Taxpayer’s Comprehensive Guide to LLCs and S Corps
(Shortie Version)

2017 Edition

by Jason Watson

and

The Watson CPA Group
Certified Public Accountants
Business Consultants
Introduction

How can I avoid self-employment taxes? This simple question was the inspiration for creating an article describing the benefits of an S Corporation. That original article, which was about four pages long, quickly became a series of KnowledgeBase articles on the Watson CPA Group website. The articles touched on basic topics such as how to elect S Corp status, shareholder payroll, reasonable salary determination, retirement planning, health care, fringe benefits and liability protection.

Those broad topics demanded much more information, both horizontally by spanning into more related issues, and vertically by digging deeper into the granular yet riveting levels of the tax code. The articles were grouped and relabeled as the Taxpayer's Comprehensive Guide to LLCs and S Corps which grew to 39 pages in its first edition. Sorry, all the good titles were taken (remember, the longer the title the less important the material is. Bible, Beowulf, Caddyshack... short and sweet). The Hunt for Red October is one exception, yet we digress.

Time marched on, and more information was added to the first edition such as expanded retirement planning concerns, health care options after the Affordable Care Act and business valuations including exit strategies. Boom, we now had our second edition at over 100 pages. At that point it was suggested by some clients and colleagues to convert the PDF into an eBook as well as paperback. So here we are on our fifth edition which is now called the 2017 edition.

Each week we receive several phone calls and emails from small business owners and other CPAs across the country who have read our Taxpayer's Comprehensive Guide to LLCs and S Corps and praised the wealth of information. Regardless of your current situation, whether you are considering starting your own business or entertaining a contracting gig, or you are an experienced business owner, the contents of this book are for you.

Our book will show you how to reduce your self-employment taxes through an S Corporation election and how to use your corporation to your retirement and fringe benefit advantage. You will also learn the operational considerations of an S Corp plus the 185 reasons you should NOT elect S Corp status. Want to buy or sell a business? That’s in here too.

Our book is written with the general taxpayer in mind. Too many resources simply regurgitate complex tax code without explanation. While in some cases tax code and court opinions are duplicated verbatim because of precision of the words, this book strives to explain many technical concepts in layperson terms with some added humor and opinions. We believe you will find this book educational as well as amusing.
Shortie Version

This PDF is our teaser. We want to show you some of the basic concepts you need to consider when operating an LLC with and without an S Corp election. Throughout this PDF we will bring up additional concerns and solutions including tax court cases that are only available in our purchased print copy from Amazon or downloadable electronic PDF copy.

Yes, we are trying to monetize our efforts. Then again if our audience is business owners then this shouldn’t come to you as a surprise since you are doing the same thing. Having said that, all this material is available from our KnowledgeBase as individual articles. The only difference is delivery- you can click away and get everything you need, or you can purchase printed and downloadable versions.

Please visit www.watsoncpagroup.com/book for more information on purchasing or www.watsoncpagroup.com/kb for our KnowledgeBase version which contains the full text in web format.
About the Author

Jason Watson
Managing Member

Jason Watson is the Managing Member for the Watson CPA Group, a Colorado Springs tax, accounting and consultation firm. His main focus as Managing Member is small business consultation, and financial, investment and estate planning.

Jason has owned two small businesses in the past and holds both a Bachelor’s and Master’s in Business Administration from the University of Wisconsin – Madison. He also became an Enrolled Agent with the IRS in 2013 and passed the Series 7 General Securities test in 2015.

Note, he is not a CPA. During college he migrated towards finance, economics and statistics, and not towards accounting. However, he preparing the CPA exam which has four parts. Two tests down. Two to go. Done in spring of 2018. So, if he’s a bit grumpy please understand why. Debits and credits. Yuck. Why do they have to equal? What a crummy system.

Aside from carrying the one in accounting class, his desire is speaking with small business owners and creating a dynamic map for the future. Jason enjoys talking about business planning, corporate structures, self-employment taxes, health insurance issues and retirement planning. He is quick to point out that while 70% of all situations can be covered with the basics, every business and person is truly unique.

Ask a question and have a dry erase board handy, and you’ll see the true passion of a person who not only wants to educate but also wants to see small business owners thrive. And while this book is on LLCs and S Corporations can be labeled as shameless self-promotion, at the same time it truly came from Jason’s heart to help small business owners everywhere.

Jason is also a Certified Divorce Financial Analyst and business valuator, and offers mediation support for divorcing couples. He also appears as a financial expert witness, and volunteers for the National Institute of Trial Advocacy in Boulder, Colorado.

Jason is also founder and Principal of One Call Capital Group, a registered investment firm in Colorado. He approaches investment strategies from a financial planning perspective, and wants to ensure the plan meets the objectives. One Call Capital Group embraces a fee based approach to investment and financial planning, as opposed to commissions.

While not speaking to a group of business owners, chatting it up with Colorado Springs CPAs or reading the latest thrilling IRS Publication, Jason likes dirt biking, boating in Wisconsin, watching the Packers beat the Bears (it never gets old), and running trails in Colorado. He used to also be a pilot for SkyWest Airlines, a United Express airline, but resigned in March 2015 to focus on small business owners and financial planning.

Lastly and most importantly, he is a father of three numbskulls (Brendan, Corinne and AJ) and married to the Watson CPA Group’s founder and Senior Partner, Tina Watson CPA.

You contact Jason at 719-428-3261 (direct) or jason@watsoncpagroup.com.
Progressive Updates
The tax law is continuously changing from the acts of our government, to the decisions by the tax court and federal courts, and through notices and private letter rulings from the IRS. In addition to changes, other topics of interest pop up in various trade journals such as Journal of Accountancy and Kiplinger’s Tax Letter. As we discover other issues concerning LLCs, S Corporations and self-employment taxes, we want to get the word out right away.

More importantly, the frequent business consultations we perform and the questions we field provide a steady stream of new ideas that are worthy of being wormed into this book. So here’s to you- the curious small business owner helping others. We encourage you to visit our website for information on updates-

www.watsoncpagroup.com/book

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Shameless Self-Promotion
This book originally was a collection of KnowledgeBase articles that were written to help small business owners and to help our own small business through educational marketing.

Since you probably paid some money for the privilege of being bombarded with shameless self-promotion, we hope you take our comments with a grain of salt. Our primary focus is to educate you, minimize your tax consequence, maximize your wealth and keep you out of trouble. If you read this, arm yourself with knowledge and then ask pointed questions to your accountant, we are completely happy. We have done our job with this book.

Having said that, if you want the Watson CPA Group’s assistance in whatever capacity necessary, from quick second opinions to full-time service, we are also happy to provide that. Want more information? Please visit our website at www.watsoncpagroup.com/fees for the most up to date information.
Testimonials

Here are some testimonials that we peeled from consultation requests and emails. To say that everyone loved our book is to say that everyone liked sliced bread. We’re sure there are people who hate sliced bread. At any rate, here are some testimonials which represent most of our audience.

Justin S, CPA
I love the LLC and S Corp Book and it has been very helpful. I have a question that hopefully you can provide clarification on. I have a client that uses two vehicles for business purposes...

Alex J.
I am in the planning stages of starting my own consulting company that will launch in January 2018. I came across your firm, and specifically your TCGLS document, through a number of various Google searches and was immediately captured by your thought leadership and communication style. I just finished reading the TCGLS Shortie, and will admit that I both externally laughed and internally cried. In both cases, I learned a lot.

Britt S., Esq.
Thank you so much for speaking with me last week! You are amazing and I greatly appreciate all of the information you emailed me. I am in complete adoration of your book!

Tyrone G. says
I just got done reading your book. I’m actually on my second time reading it. The fact that you use humor to help with the complicated wording of the IRC is absolute genius. I like the part where you stated that accountants renamed LLCs to mean ‘Lawyers Likely Choice.’

Michael K.
Hello, your LLC/S Corp book has been extremely helpful, but I am struggling to get proper advice on how to best structure our business long-term. Currently it is setup as an SMLLC, however I would like to add a partner (wife to be) to help expand the business while I continue to work full-time.

Sean D.
My search re: pros & cons of how to own/expense a vehicle used for business purposes dropped me into your KB. Almost a black hole! Hours later, my head throbbing & stuffed with as much as it could absorb in one session--vehicles, entity structures, state tax laws, retirement accounts, and more--I figured maybe I should crawl out & get in touch with the people responsible for assembling all that!

Michael B.
Great read by the way. I read another book by Mark Kohler which lead me astray, or maybe I just had poor reading comprehension that night.

Anne M.
From what I read in your excellent book, [my husband] has done (quite) a few things the IRS frowns upon and I’m sure that if I knew more about S-Corps, it might help to give me an edge in negotiations. I would like to tell you more about the specifics of my situation to see if you can be of help in this area.
AJ B.
Hello, first of all I love reading the book on LLC’s and S-Corps. I downloaded a copy about a year ago, and it’s still a fun read. I currently have a handful of businesses (all within a 2 year period, so some lose money and some are moving ahead) and they involve different industries and structures as well.

Brett B.

Scott G.
BTW, I read [your] book and really enjoyed it although some of it was beyond me.

Josh H.
Found your book on Amazon—read and enjoyed it. I have some questions about optimizing my business structure, and further understanding taxation on distributions/dividends.

Don’t take our word or the words of your colleagues… read on to see if this could help you leverage more out of your business, build wealth and minimize taxes.
## Table of Contents

There is a lot of information here. Over 280 pages- whoa! And not a lot of picture pages. Put it on your bedside table and work through it over the next few days. Or use your handy tablet. You’ll be glad you did (or so we think). Happy reading!

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Chapter 1
Business Entities and LLCs

Basic Business Entities
There are three basic business entities with variations within. The three basic are-

▲ Limited Liability Company (LLC)
▲ Limited Liability Partnership (LLP) or General Partnership (GP)
▲ C Corporation including Professional Corporation (some states require doctors, for example, to be a Professional Corporation)

Two notables missing from the list. First, sole proprietors are not an entity nor is the variant “Doing Business As” (DBA). If you wake up and want to sell used copiers, you can, right now, without any formalized structure. It is not smart, but certainly permissible. At times sole proprietors are interchanged with single-member limited liability companies (SMLLC) since the IRS and most states consider a SMLLC to be a disregarded entity for taxation, and both a sole proprietorship and a SMLLC will end up on Schedule C of your Form 1040. However, they are truly different in several underlying ways.

Also note how an S corporation is not listed. It is not an entity. It is a taxation election. The underlying entity has to be one of the above, and usually it is an LLC (either single-member or multi-member) for the ease of formation.

If you want to learn more about these separate business entities beyond the LLC taxed as an S Corp structure, please visit www.watsoncpagroup.com/book for more information or visit our KnowledgeBase at www.watsoncpagroup.com/kb/.

S Corporations
This book is all about S corporations so we saved the best for last. The benefits include corporate financial liability protection and easier ownership transfer yet the big benefit is the reduction of payroll taxes. Read that again. Payroll taxes. There is very little difference between a garden-variety LLC and an S corporation from an income tax perspective; the savings is from the reduction of payroll taxes which comprise of Social Security and Medicare. Recall that Social Security taxes stop at $127,200 (for the 2017 tax year) but Medicare continues into perpetuity. Other payroll taxes such as Unemployment, State Disability Insurance, etc. actually increase by electing S Corp taxation, but they are minor.

S Corporations are a pass through entity and therefore do not pay Federal income taxes, and the shareholders do not pay Social Security nor Medicare taxes on distributions from an S corp. Having said that, S corporations have a various sweet spots in terms of income versus payroll tax savings. In a later chapter, we’ll demonstrate the savings from $40,000 to $2 million, between sole proprietorships, LLCs, partnerships and entities taxed as an S corporation.
S corporations are never formed contrary to popular belief. They are spawned from a limited liability company, partnership or C corporation that elects to be taxed as an S corporation. After the election is made on Form 2553, you are treated as an S corporation for taxation purposes only yet all future governance such as minutes and adoptions should follow the corporate structure. Some attorneys argue that this bolsters your corporate shield however you remain a closely-held corporation where veils are pierced every day during Jerry Springer commercials. Most junior associates can do this left-handed so don’t think you have this impervious shield.

