Taxes and entities

March 5, 2020

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Today's presenters and agenda

Presenters

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Agenda

- Entity formation considerations
- Basic filing requirements
- *Wayfair* — the new business landscape
- Business considerations
- US payroll tax considerations
- Question and answer

Entity formation considerations and basic filing requirements

Entity formation considerations

- Entity choice / business structure affects
  - Taxes owed
  - Reporting forms to file
  - Ability to raise money
  - Personal liability

- Make this choice carefully as you may convert to a different business structure in the future, however you may be restricted in your options along with unintended tax consequences or dissolution

Sole proprietorship

- One owner
- Easy to form
- Gives complete control of your business
- Not considered a separate business entity
  - Business assets and liabilities are not separate from your personal assets and liabilities
  - Can be held personally liable for debts and obligations of the business
- Difficult to raise money
  - Can’t sell stock
  - Banks can be hesitant to lend to sole proprietorships
- Profits and losses are reported directly on individual income tax return
- Can be a good choice for low-risk businesses and owners who want to test a business idea before becoming a more formal business

Partnership

- Two types
  - Limited partnerships (LP)
  - Limited liability partnerships (LLP)
- Limited partnerships have one general partner with unlimited liability, all other partners have limited liability and limited control over the company
- General partner must also pay self-employment tax
- Limited liability partnerships give limited liability to every owner
- Each partner in LLP is protected from debts against the partnership and won’t be responsible for actions of other partners
- Considered a flow-through entity such that profits and losses are passed through to personal tax returns via Schedule K-1 (1065)
- Partnerships are a good choice for businesses with multiple owners

Limited liability company (LLC)

- LLCs protect from personal liability in most instances
  - Personal assets won't be at risk in case the LLC faces bankruptcy or lawsuits
- Considered a flow-through entity such that profits and losses are passed through to personal tax returns via Schedule K-1 (1065)
  - Single-member or multi-member
  - Can elect to be a regarded or disregarded entity
- Taxation may vary at the state level
- Members of an LLC are considered self-employed and must pay self-employment tax
- LLCs are a good choice for owners with significant personal assets they want to protect

C Corporations (C Corp)

- Legal entity separate from its owners
- Offer strongest protection to its owners from personal liability
- C corporations pay income tax on profits and may be taxed twice if dividends are paid to shareholders on their personal tax returns
- Capital can be raised through sale of stock
- C corporations are good choice for businesses that need to raise money or plan to go public or eventually sold

S Corporations (S Corp)

- Avoid the double tax of C corporations
- Must make election to file as S corporation
- Considered a flow-through entity such that profits and losses are passed through to personal tax returns via Schedule K-1 (1120-S)
- Limited number of shareholders
  - Can’t have more than 100
  - All must be US citizens
  - Personal assets won’t be at risk in case the S corporation faces bankruptcy or lawsuits
- Taxation may vary at the state level

Entity formation considerations

- Federal and state filings
  - Federal
    - Form 1040 — due April 15 / extended to October 15 with Form 4868
    - Form 1065 — due March 15 / extended to September 15 with Form 7004
    - Form 1120-S — due March 15 / extended to September 15 with Form 7004
    - Form 1120 — due April 15 / extended to October 15 with Form 7004
  - State
    - Filing deadlines vary, and can follow Federal deadlines or lag 1-2 months
    - Federal taxable income generally used as starting point
    - File state income tax returns where entity has nexus
    - Review property, payroll and sales factors

Case Study – Sole Proprietorship

- Joe Smith starts a business – Joe's Good Eats LLC (Joe's)
  - Owns 100% of LLC, making this a single member LLC or sole proprietorship
  - No separate tax form is filed for Joe's
- Reporting
  - All income and expenses from Joe's is reported on Form 1040, Schedule C – Profit or Loss From Business
    - Income - cash, property and services received from all sources applicable to the activity
    - Expenses - ordinary and necessary expenses incurred in connection with the activity
  - Profit or loss is reported from Schedule C on line 3, Schedule 1 – Additional Income and Adjustments to Income
  - This amount flows to Form 1040, page 1, line 7a – Other income from Schedule 1
  - Tax calculated on total income, including profit or loss from business and paid with Form 1040

