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# Tax Issues for Startups

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# The Burning Questions



- › What **entity structure** is right for my business?
- › What types of **taxes** are associated?
- › What are my top **first year considerations**?
- › Do I hire **employees or** work with **independent contractors**?
- › What's the best approach to **equity compensation**?

# Entity Selection



## › Types of Entities

- Sole Proprietorship / Single Member LLC
- LLC / Partnership
- S Corporation
- C Corporation



# Sole “Prop” / Single Member LLC



- › Not a separate entity apart from the owner for tax purposes (owner pays the taxes)
- › Report on Schedule C of Form 1040



# Sole “Prop” / Single Member LLC



- › Pros
  - Simple
  - Minimal admin costs
- › Cons
  - Pay self-employment tax on net earnings
  - Not an option with more than one founder/owner

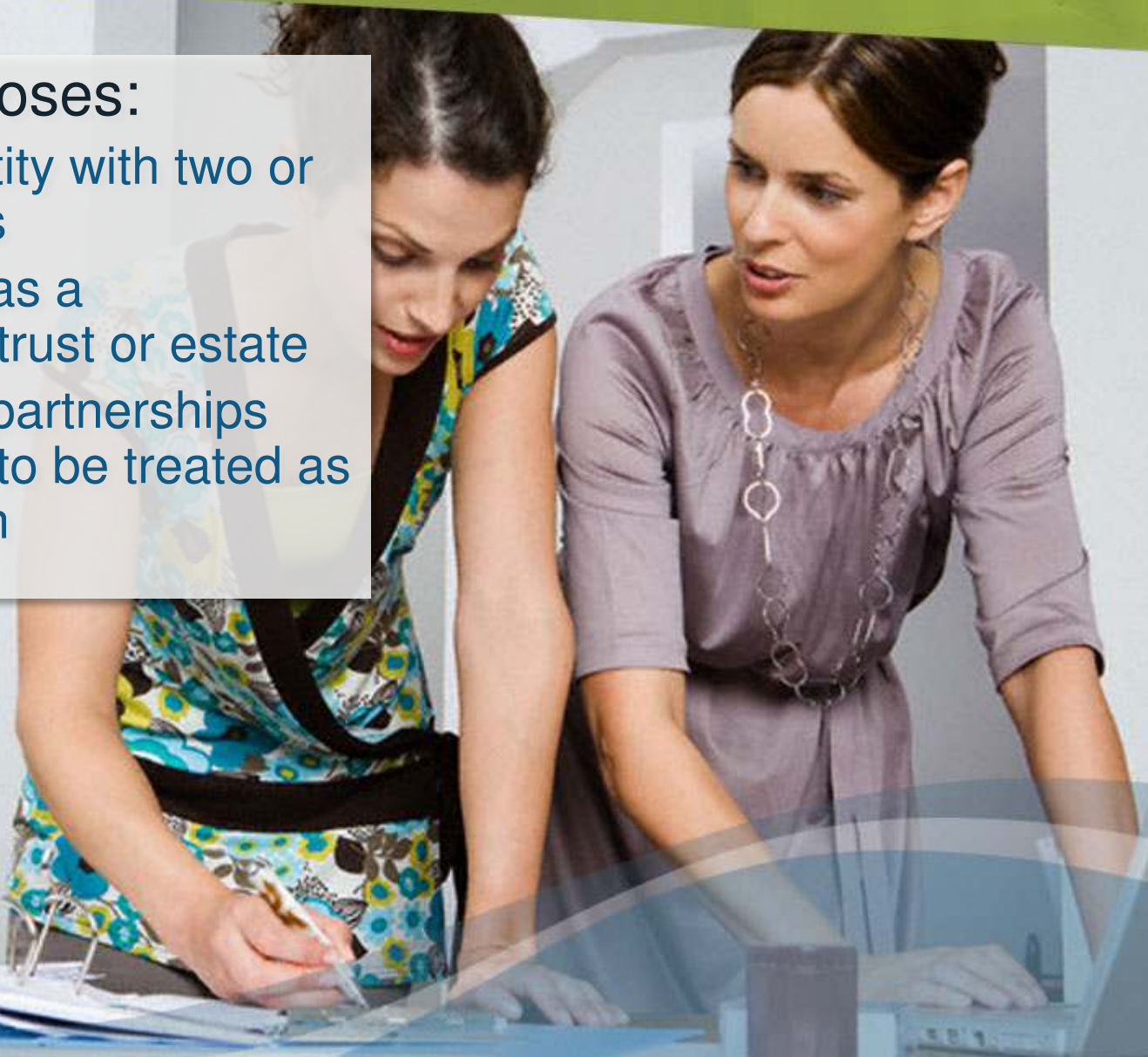




# LLC / Partnership



- › For tax purposes:
  - Business entity with two or more owners
  - Not defined as a corporation, trust or estate
  - Taxed as a partnerships unless elect to be treated as a corporation



# LLC / Partnership



## › Pros:

- Flexible allocation of income and loss
- No limitation on number of LLC members/partners
- Tax efficient exit
- LLC members/partners' tax basis increases when their share of LLC/partnership liabilities increases, thus increasing their ability to deduct losses
- No limitation on type of entity that can own an LLC membership/ partnership interest





# LLC / Partnership



## › Cons:

- Outside investors may not want to complicate their tax filing with another K-1
- Operating agreement can get very complicated
- Tax basis must be tracked
- Passive activity loss limitation issues
- Active LLC members/partners are subject to self employment tax on income allocated to them





# S Corporation



- › Corporations that qualify as a small business corporation
  - Be a domestic corporation
  - No more than 100 shareholders
  - Have no shareholders other than individuals who are US citizens or residents, estates, certain types of trusts, or certain types of exempt organizations
  - Have only one class of stock

