolio securities.

The IRS position is that the mere right to exercise management authority can trigger liability for SE tax. On the other hand, being a member without management authority, as defined in the partnership agreement or the member control document, can avoid the SE tax problem.

In the case of a husband-wife LLC, the SE tax implications can go either way. If the business income is very substantial, the two-member LLC could double the SE tax because each spouse has a full lower-tier base amount subject to the tax (i.e., roughly the first \$100,000 of income to each owner is subject to the full 15.3% SE tax, while earnings in excess of \$100,000 are only taxed at 2.9%). On the other hand, the SE tax can be less if a portion of the business earnings are allocated to a spouse with a large W-2 who has already maximized the lower tier Social Security base amount.

Example. Bill is semi-retired and has developed a successful furniture-making business that has become increasingly profitable. His spouse, Sue, is a physician and earns in excess of the lower-tier Social Security base. To provide liability protection, Bill's business is transferred into an LLC. If he is the sole member-owner of the LLC, the business will continue to be subject to the same SE tax as occurred previously (i.e., the full 15.3% on the about the first \$100,000 of net income). But if it is a two-member LLC filing a partnership return, Sue's share of the business net income is only subject to the 2.9% Medicare tax, not the full 15.3% Social Security SE tax.

In this matter of SE tax implications, there is no single optimum model. Rather, this topic requires a case-by-case analysis of the amount and character of the business income, and the comparative position of each member with respect to exposure to the SE tax.

As a further complication, the IRS proposed regulations that address when an LLC member is subject to SE tax have never been finalized. However, the tentative rules do provide some opportunity to structure LLC membership in a way that avoids or minimizes the SE tax burden. As a result, this is a situation where the design of each newly-formed LLC should give careful consideration to the SE tax implications.

Please let us know if we can assist in advising about the proper structure for your small business activity.

SE Tax Risk on Land Rents

Even among urbanites, it is common to find ag land included in the individual's investment portfolio. Often this is inherited property, and it is held in landlord status producing rental income to the owner. Collecting rental income on real estate is exempt from the self-employed Social Security tax (SE tax). But the IRS recently issued a Notice, taking a position that for the first time imposes SE tax on certain types of land rents.

The issue relates to ag land that is placed in the popular Conservation Reserve Program (CRP). CRP was first authorized in 1985. Farmland is placed in the program under an agreement with the U.S. Department of Ag, under which the land is not tilled and a grass cover is maintained for conservation purposes. Under this contract, the USDA pays the landowner a rental payment, based on comparable land rents in that geographic area.

There have been several tax court cases addressing the issue of whether CRP is simply a form of land rent that is exempt from SE tax, or whether it is farming business income that should be subject to SE tax. Two court cases have held that active farmers (as opposed to landlords) who place their land in CRP must report the CRP rents as active business income, in the same manner as any other USDA ag subsidies. But until this point, there has been no authority suggesting that landlords or investors who held land that produced CRP rents could be subject to SE tax.

It is important to note that this IRS position attempting to impose SE tax on all CRP rents is only in proposed form. At this point, there is nothing binding about the tentative IRS position. However, somewhere in the next year or so we can expect the issuance of an official IRS position, and we may well be faced with the need to pay SE tax on all CRP rents.

If the IRS does ultimately take this position of imposing SE tax, in a few cases it may actually enhance some tax returns. If CRP income is construed as subject to self-employment tax, it would also represent earned income that could support tax deductible funding of a self-employed retirement plan. Also, the income would be eligible for farm income averaging, meaning that it could be taxed at a lower income tax rate based on your prior three-year history.

Again, stay tuned. Nothing is final yet, but those who own land on which CRP rents are collected will want to pay attention as this issue moves forward.

BUSINESS DEVELOPMENTS

Loans to S Corporations

In 2005, the IRS lost an important tax court case on how S corporation shareholders can use loans to support the deductibility of their S corporation losses. In reaction, the IRS has now issued proposed regulations that may restrict the ability of S corporation shareholders to claim pass-through losses from an S corporation in their Form 1040. When these regulations become final, it will represent an important change, and those affected will need to operate differently to continue claiming their share of the S corporation losses.

The Brooks Case

In that 2005 tax court case, the shareholder had made a series of open account advances to his S corporation. The shareholder maintained a running loan account of advances to and from the S corporation. These were not evidenced by separate written notes, but rather simply tracked as a single ongoing open account debt.

An S shareholder is allowed to deduct his or her share of the S corporation losses only to the extent of the shareholder's cumulative investment in the corporation, whether in the form of stock purchases or loans to the corporation. For that reason, a loan to an S corporation can be very important if that S corporation is running in the red.

In the *Brooks* case, the shareholder was using this open account debt to have sufficient investment in the S corporation to claim all of the pass-through losses. The tax law in this area focuses on the shareholder's investment as of the last day of the S corporation year, usually December 31. In the facts of the *Brooks* case, the taxpayer borrowed money from a bank and advanced it as open account debt to his S corporation shortly before year-end. This provided sufficient investment in the corporation to allow the annual use of the losses.

But the corporation repaid the shareholder advance early in the next year. Normally, this would result in the recognition of gain from repayment of that debt. To avoid this, the shareholder again advanced money to the corporation shortly before the end of the subsequent tax year, on the premise that the loan was all one debt under its open account status. As a result of this in-and-out series of transactions in an ever-increasing amount, the shareholder was effectively able to use losses based on nothing more than very temporary year-end advances to the S corporation.

