# CDB Section 7 - Taxes

The only thing certain in life is death and taxes, and that's what we're going to be talking about here in CDB, section seven. Welcome and congratulations for getting through section six. Now, obviously, I don't want you to become a tax professional with what we're about to chat about here. Some of you I know also are tax professionals, and I congratulate you. I don't know how you can keep two hats on at once like that, you are much smarter, and can retain a lot more information than me. What I want to do here is just to make sure that you understand the impact of taxes, and we're talking about U.S. taxes here within this section. If you're listening to this, and you're Canadian, or from another province, then you're in the wrong section. You should not be in this one. This is related to U.S. taxes only.

Here are the objectives. We want to recognize differences between the entity types, and how it affects the tax liabilities. Income tax liabilities, there's a lot of varying things, and we'll talk about those here. Again, I know that you probably have a good working understanding of this, and we're not trying to make you a tax pro. What we're trying to be able to do is to understand how we explain things, simple concepts, as it relates to taxes, and how we really push our clients over to the tax professional when it comes to very specific matters, as it relates to their taxes. Second objective, identify responsibilities surrounding the need, and the issuance of 1099s. That's a big hot button with the IRS these days.

Number three, understand your relationship to the tax preparer, and what advice that you can, and cannot give, or should and should not give to your client, and then, finally, determine how fixed assets deductions, and non-income taxes affect the bookkeeping, because we also know one of the challenges is that sometimes we get stuff back from the tax preparer, they've made changes to the QuickBooks file. We want to go out there, and become, fretty, and we can't do that, so we're going to talk about some of those differences, and how we prevent those, but let's start off with a very fun topic here, and talk about the different entities.

First and foremost, and we're going to kind of go through, in terms of complexity. We have a sole proprietor. If we've not formed an entity, our client has not formed an entity, then by default, if it's just us, we are a sole proprietor. In this case, an owner of a sole proprietor does not take payroll. The owner files what's called a Schedule C on their personal income tax return, 1040. They pay income tax, they pay Medicare, social security on basically the net taxable income that's derived on what is called a Schedule C of IRS form 1040. There's a lot of taxes, layers, self-employment tax, all that good stuff.

Now, if they form an LLC, and it's just them, that's what's known as a single member LLC, one individual. The owner again, does not pay payroll tax unless they have elected to be an S-Corporation, so if you have a single member LLC, they may make a determination under what's called IRS form 2553 to be an S-Corporation. Aren't you glad that you came to this class just to learn that form number? But the owner is going to file a Schedule C again on their personal tax return, just like a sole proprietor. Now, this is a separate legal entity. It is recognized by the state in which they have formed this entity, but the IRS has basically said,

"Hey, to reduce the paperwork, then we just want you to file on your personal income tax return this Schedule C, if you're a single member LLC."

Or, "If you're spouses, and proactively elect, if you're the two members, then you can still file it underneath the 1040." That's the only exception. Now, if we have a multi-member LLC, which means more than one, and it's not a spouse, or we haven't made that election, or we are a partnership, then the members, or partners are paid depending on how they are taxed. They could get guaranteed payments, they could get distributions, but they're not going to get a W2. They should not get a W2, and then, at the end of the year, the partners, and I should say, members are going to receive, what's called a K-1 statement that shows the flow through items, because these LLCs and sole proprietors, whether it's multi-member, or single member LLC, or partnership, they don't pay tax at the entity level, typically.

There are some oddball cases where they could, but 99.99999 of the time, they're not going to pay tax at the entity level. All of the income, or losses is passed through, that's why it's called a pass-through entity, is passed through to the partner, or the member, or the shareholders, we'll talk about here in S corps, through what's called a K-1. That K-1 is then taken, and the information is off of that, put on to their personal tax return. Now, S-Corporations, let's get one thing out of the way. If I were to go out and form a corporation today, the state doesn't care, the state secretary of state, or whoever ordains me to be a corporation doesn't care if I'm an S-Corporation or C-Corporation.

The difference between an S and a C-Corp is only for tax purposes. It's only recognized by the IRS, and, or maybe a state governing tax body, so certain states make you also make an election, but it's just an election for tax purposes. The owner here in an S-Corporation will typically be on payroll, and I'll say, typically, if they've not made any money, if they're not active, there could be some extenuating circumstances where they would not be on payroll, but they are typically going to be on payroll. They're going to be on reasonable compensation. Meaning if they hired somebody to do the job that they do, what would they have to pay them? That's kind of a short version for what reasonable payroll is.

