

Chapter 5: Business Entities

Introduction	243	<i>C Corporation</i>	265
Entity Classification	243	<i>S Corporation</i>	275
Choice of an Entity	244	<i>Retirement Plans</i>	276
Considerations in Choosing an Entity	245	<i>Sale of Corporate Assets</i>	276
<i>Partnership</i>	245	<i>Distributions</i>	276
<i>Corporation</i>	250	<i>Shareholder Basis</i>	277
Various Aspects of Each Entity	261	<i>Redemption of Stock</i>	277
<i>Partnership</i>	261	<i>Liquidation of an S Corporation</i>	278

Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

INTRODUCTION

Business owners face a variety of choices when deciding which type of entity to use for operating a business and for tax purposes. Many business operations start out as sole proprietorships, whether it is a Schedule C or a Schedule F business. Frequently, the successful business owner will decide to switch to a different form of business entity.

While income tax considerations for the business are usually the primary objective in seeking the right business entity fit, there are other non-tax considerations that come into play. The non-tax considerations include:

- **Limited Liability.** All businesses are exposed to liability. A business entity operating as a corporation will generally offer less personal risk than the same business would if it were operating as a sole proprietorship. However, a professional corporation generally will not reduce liability. Business counselors will advise that adequate liability insurance is important regardless of the type of entity chosen.
- **Transfer of Business Interests.** By converting the sole proprietorship to a partnership or corporation, the owner can sell or gift a partial interest to other partners and/or shareholders. The Schedule C or F operation does not offer this flexibility. Additionally, the business owner can ensure the continuation of the business if the business is transferred without his direct involvement when he takes a non-active role or when the business is transferred at death. Estate-tax planning for the transfer of a business interest is much more desirable if the business operation is in the corporate or partnership form, since the heirs can preserve the business.

ENTITY CLASSIFICATION

The Internal Revenue Code defines **two basic entities** for tax purposes — the corporation and the partnership. Although the limited liability company (LLC) is not specifically recognized in the tax code, it receives a **default** classification as a partnership. However, the LLC can elect out of its default status as a partnership and be treated as a corporation for tax purposes.

Observation. There are only a few situations where an LLC will elect out of its default status as a partnership and choose to be taxed as a corporation. An important reason for establishing an LLC is to provide debt and business liability protection for the owners (also the case for shareholders of a corporation). Another important reason is to utilize partnership tax status for the entity.

CHOICE OF AN ENTITY

There are two choices of entity when a business owner decides to change business structure from a sole proprietorship:

1. Corporation
2. Partnership

Each business entity has its advantages and disadvantages, not only for tax considerations, but also for issues such as limited liability and ease of transferring ownership.

Below are two examples of business owners exploring choice of entity. The examples show the same income for each entity and the corresponding tax consequences. This is followed by a more detailed look at tax traps and pitfalls to avoid in the entity-selection process, including examples of changing from one business structure to another.

Example 1. Jack Rutger has been a union ironworker for the past 12 years. In August 2001, Jack started a business as a sole proprietorship (Schedule C). He ended the year with a \$40,000 net profit. Jack paid all the self-employment taxes and regular income taxes on a monthly basis. In 2002, Jack and his good friend, Devin Helton, start their own iron-working subcontractor business.

Mr. Rutger and Mr. Helton seek advice from a tax professional about their new venture. They want the best possible vehicle for their tax situation. They expect to gross more than \$600,000 in 2002 and net around \$150,000. Mr. Rutger asks about forming a corporation. He heard a person can own a corporation and not have to pay taxes. This idea appeals to both Jack and Devin. They seek advice regarding their potential 2002 income and an evaluation of the various forms of business structures and what would be best suited for them. Once an entity is selected, they will need to know how to proceed with its implementation. The entrepreneurs have established a budget for operations as follows:

Jack Rutger and Devin Helton 2002 Income and Expense

Gross receipts	\$600,000
Labor	(250,000)
Materials	(75,000)
Crane rental	(50,000)
Overhead costs	(75,000)
Net income to owners	\$150,000

If Jack were to continue as a Schedule C sole proprietorship in 2002, without adding Devin as a co-owner, he will pay regular tax on the net income of \$150,000 and self employment tax on \$85,400 and Medicare tax on the remainder of his net self employment income.

Since the men have decided to form an entity with two owners, they will need to evaluate which entity is best suited to their needs.

CONSIDERATIONS IN CHOOSING AN ENTITY

PARTNERSHIP

A partnership is defined as an association of two or more owners carrying on a trade or business for a profit. Jack and Devin believe this type of entity “fits them to a tee.” A partnership is not hard to form. Often, the formation is as simple as a handshake (not recommended) or as complex as the legal documents would dictate. Outside of a formal agreement between the two partners, the only remaining step is to obtain an Employer Identification Number (EIN). This is done by completing Form SS-4 (Application for Employer Identification Number).

The partnership is a separate entity and files its own tax return (Form 1065). No federal tax is paid by the partnership but the income (or loss) of the partnership is reflected on the individual income tax returns of the partners. The partnership transmits this information to the individuals using a K-1 form. Each partner receives a K-1 annually. The K-1 not only details the actual income or loss, it also shows the specific line items of the partnership transactions that are separately stated on the individual partners’ tax returns.

Jack and Devin like the fact that the partnership does not pay any tax. However, the tax practitioner reminds them that the partners will pay tax on the income via the K-1.

Question A. Jack and Devin ask if the partners can be employees of the partnership and receive W-2 forms, like they have in their past work.

Answer A. No, partners can never be employees of their partnership. They cannot receive W-2s.

Partners can receive guaranteed payments from the partnership. All earnings from the partnership, whether in the form of net income or as guaranteed payments, is subject to self employment tax since the partnership will be conducting an active trade or business.

Question B. Devin asks about liability coverage. An iron worker faces demanding physical activity daily, and the possibility of a major accident. As a business owner, he can be sued if damages from an accident exceed his insurance coverage.

Answer B. Liability can extend to the individual partner through a partnership. However, a Limited Liability Company (LLC) may solve this problem.

An LLC is a new type of entity which has become popular over the past dozen years. An LLC offers the limited liability features of a C corporation but generally files a partnership tax return. If individual partner liability is a major concern, and the partners want to operate within the partnership form of business, the owners should consider an LLC. The LLC is similar to an S corporation, which will be discussed later.

Observation. LLCs are designed to be partnerships. The 1997 Tax Act stated the default classification for LLCs would be a partnership under the “**check a box**” concept. However, the taxpayer can elect out of this default classification and choose the corporate form of organization. One-person LLCs cannot file a partnership return and merely reflect income and expense on the Schedule C, E, or F component of the Form 1040.

Individual owners in a partnership are referred to as “partners.” Individual owners in an LLC are referred to as “members.”

Jack and Devin choose to become an LLC, since they like the limited liability feature. Before creating all the needed documentation and filing to establish the LLC with the state, John and Devin want to know how LLC income is reflected on Form 1065 and how the tax will be handled. They choose “Steel That Stands, LLC” as their company name.

The tax practitioner creates a draft of the income portion and K-1 of Form 1065 for each member. Income remains at the \$150,000 as projected, and the income is divided equally between the partners. Each partner will pay regular and self employment tax on their \$75,000 profit.

2002 Workbook

For Discussion Purposes Only – Partnership

Form 1065 Department of the Treasury Internal Revenue Service	U.S. Return of Partnership Income For calendar year 2002, or tax year beginning, 2002, and ending, 20..... ▶ See separate instructions.		OMB No. 1545-0099 <div style="font-size: 2em; font-weight: bold;">2002</div>
A Principal business activity Construction B Principal product or service Steel erection C Business code number 235900	Use the IRS label. Other- wise, print or type.	Name of partnership Steel That Stands, LLC Number, street, and room or suite no. If a P.O. box, see page 13 of the instructions. 14 Larkin Lane City or town, state, and ZIP code East Buford, IL 62050	D Employer identification number 30 : 8000444 E Date business started 01/01/02 F Total assets (see page 14 of the instructions) \$ * See below

G Check applicable boxes: (1) ☒ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
H Check accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ **2**

Caution: Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a Gross receipts or sales	1a	600,000			
	b Less returns and allowances	1b		1c	600,000	
	2 Cost of goods sold (Schedule A, line 8)	2		397,000		
	3 Gross profit. Subtract line 2 from line 1c	3		203,000		
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach schedule)	4				
	5 Net farm profit (loss) (attach Schedule F (Form 1040))	5				
	6 Net gain (loss) from Form 4797, Part II, line 18	6				
	7 Other income (loss) (attach schedule)	7				
8 Total income (loss). Combine lines 3 through 7	8		203,000			
Deductions (see page 15 of the instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)	9				
	10 Guaranteed payments to partners	10				
	11 Repairs and maintenance	11				
	12 Bad debts	12				
	13 Rent	13				
	14 Taxes and licenses	14				
	15 Interest	15				
	16a Depreciation (if required, attach Form 4562)	16a				
	b Less depreciation reported on Schedule A and elsewhere on return	16b		16c		
	17 Depletion (Do not deduct oil and gas depletion.)	17				
	18 Retirement plans, etc.	18				
	19 Employee benefit programs	19				
	20 Other deductions (attach schedule) Overhead Costs and Insurance	20		53,000		
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21		53,000			
22 Ordinary income (loss) from trade or business activities. Subtract line 21 from line 8	22		150,000			

* For the purpose of this example, balance sheet information has been omitted.

For Discussion Purposes Only – Partnership

Form 1065 (2002) **Steel That Stands, LLC**

30-8000444

Page **2**

Schedule A Cost of Goods Sold (see page 18 of the instructions)

1	Inventory at beginning of year	1	
2	Purchases less cost of items withdrawn for personal use	2	75,000
3	Cost of labor	3	250,000
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	72,000
6	Total. Add lines 1 through 5	6	397,000
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	397,000

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c). ☐

c Check this box if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☐

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? . . . ☐ **Yes** ☐ **No**

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ **Yes** ☐ **No**

If "Yes," attach explanation.