Case Study – Sole Proprietorship

- Self-employment tax
  - Tax rates
    - 12.4% Social Security tax (up to $132,900 in 2019)
    - 2.9% Medicare tax, may have 0.9% additional Medicare tax in certain situations
  - Reporting
    - Profit and/or loss needs to be reported on Form 1040, Schedule SE – Self-Employment Tax
    - Self-employment tax is reported on line 4, Schedule 2 – Additional Taxes
    - ½ of self-employment tax is allowed as a deduction on line 14, Schedule 1

Case Study - Partnership

- Joe Smith and Mary Baker start a business – JM's Good Eats LLC (JM)
  - Mary and Joe decide to form a partnership
  - They each contribute $50,000 of cash and receive a 50% interest in JM
  - Form 1065 – U.S Return of Partnership Income will need to be filed for JM
- Reporting
  - All income and expenses is reported on Form 1065, but not taxed at the partnership level
  - Each partner will receive Schedule K-1 – Partners Share of Income, Credits, Deductions, etc. which reports his/her respective share of income and expenses from JM
  - Ordinary income or loss from business is reported on page 2, Schedule E – Supplemental Income and Loss in Form 1040

Case Study - Partnership

- Self-employment tax
  - Tax rates
    - 12.4% Social Security tax (up to $132,900 in 2019)
    - 2.9% Medicare tax, may have 0.9% additional Medicare tax in certain situations
  - Reporting
    - Self-employment earnings from partner’s Schedule K-1, box 14, Code A reported on Form 1040, Schedule SE – Self-Employment Tax
    - Self-employment tax is reported on line 4, Schedule 2 – Additional Taxes
    - ½ of self-employment tax is allowed as a deduction on line 14, Schedule 1

Case Study – S Corporation

- Joe Smith and Mary Baker start a business – JM's Good Eats Corporation (JMC)
  - Mary and Joe decide to have JMC file as an S Corporation
  - They each contribute $50,000 of cash and receive 50 shares of JMC
  - Form 1120S – U.S Income Tax Return for an S Corporation will need to be filed for JMC
- Reporting
  - All income and expenses is reported on Form 1120S, but not taxed at the corporate level
  - Each partner will receive Schedule K-1 – Shareholder's Share of Income, Credits, Deductions, etc. which reports his/her respective share of income and expenses from JMC
  - Ordinary income or loss from business is reported on page 2, Schedule E – Supplemental Income and Loss in Form 1040
- Self-employment tax
  - Income from S Corporation is not subject to self-employment tax

Estimated tax payments

- Estimated tax payments (federal and state)
  - Method used to pay tax on income not subject to withholding
    - Self-employment income
    - Investment income (interest, dividends, capital gains)
  - Must have at least 100% of your prior year tax* or 90% of your current year tax paid in to avoid penalty
    - *If adjusted gross income is > $150,000, 110% of prior year tax for federal estimates only
    - Paid in includes any withholding
  - Estimates due April 15, June 15, September 15, January 15 of the next year