A lot of times we see S-Corporations trying to Hoodoo the government saying, "Hey, I'm a dentist. I'm making $300,000 a year, but I'm only going to pay myself $30,000 in terms of my salary." The IRS, if they were to catch him, is going to go, "Nope, because you'd have to pay somebody else $150,000. Guess what? Pay up." That's what's going to happen there. Also, the S-Corporations, there could be an expense reimbursement if there's what's called an accountable plan, which we'll talk about here in a second. Underneath this, the owner's equity is called shareholders equity, because this is a corporation if it is formed as a corporation. Now, here's one of the big misconceptions, if it is formed with the state as an LLC, and it makes an election to become an S-Corporation that is for income tax purposes only, and those financial statements should be reflective of an LLC.

It shouldn't say shareholder's equity, because there ain't no such thing as a shareholder. It's just made for income tax purposes, so if that's not enough to confuse you, welcome to the club. And then, finally, we're going to go out here, and talk about finally, if I can get my slide to move

over here, S-Corporations, this is the only one. Everything else above this is what's called a flow through or pass through entity. Meaning that entity itself is not going to pay taxes. Things just flow through that to the individual shareholder, member, or partner. A C-Corporation is different. By default, if I go out today, and I form a corporation with the state of Georgia, and I don't proactively make an election to be an S-Corporation, or I don't qualify, then I'm going to be a C-Corporation, which means the corporation is taxed.

And then, I, as the owner am going to be taxed on certain elements like my salary, and if I take any cash, or property dividends. So in this case, the owner is typically going to be on payroll. The tax again is at the business level. There is a corporate income tax. The entity, if they're taxable is going to have to make estimated tax payments, and again, just like with an S-Corporation, owners' equity is called shareholders equity. Again, the owner might receive cash dividends, property dividends. That's not typical. C-Corporations have become a little bit more in vogue these last few years, because in the U.S. the tax rates have dropped to 21%, whereas before they were higher, 35%, and even above that. In some cases, 38%, but they've become a little bit more in vogue. It's important that we understand if a client elects that.

Really the way that we do this is when we bring on a client, we're getting that information that shows us their entity formation paperwork with the state that shows, "Hey, you're an LLC." And then, maybe an S-Corp election that's approved by the IRS, and their CP-575, which shows their identification number. All this stuff is things that we should gather as documentation when we're taking on a new client to confirm the type of entity level, because we don't want to be thinking that they're one, and then, we go, and then, gets tax returns, and they are something else. Again, we're not the tax preparers here, but we want to make sure that we're doing everything in our power to make the clients, and the tax preparer's job as easy as possible when it comes to year end, so that's a brief overview of entities.

Now, let's talk about old form 1099s. When are these supposed to be issued? Well, they're supposed to be issued to contract labor and services paid over $600, and for rent in one year. Let's say it's December of 2022, or we've just gone through 2022. By January 31st of 2023, and let's say that I paid a contractor one $1,100. I'm supposed to issue that contractor a form 1099, because I paid that person over $600. It's important that we get those sent out. Again, this is one of those things that the IRS is making sure and cracking down on, because this is helping people to avoid paying taxes, because the IRS can't track the money going from an entity, or an individual to another individual.

Who is supposed to receive a 1099? Well, any LLCs not taxed as corporations, sole proprietors and attorneys. Unless that's a corporate entity, you're going to need to issue, or your client's going to need to issue a 1099. Again, if you're in doubt, and I'll show you in the next step where you'll know for sure, but if you are in doubt issue the 1099. I'm just going to go off here on a little bit of a tangent. Before your client ever starts working with a contractor, they should receive what I've got right here, that's a W-9. I put request a W-9 from vendors, I would say require a W-9 from vendors. As a best practice, I'm going to start working with a new vendor. Great, that's cool. Hey, before you start work, I got to have this W-9 filled out.

That W-9 is going to show the entity name, or the individual's name, their address, their social security number, or their tax ID number. I need to have that information. Guess what? I'm not going to get that information January of 30th next year, when I'm no longer working with that person, I can't find them. I'm scurrying around trying to get their tax ID number, or their social security number, and now I'm going to get hassled by the IRS, because I don't have that. That's why it's best practice to have the W-9 upfront before they ever start work so that you already have that information, that you keep it on file, that it’s part of the permanent documentation.

