Tax Traps for the Unwary Start-up

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For the determined entrepreneur, no challenge is too daunting. Whether the task at hand is raising capital, assembling a management team, or fine-tuning a business plan, entrepreneurs in the start-up phase are constantly encountering and overcoming new obstacles. With all of these components to address, when is the right time to focus on a start-up's tax status and records and what are the key issues at hand?

Forming a Corporation Versus a Limited Liability Corporation (LLC)

If a corporation or Limited Liability Company (LLC) is formed, you may not technically require a tax filing for over a year after the formation date. However, waiting this long to find a tax advisor means you have already made important decisions about the way your business will be taxed without any professional advice. The main difference in the tax implications of forming a corporation and forming an LLC is that the default treatment of taxable income and deductions of an LLC is that of a partnership, in which these tax attributes pass through to their owners and are taxed on the respective owners' tax returns. To avoid the additional level of taxation and the costs associated with forming a corporation, more and more businesses are being formed as LLC's each year; but this is certainly not the preferred structure for every start-up. Forming an LLC can deter foreign and institutional investors, and will also preclude the capital gain exclusions available under Internal Revenue Code Section 1202, which exempts up to $10 million of income for the sale of qualified small business stock.

Determining Employees Versus Independent Contractors

Another hot button issue which deserves some upfront consideration is determining who your employees are, and what payments are truly made to independent contractors. Start-ups that are looking to keep their bottom lines sharp may want to hire more independent contractors in the early stages. Independent contractors will be responsible for paying their own payroll taxes, and also won't be included in any employee benefit plans, such as health and pension plans, so the overall Human Resource capital needed to manage and support contractors is much lower. While the determination is ultimately based on individual facts and circumstances, state labor departments are eager to make sure there aren't any employees that are being paid as independent contractors. When an employee is paid as an independent contractor, the state usually loses out on employment tax revenue such as unemployment fund and disability contributions; so they are eager to make assessments to collect back taxes along with penalties and interest.

Nexus Considerations

In recent years, states have also been aggressively pursuing businesses regarding their nexus, or connection, to the state. Even businesses with no taxable income need to be certain they are registered and filing tax returns in all the necessary states. Many states charge a minimum tax, or franchise fee, for doing business in the state. Without filing a return and remitting this tax, a start-up could be liable for the fee, as well as penalties and interest. Speaking to a tax advisor could help you remain compliant, and provide advice that avoids transactions and activities which lead to nexus.

Seek Professional Advice Early On

For the start-up entrepreneur, there is a never-ending list of tasks that require attention. Many common deductions or credits, such as auto travel, meals and entertainment and research & development, require very specific documentation to satisfy IRS codes and regulations. Simply providing bank statements which show the expenditure may not be enough to qualify for a tax deduction or credit.

Involving tax advisors from day one will ensure that your accounting and tax records are adhering to the rigorous standards required by the IRS.