ABA Tax Section May Meeting
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Elizabeth Stieff, Venable, LLP, Baltimore, MD
efstieff@venable.com

Robb Longman, Longman & Van Grack, LLC, Bethesda, MD
rlongman@lvglawfirm.com

Joseph Schimmel, Cohen, Chase, Hoffman & Schimmel, P.A.
jschimmel@miamitaxlaw.com
EMPLOYEES AND INDEPENDENT CONTRACTORS
Employee v. Independent Contractor

• Facts and circumstances analysis:
  • Whether the worker is required to comply with the other person’s instructions about when, where, and how he or she is to work;
  • Whether the worker is required to engage in specific training;
  • Whether the worker’s services are integrated into business operations and the extent to which the success of the business depends on the performance of certain services by such worker;
  • Whether the services must be rendered personally by the worker;
  • Whether the service recipient hires, supervises, and pays assistants;
  • Whether there is a continuing relationship between the service recipient and the worker;
  • Whether the service recipient establishes set hours of work;
Employee v. Independent Contractor

• Facts and circumstances analysis:
  • Whether the worker must devote substantially full time to the business of the service recipient;
  • Whether the worker performs the work on the premises of the service recipient;
  • Whether the service recipient requires the worker to perform services in a specific order or sequence;
  • Whether the worker must submit regular or written reports to the service recipient;
  • Whether the worker is paid by the hour, week, or month;
  • Whether the service recipient ordinarily pays the worker’s business and/or traveling expenses;
Employee v. Independent Contractor

• Facts and circumstances analysis:
  • Whether the service recipient furnishes significant tools, materials, and/or other equipment to the worker;
  • Whether the worker invests in facilities to be used to perform the services;
  • Whether the worker can realize a profit or suffer a loss as a result of his or her services;
  • Whether the worker performs more than a de minimis amount of services for a number of unrelated persons at the same time;
  • Whether the worker makes his or her services available at the general public;
  • Whether the service recipient has the right to discharge the worker; and
  • Whether the worker has the right to end his or her relationship with the service provider at any time
Employees

• Employer:
  • Must file Form W-2;
  • Must withhold federal and state income taxes from the worker’s wages;
  • Must withhold the employee’s share of payroll taxes (6.2% for Social Security on the employee’s first $128,400 of earnings, 1.45% for Medicare, and an additional 0.9% for the Medicare surtax, if applicable);
  • Must pay the employer’s share of payroll taxes (6.2% for Social Security on the employee’s first $128,400 of earnings and 1.45% for Medicare);
  • Must provide the employee with fringe benefits (to the extent such benefits are available to other employees); and
  • Must pay Federal Unemployment Tax with respect to the employee

• Service Provider – may be eligible for certain other benefits (worker’s compensation, paid time off, parking reimbursements, and unemployment compensation)
Independent Contractors

• Service Recipient:
  • No withholding obligation; and
  • Must file a Form 1099 with respect to any compensation paid

• Independent Contractor:
  • Must pay federal and state income taxes (which may involve estimated tax payments on a quarterly basis) and self-employment tax (at a 15.3% rate, with the 12.4% Social Security tax due on the employee’s first $128,400 of earnings); and
  • Not entitled to any fringe benefits (including health care coverage or other benefits)
Tax Reform

• More of an issue now because of tax reform:
  • Employees cannot take advantage of the Section 199A deduction but independent contractors are eligible
  • Unreimbursed expenses incurred as an employee are not deductible, but unreimbursed expenses incurred as an independent contractor are deductible (due to suspension of the deduction for miscellaneous itemized expenses)

• Note that the Section 199A Regulations provide that an individual that was properly treated as an employee for Federal employment tax purposes and becomes an independent contractor, despite performing substantially the same services, is presumed to be an employee
Misclassification

- Misclassification can lead to significant penalties:
  - Assuming a Form W-2, Wage and Tax Statement, is not filed within by August 1 of the year following the year of service, $250 per Form W-2 (i.e., $250 per misclassified worker per year);
  - 1.5% of the employee’s wages (as a penalty for failing to withhold income tax) (increased to 3% if the applicable information returns were not filed);
  - 20% of the employee’s share of Social Security and Medicare taxes (increased to 40% if the applicable information returns were not filed); and
  - 100% of the employer’s matching Social Security and Medicare contributions

- The employer’s liability is not reduced by the amount of income or employment tax payments made by the employee and the employer cannot recover these taxes from the employee
Section 530 Relief

• Employers/service recipients can avoid liability under Section 530 for misclassifying independent contractors

• To qualify, employer/service recipient must show:
  • The service provider consistently has been treated as an independent contractor;
  • The service provider (or any person providing substantially similar services) was never treated as an employee at any time after December 31, 1977; and
  • The employer/service recipient had a reasonable basis for the classification

• If Section 530 applies, the IRS cannot retroactively reclassify independent contractors as employees and subject the service recipient to employment taxes, penalties, and interests with respect to the misclassification
When is this an issue?

