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Employees vs. Independent Contractors

It's crucial to know whether your workers are employees or independent contractors. Big dollars may be at stake in the form of Federal and State assessed penalties resulting from misclassification. The validity of your company's pension plan may also be at stake.

A periodic review of the status of your workers to see if they are properly classified is critical...but the process isn't easy due to the complexity of the issue. Under the "common law" rules, a worker generally is an employee if the employer has the right to control and direct the worker regarding the job he is to do and how he is to do it. The IRS usually applies 20 factors to see if the employer has that right. There is no litmus test for exactly how many factors must be satisfied, nor are the factors uniformly applied.

If you'd like to discuss these complex rules with us and see how they apply to your business in order to make sure that none of your workers are misclassified, please call our office to arrange for an appointment.



To Lease or Not to Lease

With lease prices becoming increasingly attractive, many individuals are wondering if it is indeed advantageous to go that route.



The decision to lease or buy a vehicle depends on the terms of the lease as well as the particular circumstances of the individual.

Leasing may be advantageous if you trade cars every few years and borrow the money to do so. Since leasing provides more car for less money, this may be the way to go if you want a high-priced vehicle. Leasing also can provide a business owner with more cash flow since monthly lease payments on comparable cars are generally about one-third less than loan payments.

You probably want to consider purchasing the car if you intend to keep it for a long period of time or plan to drive more than 15,000 miles per year. Most lease contracts include a hefty additional charge for every mile driven over the limit. Also, purchasing a vehicle can generate a larger initial write off if the car is not subject to "Luxury Auto" rules for depreciation.

After making a decision to lease, be sure to negotiate the purchase price that the leasing company uses to calculate the lease payments and read the lease contract carefully to avoid hidden costs and penalties. Finally, comparison-shop to get the best deal available.

Pre-Opening Expenses

Business owners often incur many expenses before the business actually opens its doors. Expenses paid in setting up a business or in investigating a potential business are start-up costs. Understanding how the tax law treats start-up expenses is crucial. These expenses are generally not deductible currently. They must be capitalized. However, an election can be made to expense the start-up costs equally over a period of 60 months or more. The statement making the election must be filed no later than the return due date for the year in which active trade or business began. Failure to make a proper election usually results in the loss of the deduction entirely.

Reasonable Compensation

Federal income tax and self-employment tax are calculated based on the net earnings of a sole proprietorship, regardless of how the owner takes the funds out of the business. Because a C corporation is considered to be a separate entity from its owner, the tax consequences can vary, depending upon how the distribution was withdrawn from the corporation.



One method of distributing money to corporate owners is by the payment of wages for services. In most situations, a shareholder of a closely held C corporation who performs services for the corporation is considered an employee and should be compensated based on the level of services rendered. The amount paid must be reasonable since the IRS will reclassify unreasonable compensation as dividends, for which additional tax would be due. The dollar figure should be based on the amount the corporation would pay a non-owner for performing the same work.

Individual Net Operating Loss

If business deductions are greater than business income in a particular year, a net operating loss (NOL) may result. If this occurs, the NOL must be calculated by adjusting for certain disallowed items. The NOL may then be used by deducting it from income in another tax year. In most cases, the current year NOL should be carried back to the second preceding tax year and then forward for up to 20 years from the NOL year.

An irrevocable election to forego the carryback period may be made on a timely filed return including extensions. Form 1045, Application for Tentative Refund, or an amended return may be filed to claim a refund of taxes paid in a carryback year. Self-employment tax in a carryback year is never changed by an NOL. However, certain items must be modified in carryback and carryforward years.

Place Family on the Payroll

Hiring your children will not only provide them with spending money, but your business will obtain a deduction for their wages as well. If your business operates as a sole proprietorship or parent-owned partnership, FICA and federal unemployment taxes need not be paid if your child is under age 18 and 21, respectively.

If you have a legitimate job offering, consider placing your spouse on the payroll. His or her wages are exempt from federal unemployment taxes, and he or she will be able to earn Social Security credits for the year.

If your spouse is a bona fide employee and you are covered under your spouse's health insurance policy, the expense of providing the plan is deductible as a business expense. Since other employees may have to be covered under the plan, this may be too costly if you have eligible employees besides your spouse.

Bartering Income

Transactions involving the exchange of property or services instead of cash are called barter exchanges. The fair market value (FMV) of the property or services received in an exchange is taxable income to the recipient.

For example, an auto mechanic repairs a landlord's car in return for 6 months rent-free use of an apartment. The landlord reports the FMV of the auto repair as rental income and the mechanic reports the fair market rental value of the apartment as self-employment income.

Caution: due to increased bartering activity via the Internet, the IRS has recently signaled its intent to pursue tracking barter exchanges.

Padgett Business Services — Building success stories, one entrepreneur at a time.



Padgett Business Services is dedicated to meeting the tax, government compliance, profit & financial reporting and payroll needs of businesses with fewer than 20 employees in the retail and service sector of the economy. This publication suggests general business planning concepts that may be appropriate in certain situations. It is designed to provide complete and accurate information to the reader. However, because of the complexities of the tax law and the necessity of determining whether the material discussed herein is appropriate to your business, it is important you seek advice from your Padgett office before implementing any of the concepts suggested in this newsletter.

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