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Tax & Business Alert

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WHICH BUSINESS ENTITY SHOULD YOU CHOOSE? _____

Are you in the process of starting a business or contemplating changing your business entity? If so, you'll need to decide how to organize your company. Should you operate as a C corporation or as a pass-through entity such as a sole proprietorship, partnership, limited liability company (LLC) or S corporation?

Organizing your business as a C corporation may reduce the federal income tax on your business's income. A C corporation is currently taxed at a flat 21% rate. With a pass-through entity, income the business passes through to you is taxed at individual rates, which currently range from 10% to 37%. So, the overall rate, if you choose to organize as a C corporation, may be lower than if you operate the business as a pass-through entity.

MORE TO CONSIDER

There are other tax-related factors you should take into account. For example:

Will most of the business profits be distributed to the owners? If so, it may be preferable to operate the business as a pass-through entity, since C corporation shareholders will be taxed on dividend distributions from the corporation (double taxation). Owners of a pass-through entity will be taxed only once on business income, at the personal level.

Does the business own assets that are likely to appreciate? If so, it may be better off to operate as a pass-through entity to avoid a corporate tax when the assets are sold or the



business is liquidated. This is because there is no step up in tax basis for assets owned by an entity.

For a business that is a pass-through, the owner's basis is stepped up by an owner's interest in the entity. That can result in less taxable gain for the owner when his or her interests in the entity are sold.

Is the business expected to incur tax losses for a while? If so, you may want to structure it as a pass-through entity, so you can deduct the losses against other income. Conversely, if you have insufficient other income or the losses aren't usable (for example, because they're limited by the passive loss rules), it may be preferable for the business to be organized as a C corporation, since it'll be able to offset future income with the losses.

THE QBI DEDUCTION PROVIDES RELIEF FOR PASS-THROUGH ENTITIES

Currently, the corporate federal income tax is a flat 21% rate and individual federal income tax rates begin at 10% and go up to 37%. The difference in rates can be alleviated by the qualified business income (QBI) deduction, which is available to eligible pass-through entity owners who are individuals, and some estates and trusts.

The QBI deduction is scheduled to expire in 2026, unless Congress acts to extend it, while the 21% corporate rate is permanent. Also, noncorporate taxpayers with modified adjusted gross incomes above certain levels may be subject to an additional 3.8% tax on net investment income.

Is the business owner subject to the alternative minimum tax (AMT)? If so, it might be better to organize as a C corporation, since corporations aren't subject to AMT. AMT rates on individuals are 26% to 28%.

CONTEMPLATE THE ISSUES

Clearly, many factors are involved in determining which entity type is best for your business. This only covers a few of them. Consult with us for details about your situation. ■

KEEP CONTROL OVER INVENTORY AT YOUR BUSINESS

Many businesses need to have some inventory available. But having too much inventory is expensive — not just to purchase but to store, safeguard and insure. So, keeping your inventory as lean as possible is critical. One rule of thumb says the expense of maintaining stock in inventory averages about 2% of the cost of goods sold, for each month items aren't sold. That means if your business carries an item for a year, you may be down 24%. That's hard to overcome, especially in tough times.

Here are some ways to trim the fat from your inventory without compromising revenue and customer service.

WHERE TO BEGIN

Effective inventory management requires starting with an accurate physical inventory count. That allows you to determine your true cost of goods sold — and to identify and remedy discrepancies between your physical count and perpetual inventory records. A CPA can introduce an element of objectivity to the counting process and help minimize errors.

Next, compare your inventory costs to those of other companies in your industry. Trade associations often publish benchmarks for:

- Gross margin ($[\text{revenue} - \text{cost of sales}] / \text{revenue}$),
- Net profit margin ($\text{net income} / \text{revenue}$), and
- Days in inventory ($\text{annual revenue} / \text{average inventory} \times 365 \text{ days}$).



Your company should try to meet — or beat — industry standards. For a retailer or wholesaler, inventory is simply purchased from the manufacturer. But the inventory account is more complicated for manufacturers and construction firms. It's a function of raw materials, labor and overhead costs.

The composition of your company's cost of goods will guide you on where to cut. In a tight labor market, it's hard to reduce labor costs. But it may be possible to renegotiate prices with suppliers.

Don't forget the carrying costs of inventory, such as storage, insurance, obsolescence and pilferage. You can also improve margins by negotiating a net lease for your warehouse, installing antitheft devices and opting for less expensive insurance coverage.