All kidding aside, the equity section in your balance sheet should also have a Capital Stock account and an Additional Paid-In Capital account. We can help with the journal entry to populate these accounts correctly so your equity section resembles that of a corporation. This is necessary for tracking basis in your S corporation. Chapter 4 has some examples.

You are in a weird limbo with electing to be taxed as an S corporation. You need to walk and talk like a corporation, but the underlying entity and what the secretary of state will have on file is going to be an LLC, partnership or C corporation. More on the election, and the behind the scenes stuff in a later chapter plus our thoughts on corporate governance such as meetings and minutes.

Other Formation Considerations
There might be some situations where layering entities or creating a brother-sister or parent-child type of overall structures makes sense.

Holding Company and Operating Company
This is one of the most common situations where you own two entities that do business between themselves. For example, you are a typical poor accounting firm with the usual high maintenance clients, and you feel that everything would be better if you also owned your own office building. You would create an LLC as the holding company which owns the building, and another LLC (and probably taxed as an S Corp) for the operating company.

This allows for some excellent ownership separation. For example, if you and your father-in-law own the building, he doesn’t have a stake in your accounting firm, and vise-versa. You might also want to make one of your key employees a business partner in your operations, but he or she should not have a stake in the building. Chinese Wall.

This arrangement can also reduce self-employment taxes or payroll taxes since this conduit changes the color of money. Huh? Your accounting firm’s income is earned income, taxed both at the self-employment tax level (or payroll tax level) and the income tax level. However, you reduce this earned income by the amount of rental expense and that subsequent rental income on the other end is considered passive, and only taxed at the income tax level. Beauty. You must have a lease and the rent must be market rates.

Parent-Child Arrangement (Income Flows Up)
You might have two business entities, and you want to combine them but they are also very different. For example, you are a realtor and your spouse is an IT consultant. We could create a holding LLC called Smith Ventures which owns the realtor LLC and the IT consultant LLC. In other words, the realtor LLC and IT consultant LLC have a single member, and that single member is the holding LLC.
The holding LLC would then make the S Corp election, and all the LLC income would flow into the S corporation as wholly owned subsidiaries. Remember, single-member LLCs are disregarded entities and are reported on the sole member’s tax return. In this case the sole member is the S corporation.

This entity structure solves some big problems yet creates some minor inconveniences. Instead of running multiple S corporations each with payroll processing and tax returns, all the payroll for the shareholders is handled out of a single S Corp. Each single-member LLC (SMLLC) is a disregarded entity and therefore on a singular tax return is required at the S corporation level.

Another benefit is that one of these business units, subsidiaries or whatever you want to call them can be carved away and later sold off. You could also expand ownership in one without expanding ownership in the whole structure (see below).

On to the minor inconveniences. Each entity should have its own checking account and set of books. Common expenses such as an umbrella policy or tax preparation fees would be paid at the S corporation level, while subsidiary-specific expenses such as website hosting would be paid at the LLC level.

Also, if you want to take a distribution out of one of the subsidiaries, truly the S corporation would receive the distribution first, and then make another distribution to you, the shareholder. A double hop. In other words, transfer money from the SMLLC’s checking accounting to the S corporation’s checking account to your checking account.

Another inconvenience is that each entity might be slapped with high annual fees from the state in the form of filing fees, or franchise taxes (like California) or both. The benefits might still outweigh the costs, but be careful.

This is a common strategy between husband and wife teams where the business entities are completely different, yet the household wants to enjoy the benefits of an S corporation. Plus, one of the spouses can expand ownership in his or her respective entity without upsetting the whole apple cart.

Bonus- one spouse could also have a 401k plan in one entity without affecting the other 401k plan in the other entity. For example, one entity has employees and the 401k plan has elected safe harbor to not fail HCE testing. No problem. The other 401k plan at the S corporation level maxes out each shareholder’s contributions. There are certain rules about control groups, but this example gets around it (more information in Chapter 9 – Retirement Planning).
Parent-Child Arrangement (Income Flows Down)

Another thought along these lines involves a multi-member LLC where you and another non-spouse partner are the members. Later in Chapter 3 you’ll learn that one of the limitations of an S corporation is that distributions must be made in the same percentage as ownership. So, if you are 50-50 with another shareholder, distributions must also be 50-50.

Backup for a moment. If this multi-member LLC was not taxed as an S corporation, the Operating Agreement could dictate a different schedule of distributions. For example, you and another insurance agent team up. But you want an Eat What You Kill revenue model. In this case, you could be 50-50 partners, but have the distributions be tied to the production of each insurance agent. No problem.

You S Corp this thing, and now it blows up. Regardless of production or revenue splitting detailed in your Operating Agreement, or whatever, distributions must be 50-50 since that is the ownership percentage among the two shareholders. But you still want to save on self-employment taxes. What can be done?

We create three entities. A holding company that is a multi-member LLC (MMLLC), with each member being an S corporation. Each S corporation is owned 100% by each principal involved. Stay with us on this one. The following example shows three S corporations as members of the MMLLC, but just ignore one side if you are two-person show.

The MMLLC is really a funnel. All revenue goes in, all common expenses are paid out such as internet, copier lease, admin functions, etc., and an Operating Agreement dictates how the distributions are to be handled. K-1s are issued to the members which happen to be S corporations. And then those S corporations pay a reasonable salary to its respective sole shareholder and distribute the remainder.

There are some excellent benefits with this arrangement beyond the revenue splitting and saving of self-employment taxes. Each S corporation is independent. In using the previous schematic, Fred could buy whatever company car he wanted. Velma could work from home and reimburse herself for a home office. Shaggy could rent an office since his place is… well… a dog house of sorts. Each S corporation can run expenses through as it sees fit without upsetting the other business partners.

We see this arrangement commonly in medical groups (surgery groups, physicians, doctors, anesthesiologists, nurse anesthetists, etc.), insurance agents and financial advisors. It is very common in entities where the revenue is not shared equally, but rather on production.

401k plans in this situation is tough since it is a controlled group. More information can be found in Chapter 9 on controlled groups, and how retirement planning within this scheme works.
Conclusion
There are several other entity structures and formalities to consider such as:

- Husband and wife teams (two owners, or just one owner with the other on payroll?)
- Husband and wife teams that have an outside partner
- How community property states differ from common law
- Having your trust own a holding company for your businesses
- Operating Agreements to handle death, divorce, corporate waste, minimum distributions, dispute resolution and exit plans.
- Corporate veils and the sham of the LLC protection

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Avoiding or Reducing Self-Employment (SE) Taxes

A common complaint from those who own their own business is self-employment tax. Can you avoid, reduce, eliminate or lower your self-employment taxes or SE taxes? Yes, to a large extent actually but it takes some effort.

If you own a business as a sole proprietor or as a garden variety single-member LLC (one owner or shareholder) your business income will be reported on your personal tax return under Schedule C and is subject to self-employment tax (currently 15.3%) and ordinary income tax. So, you could easily pay an average of 40% (15.3% in SE taxes + 25% in income taxes) on all your net business income in Federal taxes. Wow, that sucks! Similar taxation for partnerships / multi-member LLCs too.

Drive this concept into your head, pretty please. On business income as an LLC or partnership, you are being taxed twice. Once at the self-employment tax level and again at the ordinary income tax level. Income taxes are a concern, but they are not the crux of the S Corp election and subsequent tax savings.

We are all humans, and we generally spend what we make. If you are not prepared for 30% to 40% in taxes for your business income, it could be a shocker on April 15.

How SE Tax Is Computed

A bit of disclosure is in order. Self-employment taxes are 15.3% which is derived from the “employer” portion at 7.65% and the “employee” portion of 7.65%. However, a small business gets to deduct its portion of payroll taxes from income before determining the taxable income. Huh?

Think of your last job where you received a W-2. The employer might have paid you $100,000 and withheld your portion of Social Security and Medicare taxes on your behalf. The company also had to pay its portion of Social Security and Medicare taxes, so its total expense was the $100,000 salary plus $7,650. Similar concept with sole proprietorships and LLCs.

Here is an illustrative table-

<table>
<thead>
<tr>
<th>Net Business Income</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less SE Tax Adjustment at 7.65%</td>
<td>7,650</td>
</tr>
<tr>
<td>Taxable Business Income</td>
<td>92,350</td>
</tr>
<tr>
<td>SE Tax at 15.3%</td>
<td>14,130</td>
</tr>
<tr>
<td>Tax Deductible Portion</td>
<td>7,065</td>
</tr>
</tbody>
</table>

Do you see the $14,130 or 14.13% of $100,000? That is essentially your effective rate of tax on self-employed business income because of the deductible portion of 7.65%. Probably doesn’t make you feel any better but there you go.
Quick Analysis of S Corp Savings

If you own an LLC and have elected to be treated as an S Corp (Subchapter S) for taxation, the business now files a corporate tax return on Form 1120S. What’s the big deal? Before we get into that, let’s look at some quick numbers. These are based on using a salary of 40% of net business income for incomes up to $500,000 and then decreased incrementally to 30% for the millionaire at $2,500,000 below (real case actually). The 40% / 30% is for illustration.

<table>
<thead>
<tr>
<th>Income</th>
<th>Total SE Tax</th>
<th>Salary</th>
<th>Total Payroll Tax</th>
<th>Savings $$</th>
<th>Delta %</th>
</tr>
</thead>
<tbody>
<tr>
<td>30,000</td>
<td>4,239</td>
<td>12,000</td>
<td>1,836</td>
<td>2,403</td>
<td>8.0%</td>
</tr>
<tr>
<td>50,000</td>
<td>7,065</td>
<td>20,000</td>
<td>3,060</td>
<td>4,005</td>
<td>8.0%</td>
</tr>
<tr>
<td>75,000</td>
<td>10,597</td>
<td>30,000</td>
<td>4,590</td>
<td>6,007</td>
<td>8.0%</td>
</tr>
<tr>
<td>100,000</td>
<td>14,130</td>
<td>40,000</td>
<td>6,120</td>
<td>8,010</td>
<td>8.0%</td>
</tr>
<tr>
<td>150,000</td>
<td>18,711</td>
<td>60,000</td>
<td>9,180</td>
<td>9,531</td>
<td>6.4%</td>
</tr>
<tr>
<td>200,000</td>
<td>20,050</td>
<td>80,000</td>
<td>12,240</td>
<td>7,810</td>
<td>3.9%</td>
</tr>
<tr>
<td>300,000</td>
<td>22,972</td>
<td>120,000</td>
<td>18,174</td>
<td>4,798</td>
<td>1.6%</td>
</tr>
<tr>
<td>500,000</td>
<td>29,991</td>
<td>200,000</td>
<td>20,494</td>
<td>9,497</td>
<td>1.9%</td>
</tr>
<tr>
<td>750,000</td>
<td>38,764</td>
<td>262,500</td>
<td>22,307</td>
<td>16,457</td>
<td>2.2%</td>
</tr>
<tr>
<td>1,000,000</td>
<td>47,537</td>
<td>350,000</td>
<td>24,844</td>
<td>22,693</td>
<td>2.3%</td>
</tr>
<tr>
<td>2,000,000</td>
<td>82,630</td>
<td>600,000</td>
<td>32,094</td>
<td>50,536</td>
<td>2.5%</td>
</tr>
<tr>
<td>2,500,000</td>
<td>100,177</td>
<td>750,000</td>
<td>36,444</td>
<td>63,733</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

This also does not include self-employed health insurance premiums which increase your savings. Pretty graphical representation follows-

![Graph showing net business income and savings](image.png)

Net business income on the left and savings in dollars across the bottom. The scale is crummy for those below $500,000 which most small businesses.
Chart Notes

Let’s review some interesting things about the data on the previous page.