Now, let's talk about these questions around, "Hey, is it a 1099, is it contract labor, or is it an employee?" Well, the IRS, the government, and the Department of Labor in some other places, determine really who is an employee versus a contractor. I'm not going to go through all of those here, but there are resources that the IRS has, flowcharts. Most of the time when I've seen these cases, people are in fact employees, but they're being paid as 1099s. Again, this is one of those hot buttons that the IRS is pressing, because people need to be classified properly. We are certainly not the police, but we need to be the ones that are making our client aware, "Hey, this relationship is really an employee." So, I want to make sure that if the IRS comes in here, or the Department of Labor, that you don't get busted.

How do they get busted? They let go of the contractor. The contractor goes to the state for unemployment. The state says, "Hey, we don't show you as an employee. Tell us what's up?" That contractor says, "Hey, yeah, I went into the office, I did this. They gave me a computer, did blah, blah, blah." The state goes, "You sound like you were an employee." Now, they go back and reclassify. Ask me how I know? I've seen this happen to client’s time and time again. Again, this is not meant to be a comprehensive explanation of everything taxes, but just want to make you aware. Now, let's talk about your relationship to the tax preparer, because it's important as we talk about that we have a solid relationship with all the other professionals within the portfolio of the clients that we're working for.

How do we help? Well, first and foremost, we record all the expenses, even if they're not deductible to the business. One of the things that I like to do on a practical basis is to tag, or to assign to a class, a list of any questionable transactions, or ones that I know that I need to speak with the tax preparer about, or ones that I know the tax preparer needs to look into. If I tag those as tax, I can pull that list up or the tax preparer if they have access to the QuickBooks Online, or whatever bookkeeping application. They can pull that up, and look at things. That's just a best practice that makes it easier for them, that's how we help. Also, getting those expenses recorded into the right category, recording depreciation, recording new fixed asset purchases, putting details about those fixed asset purchases in there, keeping up with all of that data.

They're going to need access to certain records. Most of the time and practical purposes, a tax preparer is going to be accessing their bookkeeping application, so if your client's using Xero, QuickBooks Online or something else, they're probably in there as a user, so that they can pull the information that they need, which would include a balance sheet, an income statement, and the general ledger. Also, I like to have a little conversation with the tax preparer to go,

"Hey, I want to make sure that you went through this, let me show you the relevant transactions to the things." Obviously, always getting written permission from our client before we ever start working with a tax preparer, or anybody else for that matter. Make sure that you don't just start carte blanche, talking to people.

We've got to have the express written permission of our clients to actually go in and start doing that. Again, that's what I have right here, the confidentiality. Now, here's one crazy thing. People think, "Oh my gosh, you know what? I keep my books on cash basis, so therefore, I can't keep my books on the accrual basis." Well, that's phooey. That's the whole reason that the IRS created M1. There's nothing that says that I can't keep my books on the accrual basis, and then, if I qualify all things being equal, I can do my taxes on the cash basis. That's just phooey. I hear this from CPAs, and from tax preparers all the time, "Why did you switch to accrual? You can't do that." Yeah, you can. There's just a difference, a book to tax difference that you have to record, stop being a lazy tax preparer, and do your work, do your job.

Again, more information for the tax preparer, what can we gather from them? Starting balances. Now, we're going to be able to pull these off of Schedule L, if they file an 1120-S, a 1065 and 1120. If they are, what we have here, a single member LLC, SMLLC, or sole proprietor, a Schedule C is not going to have that information on it. The Schedule C only has taxable income and the deductions, and that fun stuff, it does not have the opening balances, which is one of the drags on Schedule C. As a nerd, I wish that they would require that to be on there, because I love getting a Schedule L that's actually been completed and is accurate.

Adjusting journal entries, so the tax preparer is going to provide a list of tax adjusting journal entries, and we should receive those. Documentation requirements; source documents, obviously this relates to tax, but there's a lot of overlap, pretty much the same as what we talked about under the documentation section. Original documents from purchases, original loan documentation, all of these things remain in the permanent file, so that we always have access to those, as well as our clients. Register tape, canceled check, receipts, invoices. If it's there, we need to be keeping it. Again, those are source documentations, supporting documentations, bank and credit card statements. If in doubt, that's one of those things where we file it away and we make it into a document management cyber system.

Now, advice you can give, basically is none, unless you are their tax preparer. Any specific questions that relate to the filed returns should be directed to the tax professional. Don't be going out there and giving tax advice. Don't say I heard from my brother Earl, that this is something that we could do. Also, you need to know that there are estimated taxes that are required for some businesses and almost all individuals, if they're making money, which hopefully, they are, to pass through entities, there's quarterly requirements. In the U.S. currently as of this recording, they have to make estimated tax payments on April 15th, June 15th, September 15th and January 15th. Again, it's important that we do all that, and that our tax preparers, whoever's doing that is preparing those estimated taxes here. That's very important. You can research any questions or direct those again to the tax preparer, irs.gov has a ton of information. Always, always recommend that they consult with their tax preparer, unless that happens to be you.