The new business landscape

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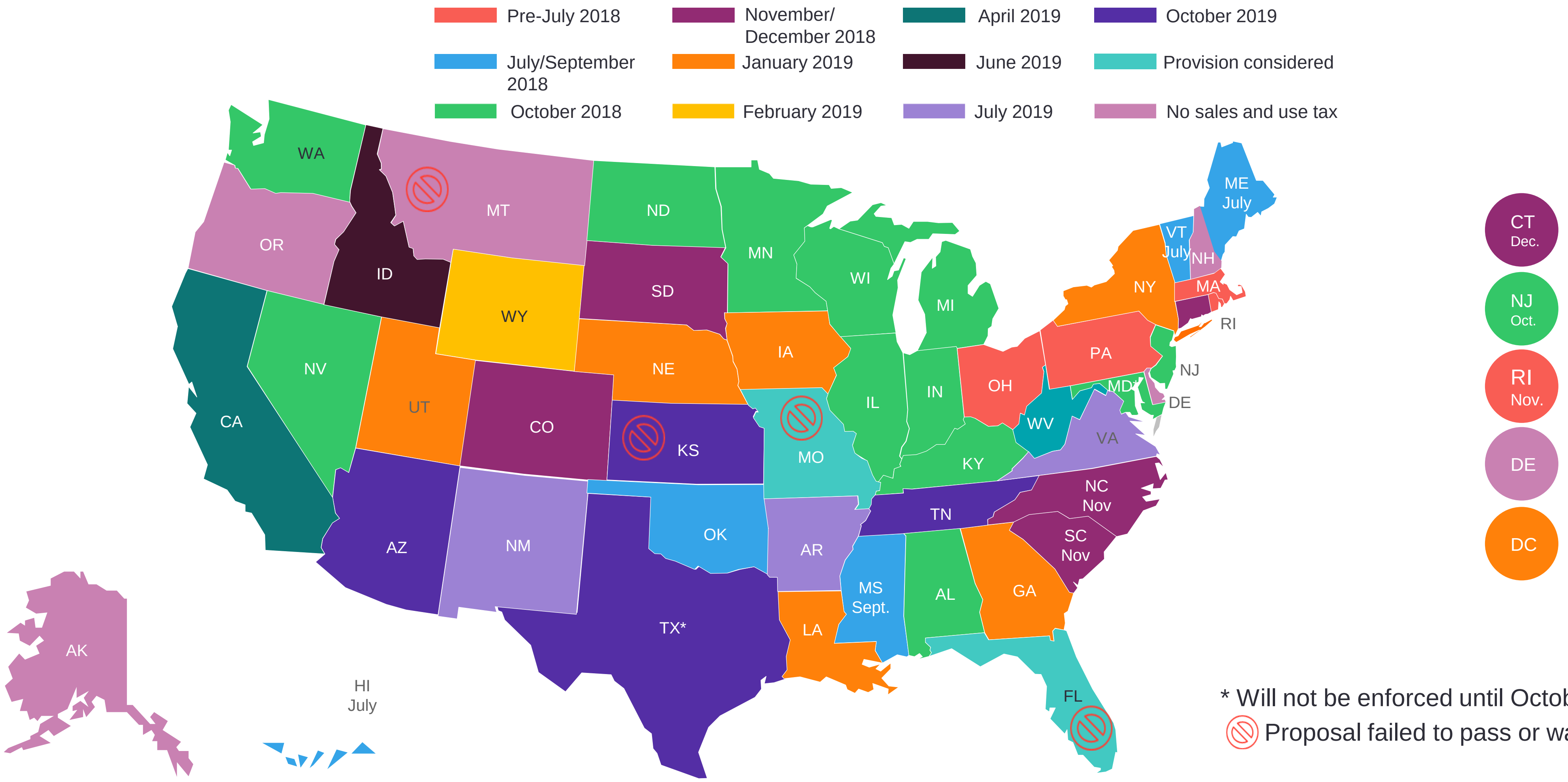
South Dakota v. Wayfair: the fallout

- The *Wayfair* decision eliminated the need for a remote seller to have physical presence in order for the state to compel registration/collection.
  - Physical presence still creates nexus.
  - Other state efforts to “work around” *Quill* remain in place (e.g., click-through, affiliate, and notice/reporting provisions).
- The new standard (economic nexus) allows states to require remote sellers to register and collect based on economic presence, measured by sales and/or transaction volume.
  - Most states require registration and collection if sales made into the state exceed $100,000 per year or occur in 200 or more transactions.
- Nearly all states have adopted some form of economic nexus, and approximately 40 states have extended the requirement to marketplace providers/facilitators.