Steel That Stands, LLC 30-8000444
 Form 1065, Schedule A, Line 5
Other costs

Subcontractor crane rental	<u>50,000.</u>
Payroll taxes	<u>22,000.</u>
Total.	<u>72,000.</u>

2002 Workbook

For Discussion Purposes Only – Partnership

SCHEDULE K-1 (Form 1065) <small>Department of the Treasury Internal Revenue Service</small>	Partner's Share of Income, Credits, Deductions, etc. ▶ See separate instructions. For calendar year 2002 or tax year beginning , 2002, and ending , 20	OMB No. 1545-0099 <div style="font-size: 2em; font-weight: bold;">2002</div>	
Partner's identifying number ▶ 500-99-1000		Partnership's identifying number ▶ 30: 8000444	
Partner's name, address, and ZIP code Jack Rutger 14 Larkin Lane East Buford, IL 62050		Partnership's name, address, and ZIP code Steel That Stands, LLC 14 Larkin Lane East Buford, IL 62050	
A This partner is a <input type="checkbox"/> general partner <input type="checkbox"/> limited partner <input checked="" type="checkbox"/> limited liability company member B What type of entity is this partner? ▶ Individual C Is this partner a <input checked="" type="checkbox"/> domestic or a <input type="checkbox"/> foreign partner? <div style="text-align: center;"> <small>(i) Before change or termination (ii) End of year</small> </div> D Enter partner's percentage of: Profit sharing % 50.0 % Loss sharing % 50.0 % Ownership of capital % 50.0 % E IRS Center where partnership filed return: Cincinnati, OH		F Partner's share of liabilities (see instructions): Nonrecourse \$ Qualified nonrecourse financing \$ Other \$ G Tax shelter registration number . ▶ H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) <input type="checkbox"/> I Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1	
J Analysis of partner's capital account:			
(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	
		75,000	
		(d) Withdrawals and distributions	
		(75,000)	
		(e) Capital account at end of year (combine columns (a) through (d))	
		0	
(a) Distributive share item		(b) Amount	
(c) 1040 filers enter the amount in column (b) on:			
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1 75,000	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065). Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) Sch. D, line 12, col. (f) Sch. D, line 12, col. (g) Line 5 of worksheet for Sch. D, line 29 Enter on applicable line of your return. See page 6 of Partner's Instructions for Schedule K-1 (Form 1065). Enter on applicable line of your return.
	2 Net income (loss) from rental real estate activities	2	
	3 Net income (loss) from other rental activities	3	
	4 Portfolio income (loss):	4a	
	a Interest	4b	
	b Ordinary dividends	4c	
	c Royalties	4d	
	d Net short-term capital gain (loss)	4e(1)	
	e (1) Net long-term capital gain (loss).	4e(2)	
	(2) 28% rate gain (loss)	4e(3)	
	(3) Qualified 5-year gain	4f	
f Other portfolio income (loss) (attach schedule)	5		
5 Guaranteed payments to partner	6		
6 Net section 1231 gain (loss) (other than due to casualty or theft)	7		
7 Other income (loss) (attach schedule)			
Deductions	8 Charitable contributions (see instructions) (attach schedule)	8	Sch. A, line 15 or 16 See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	9 Section 179 expense deduction	9	
	10 Deductions related to portfolio income (attach schedule)	10	
	11 Other deductions (attach schedule)	11	
Credits	12a Low-income housing credit:	12a(1)	Form 8586, line 5 See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	(1) From section 42(j)(5) partnerships	12a(2)	
	(2) Other than on line 12a(1)	12b	
	b Qualified rehabilitation expenditures related to rental real estate activities	12c	
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12d	
	d Credits related to other rental activities	13	
	13 Other credits		

For Paperwork Reduction Act Notice, see Instructions for Form 1065.

Cat. No. 11394R

Schedule K-1 (Form 1065) 2002

2002 Workbook

For Discussion Purposes Only – Partnership

Schedule K-1 (Form 1065) 2002

Page **2**

(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Investment Interest	14a Interest expense on investment debts	14a	Form 4952, line 1 See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f	14b(1)	
	(2) Investment expenses included on line 10	14b(2)	
Self-employment	15a Net earnings (loss) from self-employment	15a 75,000	Sch. SE, Section A or B See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	b Gross farming or fishing income	15b	
	c Gross nonfarm income	15c 300,000	
Adjustments and Tax Preference Items	16a Depreciation adjustment on property placed in service after 1986	16a	See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251.
	b Adjusted gain or loss	16b	
	c Depletion (other than oil and gas)	16c	
	d (1) Gross income from oil, gas, and geothermal properties	16d(1)	
	(2) Deductions allocable to oil, gas, and geothermal properties	16d(2)	
	e Other adjustments and tax preference items (attach schedule)	16e	
Foreign Taxes	17a Name of foreign country or U.S. possession ▶	17b	Form 1116, Part I
	b Gross income from all sources	17c	
	c Gross income sourced at partner level		
	d Foreign gross income sourced at partnership level:		
	(1) Passive	17d(1)	
	(2) Listed categories (attach schedule)	17d(2)	
	(3) General limitation	17d(3)	
	e Deductions allocated and apportioned at partner level:		
	(1) Interest expense	17e(1)	
	(2) Other	17e(2)	
	f Deductions allocated and apportioned at partnership level to foreign source income:		
	(1) Passive	17f(1)	
(2) Listed categories (attach schedule)	17f(2)		
(3) General limitation	17f(3)		
g Total foreign taxes (check one): ▶ <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	17g	Form 1116, Part II Form 1116, line 12	
h Reduction in taxes available for credit (attach schedule)	17h		
Other	18 Section 59(e)(2) expenditures: a Type ▶	18b	See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	b Amount		
	19 Tax-exempt interest income	19	Form 1040, line 8b
	20 Other tax-exempt income	20	
	21 Nondeductible expenses	21	See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065).
	22 Distributions of money (cash and marketable securities)	22	
	23 Distributions of property other than money	23	
	24 Recapture of low-income housing credit:		Form 8611, line 8
a From section 42(j)(5) partnerships	24a		
b Other than on line 24a	24b		
Supplemental Information	25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed):		
		
		
		
		
		



Schedule K-1 (Form 1065) 2002

For Discussion Purposes Only – Partnership

SCHEDULE K-1 (Form 1065) <small>Department of the Treasury Internal Revenue Service</small>		Partner's Share of Income, Credits, Deductions, etc. <small>► See separate instructions.</small>			<small>OMB No. 1545-0099</small> 2002
For calendar year 2002 or tax year beginning , 2002, and ending , 20					
Partner's identifying number ► 600-99-1400		Partnership's identifying number ► 30 : 8000444			
Partner's name, address, and ZIP code Devin Helton 7744 Homeview Drive Buford, IL 62051		Partnership's name, address, and ZIP code Steel That Stands, LLC 14 Larkin Lane East Buford, IL 62050			
A This partner is a <input type="checkbox"/> general partner <input type="checkbox"/> limited partner <input checked="" type="checkbox"/> limited liability company member		F Partner's share of liabilities (see instructions): Nonrecourse \$ Qualified nonrecourse financing \$ Other \$			
B What type of entity is this partner? ► Individual					
C Is this partner a <input checked="" type="checkbox"/> domestic or a <input type="checkbox"/> foreign partner?		G Tax shelter registration number			
D Enter partner's percentage of: Profit sharing % 50.0 % Loss sharing % 50.0 % Ownership of capital % 50.0 %		H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) <input type="checkbox"/>			
E IRS Center where partnership filed return: Cincinnati, OH		I Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1			
J Analysis of partner's capital account:					
(a) Capital account at beginning of year		(b) Capital contributed during year		(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions
				75,000	(75,000)
				0	
(a) Distributive share item				(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	75,000	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065). Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) Sch. D, line 12, col. (f) Sch. D, line 12, col. (g) Line 5 of worksheet for Sch. D, line 29 Enter on applicable line of your return. See page 6 of Partner's Instructions for Schedule K-1 (Form 1065). Enter on applicable line of your return.	
	2 Net income (loss) from rental real estate activities	2			
	3 Net income (loss) from other rental activities	3			
	4 Portfolio income (loss):				
	a Interest	4a			
	b Ordinary dividends	4b			
	c Royalties	4c			
	d Net short-term capital gain (loss)	4d			
	e (1) Net long-term capital gain (loss).	4e(1)			
	(2) 28% rate gain (loss)	4e(2)			
	(3) Qualified 5-year gain	4e(3)			
	f Other portfolio income (loss) (attach schedule)	4f			
5 Guaranteed payments to partner	5				
6 Net section 1231 gain (loss) (other than due to casualty or theft)	6				
7 Other income (loss) (attach schedule)	7				

Note. The remainder of Schedule K-1 for Devin would be the same as Jack's Schedule K-1.

CORPORATION

After considering all the partnership entities, Jack and Devin decide to evaluate the corporate form of ownership for the new business venture for the year 2002.

If the entrepreneurs decide to form a corporation, they will need to submit Articles of Incorporation and file an application, including a corporate name, with the Secretary of State. In this case, "Steel that Stands, Inc.," is the chosen name. Provided this name is available in the state, they will receive their corporate charter. They must obtain a corporate employer identification number. Form SS-4 (Application for Employer Identification Number (EIN)) is used for obtaining this.

Observation. A common misconception among business owners is that the EIN used by the proprietorship can be continued with the new business entity. This is not the case. A new number is needed as the new form of business structure is a separate entity.

Jack and Devin will be issued all outstanding stock in their new corporation since they are the 100% owners of the company. The tax practitioner will work with taxpayers to ensure the transfer of assets from personal into the corporation qualifies as a tax-free exchange as defined by I.R.C. §351. Essentially, the individuals are transferring all business assets (Cash, Accounts Receivable, and Equipment less Accumulated Depreciation), less business liabilities, in exchange for the stock in their new corporation. Provided the liabilities do not exceed the adjusted basis of the assets transferred in exchange for 100% of the outstanding common stock, the transaction will be a tax-free transfer.

Types of Corporations

Jack and Devin have successfully incorporated their business. Once they have obtained their EIN, the business can begin operating.

C Corporation

Jack and Devin choose to become a C corporation. Within a C corporation, they pay themselves a reasonable salary. They can benefit from the deduction of certain fringe benefits that were not available as a Schedule C business owner or as a partnership. For example, they may be able to deduct 100% of their health insurance premiums, even if no health insurance is provided to other employees. They can use a fiscal year, which might mirror their business cycle more closely, rather than a calendar year. The C corporation has two levels of tax. One is at the corporate level, and the other is at the individual level. The net profit remaining at the C corporation level is taxed at 15% on the first \$50,000 of taxable income. This rate rapidly escalates to a maximum tax rate of 34% on taxable income.

