2000 Income Tax School

BUSINESS ENTITIES

ISSUE 1: CHOICE OF BUSINESS ENTITY

Choosing the right business entity is one of the most important decisions a business owner can make. Although most businesses start out as sole proprietorships, at some time during the business life cycle most successful business owners make the decision to convert to another business entity form. This chapter provides a general guide to the tax and business consequences of choosing a business entity or changing the form of the original entity to meet changing business or personal objectives.

Tax Considerations. If income tax minimization were the client's only objective, choice of business entity could be reduced to a mathematical calculation. If the client had perfect knowledge of taxable business income and appreciation of capital business assets, a planner could suggest the entity whose income and capital gains tax rate resulted in the lowest total tax liability.

Table 1 illustrates the difference between individual and corporate income tax rates. Table 2 shows capital gain rates for individuals and corporations. Corporations' capital gains are taxed at the same rate as ordinary income up to 35%. The 1997 Taxpayer Relief Act (TRA) lowered the individual capital gain rates to 10% for individual taxpayers in the 15% tax bracket and to 20% for individuals in the 28% or higher tax bracket.

Table 1

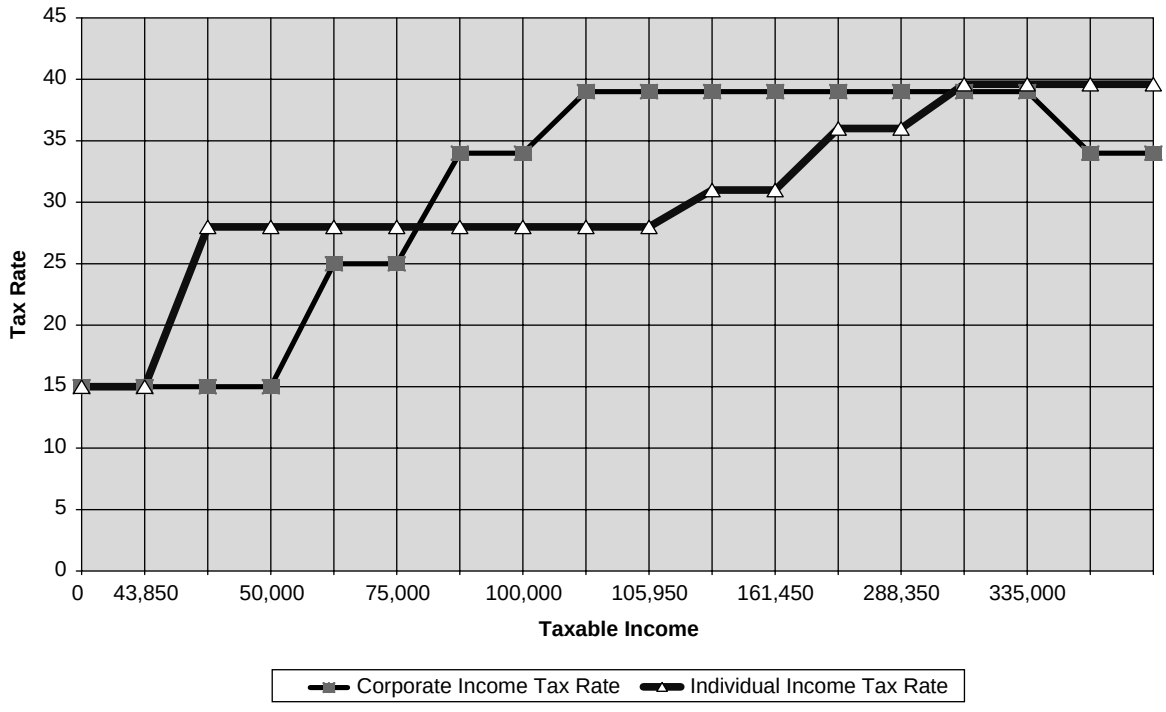

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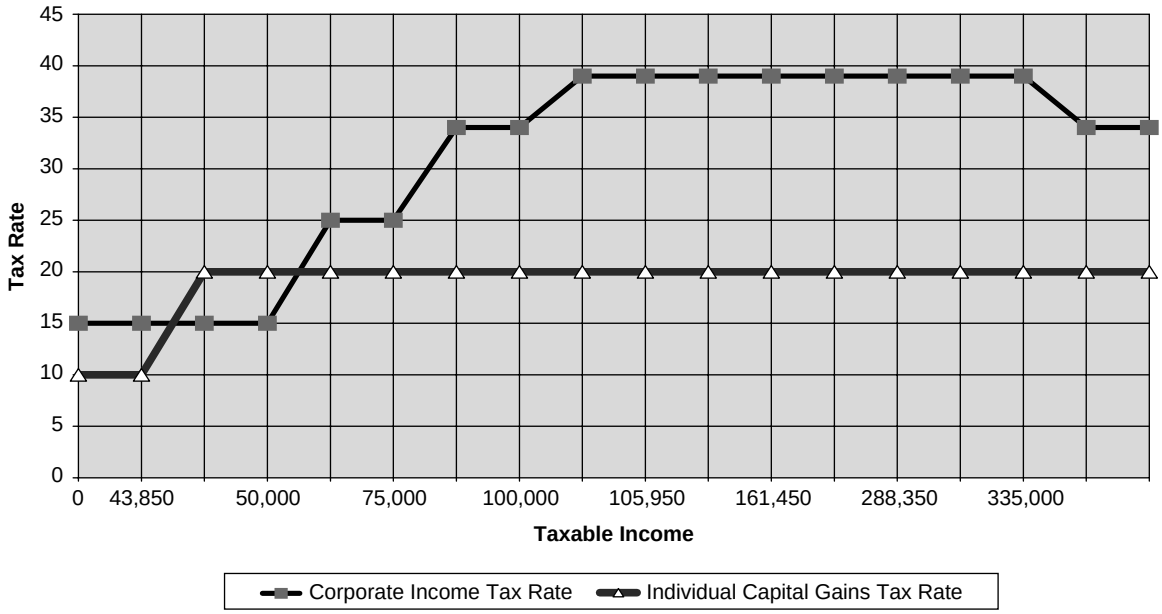
Table 2



However, rarely is income tax the only business objective. In addition to income tax, other taxes that should be considered include: self-employment, sales, property, excise, franchise, estate, gift, and state income tax. There also will likely be many nontax and personal objectives to consider, such as

- **Limited Liability:** In today's litigious society, all businesses are exposed to some type of liability. Employees create potential liability; even a sole proprietor driving a personal vehicle for business purposes creates liability.
- **Transferability of Business Interest:** If the business owner wants the business to continue without his or her direct involvement or wants it to carry on after his or her death, the business entity should allow for easy transfer.
- **Business Life Cycle:** More than seven of ten new businesses start as sole proprietorships. However, growing, successful businesses usually "outgrow" the sole-proprietorship model and convert to another entity for a variety of reasons.
- **Intergenerational Transfers:** Dividing a business among several heirs can cause the failure of successful businesses. Proper planning can preserve the business and treat heirs who are not part of the business equitably.

Many authors provide tables of the general advantages and disadvantages of the different forms of business entities. From these tables, general "rules of thumb" can be determined. However, every business and business owner has a unique set of tax and nontax objectives. Practitioners who hold themselves out to be entity planning specialists should obtain complete information about each client.

ENTITY PLANNING, SCENARIO 1 (NOT THE BEST APPROACH):

Client wants to meet with an entity planning specialist to establish a "new entity." Client has heard or read (from magazine article, infomercial, coffee shop, co-worker, brother-in-law, or barber) that the "new entity" will allow tax deduction of the personal residence, all meals and entertainment, and two of the cats. The resulting three-hour explanation of the law and alternative entity strengths and weaknesses leaves everyone confused and exhausted.

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ENTITY PLANNING, SCENARIO 2 (A BETTER APPROACH):

Same as above, except that the entity planning specialist meets with the client and asks the client to fill out the "Choice of Business Entity Questionnaire." The specialist then answers the client's questions about the questionnaire and stresses the need for accurate information. The specialist requests that the client return the questionnaire so that she may prepare for a future meeting to discuss the results. Entity choice may be similar to "peeling an onion"; that is, more than one iteration of this process may be required.

The following questions provide practitioners the information necessary to help clients make an informed entity choice.

Getting to Know Your Client

1. What is your age?
2. Do you have other sources of income?
3. Do you have other sources of health insurance coverage?
4. Do you have other sources of retirement benefits?
5. Do you have Social Security coverage?
6. What is your estimated monthly Social Security benefit?
7. What is your individual marginal income tax rate?
8. Do you have a retirement plan?
9. Do you have an estate plan, will, or trust?

Sizing Up Your Client's Abilities

10. Do you have training or experience in accounting or bookkeeping?
11. What is your current system of keeping personal and business records?
12. Do you regularly balance and reconcile your personal and business bank statements?
13. Can you recognize business assets and bank accounts as being separate and apart from your personal assets?

Getting to Know Your Client's Business

14. Is this a new business? If no, how long have you been in business?
15. What products or services do you sell?
16. Do you currently have business liability insurance?
17. Will your business be conducted in only one state?
18. Will there be more than one owner?
19. Will there be employees?
20. Will there be employees other than family members?
21. Do you expect losses in the initial startup of the business?
22. Do you expect your business to generate long-term profits consistently or to generate profits and losses on an unpredictable basis?