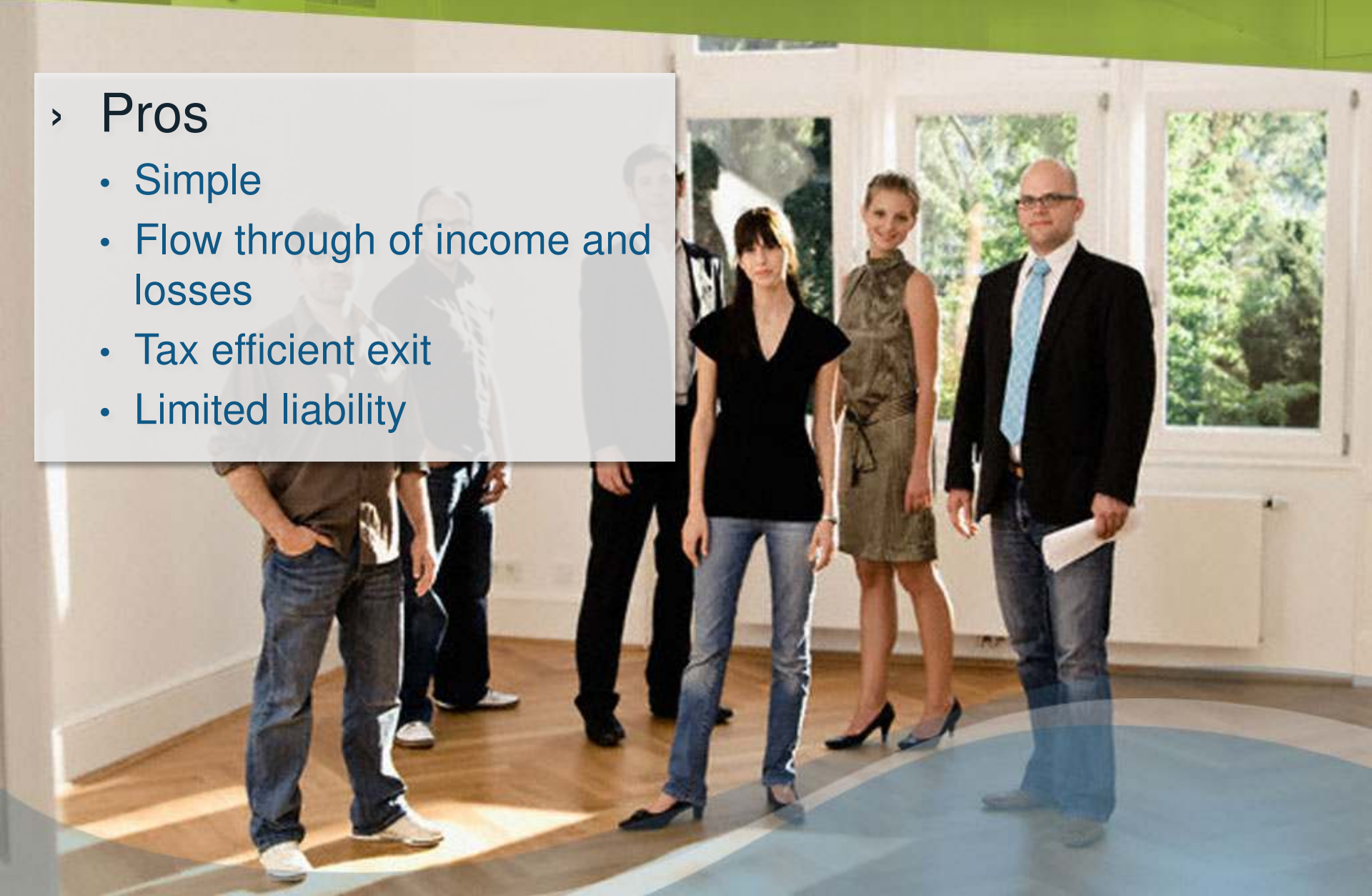


# S Corporation



## › Pros

- Simple
- Flow through of income and losses
- Tax efficient exit
- Limited liability





# S Corporation



## › Cons

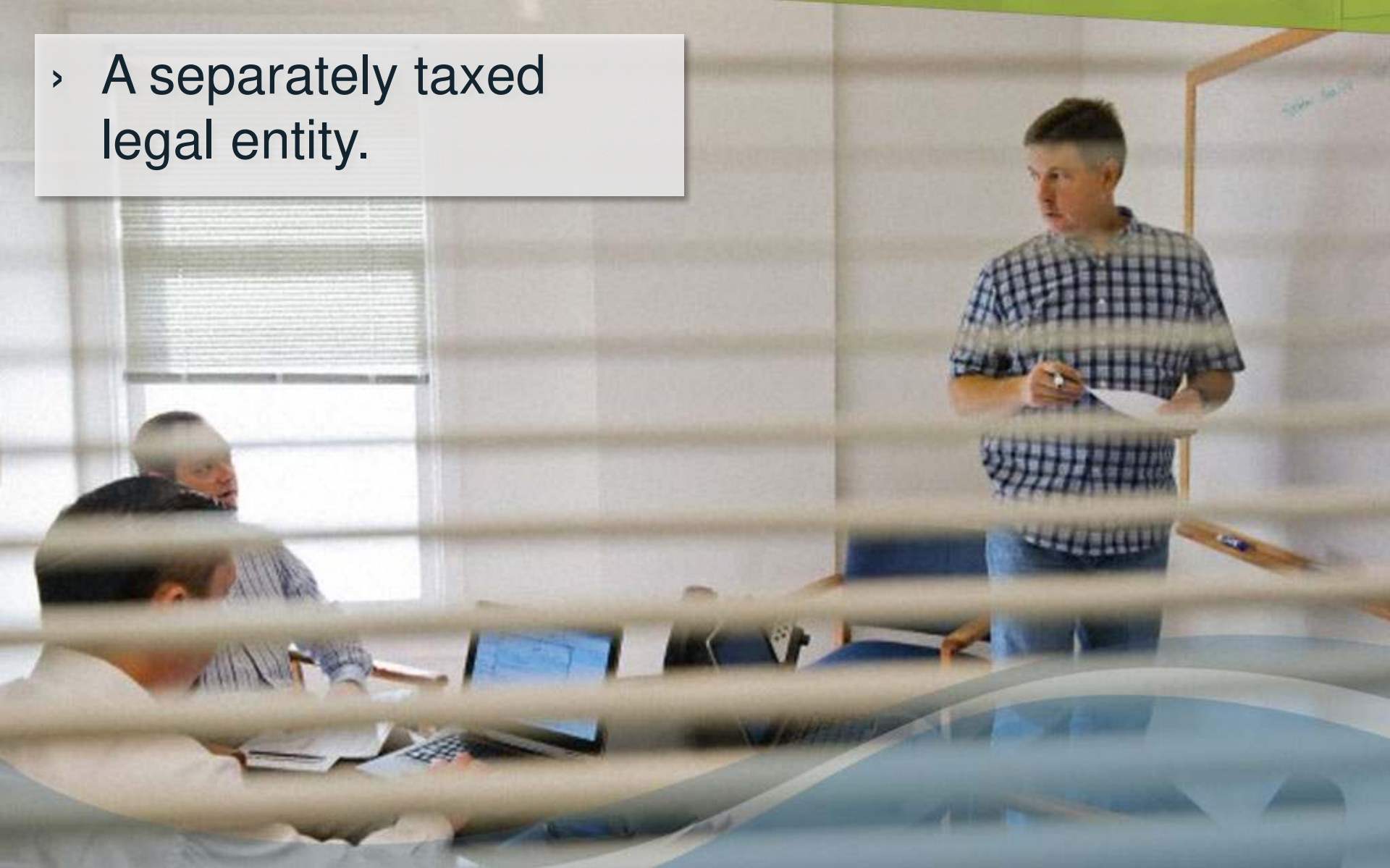
- Must have 12/31 year end
- Shareholder limit = 100
- One class of stock
- Limitation to certain types of shareholders
- Potential suspended loss issues
- Tax basis must be tracked
- Outside Angel investors may not want to complicate their tax filing with another K-1



