Making the Jump

A Planner's Guide to Advising on Self-Employment

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Agenda

Part I: Selecting an Entity and Tax Classification

- Reporting income and expenses
- Registering an LLC

Part II: Tax Requirements and Guidelines for the Self-Employed

- Estimated payments, filings and payroll
- Electing S Corporation treatment

Part III: Planning Opportunities for the Self-Employed

- Business deductions and TCJA provisions
- Investing strategies and qualified plans

Q&A

The Emergence of The Side Hustle

45% of working Americans have part-time employment outside of their primary job

- Nearly one in five hope to turn their side hustle into their full-time business

Common reasons for having a side hustle

- Extra money for spending or goal funding
- Covering monthly expenses
- Paying down debt

The new retirement?

- One in three people with a side hustle are in their mid-50s or older
- 27% rely on the additional part-time income to cover their bills

<u>20% of those with side hustles had an unexpectedly high tax due in their first year of self-employment</u>

Entity Options and Taxation

Sole Proprietorships and Partnerships

- Schedule C – business income and expenses for sole proprietors
- Schedule E – income from partnerships, and rental and investment properties

Advantages

- Minimal setup requirements
- Simplified tax reporting/filings

Disadvantages

- Personal liability
- SE tax on all income for sole proprietors and most partnerships (investing, non-active partner has none)

Entity Options and Taxation

C Corporations

- Form 1120 – Corporate Income Tax Return (taxed as an entity)

Advantages

- Limited liability
- Flat tax rate under TCJA

Disadvantages

- Expensive and lengthier setup process
- Double taxation of income

Entity Options and Taxation

S Corporations

- Form 1120S – Income Tax Return for an S Corporation (passes through to shareholders)
- Schedule E – Net Profits Passed Through to Owners

Advantages

- Some limited liability
- Net profits avoid SE tax (FICA)

Disadvantages

- Costs associated with payroll required for owners
- Stricter requirements to retain this tax treatment

Entity Options and Taxation

Limited Liability Company (LLC)

- One owner defaults to sole proprietorship treatment (aka disregarded entity)
- Multiple owners defaults to partnership treatment
- Can elect to be taxed as a C-corp or an S-corp (must file an election through IRS)

Advantages

- Limited liability regardless of tax treatment
- Segregates multiple business activities

Disadvantages

- Each LLC must be registered separately
- Separate filings if corporate treatment is elected

Income Reporting Documents

Sole Proprietorships (and LLC disregarded entities)
- 1099-NEC (contractors or gig economy workers)

Partnerships and S Corporations (and LLCs taxed similarly)
- K-1

C Corporations
- W-2 wages and salary
- 1099 executive compensation

Non-Owner Workers
- W-2 for employees
- 1099-NEC for contractors

Registering an LLC in Ohio

Checklist Available on Secretary of State Website

- Starting a Business - Ohio Secretary of State (ohiosos.gov)
- Most single-member LLCs (disregarded entities) only need to complete steps 1 through 4

Fee of $95 to register with the state

- No cost to create federal EIN with IRS, and most banks don’t charge to open business checking

Engaging an estate attorney or tax professional is recommended for:

- Complex ownership structure (especially corporations)
- Unequal sharing of expenses, profits, etc. between owners
- Partnerships with general and limited partners
- Non-owner employees or contractors involved or expected to be hired

Additional Taxes

Self-employment (SE) tax

- Covers both employer's and employee's contribution to FICA (i.e. Social Security and Medicare)

Payroll taxes, including

- Employer's contribution to FICA
- Federal Unemployment Tax (FUTA)
- State Unemployment Tax (SUTA)
- Bureau of Worker's Compensation payments (BWC)

Commercial Activity Tax (CAT)

- $150 per year assessed on businesses with gross receipts between $150,000 and $1 million
- Higher amounts due when gross receipts exceed $1 million

Payment Requirements

Quarterly estimated taxes

- Equal amounts each quarter if income is consistent (revisit quarterly for varying or changing income)
- Federal and Ohio state due dates: April 15, June 15, September 15, January 15