Business Planning

23. Do you need to accumulate profits in the business to expand facilities or grow the business?

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24. Are fringe benefits such as company-paid health insurance, vehicles, and dependent care important to attract employees or reward owners?
25. What is the value of your assets and liabilities, and will your business assets appreciate in value?
26. Will the total number of members, owners, or investors be less than 75?
27. Would annual state franchise tax based on asset values be a significant expense?
28. Do you plan to sell your business at some point in the future, or is your goal to transfer the business to a family or non-family member?

Example 1. Choice of Entity. John and Marsha, who are unrelated, seek your help to decide the best form or entity to operate their business. John has successfully operated a marketing and promotional products business for the last three years as a sole proprietorship. Marsha has in the same time developed a thriving graphic arts and design business, also operated as a sole proprietorship. During the last three years they have referred clients to each other and worked together on big projects, each billing the clients individually. John and Marsha think they may be able to gain efficiency, reduce cost, increase profits, and show a more professional business presence as John, Marsha & Associates. They have completed the client questionnaire, and you have made notes about each of their answers and the alternatives they may consider. For each question and answer that indicates a relative strength or weakness for a particular entity choice, a relative score is assigned to that entity. The sum of the relative scores is summarized in table form at the end of the questions. **A score of 5 indicates a strong preference or strength for an entity. A score of 1 or 0 would indicate that the entity may not meet the client's goals and objectives.**

CHOICE OF BUSINESS ENTITY
CLIENT INFORMATION QUESTIONNAIRE

Please answer the following questions about yourself and your business to help me provide the best possible service to you:

A: Tell me about yourself:

1. *What is your age?*

John: age 45	Marsha: age 51

2. *Do you have other sources of income?*

John: No	Marsha: Husband works for university; $50,000 W-2 income

3. *Do you have other sources of health insurance coverage?*

John: No	Marsha: Covered by husband's insurance

4. *Do you have other sources of retirement benefits?*

John: Regular IRA $15,000, Roth IRA $4500	Marsha: None, Husband yes

5. *Do you have Social Security coverage?*

John: Yes	Marsha: Yes

6. *What is your estimated monthly Social Security benefit?*

John: $600/month, would like to increase benefits or put money into other retirement plan.	Marsha: $350/month, would like to increase benefits.

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Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
4	4	4	4	5	3

7. *What is your individual marginal income tax rate?*

John: 15%

Marsha: 28%

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
4	4	4	4	3	2

8. *Do you have a retirement plan?*

John: No, other than IRAs

Marsha: Social Security and husband

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
4	4	4	4	5	3

9. *Do you have an estate plan, will, or trust?*

John: No, but need to do that next, would like for son to inherit business

Marsha: Yes, husband took care of

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
1	2	4	4	4	4

B: Tell me about your experience in accounting for and managing other businesses:

10. *Do you have training or experience in accounting or bookkeeping?*

John: Some and wife is doubling my knowledge on a regular basis

Marsha: Double major in art and accounting

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
3	3	4	4	4	4

11. *What is your current system of keeping personal and business records?*

John: Whatever software wife uses

Marsha: Home & Business version of software

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
3	3	4	4	4	4

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12. *Do you regularly balance and reconcile your personal and business bank statements?*

John: No, but wife does

Marsha: Yes

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
3	4	4	4	5	5

13. *Can you recognize the business assets and bank accounts as being separate and apart from your personal assets?*

John: No, but wife is accountant and takes care of all the stuff

Marsha: Yes, use a computerized accounting system to maintain complete business and personal records

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
3	4	4	4	5	5

C: Tell me about your business:

14. *Is this a new business? If no, how long have you been in business*?

John: In business for 3 years

Marsha: Business 3 years old

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
5	5	4	4	3	3

15. *What products or services do you sell?*

John: Custom marketing, trade show promotions, design, premailers, products, and complete outsource services

Marsha: Art design, publication layout, logos

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
1	1	3	3	4	4

16. *Do you currently have business liability insurance?*

John: General liability $100,000, need more protection as clients and orders increase

Marsha: Never thought about it, maybe should

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Observation. Liability is one of the biggest problems for small businesses. Sole proprietors' and general partners' personal assets are exposed to unlimited business liabilities. Limited partners', LLC members', and corporation shareholders' liability is limited to the amount invested. However, lenders may require LLC members, corporation shareholders, and, in some cases, limited partners to personally guarantee loans to the entity. The limited-liability advantage is lost to the extent of those personal guarantees but remains for other debts, such as tort liability of the entity, for which there is no personal liability of the owner. Also note that the legal history of corporate liability protection is longer and better defined than that for relatively newer LLCs.

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
1	1	3	3	5	5

17. *Will your business be conducted in only one state?*

John: Yes, clients in other states but no salesmen or physical presence in any other state. Business done by email, Internet, and UPS

Marsha: Yes, but could change if husband becomes dean at another university

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
1	1	0	0	3	3

18. *Will there be one or more than one owner?*

John: Yes, Marsha

Marsha: Yes, John, others in future

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
0	3	3	3	4	4

19. *Will there be employees?*

John: Yes, business is growing

Marsha: Yes, using hourly university students

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
0	0	3	3	5	5

20. *Will there be employees other than family members?*

John: Son, a senior in high school, designs all the Web pages, may work part-time while in college

Marsha: No family members other than self

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
0	0	4	3	5	5

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21. *Do you expect losses in the initial startup of the business?*

John: Yes, have had losses, but not in future

Marsha: Yes, and could have in the future

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
1	2	2	0	5	2

22. *Do you expect your business to generate long-term profits consistently or to generate profits and losses on an unpredictable basis?*

John: First 2 years were losses, don't anticipate future losses

Marsha: Like John, had losses in first year, but business is tied to the economy

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
2	3	3	3	4	3

D: Where do you see this business in five or ten years?

23. *Do you need to accumulate profits in the business to expand facilities or grow the business?*

John: Yes, as business grows, large orders create cash flow problems

Marsha: Yes, same problems for me

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
0	1	2	1	5	2

Observation. Sole proprietorship was given a score of zero because its profits are subject to federal, state, and self-employment taxes, leaving fewer after-tax dollars for expansion. General partnerships and LLCs allow some tax planning to move income into lower tax brackets, which may leave more after-tax profits for expansion. S corporation profits and the profits that pass through to limited partners may not be subject to self-employment tax. C corporations' profits up to $75,000 are taxed at a rate lower than comparable individual tax rates and are not subject to self-employment tax. Thus more after-tax dollars are available for expansion.

24. *Are fringe benefits, such as company-paid health insurance, vehicles, and dependent care, important to attract employees or reward owners?*

John: Yes, very important and retirement too if profits allow

Marsha: Would be nice but not as important, husband has retirement planned. Now that I think about it, maybe really important if husband runs off with 21-year-old student

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
2	2	3	3	5	3

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25. *What is the value of your assets and liabilities, and will your business assets appreciate in value?*

John: Computers, printers, and vehicles, $15,000 will not appreciate, no liabilities

Marsha: Same as John

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
3	3	3	3	3	3

26. *Will the total number of members, owners, or investors be less than 75?*

John: Yes

Marsha: Yes

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
0	2	3	3	4	5

27. *Would annual state franchise tax based on asset values be a significant expense?*

John: Fixed assets less than $15,000, not a problem

Marsha: Fixed assets about $20,000, not a big expense

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
5	3	3	2	0	0

28. *Do you plan to sell your business at some point in the future, or is your goal to transfer the business to a family or non-family member?*

John: In 10 to 15 years, bring in a full-time manager, or train son to take over business, so I can play golf and work part-time in retirement

Marsha: Sell in 12 years when husband retires, travel, or maybe work part-time

Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
0	4	5	5	3	3

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SUMMARY TABLE ENTITY CHOICE

Question No.	Sole Proprietorship	General Partnership	Limited Partnership	Limited Liability Co.	C Corporation	S Corporation
1–5	0	0	0	0	0	0
6	4	4	4	4	5	3
7	4	4	4	4	3	2
8	4	4	4	4	5	3
9	1	2	4	4	4	4
10	3	3	4	4	4	4
11	3	3	4	4	4	4
12	3	4	4	4	5	5
13	3	4	4	4	5	5
14	5	5	4	4	3	3
15	1	1	3	3	4	4
16	1	1	3	3	5	5
17	1	1	0	0	3	3
18	0	3	3	3	4	4
19	0	0	3	3	5	5
20	0	0	4	3	5	5
21	1	2	2	0	5	2
22	2	3	3	3	4	3
23	0	1	2	1	5	2
24	2	2	3	3	5	3
25	3	3	3	3	3	3
26	0	2	3	3	4	5
27	5	3	3	2	0	0
28	0	4	5	5	3	3
Total	46	59	76	71	93	80

Caution. A simple summation of the relative scores of strengths and weaknesses may be misleading, because each relative score has an equal weight. Any one strength or weakness may outweigh all others for a particular client or entity choice.

Question 1A. Based on the summations of the relative scores of strengths and weaknesses, as practitioner, what is your recommendation to John and Marsha?

Answer 1A. There is no one single right answer. We can provide John and Marsha with the strengths, and weaknesses, and the consequences of their choice (see sample client letter) of one or the other entity, but it should be their choice.

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SAMPLE CLIENT LETTER

Based on the answers to the client questionnaire, you have provided me information about your situation, your type of business, and your business and personal objectives. A simple numeric count of strengths and weaknesses would indicate that a C corporation could provide definite benefits. It would be possible for each of you to contribute the assets and liabilities of your sole proprietorships to a C corporation in exchange for stock without recognizing gain on the transfer.