Now, fixed assets. Check the depreciation worksheet for a list of all the assets, and the original purchase date, and original purchase price. The depreciation schedule within the tax return should show anything that's fully depreciated in the year. The books can or might not match that schedule, so that's why it's important that we have a reconciliation that we write off anything, that we're keeping tabs with this. I'm very fastidious, let's use that word, when it comes to booking the differences between tax and understanding those, and keeping a register, or a spreadsheet of how those differ right there,

Researching the useful life. Again, we want to make sure that we record. The biggest thing for us to do is record that fixed asset purchase, to record exactly what it is, to put as much information, to have the source documentation. If we're not the tax preparer, then we're not going to be in charge of the depreciation, but how can we help our client? How can we help our tax preparer to be ready for that? And so, one of the things we have to do is, is what is the useful life of this assets? These are the biggest one; five, seven, 15, 27 and a half, or 39 years, and a whole bunch of stuff in between. Five years example would be computer equipment, seven years, office equipment, 15 years could be intangible assets. 27 and a half years is for residential rental, and 39 years is for commercial rental. Again, we are keeping depreciation on the books, but we need to be familiar with this sort of thing as it relates to taxes.

And let's talk about accountable plans. As I mentioned earlier, what are they? These are also known as section 125 plans when it comes to the health insurance and the deductions, but it documents outlining how expenses are reimbursed to owners, and to employees. This is called an accountable plan, because it's not just something going, "Hey, I can reimburse people." No, it's something that strictly documents how this is supposed to do. What do they do? They qualify home office, and vehicle expenses as deductible for an S-Corporation. Who are they for? They're for anyone with employees, and that includes business owners, as in the employees, and then, partnerships that need plan documented in their operating agreement to be valid. Accountable plans just know what they are.

Some deductions, here are some common misconceptions. Charitable deductions are deductible for a C-Corporation up to certain levels, but they pass through for an S-Corp, so I can pay them out of my corporation, but my entity is not going to get a tax deduction. Remember an S-Corporation, or an LLC is a pass-through entity, so on that K-1 that we referenced earlier, there's going to be a separate number, a separate box that says, "Here's the charitable contributions that were paid."

For loans, I know that we all know this, but let's get on the same page here. Only the interest is deductible as an expense. The principal pay down is just that, a principal pay down. We don't get a deduction for it. Clothing, yeah. All my clients are, they want to go out there, and deduct all their suits, and everything. If they can be worn outside the workplace, it cannot be deducted. Again, we're not being the IRS police here, but mileage, it's deducted on the tax return for a sole proprietor, or a single member LLC, and not captured in the books. Typically, that's the way that it goes.

There's also a couple of other kinds of taxes here, sales taxes, we're all familiar with those. This could be remitted to both state, and local governments on a monthly basis for those that are larger, or maybe quarterly, or sometimes even annual.

But we just need to know that certain clients are required to file those. There are so many different jurisdictions, and laws about sales taxes that we cannot cover all of them, but these sales taxes, the biggest thing is that it should be tracked as a liability to the company. A sales tax on goods sold by your client is just basically a holding account. I collect the sales tax; I pay the sales tax. I collect it, I pay it. It's kind of like, I'm going to make the donuts again. I already made the donuts. I collected the tax, and then, I pay it, so that's why it's a liability, and not an expense. Now, if we have multiple states, we may have what's called nexus, and good luck with that. There's a lot of fun with that.

The big thing is if we have our clients, as we start to see things expand, and our clients are in different states, that's where it gets to be a lot of fun with sales taxes, allocating everything over there. That's how we have fun. Other types of taxes. There's also excise and use taxes. Use taxes is a big thing, because states ain't got no money, so they're going after things that are bought out of state, and use taxes aren't being paid on that, so that's a big one right there, and property taxes. That's just an overview of taxes right there. Let's talk about the taxes test, there's a lot of T's in there.

Understand entity types and their tax effects, issuing 1099s and the relationship, Actually, I should say to a tax preparer, know about deductible expenses, and the plans used to qualify expenses. There's going to be some true, false, mostly recall level, and a few application level type of questions, and you are going to be finally done with section seven. Go take that test, kick some butt, and I'll see you in the next section.