State responses: enforcement of sales tax economic nexus provisions



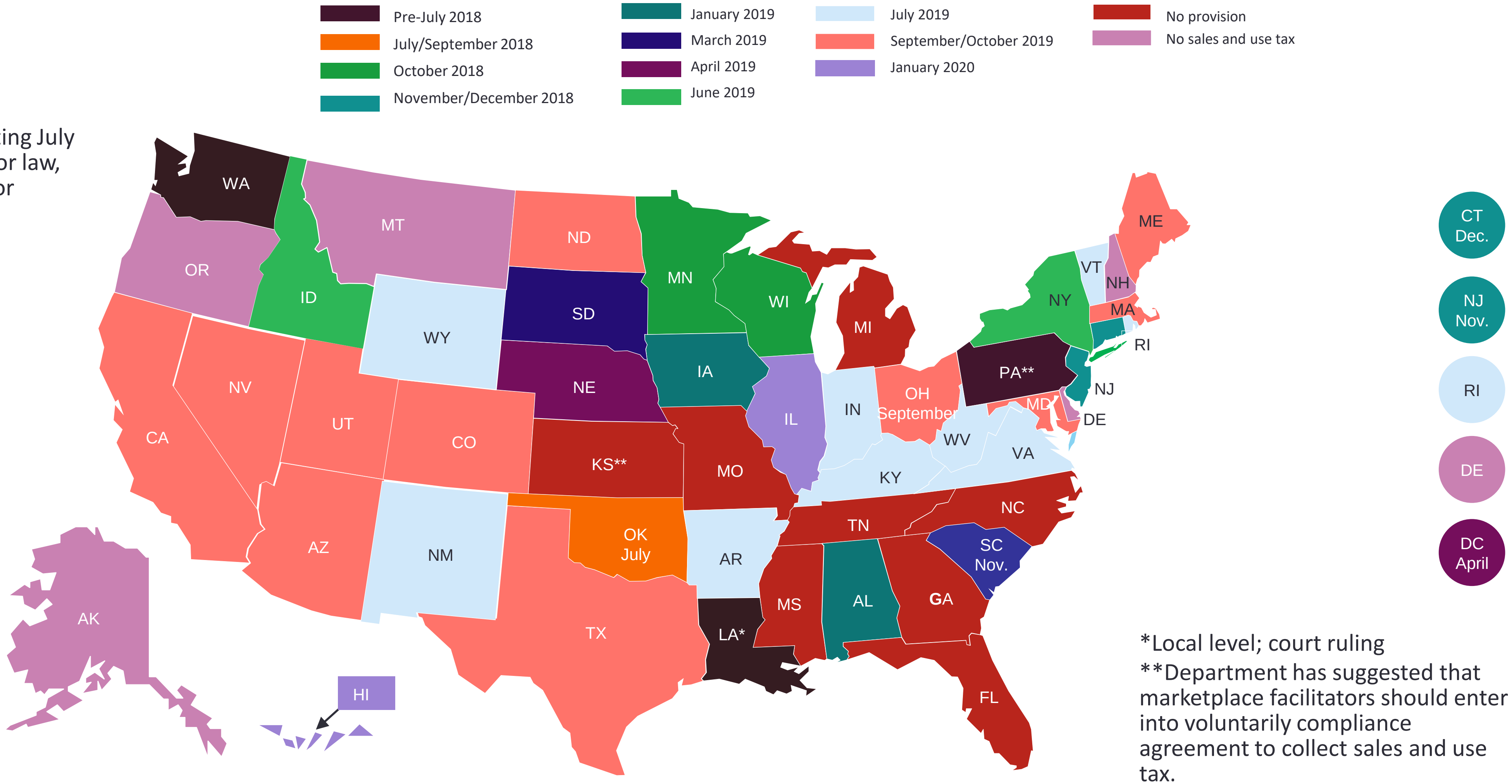
* Will not be enforced until October 2019

Proposal failed to pass or was vetoed

Source: Ernst & Young LLP analysis of state laws as of September 2019.

Enforcement of sales tax economic nexus provisions for marketplace providers

Washington's provisions are mandatory starting July 2019; under prior law, elect to collect or notify



*Local level; court ruling

**Department has suggested that marketplace facilitators should enter into voluntarily compliance agreement to collect sales and use tax.

Source: Ernst & Young LLP analysis of state laws as of September 2019

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How do the states determine what is a marketplace facilitator/provider?

- No uniformity among state and model definitions of marketplace provider/ facilitator
- General requirement that entity provides forum and processes/manages/arranges payment
- Standard business operations that do not function as traditional marketplaces may be pulled into definition in one or more states.
- Businesses may not be able to control whether they have a collection obligation as a facilitator

Marketplace facilitator/provider — examples

- **Virginia** — In order to be deemed a "marketplace facilitator" with "sufficient activity within the Commonwealth to require registration," the entity must satisfy the three-factor test focused on operating the marketplace forum, processing payments or providing customer service; and having nexus within the state.
- **Washington** — A marketplace facilitator is a business that performs three activities listed in the regulations, involving: contracting with sellers to facilitate the sale of a marketplace seller's product through a marketplace for consideration; communicating the offer or acceptance between the buyer and seller; and providing payment processing, fulfillment, or listing services.
- **New Jersey** — In order to have a collection requirement, a marketplace facilitator must provide one or more services from list related to maintaining marketplace forum or managing fulfillment services **and** one or more services from a list related to handling or processing payment on behalf of the marketplace sellers (no nexus/sales threshold specified); facilitator and seller may agree to shift collection obligation to seller.
- **Minnesota** — A marketplace facilitator is someone who provides the forum and directly or indirectly manages payments to the marketplace seller; no collection obligation if: (1) the seller makes taxable retail sales less than the current sales thresholds; (2) the seller elects to register and collect Minnesota sales tax directly and does not enter into an agreement with the marketplace provider for the marketplace to collect and remit tax; or (3) the facilitator does not maintain a place of business in the state.
- **National Conference of State Legislatures (NCSL) language** — This suggests both a "broad" definition (based on Washington State language) and a "narrow" definition (based on listing and collecting activities).