• Initial hiring of service providers;
• Any time the nature or scope of the services provided changes;
• When a service provider wants to change status for tax purposes (i.e., an independent contractor may want to be an employee to get a Form W-2; an employee may want to be an independent contractor to get Section 199A tax benefits);
• When a service provider becomes an owner of the service recipient (i.e., an existing employee of a partnership or disregarded entity who is issued equity in the employer cannot continue as an employee)
STARTING UP
BUSINESS OPERATIONS
Limited Deductibility of Start-Up Costs--§195(a)

• Start-up costs include amounts paid:
  • To investigate creation or acquisition of active trade or business
  • To create an active trade or business
  • In activity engaged in for profit and for the production of income, in anticipation of an active trade or business, before the day the active trade or business begins

• §162(a) generally determines when a trade or business has begun
  • Business must be a going concern, performing those activities for which it was organized
  • Can pharmaceutical research constitute an active trade or business?
  • An acquired business is treated as beginning when acquired. §195(c)(2)(B)
Start-up Costs

• General Rule: No deductibility or amortization of start-up costs. §195(a)

• Taxpayer may elect deductibility of start-up costs:
  • Up to $5,000, reduced by the amount by which start-up costs exceed $50,000 (no deductible portion if total start-up costs exceed $55,000)
  • Deduction is in year that business begins
  • Remainder of start-up costs amortized over 180-month period beginning with month that business begins
  • Start-up costs must be otherwise deductible (not relating to sale of equity)

• If business never begins, no deduction allowed

• Deferred start-up costs deducted in year business ends
Organizational Costs – Partnerships -- §709

• Similar to start-up costs under §195
• Costs to *organize* a partnership are not deductible, unless partnership elects under §709
  • Up to $5,000, reduced by the amount by which organizational costs exceed $50,000 (no deductible portion if total organizational costs exceed $55,000)
  • Deduction is in year that business begins
  • Remainder of start-up costs amortized over 180-month period beginning with month that business begins
  • Start-up costs must be otherwise deductible (not relating to syndication)
Financing the Closely Held Business
Financing the Closely Held Business

• Issuance of Equity Interests
  • Taxation of Investors
  • Taxation of Business Entity

• Issuance of Debt / Borrowing
  • Cost of Issuing Debt
  • Deductibility of Interest
  • Deductibility of Guarantee Fees
  • Effect of Debt on Equity Holders
Taxation of Investors

• Acquisition of equity interests with cash is never taxable to the investor

• Acquisition of corporate stock with appreciated property is a recognition event to the shareholder, unless §351 applies

• Acquisition of corporate stock for services, indebtedness of corporation, or interest on indebtedness is always a recognition event. §351(d).

• Acquisition of partnership interests for property is never a recognition event to the partner. §721.

• Acquisition of partnership interests for services may be a recognition event, if capital account received. See Rev. Proc. 93-27; Treas. Reg. 1.721-1(b); Proposed Regulations under §707(7/23/2015); §83(b)
Taxation of Business Entity

• Gross income of a corporation does not include contributions to capital. §118(a).

• Under TCJA, contributions must generally be by shareholders. Contributions in aid of construction, contributions by governmental entities and civic groups, are included in gross income. §118(b).

• Gross income of a partnership does not include contributions to capital for a partnership interest. §721.

• Contributions to partnership by non-partners are also included in partnership’s gross income, because not covered by §118(a).
Costs of Sales of Corporate Stock

• Cost of issuance of corporate stock is neither deductible nor amortizable. See, e.g., Barbour Coal Co. v. Comm’r, 74 F.2d 163 (10th Cir. 1934)

• Commissions (and other expenses) for issuance of corporate stock are equivalent to the sale of stock at a discount
Partnership Syndication Expenses

• Syndication Expenses are associated with marketing and issuing equity interests.
• Expenses include brokerage fees, legal fees, and offering costs
• Syndication Expenses must be capitalized, and cannot be amortized. Treas. Reg. 1.709-2(a),(b);
Issuance of Debt/Borrowing

