

# Sole Proprietors Tax Info Sheet (2010)

## TAX PLANNING

Sole proprietors are subject to both income and self-employment (SE) tax. Several techniques are available to reduce their tax liability.

### Tax Saving Strategies

Description	How it works	When this works best
Employ your children in the business	Children's wages are not subject to FICA if they are under age 18 (or FUTA if under age 21). However, they do reduce the business owner's income subject to SE tax. Also, wages aren't taxed at parent's rate under the kiddie tax rules.	Because the wages must be reasonable for the work done, this works best for children who are older and able to perform more skilled (that is, higher paid) tasks.
Rent property from your spouse	The rent deducted by the proprietor reduces self-employment (SE) income. However, the rent income the lessor spouse recognizes is not subject to SE tax. So, even though the couple's income tax is unchanged, the rents paid escape SE tax.	The proprietor's spouse owns property that can be used in the business. If the spouses own property jointly, half the rent paid will be deductible by the proprietor.
Employ your spouse in the business	The spouse can receive tax-free reimbursement of medical expenses from the business, even though the business deducts the reimbursements. The reimbursement plan can cover the entire family, so the family's out-of-pocket medical expenses are paid with pre-tax dollars.	The business must provide the medical benefit to all qualifying employees. Thus, the cost may be prohibitive unless there are few other employees that would have to be covered.

## EVALUATING OPTIONS

Although sole proprietorships are often appropriate, as the business grows, using a business entity may make sense.

### Comparison of Single-Owner Businesses

	Sole Proprietorship	C Corporation	S Corporation	Single-Member LLC
Simple to form and operate?	Yes.	No.	No.	Relatively.
Can interests in the business be transferred to new owners?	No—the owner can only transfer the business assets.	Yes.	Yes.	Yes—the entity becomes a multi-member LLC.
Can additional equity capital be raised?	No—the business's equity is limited to the owner's capital and ability to borrow.	Yes—the corporation can admit an unlimited number of new shareholders. No restrictions on who can be a shareholder.	Yes—the corporation can admit up to 100 shareholders. However, some restrictions on who can own S stock.	Yes—the LLC can admit an unlimited number of new members (thus becoming a multi-member LLC). No restriction on who can be a member.
Can the owner shelter income from income tax?	No—all income is taxed at owner's marginal rate.	Some—the first \$100,000 of income retained by the corporation is taxed at the corporate graduated rates. (However, income distributed as a dividend is subject to double tax and income distributed as compensation is subject to owner's marginal rates).	No—all income taxed at owner's marginal rate.	No—all income taxed at owner's marginal rate.
Can the owner shelter income from self-employment/payroll tax?	No—all income subject to self-employment tax.	Some—only income distributed as salary subject to payroll tax. IRS generally hasn't reclassified dividends as salary.	Some—only income distributed as salary subject to payroll tax, but IRS may reclassify distributions as salary if salary is unreasonably low.	No—all income subject to self-employment tax. This may differ in a multi-member LLC.
Is the owner shielded from the business liabilities?	No.	Yes—exposure generally limited to capital invested.	Yes—exposure generally limited to capital invested.	Yes—exposure generally limited to capital invested.

#### Sole Proprietorship May Be Appropriate When:

- Business has no non-family employees—only workers are contractors or family members.
- There is a relatively low level of risk associated with the business or adequate insurance is available.
- Lenders would require the owner to personally guarantee business debts if business entity was used.
- Business is in early stages and profits are relatively low.

#### Sole Proprietorship May Not Be Appropriate When:

- Business results in exposure to product, environmental, etc. liabilities.
- The business will incur substantial debts to creditors, vendors and suppliers.
- Business has employees whose actions can create liabilities (for example, delivery drivers). Just having employees may make liability protection important.
- The business provides advice or acts as an agent (for example, attorney or psychologist).
- The business's nature is hazardous (for example, toxic chemicals are handled or heavy equipment is used).
- The proprietor would like to transfer ownership in the business to heirs or employees, either by gifting or a sale.
- The business may need additional equity capital to expand.