An astute tax practitioner will stress potential traps involving C corporations:

1. The shareholders' salary must be reasonable. Salary, determined by the IRS to be excessive, can be deemed to be a dividend to a shareholder. Both salary and dividends are taxable to the owners. However, the dividend is not deductible to the corporation.
2. If the business becomes very successful and has too much profit left in the business, the IRS can assert an I.R.C. §531 Accumulated Earnings Tax if the corporation is not paying dividends. Generally, successful closely held corporations do not pay dividends since no deduction is allowed. This magnifies the double tax issue for C corporations.
3. The C corporation owners need to consider consequences of selling or liquidating the business at some future time. They will need to understand tax ramifications and how the double tax comes into play.
 - The asset sales are recorded on the corporate books, and the corporation pays its regular income tax on the net income realized for the year.
 - Cash remaining in the corporation, after paying all its income taxes and other obligations, is distributed to the shareholders as a liquidating distribution.
 - The distribution is treated as the sale price of the shareholders' stock, and gain or loss is measured between the distribution and the shareholders' basis in the stock.

In Jack and Devin's situation, each will receive a \$60,000 salary from the anticipated \$150,000 of net income. Each owner will receive a Form W-2 for their wages earned. The remaining profit of \$30,000 will be taxed to the corporation. As a result, the initial corporate tax return (Form 1120) will have a federal tax liability of \$4,500.

The following Form 1120 was prepared so Jack and Devin could see a completed form based on their projected profit.

2002 Workbook

For Discussion Purposes Only – C Corporation

Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 2002 or tax year beginning _____, 2002, ending _____, 20____ ▶ Instructions are separate. See page 20 for Paperwork Reduction Act Notice.	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold;">2002</div>
A Check if a: 1 Consolidated return (attach Form 851) <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (as defined in Regulations sec. 1.441-3(c)—see instructions) <input type="checkbox"/>	<div style="border: 1px solid black; padding: 2px;"> <div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> Use IRS label. Otherwise, print or type. Name Steel That Stands, Inc. Number, street, and room or suite no. (If a P.O. box, see page 7 of instructions.) 14 Larkin Lane City or town, state, and ZIP code East Buford, IL 62050 </div> <div style="width: 35%;"> B Employer identification number 30 8000444 C Date incorporated 01/01/02 D Total assets (see page 8 of instructions) </div> </div> </div>	
E Check applicable boxes: (1) <input checked="" type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change \$ * See below		
Income	1a Gross receipts or sales b Less returns and allowances 2 Cost of goods sold (Schedule A, line 8) 3 Gross profit. Subtract line 2 from line 1c 4 Dividends (Schedule C, line 19) 5 Interest 6 Gross rents 7 Gross royalties 8 Capital gain net income (attach Schedule D (Form 1120)) 9 Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797) 10 Other income (see page 8 of instructions—attach schedule) 11 Total income. Add lines 3 through 10	1c 600,000 2 397,000 3 203,000 4 5 6 7 8 9 10 11 203,000
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (Schedule E, line 4) Additional Wages 13 Salaries and wages (less employment credits) 14 Repairs and maintenance 15 Bad debts 16 Rents 17 Taxes and licenses Payroll Taxes 18 Interest 19 Charitable contributions (see page 10 of instructions for 10% limitation) 20 Depreciation (attach Form 4562) 21 Less depreciation claimed on Schedule A and elsewhere on return 22 Depletion 23 Advertising 24 Pension, profit-sharing, etc., plans 25 Employee benefit programs 26 Other deductions (attach schedule) Overhead Costs and Insurance 27 Total deductions. Add lines 12 through 26 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 29 Less: a Net operating loss (NOL) deduction (see page 13 of instructions) 29a b Special deductions (Schedule C, line 20) 29b	12 120,000 13 14 15 16 17 9,180 18 19 20 21a 21b 22 23 24 25 26 53,000 27 182,180 28 20,820 29c
Tax and Payments	30 Taxable income. Subtract line 29c from line 28 31 Total tax (Schedule J, line 11) 32 Payments: a 2001 overpayment credited to 2002 32a b 2002 estimated tax payments 32b c Less 2002 refund applied for on Form 4466 32c d Bal 32d e Tax deposited with Form 7004 32e f Credit for tax paid on undistributed capital gains (attach Form 2439) 32f g Credit for Federal tax on fuels (attach Form 4136). See instructions 32g 33 Estimated tax penalty (see page 14 of instructions). Check if Form 2220 is attached <input checked="" type="checkbox"/> 34 Tax due. If line 32h is smaller than the total of lines 31 and 33, enter amount owed 35 Overpayment. If line 32h is larger than the total of lines 31 and 33, enter amount overpaid 36 Enter amount of line 35 you want: Credited to 2003 estimated tax Refunded	30 20,820 31 3,123 32a 32b 32c 32d 32e 32f 32g 32h 33 0 34 3,123 35 36
Sign Here Signature of officer _____ Date _____ Title _____	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. <div style="border: 1px solid black; padding: 5px; width: fit-content;"> May the IRS discuss this return with the preparer shown below (see instructions)? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No </div>	

* For the purposes of this example, balance sheet information has been omitted.

For Discussion Purposes Only – C Corporation

Form 1120 (2002) **Steel That Stands, Inc.** **30-8000444** Page **2**

Schedule A Cost of Goods Sold (see page 14 of instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	75,000
3	Cost of labor	3	250,000
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	72,000
6	Total. Add lines 1 through 5	6	397,000
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on line 2, page 1	8	397,000

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (Specify method used and attach explanation.) ►

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ☐

Steel That Stands, Inc. 30-8000444
Form 1120, Page 2, Sch A, Line 5
Other costs Statement

Subcontractor crane rental	<u>50,000.</u>
Payroll taxes	<u>22,000.</u>
Total.	<u>72,000.</u>

Schedule E Compensation of Officers (see instructions for line 12, page 1)

Note: Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1, Form 1120) are \$500,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned		(f) Amount of compensation
			(d) Common	(e) Preferred	
1 Jack Rutger	500-99-1000	100.0 %	50.0 %	%	60,000.
Devin Helton	600-99-1400	100.0 %	50.0 %	%	60,000.
		%	%	%	
		%	%	%	
		%	%	%	
2 Total compensation of officers					120,000.
3 Compensation of officers claimed on Schedule A and elsewhere on return					
4 Subtract line 3 from line 2. Enter the result here and on line 12, page 1					120,000.

Form **1120** (2002)

S Corporation

Paying a corporate income tax on profits does not appeal to Jack and Devin. They want to have a corporation that will pay no income taxes. The tax practitioner introduces the 1120-S corporation.

Once incorporated, the shareholders quickly need to make a determination whether they wish to continue as a C corporation or elect to become an S corporation (also known as a tax option corporation or sub chapter S corporation). The election must be made within 75 days of incorporating. This is accomplished by completing and filing Form 2553 with the applicable Internal Revenue Service Center. See blank Form 2553.

Note. In recent years, the IRS has enacted generous relief provisions for late filed election requests.

2002 Workbook

The primary advantage of opting for the S status is that the limited liability of a corporation is maintained, and the S corporation generally pays no federal income tax. Profit or loss is reported on Form K-1 to the individual shareholder(s) who reflect the profit or loss on their individual tax returns. The business is a true corporation but the income tax considerations are similar to that of a partnership including the transmittal Form K-1.

Form 2553 (Rev. October 2001) <small>Department of the Treasury Internal Revenue Service</small>	Election by a Small Business Corporation (Under section 1362 of the Internal Revenue Code) ▶ See Parts II and III on back and the separate instructions. ▶ The corporation may either send or fax this form to the IRS. See page 2 of the instructions.	OMB No. 1545-0146	
Notes: 1. Do not file Form 1120S , U.S. Income Tax Return for an S Corporation, for any tax year before the year the election takes effect. 2. This election to be an S corporation can be accepted only if all the tests are met under Who May Elect on page 1 of the instructions; all shareholders have signed the consent statement; and the exact name and address of the corporation and other required form information are provided. 3. If the corporation was in existence before the effective date of this election, see Taxes an S Corporation May Owe on page 1 of the instructions.			
Part I Please Type or Print	Election Information		
	Name of corporation (see instructions)	A Employer identification number	
	Number, street, and room or suite no. (If a P.O. box, see instructions.)	B Date incorporated	
	City or town, state, and ZIP code	C State of incorporation	
D Check the applicable box(es) if the corporation, after applying for the EIN shown in A above, changed its name <input type="checkbox"/> or address <input type="checkbox"/>			
E Election is to be effective for tax year beginning (month, day, year) ▶ / /			
F Name and title of officer or legal representative who the IRS may call for more information		G Telephone number of officer or legal representative ()	
H If this election takes effect for the first tax year the corporation exists, enter month, day, and year of the earliest of the following: (1) date the corporation first had shareholders, (2) date the corporation first had assets, or (3) date the corporation began doing business ▶ / /			
I Selected tax year: Annual return will be filed for tax year ending (month and day) ▶ If the tax year ends on any date other than December 31, except for an automatic 52-53-week tax year ending with reference to the month of December, you must complete Part II on the back. If the date you enter is the ending date of an automatic 52-53-week tax year, write "52-53-week year" to the right of the date. See Temporary Regulations section 1.441-2T(e)(3).			
J Name and address of each shareholder, shareholder's spouse having a community property interest in the corporation's stock; and each tenant in common, joint tenant, and tenant by the entirety. (A husband and wife (and their estates) are counted as one shareholder in determining the number of shareholders without regard to the manner in which the stock is owned.)	K Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Shareholders sign and date below.)		
	Signature	Date	
L Stock owned		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
Number of shares	Dates acquired		
<small>Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.</small>			
Signature of officer ▶		Title ▶	
		Date ▶	

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 18629R Form **2553** (Rev. 10-2001)

Part II Selection of Fiscal Tax Year (All corporations using this part must complete item O and item P, Q, or R.)**O** Check the applicable box to indicate whether the corporation is:

1. ☐ A new corporation adopting the tax year entered in item I, Part I.
2. ☐ An existing corporation retaining the tax year entered in item I, Part I.
3. ☐ An existing corporation changing to the tax year entered in item I, Part I.

P Complete item P if the corporation is using the expeditious approval provisions of Rev. Proc. 87-32, 1987-2 C.B. 396, to request **(1)** a natural business year (as defined in section 4.01(1) of Rev. Proc. 87-32) or **(2)** a year that satisfies the ownership tax year test in section 4.01(2) of Rev. Proc. 87-32. Check the applicable box below to indicate the representation statement the corporation is making as required under section 4 of Rev. Proc. 87-32.