Fringe benefits such as health insurance, vehicles, and retirement benefits could convert some personal expenses to business and allow payment of other benefits with before-tax dollars. It would be possible to estimate the dollar value of these savings. These benefits must be weighed against the additional cost of forming and operating a corporation. I would recommend John's wife be paid for her accounting services.

Although no one can predict the future, if John's son ultimately inherits John's stock and is able to buy Marsha's stock when she is ready to retire, the C corporation would offer definite benefits. If John, Marsha & Associates, Inc., is ultimately sold for 10 million dollars, double taxation would reduce their after-tax sales proceeds, but that is not a bad problem to have. If the value of additional fringe benefits and retirement benefits were significantly greater than the added cost of accounting, operation, and potential double taxation, then a C corporation would be a good choice for you.

The choice of LLC would provide a degree of limited liability but would offer much less favorable fringe benefit taxation (similar to an S corporation). The LLC would provide easier transferability of interests than your current operation as a sole proprietor.

An alternative choice would be to continue the apparently successful relationship you have had in the past as sole proprietors. I would recommend adequate liability insurance coverage. Some of the retirement benefits could be realized. It would, however, be more difficult to transfer the business to John's son or an unrelated third party.

I hope our discussions have helped you to understand your choices of business entity and the consequences of that choice. If you have questions about this analysis or any other, I will be happy to help. Please contact me if you would like to meet again to continue our discussion or would like me to help carry out your entity choice.

Sincerely,

Help R. Us,
Entity Planner

ISSUE 2: INCOME TAX CONSEQUENCES OF CHANGING BUSINESS ENTITY

For an existing entity, the decision to change the business form and operate as a different business entity must be analyzed to determine the feasibility and tax consequences.

Feasibility. First, is it even possible to get from the current entity to the new entity? Whether it is possible to convert an existing business to a new form of entity refers to the need for an enabling statute, an allowable number of owners (two in most states), and the cooperation of creditors. A second statute may be required whenever the particular form of business being conducted is restricted to specific forms of entity, such as the conduct of professions such as law, medicine, or public accounting. Also, if the business has secured creditors who may object to the transfer of assets, they must be appeased.

Tax Consequences. Assuming the feasibility requirements are met, does it make sense? Do the tax and nontax strengths outweigh the tax and nontax costs of the conversion? Tax costs are dramatically dif-

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ferent for each of the different tax entities. With few exceptions, proprietorship and partnership conversions can be accomplished tax-free. Conversions from a corporation to a different entity can involve a corporate liquidation. That means two possible levels of tax for a C corporation and for an S corporation. However, if the assets and stock have depreciated rather than appreciated, it may be clearly advantageous to liquidate.

A: CONVERSION OF A SOLE PROPRIETORSHIP TO AN LLC

A sole proprietor has unlimited liability for his or her business debts and action. An LLC can protect the business owner's personal assets

> **Practitioner Note.** Most states have amended their statutes to allow one-member LLCs, but some states still require two or more members.

Formation. When a sole proprietorship is converted to a one-member LLC, the LLC is disregarded for tax purposes unless the member elects to have it taxed as a corporation. The sole proprietor can contribute all of the assets of the business, subject to the associated liabilities, to the newly formed entity. Although the legal owner of the asset changes, the transfer has no tax effects if the LLC is a disregarded entity, since the sole proprietor remains the owner of the assets for tax purposes. When a sole proprietor forms an LLC with another member or a one-member LLC converts to a two-member LLC (whether by selling an LLC interest to the new member or by having the new member contribute cash or property to the LLC), the transaction is treated as a partnership formation. (Rev. Rul. 99-5, 1999-5 I.R.B., I.R.C. §§721; 722; 723; 1001; 1223).

> **Practitioner Note.** There may be issues other than federal tax issues to consider, depending on state law. Other issues may include homestead exemption, franchise tax, filing new articles of organization, and filing new mortgages or other documents to secure debt.

Taxation. In general, contributions to an LLC taxed as a partnership are tax-free under Code §721. There are exceptions and special rules for contributions of debt and contributions of services. If an interest in an LLC is issued in exchange for services, the exchange is taxable if the interest is an interest in capital and may be taxable if it is an interest in profits only.

How a sole proprietorship converted to an LLC will be treated for federal tax purposes depends on the number of members and the check-a-box election. A one-member LLC is a disregarded entity reported on the member's Schedule C or F. A two-or-more-member LLC is treated as a partnership. An LLC (whether it has one member or more than one member) can elect to be taxed as a corporation by filing Form 8832, Entity Classification Election.

Sole proprietorships that convert to an LLC may also need to consider at-risk recapture under I.R.C. §465(e), application of self-employment tax, application of state unemployment, and workers compensation.

Example 2. Joe Smith operates a vegetable growing enterprise. He grows and delivers vegetables to the local grocery. He has operated in the past as a sole proprietor reporting taxable income and expenses on Schedule F. He is considering starting a pick-your-own enterprise and wants the added liability protection of an LLC. Joe's state statute provides for a one-member LLC. He has the following assets and liabilities:

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Description	FMV Assets	Liabilities	Tax Basis	Potential Gain
Land & improvements	$200,000	$75,000	$125,000	$75,000
Machinery	$ 45,000	$12,500	$ 32,500	$12,500
Total	$245,000	$87,500	$157,500	$87,500

With the approval of Joe's creditors, Joe will contribute the above assets and liabilities to Joe's U-Pick, LLC.

Question 2A. Will Joe recognize any of the $87,500 taxable gain by forming Joe's U-Pick?

Answer 2A. No, his basis from the debt is the same as the deemed distribution resulting from the LLC's assumption of his debt.

Question 2B. How will Joe report income and expenses for tax purposes?

Answer 2B. Joe will continue to report on Schedule F, unless he elects to be taxed as a corporation on Form 8832.

B: CONVERSION OF A PARTNERSHIP OR LLC TO A CORPORATION

A partnership or LLC can be incorporated three different ways: (1) a transfer of assets and liabilities from the partnership or LLC to the corporation in exchange for corporate stock and any other consideration, followed by the liquidation of the partnership; (2) a distribution of partnership or LLC assets and liabilities to its partners or members, who then transfer the assets and liabilities to the corporation in exchange for stock and other consideration; or (3) the contribution by the partners or members of their partnership or LLC interests to the corporation in exchange for corporate stock and other consideration.

The IRS has ruled that the tax consequences with regard to partnership incorporation are determined by the method that is used. (Rev. Rul. 84-111, 1984-2 C.B. 88). Incorporation of an LLC that is taxed as a partnership will be subject to the same rules. As a general rule, any of the methods will result in tax-free incorporation, but the method may affect the tax consequences. Thus, practitioners must determine the tax implications at each step of the transaction.

Example 3. Jim Jones and his dad have operated as a farm partnership for many years. They are equal partners. They bring you their records for 1999. They tell you that they incorporated their farming business in February 1999 because their insurance agent told them they needed to limit their liability from the farming operation. The balance sheet for the new corporation for 2/28/99 reflects the following:

ASSETS		FMV	Basis
Cash		$ 745	$ 745
Accounts Receivable		467	0
Inventories		615	0
Chemicals		38,207	0
Depreciable Assets	$263,472		
Less: Accumulated Depreciation	(160,045)	103,427	103,427
Co-op Book Credits		1,178	1,178
Total Assets		**$130,231**	**$105,350**

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LIABILITIES AND CAPITAL

Short-term Notes:		
Operating Note #123	$161,844	
Chemical Note - Vendor # 1	38,207	
Operating Note - #234	10,750	
Operating Note - #345	10,000	
Total Liabilities		$220,801
Shareholders' Capital Accounts		(90,570)
Liabilities and Capital		$130,231

Question 3A. Is the initial contribution to a corporation in exchange for corporate stock a tax-free exchange?

Answer 3A. No, as explained below. I.R.C. §351 states:

> Sec. 351. Transfer to corporation controlled by transferor.
> (a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined by §368(c)) of the corporation.

Thus, it **appears** that the above transaction would be tax free, if the individuals making the transfers control the new corporation. However, I.R.C. §357(c) must be considered:

> Sec. 357. Assumption of liability
> (c) Liabilities in excess of basis.
> (1) In general. In the case of an exchange–
> (A) To which §351 applies, or
> (B) To which §361 applies by reason of a plan of reorganization within the meaning of §368(a)(1)(D), if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Certain Liabilities Excluded. Since the amount of total liabilites transferred to the new corporation exceeds the basis of the assets transferred, Jim and his father must report taxable gains on their 1999 individual tax returns.

Computation of the Taxable Gain on Transfer	
Total liabilities transferred to corporation	$220,801
Less: Chemical Note which, if paid, is deductible	(38,207)
Balance	$182,594
Less: Basis of assets transferred to corporation	(105,350)
Amount of taxable gain on the conversion	**$ 77,244**

Jim and his father would each report half of the **gain,** or **$38,622,** in Part II on their 1999 Forms 4797, Ordinary Gains and Losses.

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C: CONVERSION OF A C CORPORATION TO ANOTHER ENTITY SUCH AS AN LLC

Conversion of a C corporation to an LLC can create significant negative tax consequences. Liquidation can be taxable to both the corporation and its shareholders. If the corporation's assets and/or stock have appreciated, the tax cost of liquidation can be prohibitive. If the corporation has losses, there may be little or no tax cost. Each situation must be analyzed to determine feasibility. Assuming that state statutes allow the conversion and creditors are agreeable, the tax cost of liquidation must be weighed against the benefits from conversion to an LLC.