The marketplace sales tax trap — recognizing typical business scenarios and how to deal with them

Scenario 1	Scenario 2	Scenario 3	Scenario 4
Traditional marketplace facilitators	**Non-traditional marketplace facilitators**	**Marketplace operators**	**Marketplace sellers**
Companies that provide a forum for multiple sellers — may also sell directly through their forums	Companies in which the core business is not selling or providing a forum, but they offer such capabilities or their business or delivery model fits within state definitions of marketplace facilitator	Companies that host, manage and operate the platforms in scenarios 1 and 2 and sometimes have a contractual obligation to handle sales and use tax compliance	Companies that are pure marketplace sellers or that have multiple sales streams

Dual or multiple channels and obligations — state-by-state determination of roles and responsibilities

Business considerations

General considerations

Very little guidance exists from states on how to calculate tax, including which tax is applicable.

- Relation of entities involved in transaction – seller, payment processor, platform provider
  - Cash or credit
  - Option to pick-up
  - Delivery person — staff or contractor
  - Corresponding contractual arrangements

- What exactly is taxable, and at what rate?
  - Resale
  - Service
  - Packaging
  - Delivery charge
  - Service fee
  - Consider all revenue streams

Key actions

Review compliance policy, processes and systems to assess gaps

- Filing footprint
- Taxability decisions
- Exemption certificate management
- Use tax accrual
- Accounting Standards Codification (ASC) 450, *Contingencies*

Review existing systems for determination and reporting

- Assess need for implementing a new system or updating the existing ones
- Assess whether outsourcing is a better and more immediate option
- Consider centralizing sales and use tax compliance
- Assess options available through streamlined sales tax (SST)

Monitor ongoing legislative developments

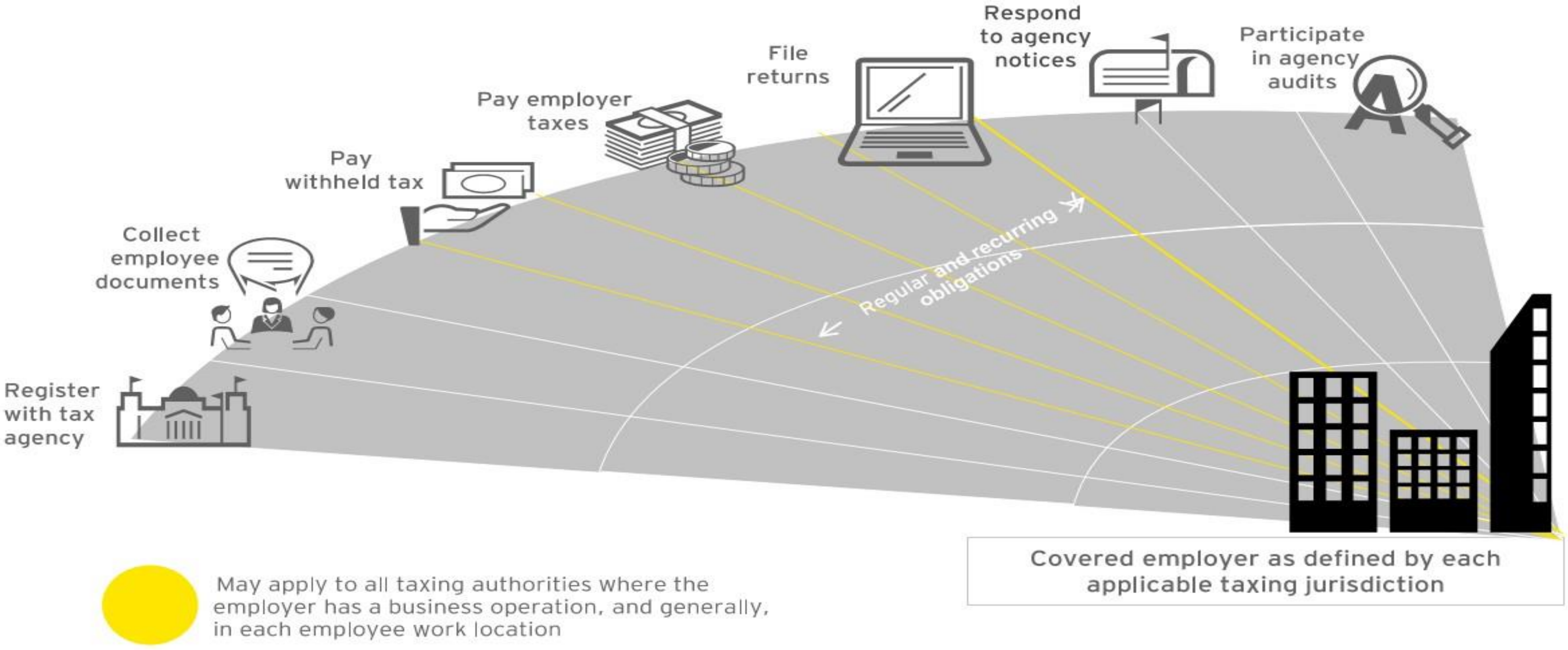
- Retroactive application unlikely in any state
- Industry-specific opt-out