1. Natural Business Year ► ☐ I represent that the corporation is retaining or changing to a tax year that coincides with its natural business year as defined in section 4.01(1) of Rev. Proc. 87-32 and as verified by its satisfaction of the requirements of section 4.02(1) of Rev. Proc. 87-32. In addition, if the corporation is changing to a natural business year as defined in section 4.01(1), I further represent that such tax year results in less deferral of income to the owners than the corporation's present tax year. I also represent that the corporation is not described in section 3.01(2) of Rev. Proc. 87-32. (See instructions for additional information that must be attached.)

2. Ownership Tax Year ► ☐ I represent that shareholders holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item I, Part I. I also represent that the corporation is not described in section 3.01(2) of Rev. Proc. 87-32.

Note: If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.

Q Business Purpose—To request a fiscal tax year based on a business purpose, you must check box Q1 and pay a user fee. See instructions for details. You may also check box Q2 and/or box Q3.

1. Check here ► ☐ if the fiscal year entered in item I, Part I, is requested under the provisions of section 6.03 of Rev. Proc. 87-32. Attach to Form 2553 a statement showing the business purpose for the requested fiscal year. See instructions for additional information that must be attached.

2. Check here ► ☐ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. (See instructions for more information.)

3. Check here ► ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, you must check box R1 and you may also check box R2.

1. Check here ► ☐ to show the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item I, Part I. To make the election, you must complete **Form 8716, Election To Have a Tax Year Other Than a Required Tax Year**, and either attach it to Form 2553 or file it separately.

2. Check here ► ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Part III Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)*

Income beneficiary's name and address	Social security number
	: : : :
Trust's name and address	Employer identification number
	: : : :
Date on which stock of the corporation was transferred to the trust (month, day, year) ► / /	

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election

Date

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust after the date on which the corporation makes the S election.



Taxpayers must be aware the S corporation has certain limitations that may reduce its appeal:

- The corporation can have only one class of stock.
- Shareholders owning stock generally must be individuals.
- The number of shareholders cannot exceed 75.

The S corporation rules are very strict regarding shareholder basis for stock. The S corporation does not offer the same flexibility as a partnership.

Jack and Devin would like to see the tax impact based on their 2002 budget. They each want to be paid a \$60,000 salary, which will result in \$30,000 of taxable income. The remaining \$30,000 is not taxed at the corporate level, but is distributed to the shareholders. The distribution is fully taxable to the shareholders, but it is **not** subject to self-employment tax. The immediate impact realized by shareholders is a corporate tax savings, and less Social Security and Medicare taxes on their individual tax returns. The \$30,000 will be taxed to the shareholders even if it is not distributed.

Observation. While the tax practitioner is outlining this entity approach to the client, it is possible that the client may raise the question, “Why should I take any salary?” The taxpayer may believe he can forgo salary and take the profit as a distribution, and not pay any self employment tax. There are many court cases in recent years where taxpayers have attempted to avoid Social Security and Medicare taxes by not taking wages. The IRS has been very successful in recharacterizing such distributions as wages. It is important to determine how much salary is “reasonable”. The balance of profits from the S corporation can then be passed through without paying Social Security and Medicare taxes on the remaining distribution.

Caution. Terminating an S election is restricted and can have tax consequences.

For Discussion Purposes Only – S Corporation

Form 1120S Department of the Treasury Internal Revenue Service	U.S. Income Tax Return for an S Corporation ▶ Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation. ▶ See separate instructions.	OMB No. 1545-0130 <div style="font-size: 2em; font-weight: bold;">2002</div>
For calendar year 2002, or tax year beginning _____, 2002, and ending _____, 20__		
A Effective date of election as an S corporation 01/01/02	Use IRS label. Otherwise, print or type. Name Steel That Stands, Inc. Number, street, and room or suite no. (If a P.O. box, see page 11 of the instructions.) 14 Larkin Ave. City or town, state, and ZIP code East Buford, IL 62050	C Employer identification number 30 8000444 D Date incorporated 01/01/02 E Total assets (see page 11) \$ * See below
B Business code no. (see pages 29–31) 235900		
F Check applicable boxes: (1) <input checked="" type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change (5) <input type="checkbox"/> Amended return G Enter number of shareholders in the corporation at end of the tax year _____ ▶		
Caution: Include <u>only</u> trade or business income and expenses on lines 1a through 21. See page 11 of the instructions for more information.		
Income	1a Gross receipts or sales 600,000 b Less returns and allowances _____ c Bal ▶ 2 Cost of goods sold (Schedule A, line 8) _____ 3 Gross profit. Subtract line 2 from line 1c _____ 4 Net gain (loss) from Form 4797, Part II, line 18 (attach Form 4797) _____ 5 Other income (loss) (attach schedule) _____ 6 Total income (loss). Combine lines 3 through 5 ▶	1c 600,000 2 397,000 3 203,000 4 _____ 5 _____ 6 203,000 7 120,000 8 _____ 9 _____ 10 _____ 11 _____ 12 9,180 13 _____ 14a _____ 14b _____ 14c _____ 15 _____ 16 _____ 17 _____ 18 _____ 19 53,000 20 182,180 21 20,820
Deductions (see page 12 of the instructions for limitations)	7 Compensation of officers _____ 8 Salaries and wages (less employment credits) _____ 9 Repairs and maintenance _____ 10 Bad debts _____ 11 Rents _____ 12 Taxes and licenses _____ Payroll Taxes 13 Interest _____ 14a Depreciation (if required, attach Form 4562) _____ 14a _____ b Depreciation claimed on Schedule A and elsewhere on return _____ 14b _____ c Subtract line 14b from line 14a _____ 15 Depletion (Do not deduct oil and gas depletion.) _____ 16 Advertising _____ 17 Pension, profit-sharing, etc., plans _____ 18 Employee benefit programs _____ 19 Other deductions (attach schedule) _____ Overhead Costs and Insurance 20 Total deductions. Add the amounts shown in the far right column for lines 7 through 19 ▶ 21 Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6.	7 120,000 8 _____ 9 _____ 10 _____ 11 _____ 12 9,180 13 _____ 14a _____ 14b _____ 14c _____ 15 _____ 16 _____ 17 _____ 18 _____ 19 53,000 20 182,180 21 20,820
Tax and Payments	22 Tax: a Excess net passive income tax (attach schedule) _____ 22a _____ b Tax from Schedule D (Form 1120S) _____ 22b _____ c Add lines 22a and 22b (see page 16 of the instructions for additional taxes) _____ 22c _____ 23 Payments: a 2002 estimated tax payments and amount applied from 2001 return _____ 23a _____ b Tax deposited with Form 7004 _____ 23b _____ c Credit for Federal tax paid on fuels (attach Form 4136) _____ 23c _____ d Add lines 23a through 23c _____ 23d _____ 24 Estimated tax penalty. Check if Form 2220 is attached _____ ▶ <input type="checkbox"/> 24 _____ 25 Tax due. If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See page 4 of the instructions for depository method of payment. _____ 25 _____ 26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid _____ 26 _____ 27 Enter amount of line 26 you want: Credited to 2003 estimated tax ▶ Refunded ▶ 27 _____	22a _____ 22b _____ 22c _____ 23a _____ 23b _____ 23c _____ 23d _____ 24 _____ 25 _____ 26 _____ 27 _____
Sign Here	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. <div style="display: flex; justify-content: space-between; align-items: flex-end;"> <div style="width: 45%;"> Signature of officer _____ Date _____ Title _____ </div> <div style="width: 45%; border: 1px solid black; padding: 5px;"> May the IRS discuss this return with the preparer shown below (see instructions)? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No </div> </div>	
Paid Preparer's Use Only	Preparer's signature _____ Date _____ Check if self-employed <input type="checkbox"/> Preparer's SSN or PTIN _____ Firm's name (or yours if self-employed), address, and ZIP code _____ EIN _____ Phone no. () _____	

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11510H

Form 1120S (2002)

2002 Workbook

For Discussion Purposes Only – S Corporation

* For purposes of this example, balance sheet information has been omitted.

Form 1120S (2002) **Steel That Stands, Inc.** **30-8000444** Page **2**

Schedule A Cost of Goods Sold (see page 16 of the instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	75,000
3	Cost of labor	3	250,000
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	72,000
6	Total. Add lines 1 through 5	6	397,000
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	397,000

9a Check all methods used for valuing closing inventory: (i) ☐ Cost as described in Regulations section 1.471-3
(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Other (specify method used and attach explanation) ▶

b Check if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d**

e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☒ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☒ No
If "Yes," attach explanation.

Steel That Stands, Inc. 30-8000444

Form 1120S, Page 1, Line 19

Other Deductions

Insurance and Overhead Costs	<u>53,000.</u>
Total	<u>53,000.</u>

Form 1120S, Page 2, Schedule A, Line 5

Schedule A, Other Costs

Subcontractor crane rental	<u>50,000.</u>
Payroll taxes	<u>22,000.</u>
Total	<u>72,000.</u>

