Entities – the Basis of Tax Strategy

Introduction

When beginning a business, you must decide what form of business entity to establish. Your form of business determines and controls how income and deductions are reported to the government on a tax return. Taxes are not the only factor in determining your entity.
Other factors include:

1. Liability,
2. Type and number of owners,
3. Accounting period and method,
4. Tax rates,
5. Tax year and filing deadlines,
6. Employees and fringe benefits,
7. Deduction of expenses,
8. Investment.
9. Not often considered but a factor as well is the expansion, sale or dissolution of the entity.

Sometimes you have a choice of the type of business organization, other times circumstances limit your choice.

The most common forms of business are the sole proprietorship, partnership, corporation, and S corporation. A Limited Liability Company (LLC) is a business structure allowed by state statute.

- Sole Proprietorships
- Partnerships
- Corporations
- S Corporations
- Limited Liability Company (LLC)

After this session, you will be able to answer the questions:

1. What form of business is not a legal entity?
2. What advantage does an LLC have over a S Corporation?
3. Does a sole proprietorship need an EIN?
4. What tax years are available for a business?

Sole Proprietorship

A sole proprietor is someone who owns an unincorporated business by himself or herself. A sole proprietorship is easy to form and gives you complete control of your business. However, if you are the sole member of a domestic limited liability company (LLC), you are not a sole proprietor if you elect to treat the LLC as a corporation.

1. The sole proprietor has the total ownership of the business.
2. Business earnings and losses are reported on the owner's personal income tax
3. All profits go to the owner.

4. The sole proprietor is not a legal entity separate from the owner. Accordingly, the owner is fully responsible for all debts incurred by the business.
5. Responsible for self-employment tax and employment taxes
6. Files taxes using form 1040

David has a sideline job. He is a computer software engineer for a company as an employee. But David's training was as a graphic designer. He decides to follow his passion and work part-time in the evenings in the gig economy as a graphic designer for profit. He has a couple of clients and no employees. He has a business license and a tax permit.

1. How will David be classified and treated by the IRS?
2. Is David's business treated as a legal entity?

Partnerships

A partnership is the relationship between two or more people to do trade or business. Each person contributes money, property, labor or skill, and shares in the profits and losses of the business. Partners are liable for the debts of the partnership.

There are several forms of partnerships: **general partnerships, limited partnerships, and limited liability partnerships.**

1. A partnership **must file** an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it **does not pay** income tax. Instead, it "passes through" profits or losses to its partners.
2. Each partner reports their share of the partnership's income or loss on their personal tax return.
3. Filing date is the **15th day of the 3rd month** following the end of the tax year.
4. Partners are not employees and shouldn't be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partner.

The **limited partnership** must have at least one general partner with unlimited liability and all other partners have limited liability. The limited partner is not allowed to participate in the management of the business.

The **limited liability partnership** is usually set up by professionals as an alternative to forming an LLC. The limited liability partnership allows the owners to limit their liability to their own acts but shields them from liabilities incurred as a result of other partner actions.

Example

Joan and Irene work as pastry chefs at a bakery in a local market. They both received their culinary arts training at the local junior college. They decide to start their own pastry store in a local shopping center. They each invest in the store to get started. They agree to share in the work and the profits.

1. How will the earnings of the store be reported on their individual tax returns?

Corporations

In forming a corporation, prospective shareholders exchange money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions. For federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. Corporations provide their shareholders with **limited liability** protections.

The Corporation files its taxes using form 1120.

1. A corporation conducts business, realizes net income or loss, pays taxes and distributes profits to shareholders.
2. The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a **double tax**.
3. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.
4. Filing date is **15th day of 4th month** following end of tax year.

S Corporations

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes.

1. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.
2. S corporations are responsible for tax on certain built-in gains and passive income at the entity level.
3. To qualify for S corporation status, the corporation must meet the following requirements:

    - Be a domestic corporation
    - Have only allowable shareholders
        - May be individuals, certain trusts, and estates and
        - May not be partnerships, corporations or non-resident alien shareholders
    - Have no more than 100 shareholders
    - Have only one class of stock
    - Not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations).

4. Filing date is **15th day of the 3rd month** following the end of the tax year.

In order to become an S corporation, the corporation must submit Form 2553 Election by a Small Business Corporation signed by all the shareholders.

Limited Liability Company

A Limited Liability Company (LLC) is a business structure allowed by state statute. Each state may use different regulations, you should check with your state if you are interested in starting a Limited Liability Company.

Owners of an LLC are called members. Most states do not restrict ownership, so members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit "single-member" LLCs, those having only one owner.

A few types of businesses generally cannot be LLCs, such as banks and insurance companies.

Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either:

1. Corporation,
2. Partnership, or
3. As part of the LLC's owner's tax return (a "disregarded entity").

Specifically, a domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it files Form 8832 and affirmatively elects to be treated as a corporation.