Liquidation of a corporation is generally a taxable event for both the corporation and its shareholders. I.R.C. §336(a) states that a liquidating corporation recognizes gain on the distribution of appreciated property, recognizes depreciation recapture as if the corporation had sold each of its assets at its fair market value, and generally recognizes loss on the distribution of depreciated property. I.R.C. §331(a) provides that the corporation's shareholder(s) also recognize gain or loss on the distribution equal to the fair market value of the distribution received minus the basis in the shareholder's stock.

If the tax cost associated with a complete corporate liquidation is too great, alternatives include:

- Parallel operations
- Installment sale followed by liquidation
- Parallel operations coupled with sale of assets
- Parallel operations coupled with leasing and/or licensing of assets
- Joint venture

No matter what conversion technique is used to convert a business from pure corporate ownership to substantial or complete LLC ownership, valuation of the business is a key issue and potential point of attack by the IRS. Any corporate conversion technique that does not involve liquidation of the corporation is an invitation to the IRS to see whether it can come up with some variation of a substance-over-form argument that would result in more tax being due. The most dramatic argument for the IRS is that there has been a constructive liquidation of the corporation.

The IRS has ample weapons–the accumulated earnings tax, the personal holding company tax, and the S corporation passive income limitation–to keep taxpayer advantages from the operation of passive corporations within reasonable bounds. All alternatives to complete liquidation carry significant risks. **Careful consideration should be given before converting a C corporation to an LLC.**

> **Practitioner Note.** Conversion of an S corporation to another entity such as an LLC has similar tax consequences at the corporate level–gain or loss is recognized on sale or distribution of assets at fair market value. However, gain recognized by the corporation passes through to the shareholders and increases the shareholders' basis in their shares of stock, which reduces their gain upon liquidation of the corporation.

ISSUE 3: FILING REQUIREMENTS FOR PARTNERSHIPS AND LLCS THAT ARE TAXED AS PARTNERSHIPS

Taxpayers in general (and agricultural producers specifically) frequently agree to pool efforts and resources to engage in different types of economic activities. These agreements should be formal written documents that specify details of formation, operation, and potential dissolution of the activity. Unfortunately, many such activities are started, operated, and terminated based on a verbal understanding, a handshake, and possibly a lawsuit.

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Definition: The Internal Revenue Code defines "partnership" in two separate sections: §761(a) and §7701(a)(2). Both define "partnership" in a negative way, i.e., what it is not. A partnership is not a corporation, trust, estate, or sole proprietorship. The IRS defines a partnership as the relationship between two or more persons who join to carry on a trade or business, with each person contributing money, property, labor, or skill and each expecting to share in the profits and losses of the business, whether or not a formal partnership agreement is made. The term "partnership" includes a limited partnership, syndicate, group, pool, joint venture, or other nonincorporated organization, through or by which any business, financial operation, or venture is carried on.

A joint undertaking merely to share expenses is **not** a partnership. Mere co-ownership of property that is maintained and leased or rented is **not** a partnership. However, if the co-owners provide services to the tenants, a partnership exists. It is not always easy to determine whether an arrangement is a profit-sharing agreement with employees or a valid partnership. If an individual proprietor takes in an outsider or an employee, who is to share in profits and losses and contributes cash or other property to the business to be used for its requirements, there is usually a partnership, regardless of whether a formal partnership agreement has been made. A commingling of funds or assets of two or more persons for a common business purpose, from which the earnings are shared, usually denotes a partnership, unless it is clear that only a loan was intended. However, a joint undertaking merely to share expenses is not a partnership. It is possible that an arrangement can make two persons partners in an enterprise even though the word "partnership" is not mentioned, if the arrangement has the effect of a partnership or joint venture. If there is a partnership, the members who participate in the venture are partners.

EXCLUSION FROM PARTNERSHIP RULES

A qualifying syndicate, pool, joint venture, or similar organization may elect under Treas. Reg. §1.761-2 not to be treated as a partnership for federal income tax purposes and will not be required to file Form 1065 except for the year of election.

Reasons for Making the Election Not to Be Treated as a Partnership

- It allows partners to make separate tax elections which, under I.R.C. §703(b), are otherwise required to be made by the partnership. For example, by electing out of the partnership provisions, partners can avoid the need to use the same accounting method as the partnership and can elect individually whether to use the installment method or not; whether to expense an asset under I.R.C. §179; whether to use accelerated or straight-line methods of depreciation; elect to expense or to capitalize intangible drilling costs, and so forth.
- It avoids the added burden of maintaining partnership records and preparing partnership tax returns
- It provides assurance of proper tax treatment when it is uncertain whether the arrangement is a partnership or a co-ownership arrangement.

Qualifying Entities. The types of entities that may make the election out of partnership treatment are unincorporated organizations that are formed according to one of the following:

- For investment purposes only and not for the active conduct of a business (investing partnerships), or
- For the joint production, extraction, or use of property, but not for selling services or property produced or extracted (operating agreement groups), or
- By a syndication of dealers in securities, for a short period, for underwriting, selling, or distributing a particular issue of securities (securities syndicates).

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Practitioner Note. Partnerships that sell goods or services in the name of the partnership do not qualify for the election.

How to Make the Election. The election not to be taxed as a partnership is made in a statement attached to, or incorporated in, a partnership tax return, Form 1065. The return does not have to set forth the information requested on Form 1065 or in its instructions relating to the partnership's income, expenses, balance sheet, and so on. It must, however, show the name and address of the organization, and it, or an attached statement, must also

- State that the organization qualifies for the election as an investing partnership, operating agreement group, or securities syndicate.
- State that all members of the organization elect that it be excluded from all partnership provisions.
- State where a copy of the agreement under which the organization operates is available. If the agreement is oral, state from whom the provisions of the agreement may be obtained.
- List the names, addresses, and identification numbers of all the members of the organization.

Sample Election 3.1. Election Pursuant to Code §761:

To Be Wholly Excluded from Partnership Rules (Subchapter K)

The name of our organization is Bosworth Enterprises, the address of which is 1234 Anyplace Rd, Anywhere, US, where a copy of the agreement under which the organization operates is available.

Pursuant to Code §761, full exclusion is hereby elected in behalf of Bosworth Enterprises from the application of all the provisions of Subchapter K beginning with the tax year ending Dec. 31, 20XX, to the return for which year this statement is attached.

Bosworth qualifies for this election as an investing partnership that satisfies the requirements of Treas. Reg. §§1.761-2(a)(1) and (2). All the members of the organization elect that Bosworth Enterprises be excluded from all the provisions of Subchapter K. The names, addresses and Social Security numbers of the members are:

Rufus P. Bosworth
1234 Anyplace
Anywhere, US
111-11-1111

James Jones
12345 Jones Rd.
Austin, TX
222-22-2222

John Jones
9 Rob Roy
Austin, TX
333-33-3333

Rufetta Bosworth
1234 Anyplace Rd.
Anywhere, US
444-44-4444

When to Make the Election. Form 1065, with the required statements attached, must be timely filed (including extensions) for the first taxable year for which the election is to be effective. There is an automatic six-month extension for making the election even if there is no extension for filing the return [Treas. Reg. §301.9100-2(b)].

Deemed Election. When an organization has not filed the forms and statements that are required to make the election not to be taxed as a partnership, it will nevertheless be **deemed** to have made a proper election if it can be shown from all the surrounding facts and circumstances that, at the time of its formation, the organization's members **intended** to secure exclusion from all of the partnership tax

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rules beginning with the first taxable year of the organization. Either of the following facts may indicate that the required intent was present:

- At the time of formation of the organization, there was an agreement among the members that the organization be excluded from the partnership tax rules beginning with the first taxable year of the organization [Treas. Reg. §1.761-2(b)(2)(ii)(a)].
- The members of the organization owning substantially all of the capital interests **report** their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from the partnership tax rules beginning with the first taxable year of the organization [Treas. Reg. §1.761-2(b)(2)(ii)(b)].

Required to File. Except as provided below, every domestic partnership must file Form 1065, unless it neither receives income nor incurs any expenditures treated as deductions or credits for federal income tax purposes.

A foreign partnership that engages in a trade or business within the United States or has gross income derived from sources in the United States must file Form 1065, even if its principal place of business is outside the United States or all its members are nonresident aliens. Entities formed as LLCs and treated as partnerships for federal income tax purposes must file Form 1065.

Each partner includes his or her share of partnership income and deductions on his or her income tax return for his or her taxable year in which the partnership year ends. It does not matter when the partnership income is distributed or distributable to the partner.

When Form 1065 is required, some partnerships can skip page 4 (Schedule L, Balance Sheet per Books, Schedule M-1 and Schedule M-2) by answering yes to all three parts of question 5 below:

Question 5: Does This Partnership Meet ALL THREE of the Following Requirements?

a. Total receipts are less than $250,000.

b. Total assets are less than $600,000.

c. Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return.

When to File. Generally, a domestic partnership must file Form 1065 by the 15th day of the 4th month following the date its tax year ended as shown at the top of Form 1065. A partnership whose partners are all nonresident aliens must file its return by the 15th day of the 6th month following the date its tax year ended. If the due date falls on a Saturday, Sunday, or a legal holiday, the tax return is due on the next business day. If more time to file is needed, **Form 8736,** Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts, should be filed for an automatic 3-month extension. Form 8736 must be filed by the regular due date of the partnership return. If additional time is needed, **Form 8800,** Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts, should be filed for an additional extension of up to 3 months. The partnership must show reasonable cause to get this additional extension. Form 8800 must be filed by the extended due date of the partnership return.