2002 Workbook

For Discussion Purposes Only – S Corporation

SCHEDULE K-1 (Form 1120S) <small>Department of the Treasury Internal Revenue Service</small>	Shareholder's Share of Income, Credits, Deductions, etc. ► See separate instructions. For calendar year 2002 or tax year , 2002, and ending , 20	<small>OMB No. 1545-0130</small> <div style="font-size: 2em; font-weight: bold; margin-top: 10px;">2002</div>																																																								
Shareholder's identifying number ► 500-99-1000		Corporation's identifying number ► 30 : 800444																																																								
Shareholder's name, address, and ZIP code Jack Rutger 14 Larkin Lane East Buford, IL 62050		Corporation's name, address, and ZIP code Steel That Stands, Inc. 14 Larkin Lane East Buford, IL 62050																																																								
A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) ► 50.0 % B Internal Revenue Service Center where corporation filed its return ► Cincinnati, OH 45999-0013 C Tax shelter registration number (see instructions for Schedule K-1) ► D Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1																																																										
(a) Pro rata share items																																																										
Income (Loss)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%;">1</td> <td style="width: 40%;">Ordinary income (loss) from trade or business activities</td> <td style="width: 5%;">1</td> <td style="width: 50%; text-align: right;">10,410</td> </tr> <tr> <td>2</td> <td>Net income (loss) from rental real estate activities</td> <td>2</td> <td></td> </tr> <tr> <td>3</td> <td>Net income (loss) from other rental activities</td> <td>3</td> <td></td> </tr> <tr> <td>4</td> <td>Portfolio income (loss):</td> <td></td> <td></td> </tr> <tr> <td>a</td> <td>Interest</td> <td>4a</td> <td></td> </tr> <tr> <td>b</td> <td>Ordinary dividends</td> <td>4b</td> <td></td> </tr> <tr> <td>c</td> <td>Royalties</td> <td>4c</td> <td></td> </tr> <tr> <td>d</td> <td>Net short-term capital gain (loss)</td> <td>4d</td> <td></td> </tr> <tr> <td>e</td> <td>(1) Net long-term capital gain (loss)</td> <td>4e(1)</td> <td></td> </tr> <tr> <td></td> <td>(2) 28% rate gain (loss)</td> <td>4e(2)</td> <td></td> </tr> <tr> <td></td> <td>(3) Qualified 5-year gain</td> <td>4e(3)</td> <td></td> </tr> <tr> <td>f</td> <td>Other portfolio income (loss) (attach schedule)</td> <td>4f</td> <td></td> </tr> <tr> <td>5</td> <td>Net section 1231 gain (loss) (other than due to casualty or theft)</td> <td>5</td> <td></td> </tr> <tr> <td>6</td> <td>Other income (loss) (attach schedule)</td> <td>6</td> <td></td> </tr> </table>	1	Ordinary income (loss) from trade or business activities	1	10,410	2	Net income (loss) from rental real estate activities	2		3	Net income (loss) from other rental activities	3		4	Portfolio income (loss):			a	Interest	4a		b	Ordinary dividends	4b		c	Royalties	4c		d	Net short-term capital gain (loss)	4d		e	(1) Net long-term capital gain (loss)	4e(1)			(2) 28% rate gain (loss)	4e(2)			(3) Qualified 5-year gain	4e(3)		f	Other portfolio income (loss) (attach schedule)	4f		5	Net section 1231 gain (loss) (other than due to casualty or theft)	5		6	Other income (loss) (attach schedule)	6		(c) Form 1040 filers enter the amount in column (b) on: <div style="border-left: 1px solid black; padding-left: 10px; margin-top: 10px;"> See page 4 of the Shareholder's Instructions for Schedule K-1 (Form 1120S). Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) Sch. D, line 12, col. (f) Sch. D, line 12, col. (g) Line 5 of worksheet for Sch. D, line 29 (Enter on applicable line of your return.) See Shareholder's Instructions for Schedule K-1 (Form 1120S). (Enter on applicable line of your return.) </div>
1	Ordinary income (loss) from trade or business activities	1	10,410																																																							
2	Net income (loss) from rental real estate activities	2																																																								
3	Net income (loss) from other rental activities	3																																																								
4	Portfolio income (loss):																																																									
a	Interest	4a																																																								
b	Ordinary dividends	4b																																																								
c	Royalties	4c																																																								
d	Net short-term capital gain (loss)	4d																																																								
e	(1) Net long-term capital gain (loss)	4e(1)																																																								
	(2) 28% rate gain (loss)	4e(2)																																																								
	(3) Qualified 5-year gain	4e(3)																																																								
f	Other portfolio income (loss) (attach schedule)	4f																																																								
5	Net section 1231 gain (loss) (other than due to casualty or theft)	5																																																								
6	Other income (loss) (attach schedule)	6																																																								

2002 Workbook

For Discussion Purposes Only – S Corporation

SCHEDULE K-1 (Form 1120S) <small>Department of the Treasury Internal Revenue Service</small>	Shareholder's Share of Income, Credits, Deductions, etc. <p style="text-align: center;">▶ See separate instructions.</p> <p style="text-align: center;">For calendar year 2002 or tax year , 2002, and ending , 20</p>	<small>OMB No. 1545-0130</small> 2002		
Shareholder's identifying number ▶ 600-99-1400 <small>Shareholder's name, address, and ZIP code</small> Devin Helton 7744 Homeview Drive Buford, IL 62051		Corporation's identifying number ▶ 30 : 8000444 <small>Corporation's name, address, and ZIP code</small> Steel That Stands, Inc. 14 Larkin Lane East Buford, IL 62050		
A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . ▶ 50.00000 % B Internal Revenue Service Center where corporation filed its return ▶ Cincinnati, OH 45999-0013 C Tax shelter registration number (see instructions for Schedule K-1) . . . ▶ D Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1				
(a) Pro rata share items (b) Amount (c) Form 1040 filers enter the amount in column (b) on:				
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	10,410	See page 4 of the Shareholder's Instructions for Schedule K-1 (Form 1120S). Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) Sch. D, line 12, col. (f) Sch. D, line 12, col. (g) Line 5 of worksheet for Sch. D, line 29 (Enter on applicable line of your return.) See Shareholder's Instructions for Schedule K-1 (Form 1120S). (Enter on applicable line of your return.)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a		
	b Ordinary dividends	4b		
	c Royalties	4c		
	d Net short-term capital gain (loss)	4d		
	e (1) Net long-term capital gain (loss)	4e(1)		
	(2) 28% rate gain (loss)	4e(2)		
(3) Qualified 5-year gain	4e(3)			
f Other portfolio income (loss) (attach schedule)	4f			
5 Net section 1231 gain (loss) (other than due to casualty or theft)	5			
6 Other income (loss) (attach schedule)	6			
Deductions	7 Charitable contributions (attach schedule)	7		Sch. A, line 15 or 16 See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	8 Section 179 expense deduction	8		
	9 Deductions related to portfolio income (loss) (attach schedule)	9		
	10 Other deductions (attach schedule)	10		
Credits	11a Interest expense on investment debts	11a		Form 4952, line 1 See Shareholder's Instructions for Schedule K-1 (Form 1120S). Form 6478, line 10 Form 8586, line 5 See pages 6 and 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)		
	(2) Investment expenses included on line 9 above	11b(2)		
	12a Credit for alcohol used as fuel	12a		
	b Low-income housing credit:			
	(1) From section 42(j)(5) partnerships	12b(1)		
	(2) Other than on line 12b(1)	12b(2)		
	c Qualified rehabilitation expenditures related to rental real estate activities	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			

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S.

Cat. No. 11520D

Schedule K-1 (Form 1120S) 2002

Summary of Entity Choices

	Partnership or LLC Form 1065	Corporation Form 1120	S Corporation Form 1120S
Net income	\$150,000	\$20,820	\$20,820
Wages to owners	None	120,000	120,000
Tax paid by entity	None	3,123	None
After wage income taxed to owner	150,000	None	20,820
SE tax	Yes	None	None

VARIOUS ASPECTS OF EACH ENTITY

Each type of entity offers both advantages and disadvantages, depending on the situation of the business and its owners. The nature of the business, whether active or passive, has a great deal to do with the proper selection.

The example of Jack and Devin explains the ramifications of selecting various business models. It is also important to consider the consequences of changing from one entity to another, and the corresponding impact on taxes.

PARTNERSHIP

Forming a partnership is simple. However, partnership tax law is very complex. Tax calculations can be challenging when a partner contributes property to the partnership or when the partnership distributes property to the partner.

Individual partners' tax basis computations can give rise to terms such as "inside basis," which means the basis of an individual partners' tax basis within the partnership, or "outside basis" defining the partners' ownership basis of an interest from his/her own records.

Partnerships were the vehicle of choice for tax shelters in 1970s and early 1980s. Almost all tax shelters operated under the partnership umbrella since this enabled investors (partners) to "leverage" their investment in the partnership by deducting losses that were several times the amount of their initial investment. The IRS acted quickly to close the loopholes by establishing at-risk rules, registering tax shelters, identifying the so called "abusive" type of shelter, and creating rules for active and material participation including limits on the dollar amounts of passive activity losses that could be deducted.

Partnerships are still **avored** by many tax professionals for **real estate rental ventures**, since these passive activities provide flowthrough of net partnership profit or loss to the individual partners' tax return. Most LLCs file as partnerships, which allows them to enjoy the added benefit of the limited liability formerly only available to corporations.

Often, a business enterprise that cannot elect S corporation status (one having corporate shareholders, for example) will choose the LLC route.

Observation. The IRS recognizes **Limited Liability Partnerships (LLP)** which are generally formed when a group of professional individuals organize as a partnership. This affords the individual partner a degree of protection from creditors of his/her individual assets in the event of negligence by another partner and/or the partnership. In an LLP, operating as an accounting firm, one partner could be negligent in his audit activities by overlooking the fact that \$3 billion in expenses were suddenly capitalized or \$3 billion in bad debt reserves were converted to income. Even though the negligence could be attributed to the firm itself and the responsible partner, the remaining partners are able to protect their individual assets.

Contributions of Property

Under I.R.C. §721, an individual who transfers property in exchange for an interest in a partnership does not generally recognize gain. Unlike a transfer of property into a corporation, there is no requirement that the transferor of property to a partnership have any particular percentage of the equity after the transfer.

Charitable Contributions

Charitable contributions made by a partnership are not deducted by the entity but are instead distributed via Form K-1 to the individual partners. The partners can claim their respective share of the donation as an itemized deduction on their individual tax return. The deduction for charitable contributions is not limited to a partner's basis in his/her partnership interest since the regulations under I.R.C. §170 limit losses to basis **except** for charitable contributions (and foreign taxes).

Passive Income

Partnerships, including LLCs, have no entity-level passive investment income probes, as such income merely flows to the partners (or members in the case of a LLC) on Form K-1. Ordinary income from a business activity flows through as self employment income to any person treated as a general partner. Passive income is then subject to limitations by the individual partner based on his/her tax situation. The most common passive income is rental real estate income which the partnership reports on Form 8825.

I.R.C. §179

The additional allowance for first-year depreciation under I.R.C. §179 is **not** reflected as a deduction on the partnership tax return, but is separately stated on Schedule K of the partnership and then allocated among the partners in their respective partnership interests. Care must be taken by the practitioner to ensure the individual partners can fully benefit from an I.R.C. §179 election. For example, in the year 2001, a partnership elects to take the maximum \$24,000 I.R.C. §179 deduction in a two-person partnership. Each partner is allocated a \$12,000 I.R.C. §179 deduction, but if one partner has already elected either individually or through another entity the full \$24,000 additional first-year deduction, the flowthrough allocation from the partnership is forever lost to the partner. The most any individual can use for an I.R.C. §179 deduction in the 2002 year is \$24,000.