The bulk of payroll taxes are Social Security and Medicare taxes, which are combined to be called FICA taxes. You might have other payroll taxes such as unemployment (Yes, some states require it even for one-person corporations) and state disability insurance (SDI).

As mentioned, salaries started at 40% thru $500,000 and then reduced to 30% at $2M and $2.5M. This is a jumping off point. The IRS standard is “reasonable shareholder salary” which includes all sorts of non-qualitative things such as your expertise, Bureau of Labor Statistics, comparison of salary to distributions, zodiac sign, favorite color, etc.

Medicare taxes of 2.9% continues into perpetuity for LLCs and partnerships who do not elect S corporation status. Not only does this go on into perpetuity, it also goes on forever. This is one of the major component of savings in the upper incomes since Medicare taxes are capped at the amount of salary with S Corps. In other words, if you earn $1M you will pay Medicare taxes on the net income, but if you elect S Corp status and pay yourself a $400,000 salary you only pay Medicare taxes on the $400,000.

The Medicare surtax starts for those earning $200,000 and filing single, and $250,000 for those filing jointly. This too continues into perpetuity for LLCs and partnerships. In the data, we assumed a joint tax return. For example, at $500,000 net business income there is a $1,906 Medicare surtax. But if this business elects S corporation taxation and pays $200,000 salary, there is not a Medicare surtax. There is not a net investment income (NII) tax on the S corporation ordinary income either (more on that loophole later).

Savings as a percentage of income starts to drop off at $127,200 which makes sense given the Social Security cap for 2017. And those savings bottom out around $300,000 net business income and then begin a decent climb rate. Without getting into excruciating details and mental gymnastics, there is an interesting dynamic at $300,000 between Medicare taxes including the surtax on the LLC / partnership income, the salary being paid within an S Corp election, and Medicare taxes associated with that salary.

The Source of the Savings

The S Corp election of your Partnership, LLC or C corporation changes how the business reports income to the IRS. An S Corp prepares and files a Form 1120S which is a corporate tax return. That in turn generates a K-1 for each shareholder. Remember, shareholder, investor and owner are synonymous terms for our discussions.

As stated earlier, a K-1 is a statement that each shareholder receives, and it is similar to a W-2 since it reports the income that each shareholder is responsible for from a taxation perspective. As we discussed earlier, there are three types of tax returns that generate a K-1.

- Partnership / MMLLC (Form 1065)
- S Corporation (Form 1120S), and
- Estate or Trust (Form 1041)

There are two types of K-1s for the purposes of our self-employment tax conversation- one is generated from a partnership tax return and the other is generated from an S corporation tax return. These K-1s look nearly identical and both are reported on page 2 of Schedule E and your Form 1040. Schedule E is the tax form used for
rental properties, royalties and **other investment income** including business income from a partnership or an S Corp.

However, a K-1 generated from a partnership tax return which has ordinary business income in box 1 and / or guaranteed payments in box 4 will typically be subjected to self-employment taxes for an active partner or member. Conversely, ordinary business income in box 1 on a K-1 from an S corporation will **not** be taxed with self-employment taxes. The S corporation election changes the color of money (we love this saying).

**Note:** S Corps do not have guaranteed payments like partnerships might- S Corps would call these payments wages or salary. A partnership (and an LLC for that matter) cannot pay its partners or owners a wage or salary. IRS frowns on this. Any periodic payment that is recurring in a partnership to one of the partners is called a guaranteed payment and is reported separately from partnership income. Both might be subjected to self-employment taxes.

You might hear terms such as pass-through entity or disregarded entity- a disregarded entity is a single-member LLC. As the terms suggests, it is disregarded, and therefore does not have to file its own tax return since the taxable consequence is reported on the owner(s) personal tax returns as a sole proprietorship.

A pass-through entity passes its Federal tax obligation onto the partner of a partnership, the shareholder of an S corporation or the beneficiary of an estate or trust. States might impose a business tax or a franchise tax on the partnership or S Corp directly (they legally cannot impose an income tax... more in Chapter 3 about interstate commerce rules).

**Quick Recap, The S Corp Money Trail**

So, when your partnership, LLC or corporation is taxed as an S Corp you are considered both an employee and a shareholder (think investor). As an employee, your income is subjected to all the usual taxes that you would see on a paystub- federal taxes, state taxes, Social Security taxes, Medicare taxes, unemployment and disability.

However, as a shareholder or investor, you are simply getting a return on your investment. That income, as the Romneys, Gates and Buffets of the world enjoy, is a form of investment income and therefore is not subjected to self-employment taxes (tiny exception for income over $200,000 (single) or $250,000 (married) where Medicare surtax is charged).

When we say self-employment taxes, we are really talking about Social Security and Medicare taxes. From a sole proprietor perspective, they are self-employment taxes. From an employee perspective, they are Social Security and Medicare taxes. Same thing. Let’s look at another visual in terms of how the money travels (yes, picture page)!-
The four boxes on the left is the money trail of your sole proprietorship, LLC or partnership. The series of boxes on the right is the money trail of your entity being taxed as an S corporation. Note the $60,000 chunk of income on the far right hand side that is not being taxed at the self-employment tax level. **This is the source of your savings.**

Also note that all your $100,000 is being subjected to income taxes. This is a common misconception- a lot of business owners believe there is a magical income tax reduction with an S Corp election. Not true. The only reduction is in self-employment taxes. All other tax deductions such as operating expenses, home office expense, mileage, meals and entertainment, etc. are equally deductible with or without an S corporation.

**Conclusion**

Once again we are short-changing you. Our full version contains additional information on-

▲ The effect of self-employed health insurance premiums, HSA contributions and other company paid fringe benefits on your S corporation savings.

▲ The Net Investment Income Tax (NIIT) and how it effects S Corps (spoiler- it doesn’t although some K-1 income might be considered investment income).

▲ The differences between earned, portfolio, passive and non-passive income.

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Chapter 3
The 185 Reasons to Not Have an S Corp or LLC

Introduction
Not everything that glitters is gold so there are a handful of downsides, some manageable, to the S Corp election or having an LLC. A lot of these examples stand alone, and some of these depend on the net income of the business and other external factors. The Watson CPA Group can help guide you through the decision-making process.

And No, there are not 185 reasons- it was just a self-proclaimed catchy number. Most of these reasons in the beginning of this chapter focus on S corporations. However, there are some general pains with having any type of formalized entity, and those are near the end.

Specific to S corporations, we ask these general questions of each business owner before diving into the nitty-gritty-

▲ Does your business earn over $30,000 net income after expenses? Say Yes.

▲ Are you located in New York City or Tennessee where S corporation tax rates are egregious and suck up all the federal tax savings? Say No.

▲ Do you have other W-2 income that exceeds or comes close to exceeding the Social Security limits of $127,200 (2017)? Say No. If you say Yes, we need business income to exceed $200,000 in #1 above.

▲ Is this a going concern? In other words, is the business going to continue to earn the same income or more each year? Say Yes.

▲ Do you have an LLC or some other entity in place that can be elected to taxed as an S Corp? Say Yes. If you say No, we have options just not elegant ones.

Are you still here? Excellent news… then read on!

State Business Taxes (Not Just Income Taxes)
State tax laws might not treat S Corp income and subsequent K-1 income in the same benevolent manner as the IRS. Recall that S corporations do not pay a federal income tax directly. Rather the income is passed onto the shareholders who are then taxed at their individual tax rates. However, some states impose an additional tax. For example, California imposes a 1.5% franchise tax on S Corp net income with a minimum of $800. Yuck. So your 8% savings turns into 6.5%.

Other income tax free states, such as Texas, have similar taxations and various exemptions too. Franchise tax is another buzzword you might come across. Why do they call it a franchise tax, or a business and operating tax as
they do in Washington State? They can’t call it income tax because of the Interstate Income Act of 1959. Yup. Way back when, and it is battled every year in court, in various representations.

Before we get into that, there are two issues at play here and we’ll pick on California to illustrate some points. One, if you are an S corporation headquartered in California you will be subjected to the franchise tax. Period. End of story.

But the other side of the coin is state nexus (which was broached earlier) where you are not physically headquartered in California, but have a nexus either physically or economically in California. This too would subject your income sourced from California to the franchise tax.

In some cases you might have nexus in California but not any California sourced income, and you will unfortunately be subjected to the minimum franchise tax of $800 (as of 2017). Nutty. You have nexus, but no taxable income, and you still pay the minimum franchise tax? Yes. This happens when you create an LLC but all your income sources are outside California and they exceed certain thresholds. There are other situations where this can happen.

Conversely, if you are a sole proprietor in California (and not an LLC or corporation), you do not pay a franchise tax. Yes, you will be subjected to Federal self-employment taxes which is why you want to consider an S Corp election. So therein lies the rub. Franchise tax versus self-employment tax.

About half of the states have some sort of franchise, business or excise tax. Back to the Interstate Income Act of 1959- it is against Federal Public Law 86-272 for states to charge an income tax on foreign businesses in certain circumstances. Remember, foreign does not mean domestic and international. Foreign is a business registered in Nevada doing business in California, as an example. Here is a snippet of Federal Public Law 86-272-

No state, or political subdivision thereof, shall have power to impose .. a net income tax on the income derived within such state by any person from interstate commerce if the only business activities within such state by or on behalf of such a person during the taxable year are either, or both, of the following-

1. The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside of the state; and

2. The solicitation of orders by such a person, or his representative, in such State in the name of or for the benefit of a prospective customer of such a person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

States are therefore prevented under Public Law 86-272

△ from taxing out-of-state businesses on income derived from activities within the state

△ if the activities are limited to mere solicitations of tangible personal property, and

△ the orders are processed from outside the state.
Note how this centers on tangible property and not services. Huge distinction! Is internet hosting a service or tangible personal property? How about an eBook? This is discussed more in a later chapter, and the current news is not great. The future isn’t good either.

So the wizards at various states came up with a tax that is not based on income or at least not called an income tax. Some states tax your gross receipts, no matter what your expenses are! Amazing. It is also noteworthy that Public Law 86-272 does not protect businesses located in and doing business in the respective state (only interstate activities, not intrastate activities). But it appears that states keep things consistent, and impose a franchise tax, a business tax or an excise tax on local businesses just the same. Genius. Here are some sample state links-

www.wcgurl.com/1304  California
www.wcgurl.com/1302  Oregon
www.wcgurl.com/1307  New York City
www.wcgurl.com/1311  Tennessee
www.wcgurl.com/1314  Texas

Major New York tax reform was passed in April 2015 which aligned taxation between New York City and New York State. NYC was like Rome, and was off in the weeds as compared to New York State. Regardless, New York S Corp tax rate is 8.85%. Tennessee is 6.5%. Texas is about 1% with exclusions and exceptions, which is similar to Washington. Washington DC has a tax it imposes on S corporations, but tax is exempt if over 80% of the revenue is from personal service.

Do you want more wrinkles? Here you go- California (we just love to pick on them) has a unique rule to their franchise tax. As a garden-variety LLC, you are taxed on gross receipts in addition to the $800 franchise tax. For example, you could have $1,000,000 in gross receipts and $1,000,000 in expenses. Your franchise tax would be $800 + $6,000 although you do not have any net income. Yuck.

However, if this LLC is taxed as an S corporation then it would pay 1.5% of the net income or $800 whichever is higher. Using the example above California’s franchise tax would be $800 versus $6,800. Therefore the lesson is that you might be forced into electing S corporation status in California just to avoid its silly gross receipts tax.