Late Filing Penalty. A penalty is assessed against any partnership that must file a partnership return and fails to file on time, including extensions, or fails to file a return with all the information required. The penalty is $50 times the total number of partners in the partnership during any part of the tax year for each month (or part of a month) the return is late or incomplete, up to 5 months.

Relief for Late Filing. The penalty will not be imposed if the partnership can show reasonable cause for its failure to file a complete or timely return. Certain small partnerships (with 10 or fewer partners) meet this reasonable cause test if

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- All partners are individuals (other than nonresident aliens), estates, or C corporations.
- All partners have timely filed income tax returns fully reporting their shares of the partnership's income, deductions, and credits.
- The partnership has not elected to be subject to the rules for consolidated audit proceedings.

(Rev. Proc. 81-11, 1981-1 C.B. 651; Rev. Proc. 84-35, 1984-1 C.B. 509)

If a penalty is assessed, a request for relief under Rev. Proc. 84-35 should be sent in writing to the service center where the return is filed. All partners' names and tax identification numbers should be included.

ISSUE 4: SELF-EMPLOYMENT TAX FOR MEMEBERS OF LLCS TAXED AS PARTNERSHIPS

Generally, a member's distributive share of LLC income is subject to self-employment tax if the member's interest in the LLC has the characteristics of a **general partner's** interest. A member's share of LLC income **is not** subject to self-employment taxes if the member's interest has the characteristics of a **limited partner,** except for guaranteed payments that are remuneration for services.

Prior to the issuance of the 1994 proposed regulations, state law controlled the definition of a limited partner. If the entity was not classified as a limited partnership under state law, the taxpayer would not be able to exclude the distributive share of partnership earnings from self-employment tax under I.R.C. §1402(a)(13). Even limited activity or participation by a partner, as a co-owner of a mineral lease was includible in computing net earnings from self-employment. (Rev. Rul. 58-166, 1958-1 C.B. 324– I.R.C. §1402)

Under this standard, members of other organizations such as limited liability partnerships LLPs, LLCs, or joint ventures could not achieve limited partner status and thus were required to include their distributive share of income in net earnings from self-employment, regardless of their participation in the business activity.

OLD PROPOSED REGULATIONS

The December 29, 1994, proposed regulations addressed the self-employment tax issue specifically for members of LLCs. They provided that a member's distributive share of income from the LLC was **not** subject to self-employment tax if the member met all of the following tests:

1. Did not participate in the management of the entity.
2. The member's activity would have resulted in qualification as limited partner.
3. The LLC could have been formed as a limited partnership under state law in the state where the entity was formed. (Preamble, Proposed regulations, December 29, 1994.)

Under these prior regulations, the definition of "limited partner," for purposes of I.R.C. §1402(a)(13), was controlled by state law. Thus, members of identical LLCs organized in different states could be treated differently for federal tax purposes. Also, the tax treatment of members of other non-LLC organizations that were treated as partnerships for federal tax purposes were not addressed in the proposed regulation. Given these deficiencies, the proposed regulations were revoked and replaced with new proposed regulations issued in January 1997 [Prop. Reg. §1.1402(a)-2].

NEW PROPOSED REGULATIONS

The new proposed regulations use a functional test to define a limited partner specifically for purposes of I.R.C. §1402(a)(13). The separate test for LLC members is eliminated. The new regulations provide like treatment for any organization classified as a partnership pursuant to the regulations under I.R.C. §7701. Treas. Reg. §301.7701-3 provides that "the term 'partnership' includes a syndicate, group, pool,

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joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954." The new regulations also resolve potential differences in tax treatment for members of identical entities created using different states' definition of limited partner.

Under the proposed regulations, a member may exclude some or all of the income from self-employment earnings if any of the following conditions exists:

1. The member is classified as a limited partner.
2. The member owns more than one class of membership interest.
3. The member bifurcates his or her distributive share. This means that the member divides his or her distributive share of income from the one class of membership interest into a portion that is treated as being subject to self-employment tax and a portion that is treated as not being subject to self-employment tax.

Generally, an individual will be treated as a limited partner under the proposed regulations unless one or more of the following is true:

1. The individual has personal liability (as defined in §301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner or member; i.e., is not a limited partner.
2. The individual has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; i.e., has rights not granted to a limited partner.
3. The individual participates in the partnership's trade or business for more than 500 hours during the taxable year.

If, however, substantially all of the activities of a partnership or LLC involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner. There is an exception for partners who provide only a de minimis amount of services. However, the term "de minimis" is not defined for this purpose.

In addition, the proposed regulations allow an individual who is not a limited partner for I.R.C. §1402(a)(13) purposes to exclude from net earnings from self-employment a portion of that individual's distributive share if the individual holds more than one class of interest in the partnership or LLC. The individual will be treated as a limited partner, and will be exempt from self-employment taxes, with respect to one of the classes of partnership or LLC interests if, immediately after the individual acquires the interest, both of the following are true:

1. Limited partners or members that meet the requirements for not being subject to the self-employment tax own a substantial, continuing interest in that specific class of partnership or LLC interest.
2. The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership or LLC interest held by those limited partners or members.

A member who is not a limited partner because he or she works more than 500 hours for the LLC may also exclude from self-employment earnings a portion of his or her distributive share. The member must own only one class of membership interest. The member must bifurcate the membership interest by excluding from income any guaranteed payment. The member is treated as a limited partner and is exempt from self-employment taxes with respect to the remaining income if, immediately after acquiring the membership interest, both of the following apply:

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1. Other members who are treated as limited partners own a substantial, continuing interest in the same class of membership interest.
2. The member's rights and obligations with respect to that class of membership interest are identical to the rights and obligations of the same class held by members who are treated as limited partners. Together, these rules exclude from a member's net earnings from self-employment amounts that are demonstrably return on capital invested in the LLC.

Example 4. Facts. A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $10 for one LLC unit. B contributes $20 for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $60 for 600 hours of services rendered to LLC and C receives a guaranteed payment of $100 for 1,000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

Solution. A is treated as a limited partner in LLC because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under I.R.C. §1402(a)(13).

B's guaranteed payment of $60 is included in B's net earnings from self-employment under I.R.C. I.R.C. §1402(a)(13). B is not treated as a limited partner, because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participate in LLC's trade or business for more than 500 hours during the taxable year. Because B does not hold more than one class of interest in LLC, he does not have a separate interest to treat as a limited interest. However, B can bifurcate his interest and be treated as a limited partner, because A is a limited partner who owns a substantial interest with rights and obligations that are identical to B's rights and obligations and B has worked more than 500 hours in the LLC. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under §1402(a)(13). B's guaranteed payments are earnings from self-employment even though she qualifies for her distributive share to be excluded from self-employment income.

C's guaranteed payment of $100 is included in C's net earnings from self-employment under I.R.C. §1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under I.R.C. §1402(a). C is not a limited partner, because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under I.R.C. §1402(a).

These proposed regulations would be applicable beginning with the taxpayer's first tax year beginning on or after the date the proposed regulation is published as a final regulation in the Federal Register.

Current Status. However, due to strong opposition to these proposed regulations, IRS was prohibited from issuing temporary or final regulations on the definition of limited partner for self-employment tax purposes prior to July 1, 1998. The congressional moratorium has now expired without Congress taking action to clarify the issue. However, the IRS has not withdrawn the proposed regulations. It has given no official indication whether taxpayers may rely on the proposed regulations. The IRS has informally indicated that it is unlikely to reissue the regulations or issue final regulations until Congress provides a legislative solution.

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Practitioner Caution. In the 1997 Taxpayer Relief Act, the Senate expressed its displeasure with the proposed regulations defining limited partners. It stated that this task should be accomplished by the legislature. The conference committee directed the IRS not to issue any temporary official regulations on this matter before July 1, 1998 (§734 of the Senate amendment to H.R. 2014).

Lack of Guidance. Based on the rejection of these proposed regulations, one may predict that future regulations would be no more restrictive that those rejected. Given no further guidance from IRS, some tax lawyers and accountants have continued to urge Congress to clarify this issue. However, since there is limited time remaining in this legislative session no help is expected from Congress or the IRS in 2000.

As a result, taxpayers who want to exempt their partnership's distributive share from the self-employment tax must be ready to prove to IRS (if challenged) that they: (a) are limited partners, and (b) have complied with the limited partnership statute where their partnership was established. A taxpayer's limited involvement in the operations of a partnership will not make the taxpayer a limited partner for self-employment tax purposes absent proof that those two requirements are met.

Practitioner Note. Self-employment taxes are not an issue if none of the members of an LLC are individuals.

Practitioner Note. If an LLC makes the election on Form 8832 to be taxed as a corporation, it is a corporation for all tax purposes. Thus, self-employment tax is not an issue.

ISSUE 5: FAMILY LIMITED PARTNERSHIPS

A family limited partnership is a very attractive estate-planning tool because it permits a parent to significantly **discount** the value of gifts to children that might not be discountable if made outright. A family partnership enables a donor to divide a large asset or pool of assets to make several smaller gifts, in much the same way that a family corporation enables a donor to make multiple gifts of shares of stock. Like an S corporation, a family partnership preserves the character of items of income, deduction, gain, and loss recognized at the partnership level and taxed directly to the partners.

