Business Entity Issues

Issue 1: Partnership Reporting Requirements

Issue 2: Social Clubs

Issue 3: Fraternal Societies

Issue 4: Tax-Exempt Entities Update
Partnership reporting requirements

- Number of partnership returns filed has increased by 59% from 2004 to 2017

- Corporation filings up only 14%

- IRS adding information reporting to review returns for compliance
Polling Question – CH 6 – Business Entity Issues

1. Over the last 10 years what has been the most popular business entity type you have seen in your practice?

A. Sole Proprietorship
B. Corporation
C. S- Corporation
D. Partnership
Capital accounts

IRC allows capital accounts to be maintained by:

- Book value,
- FMV, or
- Tax basis

Reporting requirements: state capital accounts must be reported on a tax basis
I.R.C. §704 (b) requires partnership to maintain capital accounts on book value to meet safe harbor for special allocations.

Special allocation - an allocation made other than according to overall profit and loss sharing percentages.
Increases to book capital accounts

1. Money contributed by partner to partnership
2. FMV of property contributed by partner to partnership (net of any liabilities the partnership assumes)
3. Allocations to the partner of partnership income and/or gain
Decreases to book capital accounts

1. Money distributed by partnership to partner

2. FMV of property distributed by Partnership to partner (net of any liabilities the partner assumes)

3. Allocations to the partner of partnership losses and deductions
Like book value accounts but include adjustments due to a change in the FMV of the partnership assets.

Represents each partner’s share of the FMV of the partnership’s assets.
Tax Basis Capital Account

- Aka - tax capital

- Represents equity, not based on:
  - GAAP,
  - 704(b)
  - Other principles
Increases to Tax Basis Capital Accounts

- Amount of money contributed to the partnership
- Adjusted basis of property contributed to partnership, decreased by liabilities partnership assumes
- Partner’s distributive share of partnership income or gain
- Partner’s share of the excess of the deduction for depletion over the basis of the property subject to depletion
Increases to Tax Basis Capital Account cont’d

- Amount of liabilities of the partnership distributed to partner

- Partner’s distributive share of any increase to the tax basis of partnership property under I.R.C. §§734(b) or 743(b)
Decreases to Tax Basis Capital Account

- Money distributed by partnership to partner
- Adjusted basis of property distributed by partnership to the partner less liabilities assumed by partner
- Partner’s distributive share of losses and deductions
- Partner’s distributive share of deduction for depletion not in excess of depletion property basis
Decreases to Tax Basis Capital Account cont’d

- Partner’s distributive share of the adjusted tax basis of charitable property contributed & foreign taxes paid or accrued
- Partner’s individual liabilities contributed to partnership
- Partner’s distributive share of any decrease to the tax basis of partnership property under I.R.C. §734(b) or §743(b)
### Beginning Capital Accounts

<table>
<thead>
<tr>
<th></th>
<th>Tax Basis</th>
<th>Book</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>150,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Debt</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Beg. Cap. Account</td>
<td>100,000</td>
<td>150,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>
Ex. 6.2 Capital Account Adjustments

<table>
<thead>
<tr>
<th></th>
<th>Tax Basis</th>
<th>Book</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beg. Cap. Account</td>
<td>$100,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Income</td>
<td>$190,000</td>
<td>$190,000</td>
<td>$190,000</td>
</tr>
<tr>
<td>Distribution</td>
<td>$(100,000)</td>
<td>$(100,000)</td>
<td>$(100,000)</td>
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<tr>
<td>End. Cap. Account</td>
<td>$190,000</td>
<td>$290,000</td>
<td>$290,000</td>
</tr>
</tbody>
</table>
Basis vs. Tax Basis Capital Account

- Tax basis capital accounts are not the same as a partner’s basis in his or her partnership interest.

- Key Point:
  - Basis of partnership interest cannot be negative
  - Capital accounts can be negative
Outside Basis Safe Harbor Approach

- Partnerships may calculate a partner’s tax basis capital account by subtracting the partner’s share of partnership liabilities from the partner’s outside basis.

- Notice 2020-43
  - Open for public comment
  - Two alternatives for reporting capital
Polling Question – CH 6 – Business Entity Issues

2. In your practice, which method do you mostly use to track the partners capital accounts?

A. Book Value
B. Fair Market Value
C. Tax Basis
D. I have no Partnership clients
Built-in gains and losses

- I.R.C. §704(c) defines built-in gains and losses
- Difference between FMV and adjusted tax basis of property contributed to partnership
- Required partnership to make special allocation to eliminate book - tax differences among partners
# Ex. 6.3 Built-in Gains

<table>
<thead>
<tr>
<th></th>
<th>Book Value</th>
<th>Tax Basis</th>
<th>Built-in Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Myrtle</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>1,000,000</td>
<td>400,000</td>
<td>600,000</td>
</tr>
<tr>
<td><strong>Joshua</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>500,000</td>
<td>500,000</td>
<td>0</td>
</tr>
<tr>
<td>Cash</td>
<td>500,000</td>
<td>500,000</td>
<td>0</td>
</tr>
<tr>
<td><strong>Joshua’s Total</strong></td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>0</td>
</tr>
<tr>
<td><strong>LLC Total</strong></td>
<td>$2,000,000</td>
<td>$1,400,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>
Partnerships may have to report partners’ capital accounts (including negative accounts) on the tax basis method on each partner.