In summary at some point as income increases close to $200,000 or more, a non-S corporation entity (sole proprietor, LLC or partnership) could actually pay fewer taxes without the S Corp election depending on the state and your unique circumstances. But nothing is simple and the rules are like spaghetti.

To complicate things even more, you have to apply nexus rules to all this. You might not be subjected to another state’s franchise or business tax if you don’t have an economic or physical presence in that state.

The issue of state business taxes and nexus is discussed in nauseating detail later in this chapter. More buzzwords such as economic presence, throwback rules, tangible personal property, commerce and due process clauses, etc. Bottom line- talk to your nexus experts at the Watson CPA Group to nail this down.
Conclusion

If you were keeping track we didn’t provide all of the 185 reasons an S corporation can be a problem. Truth be told, there aren’t 185. But here are some more considerations detailed in the full version-

- The differences between unemployment, state disability and workers compensation, including what you can opt out of and the dangers of doing so.

- The limits of deducting business losses.

- How shareholder loans are bad news, and how lazy CPA’s use it as a plug to balance the dare-we-say balance sheet. Lazy CPA’s is not fair. We should say CPA’s who normal, and have 10 pounds of crud to work on in a 5-pound day.

- The problems of fluctuating revenue splits in an S corporation (such as sales teams).

- The effects of other W-2 income that might effect the savings from your moonlighting.

If you want to learn more about these issues, please visit www.watsoncpagroup.com/book for more information or visit our KnowledgeBase at www.watsoncpagroup.com/kb/.
Chapter 4
State Nexus Problems

This in itself is not a reason to avoid the S corporation election, but there is not a better place for this material. State nexus stuff is getting very complicated so we decided to make this a separate chapter since it will continue to grow over time.

Every year all 50 states plus the District of Columbia and New York City participate in a survey conducted by Bloomberg. Here is the link for the latest results, but a warning is in order first. The 2015 report is 429 pages (yet the table of contents is rich with detail to find your particular area of interest).

[Link to Bloomberg survey]

There are several concepts here and a ton of material. Here is the mini table of contents-

- Nexus Theory
- Constitutional and Legislative Standards, including
  - Commerce and Due Process Clause
    - Public Law 86-272
- Sales Tax, Income Tax
- Physical and Economic Presence, Nexus Attached
- Services and Tangible Personal Property (TPP)
- Costs of Performance, Market-Based Approach
- Allocation and Throwback
- FBA (Fulfilled By Amazon), Online Retailers, Drop Shipments
- Trailing Nexus Revisited

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Chapter 5  
S Corporation Election

Formation (Election) of an S-Corp
There is a misconception floating around out there that an S-Corp is a standalone entity. Not true. There are several entity types, but the three most common are

▲ Limited Liability Companies (LLCs), either as a single member or multi-member

▲ Partnerships, including all the variants (LP, LLP, LLLP, etc.), and

▲ Corporations (C-Corps), including Professional Corporations (PCs).

Each can elect to be treated as an S-Corp for taxation purposes under subchapter S of the revenue code.

So while we might talk about your “S-Corp”, we are truly talking about your LLC, partnership or C-Corp being treated as an S-Corp for taxation. While there are partnerships and C-Corps out there who elect to be treated as an S-Corp, this book generally focuses on the “S-Corp LLC” where the underlying entity is an LLC being taxed as an S corporation. However, the information is valid for each entity type.

Also, the words member and shareholder are synonymous as well from a conversational perspective- the state considers owners to be members but the IRS considers the owners to be shareholders when issues like distributions, basis, etc. Same is true for equity accounts on the balance sheet.

ELECTING S-CORP FILING STATUS, RETROACTIVE FOR 2017
Yes, you are able to engage in revisionist history and retro activate your S Corporation election to January 1 and have your income avoid a large chunk of self-employment taxes. Which year? Good question, and Yes, of course, it depends. First things first. You must be eligible to become an S-Corp for taxation purposes-

▲ you must have an LLC, partnership or C-Corp already in place,

▲ your entity must be domestic,

▲ have 100 or fewer shareholders,

▲ have shareholders who are individuals, estates or exempt organizations, and not have any non-resident alien shareholders, and

▲ have only one class of stock (you are allowed to have voting and non-voting as one class)

There some other devils in the details, but 99% of the LLCs, partnerships and C-Corps out there qualify.
If you do not have an entity already in place, there are organizations that sell shelf companies. Note the word shelf- not shell. These shelf companies have EINs, file tax returns and all their history sits on a shelf hence the name shelf company. How this works is beyond our book and usually required a conversation.

**Late S Corp Election, Oops**

Form 2553 (the S-Corp election form) must be filed with the IRS. It is typically due within 75 days of forming your business entity or March 15 of the following year. However in typical IRS fashion there are 185 exceptions to the rule and the late S corporation election is another example. The IRS provides relief for the late filing of Form 2553. Historically, IRS Revenue Procedures 2003-43 and 2004-48 used to be the governing rules but the IRS has simplified it (imagine that!).

**IRS Revenue Procedure 2013-30**, effective September 3 2013, allows an entity to get relief and elect S-Corp status within 3 years and 75 days from the date the election was originally intended to be effective. Holy cow. Three years!

The IRS is basically saying that if you walk and smell like an S-Corp, then you are an S-Corp.

So, if it is November 2017, and you want to go back to January 1 2017, no problem. If it is March 2018 (tax season) and you are freakin’ out because you forgot to make the election earlier, you can still go back to January 1 2017. No that is not a typo… we are talking about going back to the previous year’s January 1!

There are hiccups. Isn’t hiccups such a friendly word? Sort of like bumps in the road. Bruises is another word that is about as hollow as hiccups and bumps. No one says pitfalls or disasters anymore, just hiccups. Bottom line is we can engage in some revisionist history on March 1 2018 and create a payroll event for December 31 2017. No worries.

If your current CPA or tax professional says No, we suggest you find a new accountant. The Watson CPA Group has been doing this for over a decade (there was relief provisions prior to the 2013 IRS Rev Proc as well) without major problems. You will incur late payroll filing penalties which usually can be abated under the First Time Abatement statutory relief program; some states are sticklers and don’t offer relief. Then again, if your savings is $8,000 and your penalty is $800, we'd say you are in good shape to do a late S corporation election.

**Conclusion**

Just slapping together a Form 2553 and pushing it through the IRS is not all, there are some other things to bother yourself with-

▲ Do you run a late payroll to satisfy the reasonable shareholder salary rule?

▲ If you elect mid-year, what happens to Q1 and Q2 in terms of payroll?

▲ How does the equity section in your balance sheet look after taking an LLC and taxing it as an S corporation?

▲ What happens if you need to terminate the S election?

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Chapter 6
Operating Your S Corp

The S Corp Grind, Operational Hassles
You’re probably thinking that running an S-Corp adds all kinds of burdens. Not true. When we ask the appropriate questions and recommend an S Corp election, some clients will say, “Sounds like a lot of work.” There are very few additional hassles with an S corporation as compared to other entities. All the things you do now to maintain your financial records remain the same. Determining your business income and expenses remains the same. Whether you compile data to put on a Form 1040 Schedule C or Form 1120S (corporate tax return), the effort from you is identical. Additionally, the things you do in terms of corporate governance such as meetings, minutes and voting, also remain the same.

The two other requirements are paying a reasonable salary to S Corp shareholders through payroll and preparing a corporate tax return. If you use the Watson CPA Group (and you should), then this hassle is ours not yours. Well, not entirely true- we are attached at the hip if we prepare your tax returns, and while we can be demanding for a comprehensive tax return the hassle is mostly ours.

S Corp Salary
The bulk of this chapter is devoted to reasonable S corporation salary theory and calculation. We only mention it here since calculating a reasonable salary and processing payroll is a hassle as a business owner.

Corporate Tax Return
An S Corp must file a corporate tax return by March 15 and there are additional financial reporting requirements. Since an S corporation is a pass-thru entity whereby the tax consequences are passed through to the shareholders, the personal tax returns of the shareholders cannot be completed until the S Corp tax return is completed (both can be filed simultaneously). However, if you use the Watson CPA Group to prepare your tax returns, we’ll make it seamless and pain free. Ok, taxes and pain free don’t really go together, but you get the idea.

S corporations file a Form 1120S and this in turn creates K-1s for all the shareholders. Unlike many other tax professionals, we always create a balance sheet and we always reconcile equity accounts (capital stock, additional paid in capital, retained earnings, shareholder distributions and basis). This can be challenging for us, but we feel it is important for you, the client, and for long-term reporting accuracy.

When you own an S corporation, you are both employee and investor. If you invested $100 into Google, you could only lose $100. Nothing more. The same with your S Corp as an investor. For example, if you invested $10,000 into your company, but your company lost $20,000, your K-1 will show a $20,000 loss but you are only allowed to deduct your basis which is $10,000. Without tracking this information, you could be incorrectly deducting losses in the current year instead of carrying them forward to future years.

More importantly, without shareholder basis information, there is no way to determine the gain on your future business sale. Just like stock sales, when you sell your company for a zillion dollars the IRS will consider all that to be capital gain unless you can prove otherwise.
Creating a balance sheet is also just good accounting practice, and it contributes to the overall tracking of your company’s worth. Lenders and investors will also want to see this information if you need leveraged financial assistance for company growth. Recently, a business owner was gifting away chunks of her business to her sons, and her basis needed to be calculated and transferred for gift tax filings. Her balance sheet information was a mess and needed fixing. We are retained frequently to put humpty dumpty back together and build historical balance sheet information.

Business succession, exit strategies, asset sales, business valuation, buy-sell agreements, etc. are topics rarely considered by most small business owners, and that is Ok. But as accountants and business consultants, it is our job to keep you out of future trouble by putting things on the right track today. That starts with your corporate tax returns being comprehensively and accurately prepared, which includes Schedule L (the balance sheet). While we don’t look for ways to complicate the heck out of things, demand that your tax professional prepare a balance sheet with your tax returns.

**Reasonable S Corp Salary Theory**

Determining a reasonable salary is the hardest part of running an S corporation. What the heck do I pay myself? Before we get into that, let’s discuss why shareholder salary needs to be just above bar napkin quality and just below NASA precision.

Scattered throughout this book we’ve stressed that the only tax savings an S Corp provides is the reduction of self-employment taxes, and in the case of shareholder wages we are talking about Social Security and Medicare taxes (payroll taxes). When your company pays you $10,000 in shareholder wages, 7.65% is withheld from your pay check for the employee’s portion of payroll taxes. This is broken down into 6.2% Social Security and 1.45% Medicare. The company also must pay 7.65% for a combined percentage of 15.3%. Since the company deducts its portion of payroll taxes, the effective tax rate is 14.1%.

Therefore, a $10,000 shareholder salary costs you $1,410 in additional taxes beyond income taxes. Said in a different way, if you pay yourself $50,000 when $40,000 could have been a reasonable shareholder salary, you just wasted $1,410. Even a $5,000 delta equates to $705.

Truth be told there is some philosophical issues with the reasonable salary element where your labor is the only material income-producing factor for the business. Some would argue that all the S Corp’s income should then be considered shareholder wages and subjected to Social Security and Medicare taxes, since if you died the company would die. Do we see this “loophole” being re-defined and shrinking over the next several years? Yes. But at the same time, we say let it ride until we can’t use it. The IRS and Congress move at glacial speeds- let’s worry about next time, next time.

Conversely, there might be times where your business would continue without you. When the Watson CPA Group does business valuations, especially in divorce proceedings, we assign a value to goodwill. We do this by taking a number called seller’s discretionary cash flow (SDCF) and we subtract the cash flow that is derived from tangible assets (cash, equipment, etc.). This leaves us with a theoretical number that is considered goodwill which can be used as a proxy to determine your “value” to the business.