For income tax purposes, an LLC with only one member is treated as an entity disregarded as separate from its owner, unless it files Form 8832 and elects to be treated as a corporation.

Date of Election

An LLC that does not want to accept its default federal tax classification, or that wishes to change its classification, uses Form 8832, Entity Classification Election, to elect how it will be classified for federal tax purposes. Generally, an election specifying an LLC's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. An LLC may be eligible for late election relief in certain circumstances.

Question

Both an S Corporation and the LLC offer pass through taxation limit liabilities for owners. What advantage advantages does an LLC confer over S Corporations?

- Flexibility in ownership,
- Inclusion of entity level liabilities in tax basis.

Comparative view

Entity	Establish	Tax Reporting	Management	Liability
Sole Proprietorship	No special requirements. Not a business entity	Reported on Owner Schedule C	Owner responsibility	Owner is personally liable for all debts
Limited Liability Company	Organized under state law	Flow through to owners.	Equal rights unless specified otherwise	Limited liability for owners
Partnership	Organize using written agreement	Tax reporting entity only. Flow through partners are subject to tax	Each partner has rights to manage	Partners joint and severally liable for partnership liabilities
Limited Partnership	Organize by filing with state as a limited partnership	Tax reporting entity only. Flow through to partners.	General partner manages business.	General partner manages business and is personally liable for debts and claims
Limited Liability Partnership	Organize by filing with state.	Tax reporting entity only. Flow through to partners.	All partners are general partners.	All owners personally liable for their own acts, limited liability for partnership as a whole.
C Corporation	Formed under state law, articles of incorporation	Taxed at corporate level, shareholder dividends are taxed	Elected board members, officers appointed	Shareholders liable to extent of investment
S Corporation	Formed using articles of incorporation, elect S status	Reporting only for corporation, flow through to owners	Elected board members, officers elected	Shareholders liable to extent of investment

Entity Election

In 1996, the IRS introduced the Check the Box Regulations. The Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate or noncorporate characteristics.

1. Under the check the box rules noncorporate entities with more than one owner can elect to be classified as either a partnership or a corporation.
2. An entity with only one owner can elect to be classified as a sole proprietorship or a corporation.

Eligible entities make the election as to tax status by filing **form 8832**.
In the event of a **default- no election is made-** multi owner entities are classified as partnerships and single person businesses as sole proprietorships.
The election is not available to entities that are actually incorporated under state law. However, the entity maybe eligible to be taxed as an S Corporation.

Employer Identification Number

An Employer Identification Number (EIN) is also known as a Federal Tax Identification Number, and is used to identify a business entity. Generally, businesses need an EIN.

1. Do you have employees?
2. Do you operate your business as a corporation or a partnership?
3. Do you file any of these tax returns: Employment, Excise, or Alcohol, Tobacco and Firearms?
4. Do you withhold taxes on income, other than wages, paid to a non-resident alien?
5. Do you have a Keogh plan?
6. Are you involved with any of the following types of organizations?
    a. Trusts, except certain grantor-owned revocable trusts,
    b. IRAs,
    c. Exempt Organization Business Income Tax Returns
    d. Estates
    e. Real estate mortgage investment conduits
    f. Non-profit organizations
    g. Farmers' cooperatives
    h. Plan administrators

Need a New EIN

Generally, businesses need a new EIN when their ownership or structure has changed. Although changing the name of your business does not require you to obtain a new EIN.

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1, Does David need an EIN?

Sole Proprietors and EIN's

You **will be** required to obtain a **new EIN** if any of the following statements are true.

- You are subject to a bankruptcy proceeding.
- You incorporate.
- You take in partners and operate as a partnership.
- You purchase or inherit an existing business that you operate as a sole proprietorship.

You **will not** be required to obtain a new EIN if any of the following statements are true.

- You change the name of your business.
- You change your location and/or add other locations.
- You operate multiple businesses.

Question: what circumstance requires a new EIN?

a. Change the location of your business
b. You incorporate from a sole proprietorship
c. As an existing entity you are electing S Corporation status.

Accounting Periods

You must use a tax year to figure your taxable income. A tax year is an annual accounting period for keeping records and reporting income and expenses. An annual accounting period does not include a short tax year.

You can use the following tax years:

• A calendar year; or
• A fiscal year (including a 52-53-week tax year).

Unless you have a required tax year, you adopt a tax year by filing your first income tax return using that tax year

Calendar Year: A calendar year is 12 consecutive months beginning on January 1st and ending on December 31st. If you adopt the calendar year, you must maintain your books and records and report your income and expenses from January 1st through December 31st of each year.

Fiscal Year: A fiscal year is 12 consecutive months ending on the last day of any month except December 31st. If you are allowed to adopt a fiscal year, you must consistently maintain your books and records and report your income and expenses using the time period adopted.

