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## BENEFITS

Now is an excellent time to review how your clients' legal structure affects their business and personal taxes. Let's look at the types of entities, how taxes are filed, and when clients should consider changing their entities.

**Nellie Akalp** • Apr. 24, 2023



*By Nellie Akalp.*

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different filing deadlines:

- May 15<sup>th</sup>: designated storm areas in New York
- July 31<sup>st</sup>: designated disaster/storm areas in Mississippi and Arkansas
- October 16<sup>th</sup>: disaster-affected areas in Alabama, California, and Georgia

**When to change:** Although there's no exact demarcation for when your sole proprietor clients should change entities, in general, any business growth should spur a conversation between accountant and client. Some scenarios:

- Bringing on a partner changes the sole proprietorship to a general partnership as far as the Internal Revenue Service (IRS) is concerned (with the assets and liabilities shared equally). However, the legally binding partnership agreement may outline a different partnership equity. For example, partnerships may consist of all general partners or a mix of general partners (those involved in the business's operations) and limited partners, which offers limited partners some liability based on their investments.
- To obtain liability protection, a sole proprietor may decide to form a limited liability company (LLC) by registering with the state. Unlike a sole proprietorship, an LLC protects the owners' personal assets in case of a lawsuit or debt. The LLC owners (called members) also report business profits and losses on their individual income taxes.
- A sole proprietor can also become a C Corp, a choice necessary if your client wants to raise money by attracting investors. Also, many sole proprietors decide to incorporate before hiring employees who may jeopardize the company by making costly mistakes. The "corporate shell" protects the owners from the potential errors made by the company and its employees.

## Partnerships

Business taxes are passed through to partners like in a sole proprietorship since there

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Partnerships are also subject to this rule.

For filing season 2022, the Treasury Department and the IRS updated the 1065 partnership form to simplify the computation of deductions and credits and how partners compute their federal income tax liability.

**When to change:** Again, the most significant reason partnerships may want to incorporate into an LLC or C Corp is to protect their personal assets from the debts and legal actions of the company.

- Partnerships choosing the LLC route file with the state as a “multi-member LLC” and are held to their state’s governance regarding LLCs. The IRS considers partnerships and multi-member LLCs “disregarded entities,” which means members/owners report their share of company profits and losses on their personal tax returns. The difference is the protection from personal liability for the business’s debts.
- Partners choosing to form a C Corp will become company employees and receive protection from the business’s liabilities; however, they will also be doubly taxed —once on the corporation’s income and then on their salaries as employees. Still, becoming a C Corporation allows your clients to take their companies public, offer an unlimited number of shares, and pay the federal flat corporate income tax rate of 21%.
- Another option for partners incorporating as an LLC or C Corp is to elect S Corp status through the IRS. For partnerships hoping to save on federal taxes by lowering their employment taxes, the S Corp election allows the business’s profits to be divided between salaries and dividends. As a result, owners save money because employment taxes are not due on the shareholders’ dividends, and the owners still maintain liability protection from the corporation’s debts or liabilities.

- S Corps, however, can only offer one class of stock and not have more than 100

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**When to change:** As we've already covered, an LLC can be taxed as an S Corp to save on employment taxes. Another option for the LLC is to elect to be taxed as a C Corp. If your client's goal is to receive private equity money or venture capital, the C Corp tax election is a good idea. Your client's LLC files Form 8832, which notifies the IRS it wishes to elect C Corp taxation for their LLC.

There's a difference between claiming the C Corp tax election and actually converting from an LLC to a C Corp. Conversion requires the owners to form a corporation with the Secretary of State, transfer the liabilities and assets to the C Corp, and dissolve the LLC. They must also obtain a new federal tax ID number or Employer Identification Number (EIN) from the IRS.

The downside for your clients is the double taxation and increased corporate compliance requirements such as board meetings, annual reports, and additional paperwork. Nonetheless, many LLCs see the potential to attract investors worth the extra work.

## C Corporations

A C Corporation is a separate legal entity from its owners and files separate tax returns. C Corporations must issue a W-2 to their owners, who are considered employees. Corporations must file IRS Form 1120 (U.S. Corporation Income Tax Return) and pay estimated taxes if the estimated tax is more than \$500. There is a flat tax rate of 21% on corporate income.

**When to change:** As previously covered, electing S Corp status with the IRS can save shareholders/owners on employment taxes and avoids double taxation.

- Your clients should be aware, however, of the potential "big tax" applied to S Corps, which inherited assets from a C Corp. If an S Corp sells its assets within five

years, shareholders are subject to built-in gains tax on the asset sale. In addition,

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dissolving the corporation and reforming the company as an LLC. It's vital that your clients also check with their attorneys about the state regulations on how assets, liabilities, and stock shares must be transferred to make the conversion legal.

*Nellie Akalp is a passionate entrepreneur, business expert, and mother of four. She is the CEO of [CorpNet.com](#), a trusted resource and service provider for business incorporation, LLC filings, and corporate compliance services in all 50 states. Nellie and her team recently launched a partner program for accountants, lawyers, and business professionals to help them streamline the business incorporation and compliance process for their clients.*

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