We further tease out personal goodwill and enterprise goodwill since in some jurisdictions personal goodwill is not marital property. This might seem like an odd tangent, but a similar argument can be made for a business that does not rely on you. One great example is a financial advisor that has a small team supporting him or her—typically the fee income continues well into the future without the direct involvement of the advisor (enterprise
goodwill). In this situation, an argument for a smaller salary could be warranted since enterprise goodwill exceeds personal goodwill. Consider this-

<table>
<thead>
<tr>
<th>Business Type</th>
<th>Owner Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software developer who has gone to market</td>
<td>10%</td>
</tr>
<tr>
<td>Amazon retailer, a lot of drop shipments, no inventory</td>
<td>20%</td>
</tr>
<tr>
<td>Financial advisor with small team</td>
<td>30%</td>
</tr>
<tr>
<td>Doctor who is a partner in an emergency clinic</td>
<td>40%</td>
</tr>
<tr>
<td>Consultant, Attorney, Accountant</td>
<td>90%</td>
</tr>
<tr>
<td>Actor with no endorsements or couch-jumping events</td>
<td>100%</td>
</tr>
</tbody>
</table>

Of course this is all theoretical and is open to debate, but you get the idea.

Not to go too far into the weeds, but when performing business valuations we also consider investor value. What rate of return would an investor need to earn after paying you a reasonable salary? Of course a lower salary to you results in a higher rate of return for the investor. We digress...

In this chapter, we will review-

- IRS Revenue Rulings and Fact Sheet 2008-25
- Tax Court Cases
- Risk Management Association (RMA), Bureau of Labor Statistics (BLS) and Salary.com
- Rules of Thumb, Jumping Off Point

**Conclusion**

Reasonable salary for shareholders (or Officer Compensation as the S corp tax return reads) is one of the biggest challenges to small S corporations. We have put together an excellent collection of tools to thoroughly confuse you on the calculus of salaries. All kidding aside, this is probably the best reason to read the full version of our book. In addition we discuss-

- The competing interest between self-employment tax savings and tax deferrals through 401k plans and SEP IRAs.
- How to use payroll as a conduit for tax planning and effective tax budgeting putting you in a tax neutral situation next April.
- Some other tricks such as putting kids on payroll or making Mom an inactive shareholder.

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Chapter 7
Accountable Plan

Pull Money Out, Accountable Plan
One of the goals of any business owner is to be able to pull money out of the company without creating a taxable event. There are four big ways to accomplish this-

▲ Reimbursements for Out of Pockets Business Expenses (Accountable Plan)
▲ Fund Your Retirement Account
▲ Reimbursements for Health Insurance Premiums and HSA Contributions
▲ Paying for an Employee’s Education

We encourage businesses to create an Accountable Plan which allows owners or shareholders to turn in expense reports for home office use, mileage, cell phone, internet, meals and travel. All these expenses have one thing in common- they are mixed used, both personally and business. Mixed-use expenses should be paid by the employee and later reimbursed. Conversely, anything that is 100% business use should be paid directly by the business.

Let’s say that again. Mixed use items, paid by you and reimbursed by the company through an Accountable Plan. 100% business use items, paid by the company. Of course if you are reaping some huge cash back or travel deals with your personal credit card, then by all means charge the 100% business use items to your personal card and run those expenses through an Accountable Plan. Quick warning- the IRS and credit card companies are butting heads over the rebate programs. It is an ascension of wealth and technically taxable income. Whoa! Yup. And the IRS would like 1099s to be issued to show the income. This will be battled for the next decade for sure.
The following page shows a quick comparison between reimbursing yourself through an Accountable Plan (Scenario 1) and deducting the expenses on your personal tax return (Scenario 2)-

<table>
<thead>
<tr>
<th></th>
<th>Accountable Plan Scenario 1</th>
<th>No Plan Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Profits</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>less Home Office</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>less Cell Phone</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>less Internet</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>less Mileage</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>less Meals*</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Total Reimbursements</td>
<td>11,750</td>
<td></td>
</tr>
<tr>
<td>less Employer Social Security, Medicare</td>
<td>3,213</td>
<td>3,672</td>
</tr>
<tr>
<td>Net Adjusted Profits</td>
<td>85,037</td>
<td>96,328</td>
</tr>
<tr>
<td>Reasonable Salary</td>
<td>42,000</td>
<td>48,000</td>
</tr>
<tr>
<td>Social Security, Medicare Tax @ 15.3%</td>
<td><strong>6,426</strong></td>
<td><strong>7,344</strong></td>
</tr>
<tr>
<td>Total Savings (per year!)</td>
<td><strong>918</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Meals and entertainment pose an interesting effect. The business profits on the books take the full deduction, but the business can only take a 50% deduction on the corporate tax returns. In theory, one could argue the basis for reasonable salary testing should be the “book net income” versus the “tax return net income.” This certainly is splitting hairs. We say split away!

Ok. We seriously tried to keep the above table simple. Basically under Scenario 1 you are reducing overall company profits by paying out reimbursements for shareholder expenses. This in turn reduces the jumping off point of 50% for a reasonable salary, and in turn reduces the total amount of Social Security and Medicare taxes that are being paid out. The delta is $918 between the scenarios, and there are also income tax implications too not just self-employment taxes. If you want a better explanation or a walk-thru, please have an adult beverage and then contact us. Current suggestion is Absolut Vodka and Red Bull with a splash of Cranberry. Garnish optional. But we are starting to lean towards Starbucks’ Refreshers and Champagne. Yum.

**Conclusion**

This chapter in our book actually quite short, and the primary gist is explained above. The only thing we cut out were journal entry examples to reclassify prior shareholder distributions as expense reimbursements for your Accountable Plan. Riveting.
Chapter 8
Tax Deductions, Fringe Benefits

Ahh.. the good stuff. Yes, you work hard. Yes, you want to be able to get a little extra from your hard work and your business. Yes, you want this to be tax-advantaged. We get it. This chapter will discuss the 185 tax deductions you cannot take, explain how to position yourself on allowable small business tax deductions, and then get into hot topics such as automobiles, home offices, deducting MBAs, Cohan rule and other fun things.

Chapter 6 and Accountable Plans was a snap. Chapter 7 and Tax Deductions, Fringe Benefits is long.

Three Basics to Warm Up To
Before we get into which tax deductions and tax moves you can take, there are some basic concepts to help formulate your thinking.

Marginal Tax Rate
Quick lesson on small business tax deductions. When you write a check and it has a tax savings element (office expense, 401k, IRA, charity, etc.) it is not a dollar for dollar savings. For example, if you are in the 25% marginal tax bracket, you must write a check for $4,000 just to save $1,000 in taxes. Keep this in mind as you read this information on tax deductions. Also keep in mind that cash is king, and that perhaps paying a few more taxes today with the added flexibility of cash in the bank can be comforting. More on this later in the chapter.

Cash Savings or Tax Savings
You can save $50,000 today! Yes, today! You just need to write a $150,000 check to your church. Huh? That might not sound like the best idea to a lot of people since so much cash is leaving. Another way to look at this is this- most people say “I want to save taxes” but really what they are saying is “I want to save cash.”

In other words, most people are in the cash-saving business not the tax-saving business. If we can do both, great. However, most tax-savings moves take cash, and cash is what you want to keep. So keep this concept in mind as you review business deductions below.

The Trick
Here’s the trick. The Holy Grail if you will. You need to find a way to deduct money you are already spending. Read that again. For example, if you have a travel budget then you are already comfortable with a certain amount of money leaving your person. Let’s find a way to deduct it through your business.

Automobile depreciation? Same thing. You are already comfortable with automobiles losing thousands of dollars in value especially in the early years, so let’s a find a way to make this degradation in value a tax windfall.

The remainder of this chapter is written to help educate yourself so the money you are already spending can be positioned in such a fashion that it becomes a legitimate small business tax deduction. Remember that the greatest trick the devil ever pulled was convincing the world he didn’t exist. The second greatest trick was finding a way to deduct the expense. You gotta love The Usual Suspects. Classic!
185 Business Deductions You Cannot Take

Similarly to the 185 reasons to not elect S corporation taxation, there aren’t 185 small business deductions that you cannot take. However, we want to start with the crazy things small business owners try to do since it is such a good springboard for discussion. Here is the list-

▲ 100% cell phone
▲ Mileage and gas for your automobile
▲ Home office improvements
▲ Food (unless with a business purpose)
▲ Per diem
▲ Country club dues
▲ Client gifts (limited to $25)
▲ Professional attire (unless you do it correctly)

There are others of course, but these are the ones we routinely see business owners trying to slide across our desk while we focus on a shiny object. Further explanations and tax code references can be found in the full version of our book.

Deductions the IRS Cannot Stand

Here is a quick list of the small business tax deductions that the IRS cannot stand. That isn’t phrased correctly. The IRS actually likes these tax deductions since most business owners either incorrectly deduct them or cannot substantiate an otherwise qualified deduction for lack of proper record keeping.

The IRS plays pot odds on the following business deductions since the recovery of taxes is probable and therefore profitable for the government. In poker, if it costs you $10 to bet and there is $100 in the pot, then you can be wrong 90% of the time and still break even. This is the essence of the pot odds: You’re paying a fraction to win a larger sum, and the IRS is no different. Here we go-

▲ Meals and Entertainment (shocker)
▲ Car and Truck Expenses, Mileage Logs (another shocker)
▲ Travel
▲ Home Office

There are others, but these are the biggies. We don’t want you to have a chilling effect on these expenses. You should not be afraid of an audit. You should not be afraid of losing an audit. You should only be afraid of having an unreasonable or indefensible position. Sure, easy for us to say.
At the same time, if you have legitimate expenses and you can back them up with proof, then happily deduct them. Like Muhammad Ali once said, “It’s not bragging if you can back it up.” Well, the same can be said of small business tax deductions that are at higher risk of audit. If you can back it up then deduct it!

**Automobiles and LLCs, S Corps**

A question we entertain almost daily is “I want to save taxes. Should I have the company buy me a car?” Our auto-attendant replies with, “Do you need a car?” If you answer with “Yes” the auto-attendant replies with, “Hold please.” If your “Yes” is not quick or mumbled, or if there is any recognition of hesitation, the auto-attendant is unhappy.

We digress. There are only a few questions you need to ask yourself when considering a car purchase. Are you the type of person who buys new? How long do you typically keep your cars? Is the car 100% business use? How many miles do you plan to drive? There is a decision tree at the end of the automobile section.

Back up for a bit. Remember our previous discussions about tax deductions, and how only a fraction of the money you spend is returned to you? So, back to our auto-attendant, “Do you need a car?” If the answer is “Yes” because your bucket of bolts is getting exceedingly dangerous, then Yes, buy a much-needed car out of a sense of safety. If the answer is “Not really, but I want to save taxes,” then don’t. Two rules to live by:

- **Cash is King (keep it!)**
- **Depreciation is a tax deferral not a tax avoidance system (typically)**

There might be some other external forces at play. For example, if you need a car next year but your income is ridiculously and unusually high in the current tax year, then reducing your income now makes sense. Again, tax modeling and planning is critical.

Ok, you’ve chatted with your car-loving buddies at the Watson CPA Group and we’ve determined that a car purchase should be in your near future, now what? There are all kinds of issues here, so, buckle up as we go through this stuff. There are four scenarios-

- **Company Owned Vehicle (mixed bag)**
- **You Own the Vehicle, Get Reimbursed By The Mile (clean and elegant)**
- **You Own the Vehicle, Take a Mileage Deduction (silly in an S Corp)**
- **You Own the Vehicle, Lease it Back to Your Company (exotic)**
Automobile Decision Tree

In deciding whether to own the automobile personally or through your S corporation, here is a simplified decision tree. It is not a hard and fast set of rules, but will provide some guidance.

▲ If you typically buy new cars every 2-3 years, can justify a business use above 80% and drive 15,000 miles or less per year, then have the company own it. The depreciation will be a great small business tax deduction.

