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Business Tax Structure 101

Selecting the Right Entity Type for Your Business

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Objectives

After viewing this webinar, participants will be able to do the following:

- Identify each entity type
- Recognize the pros and cons of each entity type
- Determine when to make an S-Corp election
- Explain how to appropriately compensate owners within the reasonable compensation rules
- Define Qualified Business Income (QBI)
- Understand the QBI deduction



Ground Rules

- Tax advice vs Legal advice
- Federal rules vs State rules



Entity Types



Entity Types

5 most common business structures

- Sole Proprietorship
- Partnership
- C-Corporation (C-Corp)
- S-Corporation (S-Corp)
- Limited Liability Company (LLC)



Pros and Cons



Pros and Cons

Sole Proprietorship

- Pros
 - Easy to start up
 - No need for formal meetings, bylaws, etc.
 - Tax filing is not as complex
 - Schedule C on personal tax return
- Cons
 - No personal liability protection
 - No separation between owner and business
 - Subject to self-employment tax



Pros and Cons

Partnership

- Pros
 - Involves two or more people
 - No need to register with the state (but do)
- Cons
 - Additional tax return to be filed
 - Each partner could be personally liable, depending on subset choice of partnership (GP, LP, LLP)
 - Potential loss of autonomy
 - Subject to self-employment tax



Pros and Cons

C-Corporation

- Pros
 - Independent legal entity
 - Separate from owners
 - Autonomy
 - Tax deductions for fringe benefits
 - Flat income tax rate
- Cons
 - Complex to set up and maintain
 - Double taxation
 - Reasonable compensation rules



Pros and Cons

S-Corporation

- Pros
 - Independent legal entity
 - Preserves limited liability protection
 - Pass-through entity for tax purposes
 - No double taxation
- Cons
 - Complex to set up and maintain
 - Size limits
 - Class of stock limits
 - Reasonable compensation rules



Pros and Cons

Limited Liability Company (LLC)

- Pros
 - Hybrid model
 - Limited liability protection
 - Fewer maintenance requirements
 - Flexible choice for tax structure
- Cons
 - Must register within the state



What is the Best Choice?



Best Choice?

It depends...

- Example: What is your 'business'?
 - Selling coffee mugs on Etsy that you hand made in your garage...
 - Selling gourmet coffee in select locations across western Montana, setting up your own roasting facility, 15-20 employees...
 - Coffee shops on every corner across the country, 10,000+ employees, public company...



Should I be an S-Corp?



S-Corp?

Three important questions to help answer this:

1. How are you currently structured?
2. Do you/will you have employees?
3. What is your net taxable income?

Note: S-Corps are often set up for self-employment tax savings, not necessarily to reduce federal and state income tax



S-Corp?

Example:

Sole Proprietorship

Gross Income: \$150,000

Expenses: \$80,000

Owner Comp: n/a

Net Income: \$70,000

Taxable Income: \$70,000

Income Tax: \$14,000

S/E Tax: \$10,500

TOTAL: \$24,500

S-Corporation

Gross Income: \$150,000

Expenses: \$80,000

Owner Comp: \$45,000

Net Income: \$25,000

Taxable Income: \$70,000

Income Tax: \$14,000

S/E Tax: \$6,750

TOTAL: \$20,750



Compensation Rules



Compensation Rules

Owner Compensation

- No wages or Form W-2 is issued for the owner if entity is a:
 - Sole Proprietorship
 - Partnership
 - Partners are compensated with guaranteed payments
 - For services provided for the partnership
 - Subject to self-employment tax
 - LLC that has not elected to be taxed as a corporation
- Wages or Form W-2 is issued for the owner if the entity is a:
 - S-Corp
 - Compensation must be reasonable (not too low)
 - C-Corp
 - Compensation must be reasonable (not too high)



Compensation Rules

Reasonable Compensation

- There is no bright line...
- IRS tells us to look at the three major sources that generate a business' gross receipts
 - Services of shareholder
 - Services of non-shareholder employees
 - Capital and equipment
- Also be sure to account for any administrative work
- Ask “What would I pay someone to do my job?”
- Consider retirement contribution planning



Qualified Business Income (QBI) and the QBI Deduction



QBI and the QBI Deduction

QBI Deduction (§199A)

- 20% deduction (not 20% tax rate)
- Not permanent (2018 to 2025)
- Not applicable to C-Corps
- Various limitations and restrictions:
 - Taxable income
 - Adjusted gross income thresholds
 - Type of business
 - Wages paid*
 - Business assets



ANY QUESTIONS?

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