# C Corporation



- › A separately taxed legal entity.





# C Corporation



## › Pros:

- Flexibility when raising capital from outside angel/institutional investors
- Multiple classes of stock
- Limited liability
- Fiscal year end available

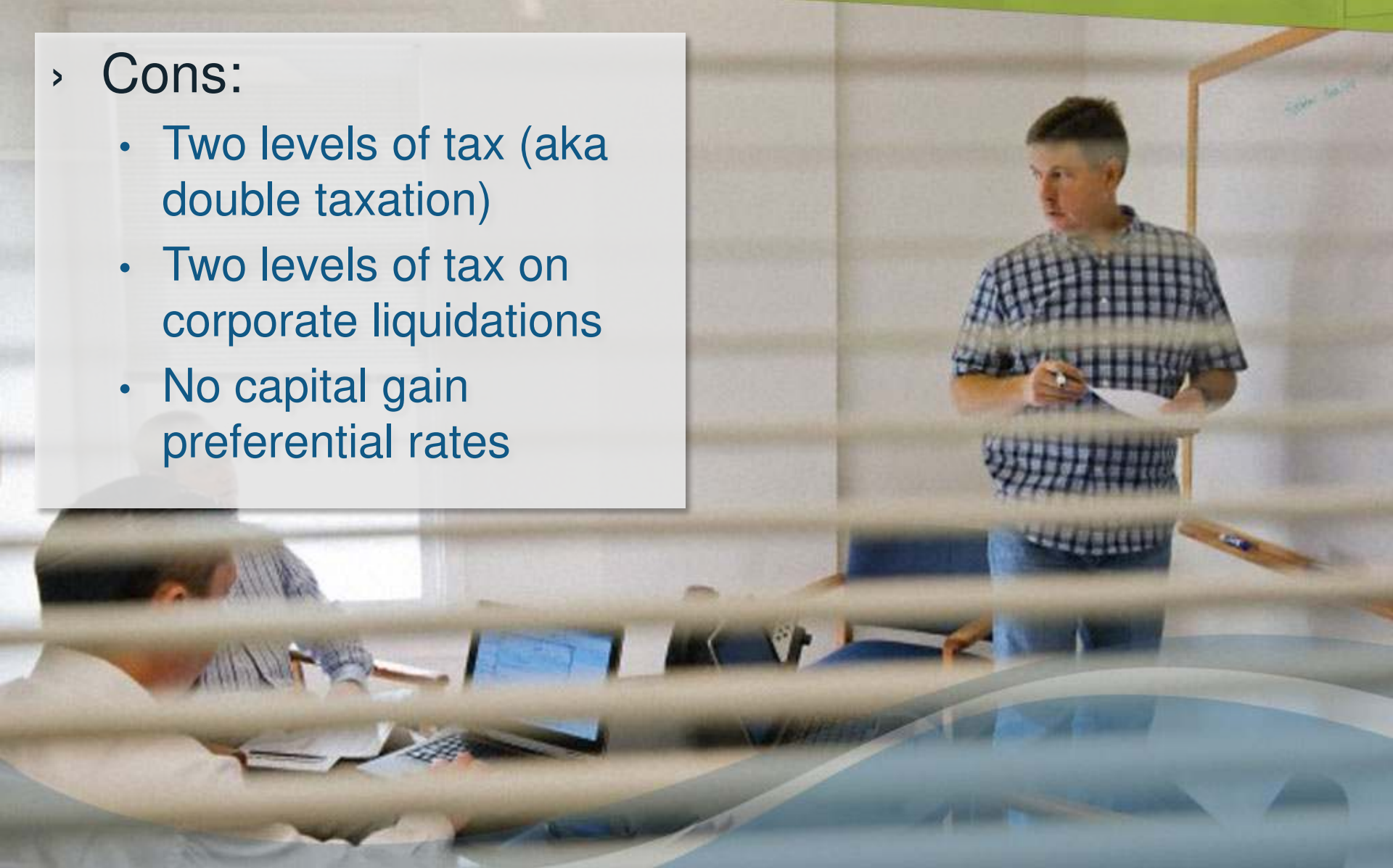


# C Corporation



## › Cons:

- Two levels of tax (aka double taxation)
- Two levels of tax on corporate liquidations
- No capital gain preferential rates





# Types of Taxes



- › Federal income tax
- › State income taxes
- › State franchise taxes
  - May not be based on income (e.g. Texas – gross margin tax, Ohio – CAT tax)
- › Payroll taxes
  - FICA
  - FUTA
  - SUTA
  - Tri-Met
- › Self employment tax
- › Sales tax



# Types of Taxes (cont.)



- › Business & Occupation (B&O) tax
- › Portland/Multnomah County tax
- › Real property tax
- › Personal property tax
- › Foreign taxes (income, branch profits, VAT)
- › Federal & State estimated taxes





# State Income Taxes



- › Nexus
- › Apportionment
- › Public Law 86-272



# State Income Taxes - Nexus



- › “Nexus” refers to the degree of contact a business must have with a state in order for the state to constitutionally impose a tax upon the business.
- › Nexus threshold for sales tax lower than income tax.



# State Income Taxes - Apportionment



- › A method for a business with operational activity in more than one state to source income or loss to a state based on its activities in the state.
- › Most states typically use a standard three-factor apportionment formula consisting of:
  - Property
  - Payroll
  - Sales
- › Many states that use the three-factor apportionment formula will weight sales more heavily (e.g. double-weight)
- › Oregon has a sales only apportionment formula
  - Sales throw back rule

# State Income Tax – Public Law 86-272



**Public Law 86-272, sometimes called the “interstate commerce clause,” provides federal legislation which prohibits any U.S. state from imposing an income tax (directly or indirectly) upon a business whose only activity within the state is “solicitation” of orders for the sale of tangible personal property, where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.**



# State Income Tax – Public Law 86-272



- › States may or may not follow Public Law 86-272
- › May not be exempt if doing more than soliciting sales
  - Training
  - Implementations

# State Income Tax – Minimum Tax



- › Oregon replaced the \$10 minimum tax with a new minimum tax of \$150 for all pass-through entities, including S Corporations.
- › C Corporations now have a tiered minimum tax based on gross Oregon sales, ranging from \$150 (gross Oregon sales below \$500,000) to \$100,000 (gross Oregon sales of \$100 million+).