- Built-in gains and losses
- Information for separate at-risk activities
1. Partnership’s total receipts for tax year < $250,000.

2. Partnership’s total assets at end of tax year < $1,000,000.

3. Partnership timely files Sched K-1 with return & furnishes the schedules to the partners by due date (including extensions) for partnership return.

4. Partnership is not filing and is not required to file Schedule M-3 (Form 1065).
Reporting Negative Tax Basis Capital Accounts

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Tax years beginning after December 31, 2019:
- Complete Item L on tax basis

Tax years beginning before January 1, 2020:
- Complete Item L
- Non-tax basis on Item L, complete line 20, code AH
- File additional statement showing partners beginning & ending share of tax basis capital
Reporting Built-in Gain

- Complete Item M for contributed property
  - Check “Yes” box
  - Attach Statement:
    - Description of property
    - Date of contribution
    - Amount of property’s built-in gain or loss
      (can aggregate if 10 or more properties, must keep gains/losses separate)

- Complete Item N – which shows the partner’s beginning and ending share of net unrecognized section 704(c) gain or loss.
I.R.C. 704(c) tracking needed for special allocations.

I.R.C. §737 requires recognition of built-in gain to contributing partner if within 7 years of contribution:

- the contributed property is distributed to another partner,
- or
- contributing partner receives a distribution of other property.
At-Risk Activity Reporting

- If more than 1 activity, check box line 21, Sch. K-1
- Provide attachment:
  - Identify each activity
  - Income, loss, or deduction for activity
  - Other items of income, loss, or deduction
  - Partnership Liabilities
  - Other information (ex. Distributions, partner loans)
- In addition to completing item K, Partner’s share of liabilities
- In addition to completing Form 6198, At-Risk Limitations
Issue 2: Social Clubs

- I.R.C. § 501(c)(7) provides tax exemption
- Pleasure, recreation, other nonprofit purposes
- Earnings cannot provide private benefit
- File Form 1024 for exemption
For-Profit Activities

- May be disqualified as tax exempt if for-profit activities are substantial

- Examples:
  renting facilities, selling real estate, timber, products, renting office space, public parking for a fee to nonmembers
Substantial purpose

- Social or recreation must be substantial purpose
- Any other member service must be incidental
- Rev Rule 71-17:
  - if total gross receipts from nonexempt activities are 5% or less of total gross receipts from total activities, the nonexempt activities are insubstantial.
Other requirements

- Must promote commingling and fellowship
- No discrimination based on race, color, or religion
- No benefit of earnings from the public to the owners
Membership issues

- Membership must be limited:
  - Open to members, spouse, dependents, and guests would be okay
  - Corporate memberships a problem

- Membership fees, dues, assessments must be primary support
  - Gross receipts from other sources cannot be > 35%
  - Of the 35%, no more than 15%, can come from use of facilities by nonmembers
Taxation of social clubs

- Taxed on unrelated business income
- Income from general public is not exempt
  - Rev. Proc 71-17 provides guest safe-harbor:
    - 8 or less individuals, where 1 is member, others are deemed to be guests
    - If more than 8, 75% must be members, remaining 25% are deemed to be guests of the members
Exempt versus nonexempt income

- **Exempt income**
  - Dues, fees, charges paid by members
  - Investment income set aside for religious, charitable, etc. under I.R.C. §170(c)(4)

- **Nonexempt Income**
  - Nonmember income
  - Investment income
  - Sales of property unless proceeds reinvested for tax exempt purposes
  - Income from nonexempt purposes even if from members
Unrelated business expenses

- Expenses directly attributable to unrelated business activity reduce nonexempt income

- Allocable expenses
  - Between services offered by club, then
  - Between services used by members vs. nonmember
Example 6.8

- Club receives nonmember income from bar/restaurant
- Club manager salary = $30,000, devotes 35% of time to bar/restaurant
- Allocate $10,500 ($30,000 x 35%) salary to total bar/restaurant expenses
- Then allocate those expenses between member & nonmember expenses.
Estimated & Employment Tax

- Estimated tax payments if tax > $500

- Employment tax exemption:
  - No withholding if providing domestic service by students in college clubs, fraternities, sororities
    - Students must be enrolled, regularly attend class
  - FUTA exception applies if Club pays < $1,000 in any quarter in current or preceding year.
Issue 3: Fraternal Societies

