



Business Entities: Taxation

Course #3105B

Taxes

2 Credit Hours

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BUSINESS ENTITIES: TAXATION

This course covers some of the tax impacts when choosing between various business entities.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Taxation of Business Entities

Study the course materials from pages 1 to 62

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify some of the tax impacts when choosing between various business entities

NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

TABLE OF CONTENTS

| | |
|--|-----------|
| Chapter 1: Taxation of Business Entities | 1 |
| I. Self-Employment Tax | 2 |
| A. DEFINITION OF “SELF-EMPLOYED” | 2 |
| II. Sole Proprietors | 3 |
| III. Required Forms | 4 |
| IV. Disregarded Entities: The Limited Liability Company | 5 |
| A. HISTORICAL TREATMENT | 5 |
| B. FEDERAL TAX RETURNS | 7 |
| C. EMPLOYMENT AND SELF-EMPLOYMENT TAXES | 8 |
| D. EMPLOYEE IDENTIFICATION NUMBER | 9 |
| F. RETAINED EARNINGS | 14 |
| G. TAXATION OF A CONVERTED ENTITY | 15 |
| H. STATE TAXES AND FEES | 20 |
| V. Partnerships | 21 |
| A. SEPARATELY STATED ITEMS | 21 |
| B. ELECTIONS | 22 |
| C. ORGANIZATION EXPENSES AND SYNDICATION FEES | 22 |
| VI. Taxation of Corporations | 24 |
| A. INCOME TAX RETURN | 24 |
| B. INCOME AND DEDUCTIONS | 25 |
| C. GOING INTO BUSINESS | 30 |
| VII. Subchapter S Corporations | 33 |
| A. RIGHT TO OFFSET OTHER INCOME | 34 |
| B. TAX ON EXCESSIVE PASSIVE INVESTMENT INCOME | 34 |
| VIII. Passive Activity Limitations | 39 |
| A. PASSIVE ACTIVITY LIMITS | 40 |
| B. AT-RISK LIMITS | 48 |
| IX. Note on Fringe Benefits | 56 |
| Chapter 1: Test Your Knowledge | 58 |
| Chapter 1: Solutions and Suggested Responses | 60 |
| Glossary | 63 |
| Index | 65 |

CHAPTER 1: TAXATION OF BUSINESS ENTITIES

Chapter Objective

After completing this chapter, you should be able to:

- Identify some of the tax impacts when choosing between various business entities.

Taxes are certainly a huge consideration in a choice of entity. While federal taxes are one of the largest considerations, state taxes and fees can also play an important role in choosing an appropriate entity. Because state law treatment varies so significantly, a detailed discussion is beyond the scope of this course. However, it will be referred to in a few select areas, particularly in considering limited liability companies.

For purposes of federal tax, the law sets forth three basic models of taxation of businesses and individuals: subchapter C, subchapter K and subchapter S. Subchapter C applies to corporations. It imposes an entity level tax on the corporation as well as a tax on individual shareholders who receive corporate distributions (i.e., dividends).

TABLE 10.1 BUSINESS FORM AND TAXATION: ADVANTAGES AND DISADVANTAGES

| Business Form | Advantage(s) | Disadvantage(s) |
|----------------------------------|--|---|
| Sole Proprietorship | No “double taxation”; income reported on individual return | Owner pays twice the amount of social security and Medicare tax than he would as an employee |
| Limited Liability Company | IRS “check-the-box” regulations allow entity to choose federal tax treatment | Active members subject to self-employment tax for social security and Medicare |
| Partnership | No “double taxation”; income taxed proportionately to each partner on their own personal returns | No personal limited liability protection for general partners |
| S Corporation | May elect to be treated similar to a partnership for purposes of federal taxation, so income is “passed through” to shareholders | Shareholders entitled to only limited employee benefits; limited to no more than 100 shareholders |
| C Corporation | Corporate tax rate does not go as high as individual tax rate; health insurance and group life insurance premiums (up to certain amount) are fully deductible and not taxable to employees | Shareholders not entitled to deduct the losses of the corporation; “double taxation” |

Subchapter S status is available to C corporations that meet certain strict statutory requirements. It allows shareholders or relatively small corporations to avoid entity-level taxation: similar to partnership treatment, all of the profits and losses of the corporation are passed through to the individual shareholders.

Finally, subchapter K applies to partnerships, limited liability companies and certain other unincorporated entities. Like S corporations, owners are allowed to elect pass-through taxation. Partnerships are not subject to the income tax. However, a partnership is required to file Form 1065, which reports the results of the partnership's business activities. Individual partners pay taxes on their individual returns.

The partnership net profit (loss) and the separately reported items are allocated to each partner according to the partnership's profit sharing agreement, and the partners receive separate K-1 schedules from the partnership. Schedule K-1 reports each partner's share of the partnership net profit and separately reported income and expense items. Each partner reports these items on his or her own tax return.

The two types of federal taxation that are most frequently considered in making a choice of entity are income tax and self-employment tax. Rules regarding income taxation of specific entities will be discussed below. Following is a discussion of self-employment tax and its application in choice of entity.

I. SELF-EMPLOYMENT TAX

Self-employment tax is a social security and Medicare tax that mainly affects persons who work for themselves. Many people consider ways to avoid self-employment taxes when considering a choice of entity. The reason is that the self-employment tax rate is 15.3%. This rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). There is, however, a cap on the amount of income that is subject to the social security tax. In 2021, the first \$142,800 of combined net earnings was subject to social security tax. All net earnings of at least \$400 are subject to the Medicare part.

Taxpayers can deduct half of their self-employment tax in figuring adjusted gross income; however, the adjustment does not affect the amount of self-employment tax actually owed.

A. DEFINITION OF “SELF-EMPLOYED”

The IRS considers the following groups of people to be self-employed and therefore subject to self-employment tax:

- Persons who carry on a trade or business as a sole proprietor or an independent contractor; and
- Members of a partnership that carries on a trade or business; and
- Persons who are otherwise in business for themselves.

A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. The regularity of activities and transactions and the production of income are important elements. You do not

need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.

1. Part-time Business

Individuals do not have to carry on regular full-time business activities to be self-employed. Having a part-time business in addition to a regular job or business may also constitute self-employment.

Example



John is employed full time as an engineer at the local plant. He fixes televisions and radios during the weekends. John has his own shop, equipment, and tools. He gets his customers from advertising and word-of-mouth. John is self-employed as the owner of a part-time repair shop.

2. Sole Proprietor

An individual is a sole proprietor if he or she owns an unincorporated business alone.

3. Independent Contractor

People such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. However, whether these people are independent contractors or employees depends on the facts in each case and the law in each state. California, for example, recently implemented legislation making it difficult to classify workers as independent contractors. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. The earnings of a person who is working as an independent contractor are subject to self-employment tax.

An individual is not an independent contractor if they perform services that can be controlled by an employer (what will be done and how it will be done). This applies even if the individual is given freedom of action. What matters is that the employer has the legal right to control the details of how the services are performed.

If an employer-employee relationship exists (regardless of what the relationship is called), an individual is not an independent contractor and their earnings are generally not subject to self-employment tax. However, their earnings as an employee may be subject to self-employment tax under other rules discussed in this section.

II. SOLE PROPRIETORS

A sole proprietorship has no existence separate and apart from its owner. It does not file a tax return and is not liable for taxes. The proprietor himself is liable for all of the profits and losses of the business.