# State Income Tax –



# Minimum Tax



## Minimum Taxes for C Corporations (effective for tax years beginning in 2009)

Oregon sales (gross)*	Minimum Tax
Less than \$500,000	\$150
\$500,000 to \$999,999	\$500
\$1 million to \$1,999,999	\$1,000
\$2 million to \$2,999,999	\$1,500
\$3 million to \$4,999,999	\$2,000
\$5 million to \$6,999,999	\$4,000
\$7 million to \$9,999,999	\$7,500
\$10 million to \$24,999,999	\$15,000
\$25 million to \$49,999,999	\$30,000
\$50 million to \$74,999,999	\$50,000
\$75 million to \$99,999,999	\$75,000
\$100 million or more	\$100,000

\* Oregon sales for this purpose means sales, net of refunds, sourced to Oregon for state apportionment purposes. The equivalent amount for prior years is reported on your 2007 or 2008 Oregon corporate income tax return on page 1, item N, or on Schedule AP, line 21, column (a).

# State Income Tax – Minimum Tax



- › In addition, the tax rates on corporate net income also increase in three phases:
  1. for tax years beginning in 2009 and 2010, the maximum rate, imposed on corporate net income over \$250,000, is 7.9%;
  2. for tax years beginning in 2011 and 2012, this rate drops to 7.6%; and
  3. for tax years 2013 and later, the 7.6% minimum tax rate is imposed only on net income over \$10 million.



# State Income Tax – Minimum Tax



- › For all years, the corporate tax rate remains at its current 6.6% for taxpayers with net income below \$250,000

**Tax Rates on Corporate Net Income**

<b>Taxable Income</b>	<b>2009 and 2010</b>	<b>2011 and 2012</b>	<b>2013 and after</b>
Up to \$250,000	6.6%	6.6%	6.6%
\$250,000 - \$10 million	7.9%	7.6%	6.6%
Over \$10 million	7.9%	7.6%	7.6%

- › C Corporations will pay either the minimum tax based on Oregon sales, or income tax based on these rates, ***whichever is greater.***

# Sales Tax



- › Typically a rate of approximately 6.5 – 7% is imposed on most sales and leases of tangible personal property and sales of specified services
- › Cities and counties may levy a sales tax on the same sales and services that would increase the rate



# Sales Tax



- › No sales tax in Oregon
- › Must have Nexus
- › Sales tax paid on product only once
- › May need to obtain resale certificate





# B&O Tax



- › Tax imposed by the State of Washington
- › Based on gross receipts
- › Tax rate varies by classification, e.g.,
  - Retailing .047%
  - Wholesaling .0484%
  - Manufacturing .0484%
  - Services 1.5%
  - New economic Nexus requirements



# State Tax Updates



- › New economic Nexus standards
  - Washington adopted “economic nexus” rules for service revenue effective June 1, 2010, which has ramifications for both businesses located in Washington as well as those headquartered outside Washington.



# State Tax Updates



## › Economic Nexus Standards

- An important distinction in the type of business:
  - For out-of-state individuals/businesses: physical presence in Washington is still required for retailers and wholesalers
  - For out-of-state service individuals/businesses: generally the service provider is taxable for B&O purposes if the customer is in Washington, with taxable revenue being apportioned based solely on a sales factor





# State Tax Updates



- › For out-of-state individuals/businesses: to be subject to B&O tax, the individual or entity providing services in Washington must also have one of the following:
  - More than \$50k of property in WA
  - More than \$50k of payroll in WA
  - More than \$250k of gross income in WA
  - At least 25% of your total property, payroll or total gross income in WA
  - If you meet any of the above tests, you must register and pay tax



# State Tax Updates



- › For in-state individuals/businesses: you may be able to apportion service income out of state for purposes of the B&O tax calculation. You must either actually pay tax in the other state or must have one of the following in the other state:
  - More than \$50k of property
  - More than \$50k of payroll
  - More than \$250k of gross income
  - At least 25% of your total property, payroll or total gross income

# Portland / Multnomah County Tax



## › Portland

- License tax based on 2.2% of net business income
- Based on sales apportionment
- Exempt if gross receipts are less than \$50K, however, you must file annual exception





# Portland / Multnomah County Tax



## › Multnomah

- Business income tax based on 1.45% of net business income
- Based on sales apportionment
- Exempt if gross receipts are less than \$50K, however, you must file annual exception



# Federal & State Estimated Taxes



- › Required for C Corporations if the tax expected to be >\$500
- › Four installments due the 15<sup>th</sup> day of the 4<sup>th</sup>, 6<sup>th</sup>, 9<sup>th</sup> and 12<sup>th</sup> months