Payroll tax withholdings

- Typically monthly and quarterly payment of withheld taxes for smaller payrolls
- Larger payrolls require more frequent payment of withheld taxes

Filing Requirements

For small businesses with payroll

- W-2 for owners' wages
- Form 941 for quarterly withholding reports

For small businesses with non-owner workers

- 1099-NEC for contractors
- W-2 for employees

For partnerships and S corps

- K-1 to report pass-through items for individual partners/shareholders

Converting to an S-Corp

Added costs of converting from sole proprietorship or partnership tax treatment include

- Payroll processing and tax and withholding requirements
- Attorney’s fees and articles of incorporation for multi-owner entities

Tax benefits of converting must outweigh cost to convert. These include

- Net profits avoid SE taxes (15.3% discount)
- Owners can create qualified plans to shelter excess income from taxes and maximize saving

When it usually makes sense (benefit outweighs cost)

- $80,000 or more of net profit from self-employment for <u>each</u> LLC member or partner
- Other employee compensation may impact this number

Business Tax Deductions

Self-employed individuals can deduct several items related to their business

- Home office expenses (must be exclusive use)
- Mileage or expenses for business auto use
- Business meals (50% deductible)
- Business travel
- Bonus depreciation and/or Section 179 deduction for computers, furniture, etc.
- Advertising/marketing and office supplies
- Professional membership fees and subscriptions
- Health insurance premiums
- Equipment converted to business use
- Other expenses incurred to operate the business

Tax Cuts and Jobs Act (TCJA)

Qualified Business Income Deduction (QBID)

- Up to 20% of net income for sole proprietorships, partnerships and S corps (and similarly-taxed LLCs)

Key deductions eliminated

- Unreimbursed employee business expenses, business entertainment, other 2% miscellaneous

State and local tax deductions (SALT) capped

- $10,000 maximum <u>includes</u> real estate taxes paid on home

21% flat tax for C Corporations

- Reduced from 28%, also eliminated corporate Alternative Minimum Tax (AMT)

Standard deduction nearly doubled; personal exemptions eliminated

- Individuals less likely to itemize deductions

Business Retirement Plans

Self-employed retirement plans have higher contribution limits and more flexibility than IRAs

Maximize contributions with:

- 401(k)/Profit Sharing Plan (Solo K for single-owner businesses)
- Defined Benefit plans (cash balance or money purchase)

Easier to set up and maintain:

- SEP-IRA
- SIMPLE plans
- Health Savings Account (HSA)

Business Retirement Plans

401(k)/Profit Sharing Plan

- A single-owner business or business jointly owned by spouses qualifies for a simplified Solo K
- Sole proprietors and partnerships (and LLCs taxed similarly) can defer up to $19,500 of net profits
- S-corp owners can defer up to $19,500 of W-2 wages, plus up to 25% of salary from net profits
- $6,500 catch-up deferral allowed if owner aged 50+
- $58,000 maximum in total contributions
- Roth contributions allowed, regardless of owner's income

Defined Benefit plans (cash balance or money purchase)

- Best used by S-corp owner after maxing out 401(k)/Profit Sharing Plan
- Contribution limit calculated each year based on owner's age and W-2 wages, and plan balance
- Other W-2 employees also considered in calculation and must receive annual contributions

Business Retirement Plans

SEP-IRA
- Effective maximum contribution of 20% of net profits, made by employer pretax
- If owner contributes maximum, employees must receive contributions equal to 25% of W-2 salaries
- No annual requirement to fund, easiest to set up

SIMPLE Plans
- Can defer up to $13,500 of W-2 wages ($3,000 catch up also allowed for aged 50+)
- All employees must be able to defer, funds must stay in plan two years to avoid penalties
- Required contributions: 100% match up to first 3% of employee contributions, or 2% nonelective

Health Savings Account (HSA)
- Contributions by a business owner are 100% deductible, dollar-for-dollar from income
- $3,600 limit for individual, $7,200 for family
- Must be in a high-deductible health plan (HDHP) with no other coverage, and under age 65 to contribute

Questions?