Systems, process and compliance considerations

- **Registration** — increased footprint based on sales; inbound companies may need to obtain Federal Employer Identification Number (FEIN)
- **Tax determination** — tools that allow sellers to set up sales and use tax calculations by state and local taxing jurisdictions of the seller's specification
  - **Taxability matrix** — determines the taxability of products and services based on the product category selected by the seller
  - **Tax rate application** — tool to determine the appropriate combined tax rate (e.g., state, city, county, and district) based on the 5-digit zip code (plus 4) of the shipping address for destination-based states
  - **Exemption certificates** — tool to apply customer-based tax exemptions and instructions to download certificates from the source files
  - **Filing** — tools that support the filing and remittance of taxes to the appropriate taxing jurisdictions
  - **Document retention** — repository to retain required records to determine the amount of tax for which a taxpayer may be liable for, as required by taxing jurisdictions; such records may include copies of all of the taxpayer's federal income tax and state tax returns and reports, as well as the taxpayer's books, records and invoices
  - **Responsible party** — which party (seller or facilitator) will provide the taxability and rate determination
- **Automation** — automatically calculate, collect and remit taxes directly or on behalf of sellers, including handling the refund of taxes
- **Structural considerations** — operational models that lead to more efficient sales and use tax management

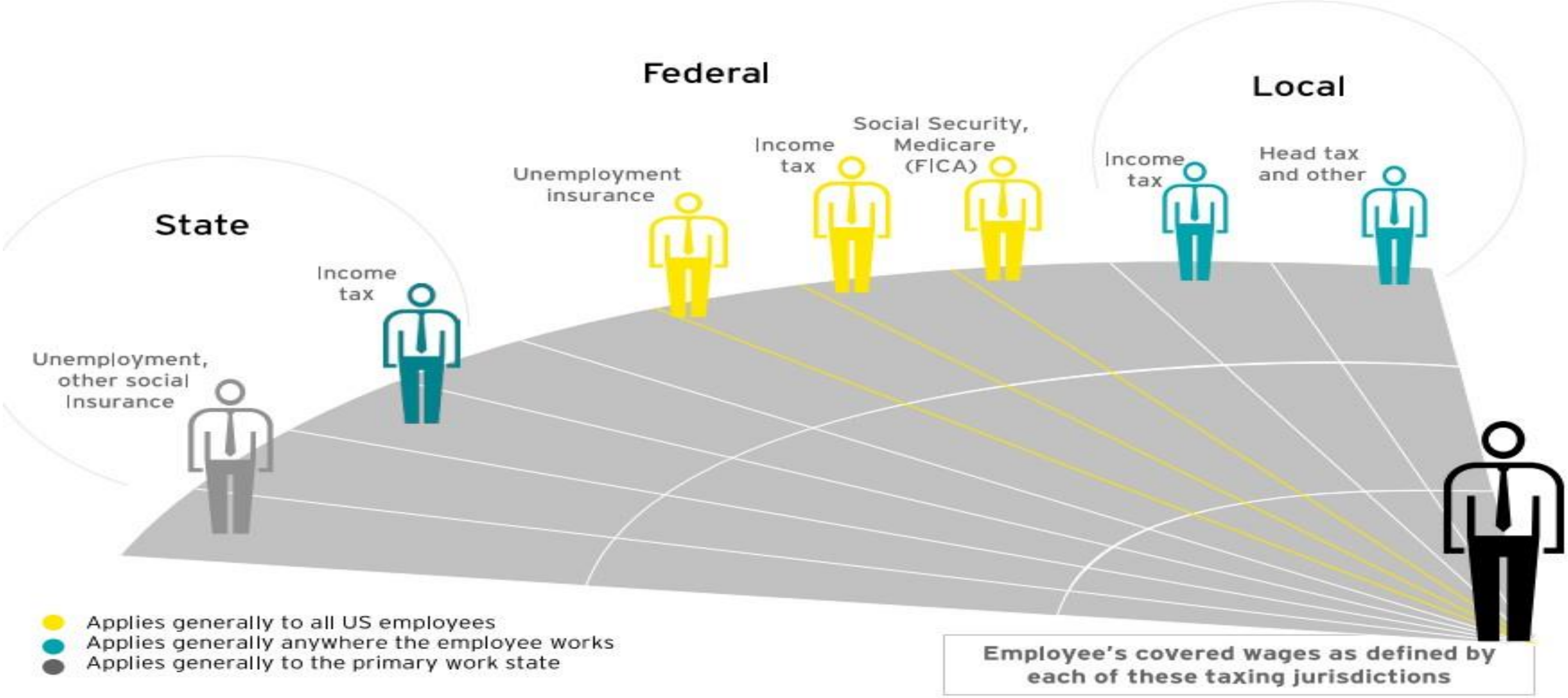
US payroll tax considerations

US payroll taxes
Employer obligations



US payroll taxes

Employee withholding tax variables



Sample employee onboarding checklist

New Hire: Hiring Checklist #1

February 21, 2018

New Hire: Hiring Checklist #1

Name: ________________________

Date of Hire: ___________________

Address: ____

Phone: _______________________