New IRS Rules

To prevent open account debt from being used to create a near perpetual tax deferral, the IRS has issued proposed regulations that will limit the use of new open account debt to an aggregate \$10,000 limit. If an S shareholder's open account advances exceed \$10,000 at any point in time, that open account debt is treated for tax purposes as a separate debt instrument. As a separate debt used to support tax losses at year-end, any repayment of that loan would trigger gain to the shareholder. It could not be "covered up" at the end of the subsequent year with a further advance to the S corporation.

While these new IRS rules will only impact S corporation shareholders who have been using a revolving open account debt to support the tax deductibility of losses, the rules will have serious tax implications to those affected. The good news is that the proposed regulations are not yet final, so there is some time for tax planning. If you or your business associates may be in this position, please contact us so that we can address a strategy to react to these pending new rules.

Employing Family Members: A Higher Standard

Many small businesses do not use formal written employment agreements, particularly for part-time workers. But if that person on the payroll for occasional duties is a family member, a recent tax court case suggests that the formalities can be very important. And the tax consequences can be significant, because it is usually not only a wage that it is in question, but one or more tax deductible employee fringe benefits such as health insurance or a medical reimbursement plan.

The Francis Case

In a recent Tax Court case, the husband was a proprietor who worked full time in the family business (*Francis*, TC Memo 2007-33). His wife was engaged by the business for part-time duties (maintaining books and records, occasional errands for the business, telephone services, etc.). There was a written employment agreement, specifying that she would receive annual compensation of approximately \$2,000, plus a fringe benefit health plan that covered the family health insurance costs and also reimbursements up to \$8,000 annually for out-of-pocket medical expenses.

These spousal employment and fringe benefit plans can be very tax-efficient. If done properly, the employer-employee relationship allows the business to deduct the health insurance and other medical benefit payments as a direct business expense, often saving both income tax and self-employment Social Security tax. But the value of those benefits is tax free to the family employee.

In this case, the Tax Court was wary of the reality of the arrangement, stating that “We apply close scrutiny to the facts in a family situation.” Based on the IRS examination, the court noted that the taxpayers had failed to prove that the total compensation paid to the spouse was reasonable. For the year under consideration by the court, the direct wage plus fringe benefits amounted to about \$12,000 in value. But the court noted that the couple had failed to document the actual services performed by the spouse for the business. There was no record of the dates nor the hours that the employee had worked, there was no hourly rate of pay established, and no evidence that the compensation package was comparable to similar employment by similar small businesses in their area.

The Lessons

This case emphasizes the importance of documenting the nature and extent of services of a spousal or other family member employee. The employment agreement should refer to the required hours of work by the employee and the hourly rate of pay used to arrive at the total compensation package. Additionally, the family member should complete some type of time record, similar to other employees, detailing the hours worked and the services performed.

Family employment accompanied by fringe benefit plans can be both very tax-efficient and lucrative. But given the benefits involved, the IRS and the courts apply a high standard of evidence to establish the legitimacy of the arrangement. If you have family employment arrangements that should be reviewed, or are interested in considering whether your facts may present an opportunity in this area, please contact us.

New IRS Attack on Expense Reimbursement Plans

Most businesses have occasions where employees are required to travel, and as a result the business reimburses those workers for their out-of-pocket expenses. If done properly, the business has a tax deduction for its expenditures, but the employee has received a nontaxable reimbursement. No wage reporting or payroll taxes come into play.

To meet IRS rules on expense reimbursements, employers generally have two choices: they can reimburse actual expenditures incurred by each employee, or they can use IRS standard allowances. To simplify recordkeeping, many employers have moved to these IRS standard allowances, such as the current 48.5¢ per mile business mileage rate. For out-of-town travel costs, there are several choices for standard per diem allowances to reimburse meals and lodging. For example, a full day of out-of-town overnight travel can result in a \$45 per day meal allowance, or even a \$58 per day amount in specified high cost locations. Similar standard amounts exist for lodging costs. As an alternative, employers may use the Federal government meal and lodging per diem amounts, which are specific to each travel locale.

In late 2006, the IRS issued a tough new ruling, holding that employers who do not follow either actual reimbursement or IRS-approved standard allowances, and are found to be reimbursing employees at a rate greater than those allowances, will have their reimbursements recharacterized as wages. This interpretation was particularly aimed at the trucking and construction industries, where apparently employees have been receiving meal allowances that are based on miles traveled and that are in excess of the various IRS-approved per diem amounts. When this occurs, the onus falls entirely on the employer. The IRS recharacterizes the **entire** reimbursement (not just the excess) as wages, and charges the employer with all delinquent payroll taxes and penalties.

But in recent administrative guidance, the IRS has taken a more reasoned approach. Where employers have used expense allowance arrangements that do not properly comply, the IRS has indicated that its examiners will not impose wage treatment in prior years unless there has been a pattern of abuse or evidence of intentional noncompliance. And further, for periods beginning in 2007 and after, the IRS will only tax employer reimbursements in **excess** of the Federal per diem limit as wages, unless the employer plan evidences a pattern of abuse or the employer has no system for tracking whether excess payments have occurred to employees.

The consequences of an out-of-compliance expense reimbursement arrangement can be very serious, so please let us know if you have any questions regarding your specific expense reimbursement policies.