If the partner has a loss from another business, that limits the amount of I.R.C. §179 that is deductible, the unused I.R.C. §179 will carry to future years.

Health Benefits

Health insurance premiums for individual partners are fully deductible by the partnership but are treated as guaranteed payments to the partners (Rev. Rul. 91-26). The guaranteed payments are subject to self employment tax. The individual partner can deduct a portion (70% in 2002) on his/her individual tax return on page one of Form 1040. This deduction does not reduce self employment income. The remaining balance, not deducted at the personal level, can be used as a Schedule A itemized deduction for medical expenses.

Caution. This can be easily overlooked by the tax preparer by attempting to segregate the amounts paid for health insurance as a separate memo entry on the Form K-1 and not taking the deduction as a guaranteed payment on the partnership tax return (Form 1065). As a result, the individual income to the partner is overstated even though self employment earnings are correct.

Retirement Plans

Although a partnership cannot maintain a qualified pension plan, it can maintain a self-employed retirement plan (“Keogh”). By doing this, the partnership can contribute the maximum allowable percentage of the partner’s self employment income to the Keogh plan each year. This contribution is a separately stated item on Form K-1 and does not reduce the partner’s self employment income for the purpose of reducing the Social Security and Medicare taxes. The full amount of self employment income is carried to the partner’s Schedule E, and then to Schedule SE (for determining the self employment taxes), and the Keogh amount is deducted separately on page one of the partner’s Form 1040.

Sale of Assets

Gain or loss resulting from the sale of business assets of the partnership are not taxed at the partnership level. They are taxed to individual partners based on their partnership percentages of ownership or by an allocation provided for in the partnership agreement. Asset sales retain the same character on the Form 1040 as on the partnership return. Portfolio assets (stocks, bonds, etc.) are reflected on a Form 1065 Schedule D and retain that capital gain (loss) character via the Form K-1. Sales of business asset under I.R.C. §1231 are reflected on a Form 4797 and the I.R.C. §1231 line item reporting is captured on the K-1 Form.

Dissolution

Generally, distributions by a partnership to its partners are tax-free to the partners if they have sufficient tax basis. Distributions reduce basis of the individual partner, and once a distribution exceeds a partner’s tax basis, the excess is treated as a gain from the sale of his/her partnership interest (I.R.C. §731(a)). A distribution issue can become complex if a partner receives a distribution within two years of a contribution of property to the partnership. There is a possibility that the distribution will be considered as a disguised sale of the contributed property to the partnership.

Partner’s Basis in the Partnership Interest

The individual partner’s basis can be determined as an “inside basis” (the calculation of basis from the books and records of the partnership), or an “outside basis” (from the individual partner’s records). For example, if a partner acquires an additional portion of a partnership interest by purchasing the interest of an outgoing partner “outside basis” will increase. The books and records of the partnership do not reflect this consideration, but this cost is part of the purchasing partner’s basis, or “outside basis.”

Example 2. Jim contributes property with an unrecovered cost of \$100,000 and a liability of \$30,000 to a new partnership. His beginning basis, both inside and outside, in his partnership interest is \$70,000. Melinda, on the other hand, purchases an interest in a different partnership from a retiring partner. She pays \$250,000 for the partnership interest. The partner had an inside basis of \$1,000. After the purchase, Melinda has an inside basis of \$1,000 and an outside basis of \$250,000.

A partner’s basis is defined as the sum total of the initial investment of the partner plus his/her allocated share of income and expense less all distributions and non deductible expenses PLUS his/ her allocated share of all recourse loans. The latter offers partners greater flexibility with tax basis and the ability to deduct losses. Any loan for which any partner or any person or entity related to the partner has personal liability is treated as a recourse liability (Reg. §1.752-1(a)(1)).

Example 3. Alex owns 50% of White Partners. His basis in his partnership interest is \$5,000. The partnership borrows \$300,000 to purchase a new machine. Since Alex owns 50% of the partnership, his basis increases to \$155,000 ($\$5,000 + \frac{1}{2}$ of \$300,000). If the partnership sustains a loss, Alex can deduct his share of the loss, up to \$155,000, on his personal tax return.

Redemption of a Partners Interest

On a buyout of a partnership interest, the selling partner first recovers his/her basis. This makes it critical to recognize any “outside basis” of a selling partner. If the payment for the interest exceeds the amount of basis of the selling partner, this difference can be capital gain, ordinary income or a combination of the two.

Generally, the sale would be reported as a capital gain if it were not for consideration of “**hot assets**,” as characterized by I.R.C. §751(b). Essentially, hot assets in a partnership are those assets that would give rise to ordinary income treatment, such as the sale of inventory, accounts receivable, and ordinary income recapture portion from the sale of assets. There are special rules for the definition of hot assets which are applicable only in the context of I.R.C. §736.

The partner and partnership also need to observe the rules for distributions within seven years of a contribution of property received by a partner, or within seven years following the contribution of other property by the partner whose interest is being liquidated. These special rules and 1993 amendments to I.R.C. §736 can be quite complex when payments are being made to a partner by the partnership in exchange for his or her interest.

Liquidation

The partners in a partnership decide to liquidate the business. The partners may proceed to sell all assets, pay all debts, and distribute the remaining cash to the partners allocated by their respective partnership interests. Gain or loss from the sale of assets retains the same character for the partners if it were sold in the partnership. When the cash is finally distributed to the partners, the partner’s basis should absorb the distribution so no gain or loss results. If property is distributed by the partnership to a partner as a payment for his interest, the receiving partner receives no step up in basis for the property received from the partnership.

Example 4. Sue and Marie operate a successful accounting practice as a partnership for many years. The two partners are getting older, and decide they will retire. They enter into agreement to sell their accounting practice and move to Florida.

However, they kept their partnership open to collect old accounts receivable and their monthly installment payments (more than 60 months) from the new purchaser of the business. The partners plan to take monthly distributions of cash from the partnership.

Question 4A. How will the monthly cash distributions be taxed to Sue and Marie?

Answer 4A. The distributions will be non taxable as the partners are merely recovering their basis in the partnership, assuming they have a positive basis. The annual filing of partnership returns will record as income the collection of old receivables (partnership was on the cash basis), and the installment sale and interest will be taxed accordingly, and passed along on a Form K-1. These collections along with sale and interest payments are taxed and add to the respective partner’s tax basis.

Inheritance

Unlike a corporation (where only the basis in a descendant’s stock can be stepped up at date of death), a partnership can make an I.R.C. §754 election to adjust the fair market value at date of death. This adjustment can significantly reduce gain (or create a greater loss) on the subsequent sale of partnership property.

Example 5. Brett Spears has a 90% interest in an apartment complex held in a family partnership and his two children, Ken and Barb, each have a 5% interest in these apartments. The tax basis, after many years of depreciation, is \$100,000. The children’s interest is \$5,000 each. Brett dies in 2001 and the apartment units are appraised at \$1,100,000 which would indicate his interest (90%) is worth \$990,000. The children seek tax advice on the sale of this property. They are aware that if the property had been sold while Brett was alive, the taxable gain would have been \$1,000,000.

Question 5A. What is the basis now to measure gain on the sale of the apartment buildings?

Answer 5A. Assuming the partnership makes the I.R.C. §754 election under I.R.C. §743(b), the inside basis of the assets held by the partnership will be as follows:

Portion held by Ken and Barb (10% of \$100,000)	\$10,000
Portion attributable to Britt's interest (90% of \$1,100,000)	990,000
Total basis after §743(b) adjustment	<u>\$1,000,000</u>

The gain recognized will only be \$100,000 (\$1,100,000 selling price less basis, as adjusted above, of \$1,000,000). It will make no difference if the partnership sold the apartments outright, or distributed a 50% interest each to Ken and Barb, who, in turn, sold their respective interest.

Observation. I.R.C. §754 can also be used when the partnership buys out the interest of a selling partner. The partnership can be an active trade or business, or a passive activity such as rental properties. But, it is important to gather the information on the purchase interest in order that an I.R.C. §754 asset can be recorded. In the event that the selling partner has a real estate interest, the amount paid to the selling partner is amortized over either 27.5 years or 39 years (depending on residential or commercial real estate) after making an adjustment for the ratio of land values. In the event that a partnership skips the I.R.C. §754 adjustment, such amount becomes part of the outside basis of the buying partner(s), and is used as basis when his/her interest is later sold.

C CORPORATION

The general public's concept of corporations is based on the large publicly held companies traded on the stock exchanges of the world. Most tax practitioners, however, deal with the small closely held corporations that are owned by a few (or just one) individuals. These companies are not subject to the Securities and Exchange Commission and most likely do not require Certified Audits each year, unless needed for some State or Federal agency or perhaps as bonding purpose. But, corporations are separate entities, separate from the individuals that own the common stock issued by these corporations.

It has been estimated that up to 85% of the new corporations being formed each year elect Sub Chapter S corporations status. There are still well established C corporations that cannot change to a S corporation due to tax considerations or the desire to keep a fiscal year for their C corporation business enterprise. There maybe compelling reasons that a corporation cannot elect S corporation status. There could be more than one class of stock — allowable for a C corporation but denied for an S corporation status. The number of shareholders may be greater than 75 or certain of the shareholders may be partnerships, trusts, other corporations, and the like. These situations prohibit a corporation from making an S corporation election.

Contributions of Property

Generally, the contributions of property, including cash, into a corporation is considered a tax-free exchange under I.R.C. §351. If both property and liabilities are transferred into a corporation, and the liabilities exceed the total basis of the assets, the shareholders must recognize gain on the excess liabilities pursuant to I.R.C. §357. In addition, if an individual contributes property and receives in exchange both common stock and cash, the latter is considered "boot" and taxable to the recipient. I.R.C. §368 requires that shareholders who transfer property and cash in exchange for stock in the new corporation, receive at least 80% of the stock.

Charitable Contributions

The corporation is a separate entity, and all items of income and expense stay in the corporation and are not passed to the individual shareholders. As such, any charitable contributions that a corporation make are deductible, subject to limitations. The contribution deduction is limited to 10% of the corporation taxable income, with certain adjustments

for net operating losses and dividend received deductions. Any unused corporate contributions, due to income limitations, can be carried forward for a period of five years (I.R.C. §170(b)(2)(B)).

Corporations are allowed a greater contribution deduction for certain types of inventory given to an organization for the care of the needy, ill, and infants, as well as computer and related equipment donated to schools (grades K through 12) [I.R.C. §170(e)(3)].