☐ Personnel and Confidential File Created (See Employment File Procedure)

☐ Application Filled out, Signed and Filed

☐ Authorizations for Background Check, Physical & Drug Screen Signed and Filed

☐ References and Previous Employment Checked and Reviewed

☐ Background Check Ordered _______ Received: _______ Reviewed By: _______

☐ Physical Exam Ordered: _______ Received: _______ Reviewed By: _______

☐ Drug Test Ordered: _______ Received: _______ Reviewed By: _______

☐ Payroll Change Notice Filled out and Signed.

Note: as provided by SHRM (www.shrm.org/about-shrm/Pages/Terms-of-Use.aspx#Disclaimer

Sample employee onboarding checklist contd.

ORIENTATION (See Orientation Procedures)

☐ I-9 Documentation

☐ Federal Tax Withholding Form

☐ State Tax Withholding Form

☐ Employee Policy Manual Acknowledgement

☐ Employee Handbook Acknowledgement Form

☐ Key/Security Policies Acknowledgement Form

☐ Employee Personal Information Sheet and Emergency Contact Form

☐ Benefit Information Reviewed

☐ Benefit Enrollment Forms Completed

☐ All Orientation Documents Filed in Personnel Record

☐ Employee Information Entered in HRIS & Payroll Systems (See Payroll Procedures)

Verified By: ____________________ Date: __________

NOTE: COMPLETED FORM TO BE FILED IN PERSONNEL FILE.

IRS, IL and other Payroll Resources

https://www.irs.gov/businesses/small-businesses-self-employed/outsourcing-payroll-and-third-party-payers

https://www.irs.gov/businesses/small-businesses-self-employed/payroll-professionals-tax-center-information-for-payroll-professionals-and-their-clients

https://www.irs.gov/pub/irs-pdf/p3144.pdf

https://www.irs.gov/businesses/small-businesses-self-employed/employment-taxes

https://www.paycheckcity.com/calculator

https://www.irs.gov/businesses/small-businesses-self-employed/employment-tax-publications

https://www.eftps.gov/eftps/

https://www2.illinois.gov/rev/research/taxinformation/payroll/Pages/default.aspx

https://www2.illinois.gov/ides/employers/Unemployment_Taxes_and_Reporting/Pages/default.aspx

Conclusions

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