# Federal & State Estimated Taxes



- › Paid at individual level for S Corporation shareholders and LLC members/partners
- › In general, individuals required to make estimated tax payments unless withholding covers 100% of prior year tax or 90% of current year tax



# Federal & State Estimated Taxes



- › Four installments due the 15<sup>th</sup> day of April, June, September and January
  - Considered prepayment of ultimate liability

# Initial Year Considerations



- › Choosing a tax year end
- › Methods of accounting
- › Section 1244 Small Business Stock
- › Section 1202 – Exclusion of Capital Gain
- › NOLs

# Choosing a Tax Year End



- › Sole Proprietor: 12/31
- › C Corporations: Any year end
- › S Corporations: Must be 12/31
- › LLC/Partnerships: Depends on the partner(s) owning the majority (50%) interest in the partnership  
LLC



# Methods of Accounting



- › Cash vs. Accrual
- › R&D Costs
- › R&D Credit
- › Deferred revenue/advance payments
- › Depreciation

# Cash vs. Accrual



- › Cash: Business reports income when it is actually or constructively received and deducts expenses in the year they are paid.
  - Pro:
    - Simple
    - Can create planning opportunities
  - Cons:
    - May not clearly reflect income
    - Corporations must have gross receipts less than \$5 million
    - Not considered a proper method under generally accepted accounting principles (GAAP)

# Cash vs. Accrual (cont.)



- › Accrual: In general, income is reported in the tax year earned and expenses are recognized in the year incurred (e.g. receivables create income and payable create expenses).
  - Pros:
    - Closer resemblance to GAAP
    - Better matching of income and expenses in the appropriate year
    - Generally required for purchases and sales of inventory
  - Cons:
    - Record keeping more complex
    - Revenue recognition issues
    - For S Corporations and LLCs/Partnerships, it may create taxable income before there is cash to distribute in order for taxes to be paid at the LLC member/partner level.



# R&D Costs



- › Currently deductible
- › Elect to capitalize the costs and amortize them over 60 months beginning with the month when benefits are first realized from them
- › Certain R&D costs qualify for the credit
- › Salaries & supplies
- › Depreciable property (i.e. computers) do not qualify
- › Detailed calculation
- › Credit has been made permanent

# R&D Credit



- › Deductible R&D costs reduced by amount of credit
- › Election can be made to calculate a reduced credit amount and still deduct the R&D costs
- › Election must be made on original return
- › May be beneficial to multistate filers
- › R&D credit also available in Oregon

# Deferred Revenue/Advance Payments



- › Typically, income recognized when payments are received for both cash basis and accrual basis taxpayers
- › Accrual basis taxpayers can elect to defer one year beyond tax year of receipt for certain advance payments, e.g. advance payments received for services or the use of intellectual property
- › Cannot defer more than amount deferred for financial statement purposes



# Depreciation



- › Establish consistent capitalization policy
- › Modified accelerated cost recovery system (MACRS)
- › Bonus (50% for 2012 & 2013, 0% for 2014)
- › Section 179
  - \$500,000 for 2012 & 2013, \$25,000 for 2014 & beyond
  - Reduced dollar for dollar by excess qualified property in excess of \$2 million & \$200,000 respectively
  - Limited to taxable income

# Section 1244 Small Business Stock



- › Ordinary loss deduction on loss sustained on the sale, exchange or worthlessness of stock
- › Limited to \$50,000 (\$100,000 on joint return)
- › Stock must be issued to an individual in exchange for money or property

# Section 1244 Small Business Stock



- › Aggregate amount of money and other property received by corporation as a contribution to capital must, in aggregate, not exceed \$1 million
- › Corporation must have >50% of its gross receipts over the 5 years before the loss be from operations versus derived from such items as royalties, rents, dividends interest annuities and gain from the sale of securities

# Section 1202 – Exclusion of Capital Gain



- › Available to non-corporate taxpayers
- › 100% exclusion from 9/27/10 through 12/31/11
- › 50% exclusion from 12/31/11 through 12/31/14