52-53-Week Tax Year: You can elect to use a 52-53-week tax year if you keep your books and records and report your income and expenses on that basis.

1. If you make this election, your 52-53-week tax year must always end on the same day of the week. Your 52-53-week tax year must always end on:
    - Whatever date this same day of the week last occurs in a calendar month, or
    - Whatever date this same day of the week falls that is nearest to the last day of the calendar month.

Short Tax Year

A short tax year is a tax year of less than 12 months. A short period tax return may be required when you (as a taxable entity):

1. Are not in existence for an entire tax year, or
2. Change your accounting period.

Tax on a short period tax return is figured differently for each situation. Income tax for a short tax year may be annualized. However, self-employment tax is figured on the actual self-employment income for the short period. Generally, you must file Form 1128 to request IRS approval to change your tax year

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1. What does David need to do to adopt a tax year?

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported on your tax return. Your accounting method includes not only your overall method of accounting, but also the accounting treatment you use for any material item.

You choose an accounting method when you file your first tax return. If you later want to change your accounting method, you must get IRS approval.

No single accounting method is required of all taxpayers. You must use a system that clearly reflects your income and expenses and you must maintain records that will enable you to file a correct return. In addition to your permanent accounting books, you must keep any other records necessary to support the entries on your books and tax returns.

Methods you can use.

Generally, you can figure your taxable income under any of the following accounting methods.

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- A hybrid method which combines elements of two or more of the above accounting methods.

Cash method.

Most individuals and many small businesses use the cash method of accounting. Generally, if you produce, purchase, or sell merchandise, you must keep an inventory and use an accrual method for sales and purchases of merchandise.

Under the **cash method**, you include in your **gross income**:

1. All items of income you actually receive during the year
2. All items you constructively receive during the tax year
3. If you receive property and services, you must include their fair market value (FMV) in income.

Constructive receipt.

1. Income is constructively received when an amount is credited to your account or made available to you without restriction.
2. You do not need to have possession of it.
3. If you authorize someone to be your agent and receive income for you, you are considered to have received it when your agent receives it.
4. Income is not constructively received if your control of its receipt is subject to substantial restrictions or limitations

   Example. You are a calendar year taxpayer. Your bank credited, and made available, interest to your bank account in December 2021. You did not withdraw it or enter it into your books until 2022. You must include the amount in gross income for 2021, the year you constructively received the interest income.

   Question: when do you recognize prepaid rent?

Expenses

Under the **cash method**, generally, you deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may not be able to deduct an expense paid in advance. Instead, you may be required to capitalize certain costs.

1. Expense paid in advance is deductible only in the year to which it applies,
   a. unless the expense qualifies for the 12-month rule. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following.
2. 12 months after the right or benefit begins, or
3. The end of the tax year after the tax year in which payment is made.

   Example. You are a calendar year taxpayer and pay $3,000 in 2021 for a business insurance policy that is effective for 3 years (36 months), beginning on July 1, 2021. The general rule that an expense paid in advance is deductible only in the year to which it applies is applicable to this payment because the payment does not qualify for the 12-month rule. Therefore, only $500 (6/36

x $3,000) is deductible in 2021, $1,000 (12/36 x $3,000) is deductible in 2022, $1,000 (12/36 x $3,000) is deductible in 2023, and the remaining $500 is deductible in 2024.

Example 2. You are a calendar year taxpayer and pay $10,000 on July 1, 2021, for a business insurance policy that is effective for only 1 year beginning on July 1, 2021. The 12-month rule applies. Therefore, the full $10,000 is deductible in 2021.

Accrual method.

Under an accrual method of accounting, you generally report income in the year it is earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

Income. Generally, you include an amount in gross income for the tax year in which all events that fix your right to receive the income have occurred and you can determine the amount with reasonable accuracy.

Under this rule, you report an amount in your gross income on the **earliest** of the following dates:

1. When you receive payment.
2. When the income amount is due to you.
3. When you earn the income.
4. When title passes.

Expenses.

Under an accrual method of accounting, you generally deduct or capitalize a business expense when both the following apply:

1. The all-events test has been met. The test is met when:
   - All events have occurred that fix the fact of liability, and
   - The liability can be determined with reasonable accuracy.
2. Economic performance has occurred.

Hybrid method.

Combines elements of two or more of the above accounting methods

1. Inventory – Accrual method for purchases and sales
2. Cash Expenses reporting uses cash method
3. Each business can be independent in method used.

Question: if you use the cash method for income, may you use the accrual method for expenses?

Note: Changes to cash method of accounting for some businesses due to the Tax Cuts and Jobs Act.

Small business taxpayers with average annual gross receipts of $5 million or less in the prior three-year period may use the cash method of accounting. Revenue Procedure 2018-40.