Passive Income

While passive income is probably the reason for many active partnerships, it is an area to be closely watched if such income develops within a C corporation. The reason is the corporation can be considered a personal holding company (PHC) and be subject to prohibitive tax rates. Common situations of corporations becoming PHCs are once active trade or business that becomes dormant or flat, and the majority of the income earned is from rents, dividends, and interest.

I.R.C. §541 provides for a 39.1% additional tax on closely held C corporations whose income is derived from passive sources rather than from an active trade or business. Passive sources include dividends, interest, rents, or royalties. Congress enacted the PHC provisions to prevent shareholders from using their corporations to accumulate income taxed at the corporate rate. They assessed these entities with the highest tax rate on undistributed PHC income to encourage distributions. Undistributed PHC income is computed by making adjustments to the corporation's taxable income, not just its PHC income.

The corporation has to meet two tests to qualify as a personal holding company:

1. **Ownership.** If 50% in value of the outstanding stock is owned directly or indirectly by five or fewer individuals, the corporation meets the first test for qualifying as a PHC. Under the rules of attribution all stock held by family members is attributed to just one shareholder. The disbursement of the company ownership to five or more unrelated individuals is not practical in many closely held companies.
2. **Adjusted Ordinary Gross Income Test.** This is met if at least 60% of the adjusted ordinary gross income for the tax year is PHC gross income. Adjusted ordinary gross income is calculated by starting with the ordinary gross income of the corporation and reducing it by certain expenses. For the purposes of the 60% test, there are eight specific types of adjusted ordinary gross income that make up personal holding income (I.R.C. §543). While rent is one of the types of income that can create a PHC, it can be excluded if it meets the following test:

If rent comprises 50% or more of the AGI, and if other PHC income does not exceed 10% of the (unadjusted) ordinary gross income, the rents are exempt from the PHC calculation.

Generally, interest, dividends, royalties, annuities and the like are the types of income that are included in personal holding company income.

The following example also illustrates the dividend received deduction available to C corporations. They are entitled to a special deduction from gross income for dividends received from a domestic corporation that is subject to income tax (I.R.C. §243). The limitations are detailed on the Schedule C of Form 1120.

Example 6. Big Al's Training Center, Inc. was formed in 1949 for the purpose of training full service gasoline station attendants. During the peak times of the business, the corporation did quite well and saved a lot of cash for investments. In recent years, the company's income has come from investments and the rental of its training center to a video rental center. Al Ambrose is the 100% owner and draws a \$100 weekly salary.

During 2002, the company had the following income and expenses:

Income:	
Gross rental income from building	\$8,600
Interest income	16,550
Divident income	11,600
Total income	<u>\$36,750</u>
Expenses:	
Depreciation of building improvements	\$790
Real estate taxes on building	1,100
Insurance on building	1,200
Repairs on building	1,475
Officer's salary	5,200
Total expenses	<u>\$9,765</u>

Question 6A. Is this corporation a personal holding company in 2002?

Answer 6A. Yes, the company meets both tests since Al is the sole owner and more than 60% of the adjusted ordinary gross income is derived from personal holding sources. In this case, almost 88% of the total income is determined to be PHC income. (Refer to completed 1120 and 1120-PH for the computations of this penalty tax.)

Question 6B. What is the PHC's additional tax for 2002?

Answer 6B. The additional tax, solely as a result of the personal holding company assessment in 2002, is \$10,416. The company's regular tax is \$2,830 for the year. The total tax bill for the company is \$13,246.

Question 6C. Is there any way the company can avoid that personal holding company tax in 2002?

Answer 6C. Yes, the company could pay a dividend equal to the current earnings to Mr. Ambrose. The corporation cannot deduct the dividend payment and Mr. Ambrose is taxed at his personal income tax rate, but the personal holding company tax penalty assessment at the corporate level is eliminated. This dividend has to be paid before the end of the corporate tax year.

For Example 6

Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 2002 or tax year beginning _____, 2002, ending _____, 20____ ▶ Instructions are separate. See page 20 for Paperwork Reduction Act Notice.	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold;">2002</div>
A Check if a: 1 Consolidated return (attach Form 851) <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input checked="" type="checkbox"/> 3 Personal service corp. (as defined in Regulations sec. 1.441-3(c)—see instructions) <input type="checkbox"/>		
Use IRS label. Otherwise, print or type. Name Big Al's Training Number, street, and room or suite no. (If a P.O. box, see page 7 of instructions.) 1488 Westward Blvd City or town, state, and ZIP code Arlington Heights, IL 60041		
B Employer identification number 36 5551000 C Date incorporated 07/08/49 D Total assets (see page 8 of instructions)		
E Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change \$ 480,000		
Income	1a Gross receipts or sales 2 Cost of goods sold (Schedule A, line 8) 3 Gross profit. Subtract line 2 from line 1c 4 Dividends (Schedule C, line 19) 5 Interest 6 Gross rents 7 Gross royalties 8 Capital gain net income (attach Schedule D (Form 1120)) 9 Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797) 10 Other income (see page 8 of instructions—attach schedule) 11 Total income. Add lines 3 through 10	1c 2 3 4 11,600 5 16,550 6 8,600 7 8 9 10 11 36,750
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (Schedule E, line 4) 13 Salaries and wages (less employment credits) 14 Repairs and maintenance 15 Bad debts 16 Rents 17 Taxes and licenses 18 Interest 19 Charitable contributions (see page 10 of instructions for 10% limitation) 20 Depreciation (attach Form 4562) 20 790 21 Less depreciation claimed on Schedule A and elsewhere on return 21a 22 Depletion 23 Advertising 24 Pension, profit-sharing, etc., plans 25 Employee benefit programs 26 Other deductions (attach schedule) Insurance 27 Total deductions. Add lines 12 through 26 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 29 Less: a Net operating loss (NOL) deduction (see page 13 of instructions) 29a b Special deductions (Schedule C, line 20) 29b 8,120	12 5,200 13 14 1,475 15 16 17 1,100 18 19 20 790 21b 790 22 23 24 25 26 1,200 27 9,765 28 26,985 29c 8,120
Tax and Payments	30 Taxable income. Subtract line 29c from line 28 31 Total tax (Schedule J, line 11) 32 Payments: a 2001 overpayment credited to 2002 32a b 2002 estimated tax payments 32b c Less 2002 refund applied for on Form 4466 32c d Bal 32d e Tax deposited with Form 7004 32e f Credit for tax paid on undistributed capital gains (attach Form 2439) 32f g Credit for Federal tax on fuels (attach Form 4136). See instructions 32g 33 Estimated tax penalty (see page 14 of instructions). Check if Form 2220 is attached <input checked="" type="checkbox"/> 34 Tax due. If line 32h is smaller than the total of lines 31 and 33, enter amount owed 35 Overpayment. If line 32h is larger than the total of lines 31 and 33, enter amount overpaid 36 Enter amount of line 35 you want: Credited to 2003 estimated tax Refunded	30 18,865 31 13,246 32h 0 33 0 34 13,246 35 36
Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
Signature of officer _____ Date _____ Title _____		
May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No		
Paid Preparer's Use Only Preparer's signature _____ Date _____ Check if self-employed <input type="checkbox"/> Preparer's SSN or PTIN _____ Firm's name (or yours if self-employed), address, and ZIP code _____ EIN _____ Phone no. () _____		

Cat. No. 11450Q

Form 1120 (2002)

For Example 6

Worksheet for Schedule C, line 9

(keep for your records)

1. Refigure line 28, page 1, Form 1120, without any adjustment under section 1059 and without any capital loss carryback to the tax year under section 1212(a)(1)	1.	26,985
2. Complete lines 10, 11, and 12, column (c), and enter the total here	2.	
3. Subtract line 2 from line 1	3.	26,985
4. Multiply line 3 by 80%	4.	21,588
5. Add lines 2, 5, 7, and 8, column (c), and the part of the deduction on line 3, column (c), that is attributable to dividends from 20%-or-more-owned corporations	5.	
6. Enter the smaller of line 4 or 5. If line 5 is greater than line 4, stop here; enter the amount from line 6 on line 9, column (c), and do not complete the rest of this worksheet	6.	0
7. Enter the total amount of dividends from 20%-or-more-owned corporations that are included on lines 2, 3, 5, 7, and 8, column (a)	7.	
8. Subtract line 7 from line 3	8.	26,985
9. Multiply line 8 by 70%	9.	18,890
10. Subtract line 5 above from line 9, column (c).	10.	8,120
11. Enter the smaller of line 9 or line 10	11.	8,120
12. Dividends-received deduction after limitation (sec. 246(b)). Add lines 6 and 11. Enter the result here and on line 9, column (c) .	12.	8,120

For Example 6

SCHEDULE PH (Form 1120)

Department of the Treasury
Internal Revenue Service

U.S. Personal Holding Company (PHC) Tax

► See separate instructions. Attach to tax return.

OMB No. 1545-0123

2002

Name

Big Al's Training Center

Employer identification number

36 : 5551000

Part I Undistributed Personal Holding Company Income (see instructions)

Additions	1	Taxable income before net operating loss deduction and special deductions. Enter amount from Form 1120, line 28		1	26,985
	2	Contributions deducted in figuring line 1. Enter amount from Form 1120, line 19		2	
	3	Excess expenses and depreciation under section 545(b)(6). Enter amount from Part V, line 2		3	26,985
	4	Total. Add lines 1 through 3		4	
Deductions	5	Federal and foreign income, war profits, and excess profits taxes not deducted in figuring line 1 (attach schedule)		5	
	6	Contributions deductible under section 545(b)(2). See instructions for limitation		6	
	7	Net operating loss for the preceding tax year deductible under section 545(b)(4)		7	
	8a	Net capital gain. Enter amount from Schedule D (Form 1120), line 13. Foreign corporations, see instructions	8a		
	b	Less: Income tax on this net capital gain (see section 545(b)(5)) (attach computation)	8b		8c
	9	Deduction for dividends paid (other than dividends paid after the end of the tax year). Enter amount from Part VI, line 5		9	
	10	Total. Add lines 5 through 9		10	
	11	Subtract line 10 from line 4		11	26,985
	12	Dividends paid after the end of the tax year (other than deficiency dividends defined in section 547(d)), but not more than the smaller of line 11 or 20% of line 1, Part VI		12	
	13	Undistributed PHC income. Subtract line 12 from line 11. Foreign corporations, see instructions		13	26,985

Note: If the information in Part II and Part IV is not submitted with the return, the limitation period for assessment and collection of the PHC tax is any time within 6 years after the return is filed. See section 6501(f).