# Section 1202 – Exclusion of Capital Gain



- › Must be qualified small business stock (QSBS)
  - Stock issued after 8/10/93
  - Domestic C-Corp
  - Gross assets <\$50,000,000 anytime before and immediately after issuance
  - Acquired at original issue in exchange for money, other property or services
  - Meets active business requirements

# Section 1202 – Exclusion of Capital Gain



- › Stock must be held for five years
- › Rollover available of gain sale of stock held for six months
  - Replacement QSBS must be purchased within 60 days
- › Disqualifying redemptions
  - 2% value test
  - 5% value test

# NOLs



- › Section 382
  - Greater than 50% ownership change based on value
  - Yearly limitation based on the value of the company times the long-term tax exempt rate
  
- › Establish State NOLs

# Employee vs. Independent Contractor



## List of 20 Common Law Factors Used to Classify Workers

- 1. *Instructions.*** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions.
- 2. *Training.*** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.



# Employee vs. Independent Contractor



## List of 20 Common Law Factors Used to Classify Workers

3. **Integration.** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. (i.e. when the success or continuation of a business depends to an appreciable degree upon the performance of the worker's services).
4. **Services Rendered Personally.** If the services must be rendered personally, presumably the person for whom the services are performed are interested in the methods used to accomplish the work.
5. **Hiring, Supervising and Paying Assistants.** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job.
6. **Oral or Written Reports.** A requirement that the worker submit regular or written reports to the person for whom the services are performed indicates a degree of control.

# Employee vs. Independent Contractor



7. ***Payment by Hour, Week, Month.*** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.
8. ***Payment of Business and/or Traveling Expenses.*** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee.
9. ***Furnishing of Tools and Materials.*** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.

# Employee vs. Independent Contractor



- 10. *Significant Investment.*** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees, that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed, and thus the existence of an employer-employee relationship.
- 11. *Realization of Profit or Loss.*** A worker who can realize a profit or suffer a loss is generally an independent contractor, but the worker who cannot is an employee. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees.
- 12. *Working for More Than One Firm at a Time.*** The fact a worker performs more than de minimis services for unrelated persons or firms at the same time, generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each.
- 13. *Making Services Available to General Public.*** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

# Employee vs. Independent Contractor



- 14. *Right to Discharge.*** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An independent contractor cannot be fired as long as he or she meets the contract specifications.
- 15. *Right to Terminate.*** A worker's right to end his or her relationship with the person for whom the services are performed at any time without incurring liability indicates an employer-employee relationship.
- 16. *Continuing Relationship.*** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists.
- 17. *Set Hours of Work.*** The establishment of set hours of work by the person or persons for whom the services are performed indicates control.



# Employee vs. Independent Contractor



- 18. *Full Time Required.*** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and by implication restrict the worker from doing other gainful work.
- 19. *Doing Work on Employer's Premises.*** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker. Control over the place of work is indicated when the one for whom the services are performed can compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
- 20. *Order or Sequence Set.*** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work.

# Equity Compensation



- › Restricted stock
- › Stock options
- › Restricted stock units (RSUs)

# Equity Compensation



- › Restricted stock
  - Sec. 83 (b) election
- › Value, value, value

# Equity Compensation



- › Stock options
  - Incentive stock options (ISOs)
  - Nonqualified stock options (NQs)



# Equity Compensation



## › ISOs

- Nontaxable date or grant
- Nontaxable date of exercise
- AMT preference
- Disqualifying disposition
- Cashless exercise

# Equity Compensation



## › NQs

- Nontaxable date of grant
- Taxable date of exercise
  - Ordinary income (OI)
  - $OI = FMV - \text{exercise price}$
  - Cashless exercise

# Equity Compensation



## › RSUs

- Promise to deliver set # or shares
- Taxable when vested
- Sec 83 (b) election not available

# Disclaimer



This presentation is a summary and is not intended as tax or legal advice. You should consult with your tax advisor to obtain specific advice with respect to your fact pattern.

Based on the most recent "best practice" standards for tax advisors issued by the Treasury Department, commonly referred to as Circular 230, we wish to advise you that this presentation has not been prepared to be used, and cannot be used, to provide assurance that penalties which may be assessed by the IRS or other taxing authority (including specifically section 6662 understatement penalties) will not be upheld.



# Questions?



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