A family partnership, however, can be more flexible than a corporation (even an S corporation) in that

- The partners can, in their agreement, detail their respective rights and interests with far greater precision.
- The tax problems attendant on withdrawal of contributed property from a partnership are far fewer than those attendant on withdrawal of contributed property from a corporation.
- The limitations on the number and type of stockholders imposed on an S corporation do not apply to a family partnership.

Discounts. Two discounts generally are available: a lack of marketability discount and a minority discount.

1. A **lack of marketability discount** reflects the fact that the partnership agreement will restrict the sale or transfer of the partnership interests so that there is no ready market for those interests.

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2. A **minority discount** reflects the inability of the limited partner to compel partnership distributions or to compel liquidation to obtain the limited partner's share of the partnership assets. It also reflects the inability of the limited partner to control partnership investments. Reversing its long-standing position, in Rev. Rul. 93-12, the IRS held that a minority discount is available with respect to transfers between family members despite the fact that, after the transfer, control exists as a family unit.

Economic Effect. The combined discounts for lack of marketability and minority can be quite substantial and might range from 30% to 60%, depending upon the facts and circumstances.

Advantages. Family partnerships offer a number of advantages as a means of transferring family wealth.

- The creation of a family partnership is relatively simple, requiring a partnership agreement, a deed of gift, and (in the case of limited partnerships) formation as a separate legal entity under State law to receive a partnership certificate.
- Using a family partnership to make gifts of real estate located in a state in which the donor does not reside can eliminate ancillary probates. Real estate owned by the decedent directly is subject to probate in the state where it is located–regardless of the state of residence of the deceased owner. A partnership interest is treated as personal property and is subject to probate only in the state of the decedent's domicile, even if the partnership owns real estate.
- A family partnership enables a donor to retain control over the property being given away. The donor can be designated the managing partner (of a family general partnership) or the general partner (of a family limited partnership). In either case, the donor could retain most or all of the managerial controls over the property, until all of it has been transferred to the donee-partners, without jeopardizing the estate tax advantages of the partnership. The IRS has ruled privately on a number of occasions that the retention of control over the partnership activities by a donor who serves as a general partner is not a retained right to control the beneficial enjoyment of the transferred partnership interests. See Ltr. Rul. 9415007, 9310039, and 9310006.
- Unlike a corporation, a partnership is not a taxable entity for income tax purposes, so the donor's interest in the family partnership's net income escapes taxation at the partnership level.
- Multi-class partnership interests can be used to freeze the value of the interests of a deceased partner for gift and estate tax purposes under the special valuation rules of Chapter 14 of the Internal Revenue Code.
- A partnership interest is relatively secure against the claims of the partner's creditors. A creditor of a partner may force the partner to transfer his or her partnership interest to the creditor, but the transferee becomes an "assignee," rather than a new partner, and is not eligible to participate in partnership activities and management. The assignee may obtain only a "charging order," entitling the assignee to the assignor-partner's share of any partnership distributions that are actually made. Status as an assignee with a charging order is generally very undesirable, because the assignee is treated as a partner for federal income tax purposes and is taxed on a share of partnership income, even if the partnership does not make any distributions. (Rev. Rul. 77-137, 1977-1 C.B. 178).
- An outright gift of a partnership interest in a family partnership (or a gift in a trust that otherwise qualifies for the gift tax annual exclusion) is generally eligible for the gift tax annual exclusion.

Disadvantages. Family partnerships used as a means to transfer family wealth have relatively few disadvantages, but any one could be significant for a particular situation.

- Legal fees for setting up a family limited partnership could be substantial. When appraisal fees are taken into account, this amount could be even higher.
- Loss of stepped-up basis. Any lifetime transfer of assets results in a tax trade-off. Although transfer taxes may be greatly reduced, the donee may take a much lower basis in the transferred

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assets by taking the assets with a carryover basis rather than a stepped-up basis. The transfer tax (estate and gift) advantages must be weighed against the possible income tax (capital gains) disadvantages.

- The donor's annual gifts of a partnership interest are valued on the date of each individual gift. Thus, a donor who retains a significant partnership interest in a family partnership in which the underlying asset continues to appreciate in value is credited with a portion of the appreciation in the value of the retained interest, making it necessary to make even more gifts to give away the donor's entire asset.
- Family partnerships are subject to the family partnership rules under I.R.C. §704(e) in order for a donee-partner to be recognized as a partner for income tax purposes. Specifically, capital must be a material income-producing factor for the partnership, and the donee-partner must be the real owner of an interest in that capital. If these tests are not met, partnership income will be taxed solely to the donor and others who invested their own capital or services, depriving the donor of the income-shifting advantages otherwise available through the family partnership.

Example 5. John and Mary, each age 55, jointly own and operate J & M Land & Cattle Company. Their two sons Jim, age 27, and Joe, age 24, are each paid a salary and are gradually taking additional management responsibilities. John and Mary would like to keep control of the assets rather than give too much too soon to their sons, who, they feel, may not be ready for the responsibility. But they want to transfer the assets during their lifetime to protect them from future creditors and reduce their taxable estate.

John and Mary have the following assets and liabilities:

Asset	Fair Market Value	Debt	Tax Basis	Potential Gain/Loss
Land & Improvements	$1,000,000	$250,000	$500,000	$500,000
Raised Livestock & Grain	200,000	100,000	-0-	200,000
Machinery & Equipment	300,000	150,000	85,000	215,000
Total	$1,500,000	$500,000	$585,000	$915,000

Assume that John and Mary contribute their assets to a family limited partnership in exchange for general partnership interests and limited partnership interests. There is no gain or loss on the transfer.

If John and Mary each retain a 30% general partnership interest and gift a 20% limited partner interest to each of their sons, the gift **may qualify for discounts for lack of marketability and a minority ownership discount.** Assuming a combined discount of 40%, John and Mary can each use their annual gift exclusion to transfer free of gift tax $16,666 FMV of assets to each of their sons. The portion of the gift over and above his or her annual gift exclusion will use up a portion of each parent's unified credit. John and Mary would be able to give a larger share of their estate by limiting the general partner interests to 10% and increasing the limited partner interests to 90%.

Question 5A. What is the value of the gift to each son, and how much of the parents' applicable exclusion amount is used?

Answer 5A.

Net value of company	$1,000,000	($1,500,000 FMV – $500,000 debt)
20% given to each son	200,000	
Less 40% discount	–80,000	
Less split gift annual exclusion	–20,000	
Taxable gift	100,000	
Applicable exclusive amount used	100,000	
Gift subject to tax	-0-	

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Question 5B. How much applicable exclusion amount would be used if discounts were not used?

Answer 5B.

20% given to each son	$200,000
Less split gift annual exclusion	$ 20,000
Taxable gift	$180,000
Applicable exclusion amount used	$180,000

Question 5C. Would future annual gifts of partnership interests be allowed the same discounts?

Answer 5C. Yes. Assuming the same combined discount of 40% (see Answer 5.1), John and Mary could use their joint gift splitting to give $20,000 of discounted partnership interest to each of their sons each year. The fair market value (FMV) of the underling partnership assets would be $33,333.

FMV of partnership assets	$33,333
Less 40% discount ($33,333 × 40%)	13,333
Discounted partnership interest	$20,000

Practitioner Note. The $10,000 annual gift tax exclusion is indexed for inflation and therefore may increase for future years.

Question 5D. Would John and Mary's individual remaining general partner interest in the family limited partnership be eligible for the same discounts when valued in their respective estates?

Answer 5D. Yes.

Planning Pointer. Reduction in estate taxes and meeting the parents' control objectives must be weighed against a loss of potential step-up in basis and cost associated with formation and operation of the family limited partnership.

Recommendation. To protect a gift of a limited partnership interest from a possible valuation contest, make a formula gift of the interest. For example, a married couple's annual exclusion gift to a child might be described as "that number of limited partnership units (including a fraction thereof) equal in value to $20,000." If the IRS successfully challenges the valuation discount, the formula simply absorbs the extra value allocated to the transferred interest. Thus, the transfer remains fully protected by the annual exclusion.

Warning. These are complex rules. Advice from specialists is strongly recommended to achieve the desired tax benefits.

Caution. Planners should be aware of the provisions of the White House proposed 2000 fiscal year (Y2K) budget, described in the Treasury Department's "General Explanations of the Administration's Revenue Proposals" (known as the "Green Book"). Among other provisions, these budget proposals would **eliminate the use of valuation discount planning in most estates** by precluding discounts for lack of marketability and lack of control with respect to family corporations, partnerships, and limited liability companies, **except to the extent that they represent an operating business.** No discounts would be allowed for stock, partnership interests, or LLC interests, to the extent that the entity's assets consisted of cash, cash equivalents, foreign currency, publicly traded securities, real estate, annu-

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ities, royalty- producing assets, non-income-producing property such as art or collectibles, commodities, options, and swaps. Interests in investment holding companies would be valued at their net liquidation values. This proposal would be effective for transfers made after the date of enactment. Congress flatly rejected this proposal, also introducted as part of the fiscal year 1999 budget proposals, in 1998, and again in 1999, and it seems no more likely to be successful in 2000, an election year.

ISSUE 6: S CORPORATION ISSUES

S corporations, like partnerships, are treated as flow-through entities for income tax purposes. Like partnerships, S corporations are not taxed (except as noted below), because income, deductions, losses, and credits flow through to the shareholders. However, S corporations are still corporations, and corporate tax rules apply, unless overridden by the Subchapter S provisions. Like regular C corporations, the shareholders of S corporations enjoy limited liability. The number and type of S corporation shareholders are limited, and allocation of income and expenses is limited to proportional shareholder interests.