• Cost of issuing debt
  • Debt/borrowing is not a §197 intangible, so costs are not amortized over 15 years
  • Generally, costs incurred in connection with debt/borrowing are amortized over the term of the loan
Issuance of Debt/Borrowing

• Interest Deductibility
  • Generally, business interest is deductible. §163
  • Business interest deduction limited to 30% of adjusted taxable income if:
    (a) Average gross receipts of taxpayer exceed $25,000,000; or
    (b) Business is a “tax shelter” under §461(i)(3) (not a C corporation, interests in the business have been registered as a security) ; or
    (c) Business is a “syndicate” under §1256(e)(3)(B). This term sweeps in many partnerships and S corporations, where more than 35% of losses are allocated to passive investors

• Deductibility of Guarantee Fees
Issuance of Debt/Borrowing

• Effect of Debt on Equity Holders
  • Significant differences among C corporations, S corporations, and partnerships
  • C corporation debt has no effect on shareholder basis
  • S corporation debt increases shareholder basis, if shareholder is lender
  • Partnership debt increases partner basis, if qualified nonrecourse debt, or if recourse debt and partner is liable for repayment.
LEASES
Types of Leases

• Real property

• Equipment

• Vehicles
Business Leases

• Two parties to every lease
  • Lessor-Owner of the property being leased
    • Recognizes business income on rents paid
    • May deduct the depreciation of the real property

• Lessee-Business renting the property
  • May deduct rents paid as an expense
  • May not depreciate all improvements made to property
Leases vs. Sale

• Characterization of a sale or lease are based upon numerous factors:
  • Intent of the parties
  • Language of the agreement
  • Conduct of parties
  • Characterization of payments
  • Transfer of title
  • Economic substance of transaction
  • Termination rights
  • Type of Renewal options
Leases with Purchase Options

• Possibly reclassified as installment sale
  • Lessor is then required to record income as return of capital, capital gain and interest income
  • Lessee cannot deduct the payments, but can depreciate, deduct maintenance, taxes and costs associated with the ownership of the property
Factors to Consider

• Payments applied to equity in leased property
• Amount of monthly payments
• Transfer of title upon completion of payments
• Price of option
• The intention of the parties
Examples of Transactions Reclassified as Sales

• Lessee made substantial improvements to the leased property. K.R. Martin V. Commr. 44 TC 731 (1965)

• Title transfers upon payments. Sec. 162(a)(3). Bowen v. Comm’r, 12 TC 446 (1949), Jefferson Gas Coal Co. v. Comm’r, 2 USTC ¶796, 52 F.2d 120 (3rd Cir. 1931)

• Permanent installation of item; payments called lease, but equaled purchase price. Midwest Metal Stamping Co. v. Comm’r, TC Memo 1965-279

• Lessee agreed to equipment lease for term equal to useful life of the property. Nominal payments after third year. Rev. Rul. 55-541
Transactions Classified as Leases

• Lease with alleged below-market purchase option to buy was classified as lease; option was never signed by lessor’s officer, other terms indicated option for FMV. Kanetzke v. Comm’r, TC Memo, 1991-152

• Lessor treated lease with option to buy as lease instead of purchase by treating rent as income and depreciating property. Cubic Corp v. U.S., 541 F.2d 829 (1976)

• Lessee paid rent, repairs, insurance and taxes, had option to buy. Lessor retained title. Option price at the end was same amount if sold to third party after being leased. Rent not applied to purchase price. LTV Corp. v. Comm’r, 63 TC 39 (1974)
Automobile Leases-Special Provisions

• Terminal Rental Adjustment clauses allow for adjustment to the rental payments, which may exceed the value of the leased vehicle. They also allow for the transfer of the liability to the lessor

• Lessee is allowed to deduct the rental payments and expenses associated with the business use portion of the vehicle

• In order to be a qualified motor vehicle lease, the following requirements must be met:
  • The lease is for a motor vehicle
  • Lessor must have a minimum amount of liability (risk) in the vehicle being leased
  • Lessee must state that property being used at least 50% of time for business purposes and that lessee is not treated as owner of vehicle for federal tax purposes
  • Lessor has no knowledge that certification in lease are false
Rental Agreements Subject to Section 467

• Tangible property
• Total rental payments exceed $250,000
  • Calculated by taking the sum of the aggregate amount of payments received as consideration for the use of property, and any other consideration to be received for use of the property
• The agreement will also have increasing, decreasing or deferred rent payments
Effects of Section 467

• Income from 467 rental agreements shall be taken into account on an accrual basis
• Rents shall be accrued in accordance with the agreement
• Interest for unpaid rents shall also be accounted for on the accrual method