▲ If you typically buy new cars every 2-3 years, but cannot justify business use above 80% or drive 15,000 miles or more per year, then own it personally and get reimbursed. At 15,000 miles the tax benefits of depreciation over 2-3 years becomes a wash.

▲ If you typically buy used cars that are 5 years or older, then own it personally and get reimbursed. The POS potentially becomes a huge money maker.

▲ If you buy a new car every 5-6 years, typically spending more than $60,000 and can justify business use above 80% then the question becomes more complicated and depends on miles driven. Fewer than 12,000 miles, have the company own it. More than 12,000 miles, own it personally and get reimbursed. At exactly 12,000 miles, flip a coin.

These are not hard and fast rules. These are rules of thumbs and generalizations. We always caution people trying to split the atom to save some money. At the end of day, most small business owners do what makes him or her feel most comfortable, and the few bucks that might be left on the table is overshadowed by the lack of anxiety and headache.

Cohan Rule

Let’s briefly discuss record keeping, and then jump into a famous New York entertainer named Cohan who ultimately provided a nifty rule that can be used during an IRS audit. To be able to demonstrate a business deduction you need to show the date, the amount and the person or business you paid. A bank or credit card statement, or canceled check, satisfies this. The second element is the business purpose must be documented either through a logbook, planner or accounting software. Proof of payment plus business purpose equals tax deduction.

Do you need receipts? Yes and no. For travel, gifts, meals and entertainment, if the amount is under $75 then you only need to document the event and business purpose in a logbook or planner. However, if you spend $10 at Costco for some paper, then you need proof of payment plus business purpose documentation. Seems a bit onerous and even contradictory, but it is true.

Enter Cohan vs. Commissioner, 39 F. 2d 540 (2d Cir. 1930). Yes, 1930 and we still use it today. George Cohan gave us “Yankee Doodle Dandy” and “Give My Regards to Broadway”, and he gave us a tax deduction rule. His rule is simple- you can approximate your business expenses and ultimately your business tax deduction. What?! No, it is not that simple.

You must have corroborating evidence that demonstrates your expense. For example, as a Colorado Springs CPA firm, the Watson CPA Group can demonstrate that we prepare so many tax returns which are so many pages in length, and therefore we can approximate our paper costs. Temp. Regs. Sec. 1.274-5T(c)(3) also gives latitude to the IRS to allow substantiation of a business expense by other means.
The Watson CPA Group has successfully used the Cohan rule in IRS examinations. We have also implemented it during tax preparation when records are incomplete or missing (i.e., one hot mess). Having said that, using estimates and approximations looks bad. Keep good records, please. Do not rely on the Cohan rule or some treasury regulation to save your butt.

The Cohan rule or any type of estimation cannot be used for travel, business gifts, meals and entertainment. All the good stuff need strict record keeping habits. Section 274(d) of the U.S. Tax Code also states that listed property must be substantiated with proper documentation. Listed property includes vehicles, equipment generally used in entertainment such as cameras and stereo equipment, and computers. Seems a bit out dated, but there you go. So, if you are a photographer who drives a car for business while entertaining guests, you will be a master at record keeping.

A logbook or planner is very influential during an audit. When a client can show contemporaneous records in a planner that coincides with travel, meals and home office use, the audit lasts about 90 minutes as opposed to four hours with a deficiency notice at the end. Contemporaneous comes from Latin, and means existing or happening during the same period. In other words, as things happen in your world, write them down in a logbook or planner.

Girls are better at this than boys because of purses which is why we now have European shoulder bags for boys. Yet boys still stink at record keeping. If you are a boy, keep in mind that your DNA precludes you from multitasking. You might be doing two things at once, but that in no way is multitasking. Your contemporaneous record keeping might be more sequential.

**Summary of Small Business Tax Deductions**

This chapter is huge, and has a ton of information in it and perhaps it is overwhelming. To reiterate information from the beginning of this chapter there are some over-arching themes and concepts for all small business deductions. The business expense must be-

- Ordinary and necessary (IRS Publication 334), **and**
- Paid or recognized in the current tax year, **and**
- Directly related to your business, **and**
- Reasonable, and not lavish or extravagant (IRC Section 162 and IRS Publication 463).

We want to give you this table to help summarize the business deductions that are clearly not allowed (black), the ones that clearly are allowed (white), and the gaggle of exceptions (grey).
<table>
<thead>
<tr>
<th>Business Expense</th>
<th>Deduction?</th>
</tr>
</thead>
<tbody>
<tr>
<td>401k Plan</td>
<td>Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.</td>
</tr>
<tr>
<td>Advertising</td>
<td>Yes.</td>
</tr>
<tr>
<td>Automobiles</td>
<td>Business use only. Use decision tree to see if you should own it or the business. Depends on price, turnover, miles driven, business use and marginal tax rates. Personal use added to W2 Box 1, 3 and 5 using Lease Value rates in IRS Pub 15-B.</td>
</tr>
<tr>
<td>Business Travel</td>
<td>All kinds of rules. Mix pleasure with business under some circumstances.</td>
</tr>
<tr>
<td>Business Meals</td>
<td>50% if business discussion with client, prospect or associate. 50% if traveling away from your tax home on business. 100% for company social gatherings or convenience of the employer (lunch).</td>
</tr>
<tr>
<td>Cell Phone</td>
<td>Business use only. Never 100% unless you have second phone. Reimbursed through Accountable Plan.</td>
</tr>
<tr>
<td>Client Gifts</td>
<td>Max $25 per recipient per year.</td>
</tr>
<tr>
<td>Commissions</td>
<td>Yes.</td>
</tr>
<tr>
<td>Commuting Expenses</td>
<td>No. If you have a home office, then commuting becomes business travel and subsequently Yes.</td>
</tr>
<tr>
<td>Copier Lease</td>
<td>If the lease can be considered a capital lease, then No. If the lease is an operational lease, then Yes. Depends on the facts and circumstances.</td>
</tr>
<tr>
<td>Defined Benefits Plan</td>
<td>Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.</td>
</tr>
<tr>
<td>Education</td>
<td>Only if improves your current work skills or necessary for professional credentials.</td>
</tr>
<tr>
<td>Food</td>
<td>50% if business discussion with client, prospect or associate. 50% if traveling away from your tax home on business. 100% for company social gatherings or convenience of the employer (lunch).</td>
</tr>
<tr>
<td>Golf Outing</td>
<td>No. Seriously. Let it go. Unless you have a close nexus to a bona fide business meeting before or after (referred to as “associated entertainment”).</td>
</tr>
<tr>
<td>Guard Dogs</td>
<td>If you are a high risk defense attorney on the East Coast and need a security detail, then Maybe. Must be a bona fide occupational qualification.</td>
</tr>
<tr>
<td>Health Savings Accounts</td>
<td>Company contributions, Yes. Added to your W2 Box 1.</td>
</tr>
<tr>
<td>Home Office</td>
<td>If regularly and exclusively used for business then Yes. Multiple locations OK provided home office is primarily used for substantial administrative activities. Reimbursed through Accountable Plan.</td>
</tr>
<tr>
<td>Insurance</td>
<td>Business liability insurance, Yes. Auto insurance, Yes if the company owns the car. Health insurance, Yes and added to W2 Box 1. Dental insurance, Yes and added to W2 Box 1. Eye insurance, Yes and added to W2 Box 1. Long Term Care insurance, Yes but limited. Disability insurance, No. Otherwise your benefits become taxable income. Life insurance, No. Only in C corporations where the corporation is the owner and beneficiary (no S corp election!).</td>
</tr>
</tbody>
</table>

### Business Expense | Deduction?
--- | ---
Kids On Payroll | Great way of reducing tax liability for the same amount of cash. Must do it correctly and follow state child labor laws.
Legal, Professional Fees | Yes.
Merchant Card Fees | Yes.
Per Diem | Maybe. If employees own more than 10% of a corporation, then No. Sole proprietors and single member LLCs including partners in partnerships, Yes.
Professional Attire | If the clothing is suitable for everyday use then No. If the clothing is a uniform then Yes. Possible advertising expense. No dry cleaning unless clothing otherwise qualifies.
Profit Sharing Plan | Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.
Retirement Plan | Get $500 tax credit from IRS for starting one. Great way to defer taxes. We can set this up.
Utilities | No, unless you have a separate office location. If using home office, utilities is a part of the deductible basis.
Website | Yes.

There you go. There are tons of variations, exceptions, rules to follow, interpretations, positioning, and many more modifiers that we can’t think of right now. Please contact us if you have any questions or concerns- we love to run through small business tax deductions with owners. And like a good parent, we try to find ways to say Yes. Yes, you can go to Johnny’s house right after you clean your room. Yes, you can deduct that expense provided you document it this way.

### Conclusion
In the full version of Taxpayer’s Comprehensive Guide to LLC’s and S Corps, Chapter 8 is 55 pages long. In the shortie version here, it is a mere 7 pages. What the heck is in the other 48 pages? Lots! Deeper explanations on-

▲ Depreciation, and how it can be an ugly tax problem at the wrong time.

▲ Small business tax deduction themes such as ordinary and necessary, paid or recognized, directly related to your business and reasonable (board meetings in Fiji for a two-person board probably not reasonable).

▲ The automobile decision tree on whether to own and get reimbursed versus having the company own the automobile.

▲ Home offices when you have another work location (spoiler- You can have another work location and still have a home office deduction).

▲ Mixing business with pleasure when it comes to business travel, and how to leverage your business in paying for your spouse’s travels.

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Chapter 9
Health Care Options

Disclosure and Updates
There is no way around this. As you already know the Affordable Care Act has turned things upside down and inside out. Some things remain the same, some things have changed, and some things have yet to change.

There are third-party administrators (TPAs) who assist small businesses (and large businesses) in implementing plans to provide health care reimbursements and to allow for pre-tax deductions of certain expenses. And what makes things exceptionally challenging is that TPAs such as Zane, Base and TASC can disagree (imagine that-lawsyers not agreeing). The IRS, DOL, ERISA, ACA and DUH, coupled with all kinds of other agencies both Federally and at the state level have chimed in.

DUH doesn’t exist. We were just testing you.

The Watson CPA Group currently endorses TASC headquartered in Madison, Wisconsin (Go Bucky!). Their positions appear to be more in line with our interpretations, their legal team has successfully litigated cases in the past, and frankly their representatives are very talented.

This chapter was last updated August 12 2014. Be sure to contact the Watson CPA Group or TASC if you have any questions or concerns about the most recent updates. We are all in for a very long and bumpy ride.

Frankly this is an area we are weak in, and haven’t found the time to firm it up.
Chapter 10
Retirement Planning

Retirement Planning Within Your Small Business
Most people have a pretty good handle on personal finance and basic retirement savings, and while the principles are generally the same in the small business world, a lot of business owners have a deer caught in your headlights at 2:00AM look when it comes to leveraging their business for retirement. And there is good reason- retirement planning within your small business carries a bunch more options and potential pitfalls (sounds like life in general, doesn’t it?).

Reasons for Small Business Financial Planning
There are three major wealth considerations for small business owners (or anyone for that matter)-

▲ Accumulation (fun and exciting part)
▲ Preservation (the tricky part)
▲ Transfer (the necessary evil part)

Each of these major wealth considerations are interwoven, and need comprehensive focus to ensure the necessary dots are connected, and no gaps or holes exist during transitions. That is where financial planning comes into play.

Accumulation is easy. Most people think if they toss some money at a mutual fund they are planning for retirement. Nope.

Preservation gets tricky since we need to have our money outlast our lives. And with people living well into their 90s, this can be tough. Let’s put it another way- if you work for 40 years, from age 25 to 65, you need to save enough to live for another 25-30 years. That is incredible. If you are spending $100,000 at age 55, you better be making $180,000 and putting the $80,000 into a moderate growth retirement vehicle.

Preservation also includes proper insurance, asset protection through trusts, pro-active maneuvering and other tools in the toolbox.