TAX ADVANTAGES

- S corporations generally are exempt from taxation. Income flows through and is taxed to the shareholders. Losses flow through to shareholders and can be used to offset income earned from other sources unless limitations apply.
- Because income, loss, and other pass-through items retain their character when they flow through to the shareholders, capital gains are taxed to individual shareholders as though they were earned by the individual.
- Shareholders generally can contribute money to or withdraw money from an S corporation without gain recognition. Shareholders are taxed only on their share of the annual income of the S corporation.
- Profits are taxed only at the shareholder level when earned by the corporation.
- A shareholder's basis in S corporation stock is increased by his or her share of the corporation's income. This basis adjustment reduces the shareholder's gain when he or she sells the S corporation stock, thereby preventing double taxation.

Adjustments to Basis. Each year, each shareholder adjusts his or her basis for his or her allocable portion of the corporation's:

- Income items, which include:
  - Ordinary income
  - Separately stated income and gains
  - Tax-exempt income
- Loss and deduction items, which include:
  - Ordinary loss
  - Separately stated loss and deductions items
  - Nondeductible expenses, such as meal and entertainment expenses
- Distributions, excluding distributions that are treated as dividends for tax purposes

TAX DISADVANTAGES

- All the corporations' current-year profits, whether distributed or not, are taxed to the shareholders.
- Tax-free corporate fringe benefits generally are not available to a more than 2% S corporation shareholder who is employed by the business. Fringe benefits provided by an S corporation are deductible by the corporation but may be taxable to the shareholder.

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- S corporations generally cannot defer income by choosing a fiscal year for the S corporation other than a calendar year.

ACCOUNTS UNIQUE TO S CORPORATIONS

In addition to any accumulated earnings and profits left over from C corporation years, there are some other accounts that the S corporation may be required to report.

1. The Accumulated Adjustments Account (AAA).
   - **a.** This account is basically the sum of the corporation's taxable income since the corporation became an S corporation.
   - **b.** It is reduced by certain expenditures and most distributions to shareholders.
   - **c.** It is the first source, from the corporation's point of view, of distributions to the shareholders.
   - **d.** Under normal circumstances a shareholder receiving distributions from the AAA will not report any income or gain, but will reduce his or her basis in S corporation stock.
   - **e.** If the corporation has been a C corporation at any time in its history and has earnings and profits, any distribution in excess of the AAA could be treated as dividend income to the shareholders. Thus, a careful calculation of this account is necessary.
   - **f.** If the corporation has always been an S corporation, the accounting for AAA poses fewer tax consequences.

2. The Other Adjustments Account (OAA).
   - **a.** This account is not mandated by law, but was created by the IRS to provide a place for items that fell through the cracks.
   - **b.** One example is tax-exempt income, which cannot go to the AAA, to PTI, or to earnings and profits.
   - **c.** This account has little economic significance–it only serves to allow a corporation to use double-entry bookkeeping on a tax basis.

3. Undistributed Taxable Income Previously Taxed to Shareholders (Previously Taxed Income, or PTI).
   - **a.** This account was created only if the corporation was an S corporation prior to 1983.
   - **b.** After 1982, the only possible adjustments to this account are reductions for distributions.
   - **c.** In general, only two rules are important to understanding this account.
     - **i.** First, the account is really a collection of individual shareholder accounts. In other words, only the shareholder who was there when his or her PTI account was created (before 1983) can receive a distribution.
     - **ii.** Second, as is the case with a distribution from AAA, a distribution from PTI will generally result in no income or gain and a reduction of the shareholder's basis in his or her stock.

ELECTION OF S CORPORATION STATUS

To achieve S corporation status, the corporation must file an election, and its shareholders must consent to that election. The S election exempts a corporation from all taxes imposed by Chapter 1 of the Internal Revenue Code (§1–1399) except for the following:

- I.R.C. §1374 built-in gains tax
- I.R.C. §1375 excess net passive income tax
- I.R.C. §1363(d) LIFO recapture tax
- Recapture of previously claimed investment tax credits

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Practitioner Note. In community property states, the shareholder's spouse must also sign the election.

Example 6. All-American Products, Inc. is an S corporation formed in 1998. It has never been a C corporation. For the tax year 1999, All-American had the following differences between its accounting records and its tax return.

1. Total meal and entertainment expenses per books was $6,142.
2. All-American paid employment taxes late and incurred a late filing penalty of $2,950.
3. All-American received tax-exempt interest of $1,000.
4. Non-deductible officer life insurance premiums were $3,200.

In addition, All-American had the following transactions:

1. Received taxable interest income of $2,346.
2. Received taxable dividend income of $3,540.
3. Sold office furniture that resulted in a $1,231 gain of $366.
4. Elected §179 expense election on qualifying capital asset purchased for $3,279.
5. Cash distribution of $144,426, to Sole-Shareholder.

Use this information and Figure 1, Schedule K, and Figure 2, Schedule L, to compute Schedules M-1 and M-2 for All-American Products, Inc.

Figure 1. Schedule K, All-American Products, Inc.

Form 1120S (1999) *All-American Production, Inc* *73-1234567* Page 3

Schedule K Shareholders' Shares of Income, Credits, Deductions, etc.

		(a) Pro rata share items		(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	37,502
	2	Net income (loss) from rental real estate activities *(attach Form 8825)*	2	
	3a	Gross income from other rental activities — 3a		
	b	Expenses from other rental activities *(attach schedule)* — 3b		
	c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4	Portfolio income (loss):		
	a	Interest income	4a	2,346
	b	Ordinary dividends	4b	3,540
	c	Royalty income	4c	
	d	Net short-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4d	
	e	Net long-term capital gain (loss) *(attach Schedule D (Form 1120S))*: (1) 28% rate gain (loss) ▶ ..... (2) Total for year ▶	4e(2)	
	f	Other portfolio income (loss) *(attach schedule)*	4f	
	5	Net section 1231 gain (loss) (other than due to casualty or theft) *(attach Form 4797)*	5	366
	6	Other income (loss) *(attach schedule)*	6	
Deductions	7	Charitable contributions *(attach schedule)*	7	
	8	Section 179 expense deduction *(attach Form 4562)*	8	3,279
	9	Deductions related to portfolio income (loss) (itemize)	9	
	10	Other deductions *(attach schedule)*	10	
Investment Interest	11a	Interest expense on investment debts	11a	
	b (1)	Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)	5,886
	(2)	Investment expenses included on line 9 above	11b(2)	

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Figure 1. Schedule K, All-American Products, Inc. *(continued)*

Credits	12a Credit for alcohol used as a fuel *(attach Form 6478)*	12a		
	b Low-income housing credit:			
	(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)		
	(2) Other than on line 12b(1) for property placed in service before 1990	12b(2)		
	(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)		
	(4) Other than on line 12b(3) for property placed in service after 1989	12b(4)		
	c Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*	12c		
	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e Credits related to other rental activities	12e		
	13 Other credits	13		
Adjustments and Tax Preference Items	14a Depreciation adjustment on property placed in service after 1986	14a	683	
	b Adjusted gain or loss	14b	-846	
	c Depletion (other than oil and gas)	14c		
	d (1) Gross income from oil, gas, or geothermal properties	14d(1)		
	(2) Deductions allocable to oil, gas, or geothermal properties	14d(2)		
	e Other adjustments and tax preference items *(attach schedule)*	14e		
Foreign Taxes	15a Type of income ▶			
	b Name of foreign country or U.S. possession			
	c Total gross income from sources outside the United States *(attach schedule)*	15c		
	d Total applicable deductions and losses *(attach schedule)*	15d		
	e Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e		
	f Reduction in taxes available for credit *(attach schedule)*	15f		
	g Other foreign tax information *(attach schedule)*	15g		
Other	16 Section 59(e)(2) expenditures: a Type ▶ b Amount ▶	16b		
	17 Tax-exempt interest income	17	1,000	
	18 Other tax-exempt income	18		
	19 Nondeductible expenses	19	9,221	
	20 Total property distributions (including cash) other than dividends reported on line 22 below	20	144,426	
	21 Other items and amounts required to be reported separately to shareholders *(attach schedule)*			
	22 Total dividend distributions paid from accumulated earnings and profits	22		
	23 **Income (loss).** (Required only if Schedule M-1 must be completed.) Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16b	23	40,475	

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Figure 2. Schedule L, All-American Products, Inc.

12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
14	Other assets *(attach schedule)*		200		200
15	Total assets		441,944		286,808
	Liabilities and Shareholders' Equity				
16	Accounts payable		57,188		35,373
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities *(attach schedule)*		37,783		16,634
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities *(attach schedule)*				
22	Capital stock		100		100
23	Additional paid-in capital				
24	Retained earnings		346,873		234,701
25	Adjustments to shareholders' equity *(attach schedule)*				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity		441,944		286,808

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Figure 3. Schedule M-1, All-American Products, Inc.