MORE STEPS TO TAKE

Cutting your days-in-inventory ratio should be done based on individual product margins. Your goal should be to stock more products with high margins and high demand — and less of everything else. If possible, return excessive supplies of slow-moving materials or products to your suppliers.

Product mix should be sufficiently broad but still in tune with the needs of your customers. Before cutting back on inventory, you should try to negotiate speedier delivery

from suppliers or give suppliers access to your perpetual inventory system. These precautionary measures can help prevent lost sales due to lean inventory.

TAKE INVENTORY OF INVENTORY

It's easy for inventory to get lost in the shuffle when you and your leadership team are facing big-picture issues such as strategic planning, innovation and compliance. Managers are often so focused on sales that it becomes easy to lose control. Contact us for help managing your inventory. ■

A TAX BREAK FOR EDUCATORS

Teachers who are getting their classrooms ready for a new school year often pay for some of their classroom supplies out-of-pocket. They may be able to get some of that cost back by taking advantage of a special tax break for educators. This deduction improved after the Tax Cuts and Jobs Act (TCJA) became effective in 2018. Currently the deduction amount is limited to \$300 per educator. This limit will rise in \$50 increments in future years, based on inflation adjustments.

HISTORY OF THE DEDUCTION

Before 2018, employees who had unreimbursed out-of-pocket expenses could potentially deduct them if they were ordinary and necessary to the “business” of being an employee. A teacher’s out-of-pocket classroom expenses could qualify and be claimed as a miscellaneous deduction, subject to a 2% of adjusted gross income (AGI) floor. That meant that only taxpayers who itemized deductions could enjoy a tax benefit, and then only to the extent that their deductions exceeded the 2% floor.

For 2018 through 2025, the TCJA has suspended miscellaneous itemized deductions subject to the 2% of AGI floor. Fortunately, qualifying educators can still deduct some unreimbursed out-of-pocket classroom costs using the educator expense deduction.

Back in 2002, Congress created the above-the-line educator expense deduction, meaning a deduction that’s subtracted from your gross income to determine your AGI. It can be claimed even by taxpayers who don’t itemize deductions.

For 2024, qualifying elementary and secondary school teachers and other eligible educators (such as counselors and principals) can deduct up to \$300 of qualified expenses. Two eligible married educators who

file a joint tax return can deduct up to \$600 of unreimbursed expenses — limited to \$300 each.

Qualified expenses include amounts paid or incurred during the tax year for books, supplies, computer equipment, related software, services, and other equipment and materials used in classrooms. The cost of certain professional development courses may also be deductible. However, homeschooling supplies and nonathletic supplies for health or physical education courses aren’t eligible.



HEAD OF THE TAX CLASS

Some additional rules apply to this deduction. If you’re an educator or you know one who might benefit from this tax break, feel free to contact us for more details. ■

USING AN IRA WITHDRAWAL FOR A QUALIFIED HOME PURCHASE

Purchasing a home is an expensive proposition that leaves many would-be buyers feeling cash strapped. If that's you, you might be considering taking money out of your traditional IRA to fill the need. But should you? If you're under age 59½, that would be considered an early withdrawal, which generally is subject to income tax and comes with an additional tax penalty of 10%. The good news is, there are exceptions, including for certain home purchases.

WHAT ARE THE CONDITIONS?

To qualify for this exception, you must be purchasing an eligible "first-time" principal residence for yourself or your spouse, your child or your spouse's child, your grandchild or parent, or other ancestor. The withdrawal will be penalty-free, though it is subject to a lifetime limit of \$10,000.

In addition, neither you nor your spouse, if applicable, can have owned a principal residence within the two-year period that ends on the acquisition date. The acquisition date is the date you enter a binding contract to buy the home or the date the building or rebuilding begins.



Timing is critical. The funds must be spent to pay qualified acquisition costs within 120 days of the day you receive the withdrawal. Qualified acquisition costs include the costs of buying, building or rebuilding a home, plus any usual or reasonable settlement, financing or other closing costs.

GET YOUR DUCKS IN A ROW

Before you take an early withdrawal, make sure you can meet the parameters above, in terms of timing, so you don't accidentally end up with a penalty. Note also that while this article focuses on traditional IRAs, Roth IRA rules are analogous. However, there are important differences. To the extent that you have either a traditional or Roth IRA and want to make a withdrawal for a first-time home purchase, contact us with questions. ■