Transfer of wealth is automatic. We have yet to see a hearse with a trailer hitch. Or, said in a completely more stark way, every life come with a death sentence. How it is executed is partially up to you. Did we just ruin your appetite? Sorry.

Transfer of wealth can also be tricky. Current federal estate tax exemption is $5.43M per person, and a passed spouse can posthumously port his or her exemption to the surviving spouse. Not bad. And most people don’t have over $11.86M in estate value. Rich people problems (now referred to as high net worth).

These federal exemption amounts are indexed each year, and while Congress can always vote to repeal, this estate tax exemption was written in stone with passing of the American Taxpayer Relief Act of 2012. However,
various states have much lower exemptions. Oregon for example is $1M and New Jersey is $600,000. Nebraska has a sliding scale. So, just because you are out of woods federally, doesn’t mean the transfer your wealth is free of taxation. Get a plan.

What about your business? Does it have an exit strategy or wealth transfer strategy? Add this to the plan.

The reason for financial planning are-

**Goals and Objectives**
Define your goals and objectives, determine your current position and discover unmanaged risks. This sounds simple and makes sense, but defining goals and objectives is a fluid concept. They change. And as they change, the plan needs to be malleable enough to adopt. Financial plans are modified annually or whenever a major life change as occurred, whichever is more frequent. This is important.

**The Plan**
Financial plans also create a blueprint and chart a course on how to get reach goals and objectives while managing risk. Again, this sounds simple. But even the most basic house needs a blueprint for framers, plumbers, electricians and even inspectors to review and implement. And in the case of a financial plan, these same players are your financial advisors, tax professionals, attorneys and insurance specialists. A financial plan brings these people together to work in concert. This is why the Watson CPA Group is a part of The One Call Team-

www.watsoncpagroup.com/toc

**Accountability**
Financial plans also provide confidence, measure success and hold everyone accountable. If everyone agrees that your financial plan will ensure financial security in your life, then it becomes a measuring stick for determining success along the way. Anyone can throw some money at an investment, but what does it mean? And does it fit the plan? And is the selection of that investment meet the plan’s objectives.

The Watson CPA Group can always assist you with retirement and financial planning as it relates to your small business and taxation. And if you need a referral for a financial advisor we can offer that too.

**Small Business Retirement Plans Comparison**
We are going to put the carriage in front of the horse, and show you a comparison of basic small business retirement plans before explaining each plan. We cheated, and used Yahoo! Finance’s online calculator to demonstrate these differences. Why re-invent the wheel? And frankly, Yahoo! Finance does a fantastic job at this type of stuff. Here is their link-

www.wcgurl.com/6103
We took a handful of salaries (for corporations) and net incomes (for sole proprietors and partners in partnerships) and plugged them into Yahoo! Finance’s calculator, and came up with the following table based on 2017 limits:

<table>
<thead>
<tr>
<th>Salary/Income</th>
<th>Entity</th>
<th>Max 401k</th>
<th>Max SEP IRA</th>
<th>Max SIMPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>40,000</td>
<td>Sole Prop</td>
<td>25,435</td>
<td>7,435</td>
<td>13583</td>
</tr>
<tr>
<td>40,000</td>
<td>Corporation</td>
<td>28,000</td>
<td>10,000</td>
<td>13,700</td>
</tr>
<tr>
<td>60,000</td>
<td>Sole Prop</td>
<td>29,152</td>
<td>11,152</td>
<td>14,124</td>
</tr>
<tr>
<td>60,000</td>
<td>Corporation</td>
<td>33,000</td>
<td>15,000</td>
<td>14,300</td>
</tr>
<tr>
<td>80,000</td>
<td>Sole Prop</td>
<td>32,870</td>
<td>14,870</td>
<td>14,665</td>
</tr>
<tr>
<td>80,000</td>
<td>Corporation</td>
<td>38,000</td>
<td>20,000</td>
<td>14,900</td>
</tr>
<tr>
<td>144,000</td>
<td>Sole Prop</td>
<td>44,837</td>
<td>26,837</td>
<td>16,408</td>
</tr>
<tr>
<td>144,000</td>
<td>Corporation</td>
<td>54,000</td>
<td>36,000</td>
<td>16,820</td>
</tr>
<tr>
<td>175,000</td>
<td>Sole Prop</td>
<td>50,954</td>
<td>32,954</td>
<td>17,299</td>
</tr>
<tr>
<td>175,000</td>
<td>Corporation</td>
<td>54,000</td>
<td>43,750</td>
<td>17,750</td>
</tr>
<tr>
<td>216,000</td>
<td>Sole Prop</td>
<td><strong>54,000</strong></td>
<td>41,044</td>
<td>18,477</td>
</tr>
<tr>
<td>216,000</td>
<td>Corporation</td>
<td>54,000</td>
<td><strong>54,000</strong></td>
<td>18,980</td>
</tr>
</tbody>
</table>

Note the underlined and bolded $54,000 number. This is the maximum defined contribution amount permitted in 2016 per plan (and Yes you can have two plans- we’ll talk about Greg and his two plans in an example later).

Crazy! Some quick observations-

▲ In 2017, the maximum you can contribute to a qualified retirement plan is $54,000. You can go above this with a defined benefits pension (cash balance)- more on that later.

▲ Partnerships (those required to file Form 1065) follow the same limits as Sole Prop above.

▲ $144,000 in W-2 salary from your C Corp or S Corp is the magic number for maximizing your 401k. After that, any increase in salary does not help. Your fastest way to reach your contribution limit is through a 401k plan.

▲ $216,000 in Schedule C income from your small business or K-1 partnership income from your Schedule E as reported on your individual tax return is the magic number for maximizing your SEP IRA contribution. SEPs are old school and used for crisis management rather than planning (more on that too).

▲ Earned income from a sole proprietor is net profit minus 50% of your self-employment tax minus your contribution. Since the contribution actually adjusts the maximum contribution, this can be a circular reference. And No, 401k or SEP contributions do not reduce SE tax.

▲ 401k max is computed by taking $18,000 employee (you) contribution, plus 25% of your W-2 or earned income (as adjusted).
▲ SEP IRA max is computed by taking 25% of your W-2 or earned income (as adjusted).

▲ Max SIMPLE 401k is basically $12,000 plus 3% of your W-2 or earned income (as adjusted). Don’t spend too much time thinking about SIMPLE 401k plans.

▲ You can add $6,000 for catchup contributions if you are 50 years old or older.

Let’s talk about each of these qualified plans in turn, starting with the 401k. Out of the box, or non-traditional retirement plans will follow (profit sharing plans, defined benefits pensions, cash balance plans, Section 79 plans, etc.). Exciting!

**Turbo Charged 401k Plans**

Oftentimes business owners want to put away a ton of money in a small business 401k plan, but cannot due to inherit limitations within the plan. Or business owners want to keep most of the plan money for themselves, which is shocking yet natural. For example, to have the company make a 10% profit sharing contribution, every eligible employee will also receive a 10% contribution which is usually undesirable. You only thought having a staff was a pain because of drama and turnover. Add this dilemma to the list.

You work hard to make money, and you shouldn’t have to work too hard to keep most of it. There are turbocharger kits you can add to your normally aspirated 401k plan. These usually work best with an underlying safe harbor 401k plan. Here we go-

▲ **Age-Weighted / New Comparability Profit Sharing Plan, and**

▲ **Defined Benefits Pension / Cash Balance Plan**

**Age-Weighted**

A profit sharing plan based on age allows older employees to receive more of the profits than younger employees (hence the tricky name of age-weighted). Another way to look at this is to consider those closer to retirement possibly needing the most assistance in saving for retirement. This also makes sense since older employees are usually more valuable, and therefore profit sharing plans can be used to discriminate in their favor.

Age-weighted profit sharing plans are designed to be top heavy, and two people earning the same salary can have very different profit sharing contributions simply based on age which is perfectly acceptable. No, there is not a weight-weighted formula where older employees are usually heavier and therefore get more of the profit sharing. That would be fun though. Brings a whole new meaning to a top heavy plan. There are probably some more jokes in there, yet we digress.

How the formula works is beyond this book, but an age-weighted profit sharing plan allows a company to contribute more to those employees who are older **including owners**.

**New Comparability**

The new comparability profit sharing formulas take age-weighted formulas one step further by grouping certain employees together such as officers, executives, clerical, etc. Officers are given a higher portion of the profit
sharing, and within the officer group the older employees are given a higher portion. A double shot. For example, a crusty officer will have a much larger contribution than a new administrative assistant.

The new comparability method is also referred to as cross-tested, and will normally have underlying actuary consulting defending the plan’s provisions and discrimination. Remember, discrimination is not bad as long as it can be justified and supported. Yes, this adds to the cost. But let’s look at a real life example that the Watson CPA Group worked on to see how this works first.

The following is a husband and wife business with over $600,000 in net profits.

<table>
<thead>
<tr>
<th>Employee</th>
<th>Age</th>
<th>Salary</th>
<th>Deferral</th>
<th>NEC</th>
<th>Profit Sharing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mike</td>
<td>43</td>
<td>265,000</td>
<td>18,000</td>
<td>7,950</td>
<td>27,050</td>
<td>53,000</td>
</tr>
<tr>
<td>Susie</td>
<td>43</td>
<td>212,000</td>
<td>18,000</td>
<td>6,360</td>
<td>28,640</td>
<td>53,000</td>
</tr>
<tr>
<td>Linda</td>
<td>35</td>
<td>62,155</td>
<td>2,486</td>
<td>1,865</td>
<td>876</td>
<td>5,227</td>
</tr>
<tr>
<td>Aaron</td>
<td>29</td>
<td>39,868</td>
<td>1,595</td>
<td>1,196</td>
<td>562</td>
<td>3,353</td>
</tr>
<tr>
<td>Timothy</td>
<td>32</td>
<td>24,611</td>
<td>0</td>
<td>738</td>
<td>347</td>
<td>1,085</td>
</tr>
<tr>
<td>Blake</td>
<td>25</td>
<td>33,452</td>
<td>0</td>
<td>1,004</td>
<td>472</td>
<td>1,475</td>
</tr>
<tr>
<td>Jacqueline</td>
<td>31</td>
<td>34,411</td>
<td>1,376</td>
<td>1,032</td>
<td>485</td>
<td>2,894</td>
</tr>
<tr>
<td>Denise</td>
<td>23</td>
<td>27,529</td>
<td>0</td>
<td>826</td>
<td>388</td>
<td>1,214</td>
</tr>
<tr>
<td>Nate</td>
<td>32</td>
<td>22,104</td>
<td>0</td>
<td>663</td>
<td>312</td>
<td>975</td>
</tr>
<tr>
<td>Tony</td>
<td>26</td>
<td>22,086</td>
<td>0</td>
<td>663</td>
<td>311</td>
<td>974</td>
</tr>
</tbody>
</table>

Tilt. Here are some observations and clarifications-

▲ NEC refers to non-elective contributions, and in this example these are the contributions required under the safe harbor 401k plan provisions.

▲ Profit sharing is based on salary and age. Note the subtle differences for everyone except Mike and Susie.

▲ $53,000 is the maximum allowed under a 401k plan with tiered profit sharing.

▲ In this real case, the owners kept 75% of all monies put into the plan. Not shabby.

▲ The annual cost in 2016 to administer this plan was $2,500.

▲ The tax deferral savings was over $53,000 for these business owners including state income taxes too (based on 39.6% federal rate and 11% state rate). This was California, and the couple plan to retire in Nevada—instant 11% tax savings.