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income (Loss) per Return** (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1	Net income (loss) per books	32,254	5	Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize):	
2	Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):		a	Tax-exempt interest $ 1,000	1,000
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16b (itemize):		6	Deductions included on Schedule K, lines 1 through 11a, 15e, and 16b, not charged against book income this year (itemize):	
a	Depreciation $		a	Depreciation $	
b	Travel and entertainment $ 3,071		7	Add lines 5 and 6	1,000
	Penalty and Office Life Ins 6,150	9,221	8	Income (loss) (Schedule K, line 23). Line 4 less line 7	40,475
4	Add lines 1 through 3	41,475			

Computations for Schedule M-1

Schedule M-1, which is similar to the Schedule M-1 on Form 1120, is a reconciliation of book income or loss with the income or loss shown on the tax return. The schedule must be completed **if** the amount on Line 15, Column (d) of Schedule L (the corporation's year-end total assets) is $25,000 or more.

Line 1. Enter net book income of the corporation on Line 1. All-American's net book income is $41,331.

Line 2. Enter all income and credits included in income subject to tax that were not recorded on the books for this year. For example, if assets that were sold during the year were carried on the books at a value greater than their tax basis, taxable income from the sale will exceed book income.

Line 3. Enter expenses that were taken into account in determining book income but are not deductible in arriving at the amount on Schedule K, Line 23.

Travel and entertainment expenses. Include on Line 3b 50% of meals and entertainment expenses, expenses for use of an entertainment facility, the excess portion of any business gifts over $25, employee achievement awards over $400, the portion of the cost of entertainment tickets above face value, the disallowed portion of luxury water travel expenses, skybox costs, cruise ship convention expenses, and other disallowed travel and entertainment expenses. All-American's disallowed travel and entertainment expense is $3,071, which is entered on Line 3b. Expenses other than depreciation and travel and entertainment expenses should be itemized on the dotted line below Line 3b. Examples of these expenses are premiums paid on term life insurance for corporate officers and interest paid to buy tax-exempt securities.

All-American enters $6,150 ($2,950 employment tax penalty plus $3,200 officer life insurance premium) on the line below Line 3b. See Figure 3, M-1.

Line 5. Income not included in Schedule K, but included in book income of the corporation, is entered here. All-American had $1,000 of tax-exempt interest, which it enters on Line 5a.

Line 6. Schedule K deductions not taken against book income are entered here.

Line 8. The amount on this line, $40,475, should equal the amount in Figure 1, on Line 23, Schedule K.

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SCHEDULE L VS. SCHEDULE M-2

The IRS provides **Schedule M-2** as part of Form 1120S for the corporation to track and report the balance of each account. The balance sheet on **Schedule L,** however, provides for only one retained earnings account. At one time, the IRS required that the balances on Schedule M-2 be reconciled with the retained earnings balance on Schedule L. This proved to be a daunting task and served little if any purpose for the IRS, so it was dropped several years ago.

As the rule now stands, the Schedule L retained earnings are maintained on a **book basis,** whereas the accounts on Schedule M-2 are carried on a **tax basis** (*Agricultural Taxation Issues,* Fall 1999, Harris, Daughtrey). Since Line 24, Retained Earnings, Schedule L, $234,701, is the same as Line 8, Schedule M-2, columns (a) plus (b), All-American's books are kept on a tax basis (see Figure 4).

Figure 4. Schedule M-2, All-American Products, Inc.

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see page 24 of the instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	346,873		
2	Ordinary income from page 1, line 21	37,502		
3	Other additions statement 8	6,252	1,000	
4	Loss from page 1, line 21	( )		
5	Other reductions statement 9	(12,500)	( )	
6	Combine lines 1 through 5	378,127	1,000	
7	Distributions other than dividend distributions	144,426		
8	Balance at end of tax year. Subtract line 7 from line 6	233,701	1,000	

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Statement 8
Form 1120S, Schedule M-2, Line 3
Other Additions

Dividend Income	$3,540
Interest Income	4,346
Section 1231 Gain	366
Total	$6,252

Statement 9
Form 1120S, Schedule M-2, Line 5
Other Reductions

Disallowed Meals and Entertainment	$3,071
Employment tax penalty	2,950
Officers Life Insurance Premiums	3,200
Section 179 Expense	3,279
Total	$12,500

Computations for Schedule M-2

Schedule M-2 analyzes adjustments to the Accumulated Earnings account, Other Adjustments account, and Previously Taxed Income account. It has no counterpart on Form 1120, because a C corporation does not have these accounts.

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Each year, adjustments are made to the beginning balance of the accounts for income or loss, deductions, and distributions reported on Form 1120S, except for distributions on Line 22 of Schedule K (distributions from accumulated earnings and profits while a C corporation).

The schedule is divided into three columns, which are designed to reconcile the three accounts that affect a shareholder's basis. Column (a) is for the Accumulated Adjustments account, Column (b) is for the Other Adjustments account, and Column (c) is for the shareholders' undistributed taxable income previously taxed account. Since All-American's first year as an S corporation was 1998, it has no balance in this last account.

In figuring Lines 2 through 7, make sure that all items of income, loss, and deductions reported on page 1 and on Schedule K are used.

Column (a). Accumulated Adjustments Account (AAA). This account reflects the corporation's accumulated undistributed net income for its post-1982 years. If the corporation has accumulated earnings and profits, it must maintain the AAA account to determine the tax effect of distributions. If it has no accumulated earnings and profits, the account will not affect the tax treatment of distributions. IRS nonetheless recommends that the account be maintained in case the corporation engages in a transaction, such as a merger into an S corporation with accumulated earnings and profits, for which the AAA would be relevant.

For an S corporation's first tax year, its AAA balance at the beginning of the year is zero.

The AAA is determined at the end of the tax year by taking into account the beginning-of-year AAA balance and the items for the tax year as explained below and in the order listed.

1. Increase the AAA by:
   - Separately computed items of income (other than tax-exempt interest);
   - Non-separately computed income; and
   - The excess of deductions for depletion over the basis of property subject to depletion (unless the property is an oil and gas property the basis of which has been allocated to shareholders).

2. Decrease the AAA by:
   - Items of separately computed loss and deduction;
   - Non-separately computed loss;
   - Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account, other than expenses related to tax-exempt income and federal taxes attributable to a C corporation tax year; and
   - The sum of the shareholders' deductions for depletion with respect to oil and gas wells.

Practitioner Note. If the total decreases under (2) exceed the total increases under (1) above, the excess is a "net negative adjustment," which should be taken into account under (4) below, and not under (2).

3. Decrease AAA (but not below zero) by property distributions (other than dividend distributions from accumulated E&P), unless the corporation elects to reduce accumulated E&P first. The AAA may not be reduced below zero for distributions. If the total distributions made by an S corporation during a tax year exceed the amount in its AAA at the end of the year, the balance in the AAA must be allocated among the distributions in proportion to their size.
4. Decrease AAA by any net negative adjustment. There can be a negative balance in the AAA at the end of an S corporation's tax year. Thus, income in a later year will cause a positive balance only after offsetting the negative amount.

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Lines 1–3. All-American's balance in the account as of the beginning of the year, $346,873, is entered on line 1.

The corporation's income and expense items that are netted on line 21 of page 1 of the return, $37,502, are entered on line 2.

Line 3. Items of income or gain (except for tax-exempt income if the corporation has accumulated earnings and profits) that are not reported on Page 1, but that are included on lines 2–6 and/or 21 of Schedule K, are entered on line 3. All-American enters the total of Schedule K, lines 4a, Interest 4b, Dividends, and line 5, Net §1231 gains, which is $6,252. (See Figure 4.)

Lines 4–8. Schedule K expense and loss items are entered on line 5. For All-American, this is the sum of Schedule K, lines 8, §179 Expense plus the $3,071 of disallowed travel and entertainment expenses and the $2,950 of disallowed penalty, and $3,200 officer life insurance premium, for a total of $12,500. The disallowed travel and entertainment and life insurance expenses reduce All-American's AAA because they are nondeductible expenses of the corporation that are not chargeable to capital account. The total of the items from lines 1–5 are combined, and the $378,127 result is entered on line 6.

On line 7, enter All-American's $144,426 distribution. The AAA end-of-year balance, $233,701, is entered on line 8. Given a positive balance for AAA after the distribution, the distribution should be non-taxable to the extent of the shareholders' basis.

Column (b). Other Adjustments Account. This account is increased by tax-exempt income amounts and decreased by nondeductible expenses related to tax-exempt income, federal taxes attributable to a C corporation year, and shareholder distributions. The account is needed because, although tax-exempt income is passed through to shareholders as tax-exempt income, distributions will not be treated as having been made out of tax-exempt income until all accumulated earnings and profits are distributed. The account must reflect tax basis values.

All-American had tax-exempt income of $1,000, which it enters here.

Because the total distributions, other than dividends, do not exceed the balance in the AAA (Column (a)), none of the distribution is applied to the other adjustments account. Therefore, All-American enters zero on Line 7 (Column (b)).

Column (c). Shareholders' Undistributed Taxable Income Previously Taxed (PTI). This account contains income that (a) was earned before 1983 in a year in which the corporation was an S corporation, (b) has been taxed to shareholders, and (c) has not been distributed. The account is used only if the corporation had a balance in the account at the start of the 1999 tax year. It can be decreased but never increased. The account must reflect tax basis values.

Although Schedules M-1 and M-2 can be quite involved, remembering the overall objective can be helpful. M-1 is designed to start with book net income and adjust for any differences between book and tax. The result will be line 23 of Schedule K. The purpose of M-2 is to expand the single retained earnings number in Schedule L, to track the annual additions to and subtractions from the accumulated adjustments account. Since All-American's books are kept on a tax basis, line 24 of Schedule L, $234,701, is equal to the sum of Column (a), $233,701, and Column (b), $1,000.

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