- Two Types:
  - Fraternal Beneficiary Societies - provides life, sick, accident or other benefits to members & dependents
    - I.R.C. §501(c)(8)
  - Domestic Fraternal Societies – does not provide these benefits
    - I.R.C. §501(c)(10)
- Both file Form 1024 for exemption
Eligibility

To be exempt:

- Has fraternal purpose
- Operates under the lodge system
- §501(c)(8) – (beneficiary) provide benefits to members
- §501(c)(10) – (domestic) all earnings to its exempt purpose
Fraternal Purpose

- Membership based on:
  - Common tie, or
  - Pursuit of a common object

- Substantial fraternal activities

- Performance of Civic, benevolent, charitable
Lodge System

- Must operate under Lodge System:
  - Minimum of two active entities:
    1. Parent organization
    2. Subordinate lodge or branch
      - Chartered by parent
      - Mostly self-governing
Benefits

- Fraternal Beneficiary Societies - Required to be provided to most members under §501(c)(8)

- Domestic Fraternal Society - May arrange *optional* insurance under §501(c)(10)
Only the domestic fraternal society must devote its earnings exclusively to religious, charitable, scientific, literary, educational, or fraternal purposes
Unrelated Business Income

- Bar and restaurant sales to nonmembers
  - Same definition as with social clubs
  - But no % limitation or required records
- Hall rental without services may be exempt
- Rental income from debt-financed property is taxable
  - Exception if $\geq 85\%$ related to exempt purpose, OR
  - Gross income from conduct of unrelated trade or business
- Gaming
- Advertising
Charitable Contribution Deduction

- Are deductible if used for charitable purpose

- No deduction if used for fraternal or social purposes

- Organization should keep funds separate
Polling Question – CH 6 – Business Entity Issues

3. Do you belong to any Social Clubs or Fraternal Societies?

A. Yes
B. No
Notification of formation of §501(c)(4) Civic leagues, social welfare, certain local employee associations

1. Notify within 60 days of formation
2. Submit Form 8976 electronically
3. $50 fee
4. IRS response within 60 days
5. $20 per day penalty for failure to notify, maximum of $5,000
Electronic Filing of Annual Returns

- Most tax-exempts must file annually
- Churches and other religious organizations:
  - No filing if $\leq 5,000$ gross receipts
  - Form 990-N (ePostcard) if $\leq 50,000$ gross receipts
- Form 990, 990-EZ, 990-PF & 990-T
  - Tax years after 7/1/19 – electronically
  - Transitional relief until 7/1/2021 if:
    - Gross receipts $< 200K$, Assets $< 500K$, OR
    - Required to file Form 990-T
Notice Required before Revocation

- IRS notice before revocation of status
  - No record of returns for 2 years
  - IRS intent to revoke tax-exempt status
  - Notice must provide info on how to comply
UBTI for transportation fringes Benefits
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- Disaster Act of 2019 repealed this provision
- Retroactive – amend 2017 and 2018
- Specific instructions for amending each year
Private Foundation Tax Rate Reduction

Good News:
- Tax rate reduced from 2% to 1.39% (Disaster Act)

Bad News:
- Eliminates prior 1% rate where certain charitable distributions had been made
- Reported on Form 990-PF
Form 1023

- Electronic Filing Mandatory for F1023 & F1023-EZ
- $600 user fee for 2020
- Supporting documents must be scanned & submitted
  - Organizing document
  - Amendments to the organizing document in chronological order
  - Bylaws or other rules of operation and amendments
  - Form 2848, Power of Attorney
  - Form 8821, Tax Information Authorization
  - Supplemental responses and any additional information
  - Expedite request
Form 1023

Other Form 1023 changes:

• Requires National Taxonomy of Exempt Entities (NTEE) code
• Answer questions for the Office of Foreign Asset Control (OFAC)
• No longer allows §501(h) election (Must file Form 5768)
• Scanned handwritten signature allowed
Requesting earlier tax-exempt effective date

Prior Law: Can file F1023 or F1023-EZ within 27 months
- Outside 27 month window:
  - F1023 – effective date = Date F1023 is filed
  - F1023-EZ – entity sends letter requesting earlier effective date

Current Law: Can file F1023 or F1023-EZ within 27 months
- Outside 27 month window (Rev Proc 2020-8), **Must file F1023**
  - Describe why late
  - Show organization acted reasonably, good faith
  - Show government interest not harmed
4. If tax exempt entities were required to pay an annual fee to stay in existence, what would be an appropriate amount?

A. $1,000
B. $500
C. $100
D. No fee should be required
Guidance for homeowners associations

§501(c)(4) homeowners associations must promote common good & general welfare of the general public

- Unrestricted access to common areas
- No exterior maintenance of private dwellings
- Meets definition of community
- May operate in tandem with social/ recreational §501(c)(7) organization
Thank you