▲ Yes, those salaries for Mike and Susie are ridiculously high. So the increase in payroll taxes must be weighed against the savings and benefits. After $127,200 (for the 2017 tax year) only Medicare taxes are being “unnecessarily” paid at 2.9%. The benefits could outweigh this 2.9%.
**Defined Benefits Pension / Cash Balance Plan**

If the age-weighted or new comparability profit sharing plans supercharge a 401k plan, the defined benefits pension and cash balance plan turbocharges it. We can hear gear heads moaning all over the country above turbo and super charging your engine. Regardless, the defined benefits pension and cash balance plan adds a ton of meat to your 401k platter. Here we go.

A defined benefit is in contrast to a 401k plan since a 401k plan is a defined contribution. A defined contribution plan specifies the amount going into the plan and has nothing to do with how much will be available when you start taking withdrawals. It could be $0 or millions. A defined benefit is a calculus where some future benefit is defined, and is usually a stream of payments similar to an annuity.

A cash balance plan is a form of a defined benefits pension, with one major difference. The participant can see his or her account balance grow over time similarly to an IRA or 401k plan. A cash balance plan can be considered a hybrid since it does not rely on formulas and salary histories although it falls under a defined benefits umbrella by definition.

A cash balance plan is usually piggybacked onto a safe harbor 401k plan, and it truly is a separate plan (the latter is a defined contribution and the former is a defined benefit). So why would a small business want a cash balance plan in addition to a 401k plan? The usual reason- put more money into a self employed retirement plan for the owners’ personal retirement and defer taxes.

Similar to age-weighted and new comparability profit sharing plans, cash balance plans use a person’s age to determine the amount that can be contributed and use actuary consultation to defend the plan’s discrimination.

Here is a quick list of the 2017 amounts that can be contributed into a cash balance plan based on age-

<table>
<thead>
<tr>
<th>Age</th>
<th>401(k)</th>
<th>Cash Balance</th>
<th>Total</th>
<th>Tax Savings @ 45%</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>60,000</td>
<td>251,000</td>
<td>311,000</td>
<td>139,950</td>
</tr>
<tr>
<td>64</td>
<td>60,000</td>
<td>257,000</td>
<td>317,000</td>
<td>142,650</td>
</tr>
<tr>
<td>63</td>
<td>60,000</td>
<td>263,000</td>
<td>323,000</td>
<td>145,350</td>
</tr>
<tr>
<td>62</td>
<td>60,000</td>
<td>268,000</td>
<td>328,000</td>
<td>147,600</td>
</tr>
<tr>
<td>61</td>
<td>60,000</td>
<td>254,000</td>
<td>314,000</td>
<td>141,300</td>
</tr>
<tr>
<td>60</td>
<td>60,000</td>
<td>241,000</td>
<td>301,000</td>
<td>135,450</td>
</tr>
<tr>
<td>59</td>
<td>60,000</td>
<td>228,000</td>
<td>288,000</td>
<td>129,600</td>
</tr>
<tr>
<td>58</td>
<td>60,000</td>
<td>217,000</td>
<td>277,000</td>
<td>124,650</td>
</tr>
<tr>
<td>57</td>
<td>60,000</td>
<td>205,000</td>
<td>265,000</td>
<td>119,250</td>
</tr>
<tr>
<td>56</td>
<td>60,000</td>
<td>195,000</td>
<td>255,000</td>
<td>114,750</td>
</tr>
<tr>
<td>55</td>
<td>60,000</td>
<td>184,000</td>
<td>244,000</td>
<td>109,800</td>
</tr>
<tr>
<td>54</td>
<td>60,000</td>
<td>175,000</td>
<td>235,000</td>
<td>105,750</td>
</tr>
<tr>
<td>53</td>
<td>60,000</td>
<td>166,000</td>
<td>226,000</td>
<td>101,700</td>
</tr>
<tr>
<td>52</td>
<td>60,000</td>
<td>157,000</td>
<td>217,000</td>
<td>97,650</td>
</tr>
<tr>
<td>51</td>
<td>60,000</td>
<td>149,000</td>
<td>209,000</td>
<td>94,050</td>
</tr>
<tr>
<td>50</td>
<td>60,000</td>
<td>141,000</td>
<td>201,000</td>
<td>90,450</td>
</tr>
</tbody>
</table>
Before you lose your mind on the tax savings (which is assumed to be at 45% total), you need the cash to do so. To save $90,450 at age 50 you need to part ways with $201,000 in cash. And if your spouse is on the payroll, you can double it. There are data available for those under 50, we started there for simplicity and to have the whole table fit on one page. Observe that age 62, the amounts decrease.

Conclusion
We are not just tax accountants. We are business consultants and financial planners. We can guide you in leveraging more from your business to help you build wealth and minimize taxes along the way. Some other things we discuss in Chapter 10 of our book-

▲ Investing without a plan is dangerous. Define your objectives and design a plan to meet those objectives.

▲ Tax savings versus tax deferrals, and how the tax bomb that could potentially go off could put a dent into your retirement plans.

▲ Why 401k plans are preferred, and SEP IRAs should only be used as crisis management (versus proper planning).

▲ How having a staff dramatically alters 401k plans, profit sharing and defined benefits / cash balance plans.

▲ Controlled groups or affiliated services group, and how that might force you to cross-test all 401k plans in a multiple entity structure.

If you want to learn more about these issues, please visit [www.watsoncpagroup.com/book](http://www.watsoncpagroup.com/book) for more information or visit our KnowledgeBase at [www.watsoncpagroup.com/kb/](http://www.watsoncpagroup.com/kb/).
Chapter 11
Business Valuations, Sale, Exit Plans

Business Valuation Techniques
Are you considering buying or selling a business? It can be exciting, but the biggest problem is determining a value. If you are Mark Cuban from Shark Tank, you have money to burn and can take risks on pricing mishaps. But if you are like most people, the value of what you are buying or selling becomes a sensitive issue.

Large corporations that are traded on the New York Stock Exchange or are listed with the NASDAQ are easily valued. If you wanted to buy Apple, you would simply buy all the outstanding shares at market price. While that is an over-simplification, small business are way more complicated in terms of valuation.

Here are the basic techniques-

▲ Market-Based- business brokers in a certain geographic area have a good feel for what a business is worth based on historical information, trends, and their ability to add value to the business being sold. But are you comfortable taking someone else’s word for it? Perhaps.

▲ Asset-Based- this technique looks at the market value, book value and liquidation value of the company’s assets. These values will all be different of course with liquidating probably being less than book (depending on prior depreciation), and with book being less than market.

▲ Earnings-Based- this takes into account past performance of the company from a cash flow and taxable earnings perspective.

The important thing to remember is that these techniques are not independent of each other. Often they are used in conjunctions with each other. For example and as alluded to earlier, a jumping off point is three times net earnings plus book value. So if your business earned $300,000 per year and had $500,000 in assets, you might be able to justify $1.4M.

Conclusion
In our full version we discuss business valuation and exit plans in much more detail and consider control premiums, earnings or cash flow calculations, purchase price allocations, non-compete agreements, debt service versus cash flow and how to structure a deal.
Chapter 12
Other S Corporation Thoughts

Rentals Owned by an LLC Fallacy
Should you put a rental in 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, but most concerns stem from tortious liability.

So, what do you do? Securing a decent umbrella policy both at the personal and commercial level is the Watson CPA Group’s strong recommendation for liability arising from your acts, errors and omissions. General umbrella policies are $300-$500 per year. The liability floor of many umbrellas is around $500,000 so you might have to raise the liability 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.

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. If you can avoid having to personally sign for the mortgage note through a non-recourse loan, that would be helpful too (lenders usually want a maximum of 60% loan to value). 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 unrelated people invest together and need ways to affect ownership changes. 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/realestatepro

Rental Losses with an S-Corp
As mentioned earlier, K-1 income from an S-Corp will be reported on Schedule E of your personal tax return since it is business investment income. If you do not materially participate in the S-Corp’s operations, this can be a huge windfall if you are a rental property owner too. How does this play into S-Corps? Here we go-
Let’s presume that you have a rental loss of $50,000. Rental income is typically considered passive, meaning that you are not directly earning the income as you would with a job. Passive losses may be deducted from non-passive income such as wages, but there are limits. Passive loss limits for married taxpayers max out at $25,000, and that number decreases as your gross income increases.

Specifically, passive loss reduces $1 for every $2 over $100,000 adjusted gross income and by $150,000 (for married filing joint taxpayers) the passive loss deduction is $0. Bummer. Not all is lost however.

Let’s also presume that you are a minority investor in an S-Corp that earned $50,000 and reported the income on a K-1. Let’s say you do NOT materially participate in the running of the S-Corp. Without the rental, you would be taxed on $50,000. Without the S-Corp you would only be able to deduct $25,000 worth of passive losses. But with both the rental and the S-Corp, you shelter $50,000 of your K-1 with your rental losses, and pay $0 tax. Cool, huh?

Granted, this is rare- most S-Corp shareholders actively participate and cannot offset their S-Corp income with rental losses. Although there might be some wiggle room with spouse A owning 90% of an S-Corp, for example, that he or she doesn’t materially participate in. The same spouse A could then own 100% of the rental properties. This can get convoluted for sure, and careful tax planning must be exercised.

As a side note, it is NOT a good idea to make an S-Corp election on your LLC if it owns rental property. Rental property by definition is passive income (unless you are a real estate professional as defined by the IRS) and therefore not subject to self-employment tax. But if you run your rentals through an S-Corp, you will be required to perform payroll and you’ll be paying Social Security and Medicare taxes which are the same as self-employment tax. Don’t do it. You’ll artificially increase your tax liability by essentially converting passive / unearned income into earned income.

**Audit Rates and Risks with an S-Corp**

There are audits risks with any business form, and for any taxpayer. Typically taxpayers under $200,000 in income face a 1% audit risk. And S-Corps face a 0.42% audit risk.

The Treasury Inspector General of Tax Administration (TIGTA) recently released figures about S-Corp audits. Over 62% of S-Corp audits resulted in a no-change audit. Good news. However, of those S-Corps with one shareholder and losses in excess of $25,000 for three consecutive years, the IRS had an average adjustment of $92,000 on the shareholder’s individual tax return. Wow! Truth be told, most S-Corp audit concerns stem from net profits being paid out as distributions without corresponding salaries, and the associated Social Security and Medicare taxes.

To reiterate, only 0.42% of S-Corps were audited, and of those examinations, a whopping 62% resulted in no change. That’s incredible odds. Same odds the Bears have of winning a Superbowl. Go Pack!

Back to audits- S-Corps have become super popular because of the low audit risk and more importantly the savings of self-employment taxes. The IRS is catching on however, and is targeting S-Corps where little to no salary is being paid to the shareholders. And this is easy to do. The IRS connects the dots by back-tracking K-1s to your company’s EIN to your company’s list of W-2s to the W-2’s Social Security numbers back to your K-1. The IRS probably has an app for that.

If your K-1 does not have a corresponding W-2, or if your W-2 income is low compared to your K-1 income you are creeping up on the “let’s call this guy” list. In other words, your audit risk is increasing.
As tax professionals we get concerned about S-Corps not paying themselves a reasonable wage for obvious reasons. And while it might appear that any salary will allow you to fly below the IRS radar, we strongly advise against it. The more abuse occurring in S-Corps is only going to attract the attention of Congress, and this quasi-loophole might close.

Read our tax article on audits, the types of audits and what to do with an audit at-

www.watsoncpagroup.com/audits

It’s riveting.

And No, we do not and cannot play Audit Lottery. As professional tax preparers and accountants, the Watson CPA Group is bound by things such as standards, ethics and law. Just because audit rates might be low, we cannot take an unreasonable position or allow a client to file a fraudulent tax return.

We hate when the law gets in the way of a creative tax return!
Thank You!

We hope you enjoyed reading our shortie version. If you purchase our book from Amazon in paper, or one of the various electronic formats, and you believe it did not help you with your small business, please let us know. We never want you to feel like you wasted your money. $10 or $1,000... wasting money never makes people feel good. We will make it right, right away.

Thanks again!

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