Part II Personal Holding Company Income (see instructions)

14	Dividends	14	11,600
15a	Interest	15a	16,550
b	Less: Amounts excluded (attach schedule)	15b	15c
16	Royalties (other than mineral, oil, gas, or copyright royalties)	16	
17	Annuities	17	
18a	Rents	18a	8,600
b	Less: Adjustments to rents (attach schedule)	18b	4,565
19a	Mineral, oil, and gas royalties	19a	18c
b	Less: Adjustments to mineral, oil, and gas royalties (attach schedule)	19b	19c
20	Copyright royalties	20	
21	Produced film rents	21	
22	Compensation received for use of corporation property by 25% or more shareholder	22	
23	Amounts received under personal service contracts and from their sale	23	
24	Amounts includible in taxable income from estates and trusts	24	
25	PHC income. Add lines 14 through 24	25	32,185

Part III Tax on Undistributed Personal Holding Company Income

26	PHC tax. Enter 38.6% of line 13 here and on Schedule J (Form 1120), line 9, or on the proper line of the appropriate tax return.	26	10,416
----	--	----	--------

For Paperwork Reduction Act Notice, see the Instructions for Forms 1120 and 1120-A.

Cat. No. 11465P

Schedule PH (Form 1120) 2002

For Example 6

60% PHC Income Test Worksheet

Ordinary and Adjusted Ordinary Gross Income and the 60% PHC Income Test

1	Gross income. Insurance companies, other than life insurance companies, see section 543(c)	<u>36,750.</u>
2	Less: Gains from the sale or disposition of capital assets and section 1231(b) property	<u> </u>
3	Ordinary gross income. Line 1 less line 2 (foreign corps see instructions)	<u>36,750.</u>
4	Adjustments:	
a	Deductions allocable to rents	<u> </u>
b	Deductions allocable to certain royalties and working interests in oil/gas wells	<u> </u>
c	Deductions allocable to compensation described in section 543(b)(2)(D)	<u> </u>
d	Certain excluded interest income under section 543(b)(2)(C)	<u> </u>
e	Total adjustments. Add lines 4a through 4d	<u> </u>
5	Adjusted ordinary gross income. Subtract line 4e from line 3	<u>36,750.</u>
6	Complete Part II of Schedule PH. Divide line 25, Part II, by line 5 above. Enter the result as a percentage	<u>87.5782%</u>

Important: If line 6 is **less than 60%**, the corporation is not a PHC. Do not file Schedule PH.

Generally, if line 6 is **60% or more** and the **Stock Ownership Requirement** of section 542(a) is met, the corporation is a PHC. Complete Parts III and IV of Schedule PH. For details and exceptions, see **Who Must File** and **Personal Holding Company** on page 1 of the IRS instructions.

Schedule PH (Form 1120) 2002

Big Al's Training Center

36-5551000

Page **2**

Part IV

Stock Ownership Requirement Under Section 542(a)(2)

Enter the names and addresses of the individuals who together owned, directly or indirectly, at any time during the last half of the tax year, more than 50% in value of the outstanding stock of the corporation.

	(a) Name	(b) Address	Highest percentage of shares owned during last half of tax year	
			(c) Preferred	(d) Common
1	Al Ambrose	1010 Falling Meadows Arlington Heights, IL 60022	%	100.0 %
			%	%
			%	%
			%	%
			%	%
2	Add the amounts in columns (c) and (d) and enter the totals here		%	100.0 %

I.R.C. §179

All depreciation of the C corporation is deducted on the tax return of the entity and the regular limitations under I.R.C. §179 would be applicable.

Health Benefits Paid by the Corporation

Premiums paid for health insurance are fully deductible by the C corporation as an ordinary and necessary business expense. The shareholder employees are specifically allowed to exclude these benefits from gross income and there is no nondiscrimination requirement for the exclusion under I.R.C. §106.

Retirement Plans at the Corporate Level

The corporation can establish a qualified pension plan and deduct such contributions to the pension plan within the prescribed allowable limits. If the pension plan is tied to the wages paid the owners and employees (such as an I.R.C. §401(k) plan), the full wages are reflected as a deduction by the corporation as well as the company's matching contribution amount. The reportable amount on employees' Forms W-2 for reporting purposes will be less than deducted on the corporate tax return for the employee portion of contributions to an I.R.C. §401(k) plan).

Sale of Assets

The corporation gain or loss from the sale of business assets remains with the corporation, and the net amount of gain or loss is **not** reflected on the shareholders' individual income tax returns.

Distributions

A non-liquidating distribution by a corporation to its shareholders is a dividend if the corporation has sufficient current earnings and profits, or accumulated earnings and profits, to cover the amount of distribution. **Earnings and profits** is the term given to the amount of distribution that a corporation can make without impairing its capital account. The issue of earnings and profits becomes complex as earnings and profits are not defined by the Internal Revenue Code. To the extent that a distribution to shareholders exceed the total of available earnings and profits, the shareholders first reduce their basis in the stock held, and any excess above basis is treated as a capital gain (as if the shareholder, in effect, sold a portion of their stock).

Shareholder Basis in Common Stock

Shareholder basis in common stock of a C corporation is the shareholders' cost for that stock plus any "step-up" in basis if all or a part of the stock was received by inheritance by the shareholder. Basis of the stock is not tied to the reporting by the C corporation, which has a definite impact on fair market value of the stock, as the shareholder basis remains the same.

Redemption of Stock

Treasury stock reflected on a corporate balance sheet would indicate there was a corporate redemption of a shareholder's common stock. A stock redemption is simply a purchase by the corporation of its own stock from its shareholders. The shareholder views this redemption as a sale of the corporation's own stock to the corporation. I.R.C. §317(b) redemption occurs when the corporation acquires its own stock from a shareholder in exchange for property.

While a redemption simply appears to be a sale, it in fact may be a disguised dividend. Before sale treatment is granted, the redemption portion of the transaction must pass the tests of I.R.C. §302. Failure to meet one of these tests takes the transaction out of the sale context, and means that the transaction will be a dividend to the selling shareholder.

The tests are:

- not essentially equivalent to a dividend (I.R.C. § 302(b)(1));
- substantially disproportionate (non pro rata)(I.R.C. § 302(b)(2));
- complete termination of the shareholder's interest in the corporation (I.R.C. § 302(b)(3);
- redemption from noncorporate shareholder in distribution qualifying as a partial liquidation (I.R.C. §302(b)(4)); and
- redemption to pay estate taxes (I.R.C. § 303).

Liquidation

Liquidation of a corporation begins within the corporation where the business sells its assets, pays its debts and obligations including income taxes, and reduces its only remaining asset to cash. This cash is distributed to remaining shareholders in the form of a liquidating dividend, which, in fact, is the amount the shareholder receives for his or her

stock. Gain or loss to the shareholder is measured by the amount of liquidating dividend received less the shareholder basis in the stock. It is reported by the shareholder on his Form Schedule D. The corporation pays its regular income tax on the gain, if any, on the sale of corporate assets.

The corporation will adopt a plan of liquidation under the applicable I.R.C. §§333 or 337. The IRS Form 966 is completed and attached to the corporate plan of liquidation and filed with the applicable Service Center before the liquidation has been completed. A copy of Form 966 with attachments is also enclosed with the final corporate tax year for the year of liquidation.

Members of a Controlled Group (I.R.C. §1561)

A controlled group of corporations is essentially a chain of corporations connected through stock ownership. The rule for controlled group members is to apportion the \$50,000, \$25,000, and \$9,925,000 taxable income brackets among themselves. Failure to do so by the corporation will require the division of taxable income equally among all the members.

The following four types of controlled groups are covered:

1. **Parent-Subsidiary Controlled Group** where at least 80% of the voting power of each corporation in the group (except the parent) is owned by one or more of the other corporations in the group, and the parent owns at least 80% of at least one of the other corporations in the group.
2. **Brother-Sister Controlled Group** are two or more corporations where five or fewer individuals own at least 80% of the combined voting power of each corporation, and more than 50% of the total combined voting power of all classes of stock, or more than 50% of the total value of shares of all stock of each corporation.
3. **Combined Group** where three or more corporations, one of which is a member of a parent-subsidiary group or brother-sister controlled group.
4. **Certain Insurance Companies.**

Example 7. Bill, Larry and Tom (B, L, and T) form a corporation, Restaurant Operations, Inc. (ROI), for the purpose of training restaurant owners to manager their businesses. They each purchase an equal number of shares of ROI. As they work with their clients, they see that many of the clients have food costs higher than normal. B, L, and T decide to form a second corporation, Restaurant Provisions, Inc. (RPI) for the purpose of selling food to restaurants. They find the cost of starting the business will require more capital than they have availably. B, L, and T finds two investors, Sam and Joe, that agree to become shareholders of RPI. At the time of formation, each share holder owns 20% of RPI.

ROI and RPI are not subject to the controlled group rules. While there are five or fewer shareholders, no group owns more than 80% of the voting power of each corporation. Therefore, each corporation has the benefit of paying tax at the 15% rate on its first \$50,000 of net taxable income.

After five years, Sam and Joe decide to reduce their investments in RPI to 5% each. Since B, L and T now own 100% of ROI and 90% of RPI, they are a controlled group. They must allocate the 15% tax bracket between the two corporations.

The apportionment election statement is attached to each affected tax return clearly identifying each corporation's address and employer ID number with an allocation of the taxable income brackets. The statement is signed by a responsible corporate officer. Members of a controlled group cannot file Form 1120-A.

Personal Service Corporation

This is a corporation owned by a professional individual or group of professional individuals as a personal service corporation (PSC). Individuals under this umbrella include medical, legal, accounting, and other professional personal service fields. The tax rate on the first dollar of corporate taxable income is at the highest income tax rate, currently 38.6%; as such, PSCs should closely monitor the income in order to pay salaries to the professional individual(s) before the end of the tax year (generally December 31) in order to avoid the high tax rate.

S CORPORATION

The S corporation is a corporation for legal purposes but its allocation of income to its shareholders offers many of the characteristics of a partnership for tax purposes. Every corporation starts as a C corporation. An S corporation makes a special election using Form 2553 to obtain this tax status. There are certain rules for an S corporation as to the type of stock (only one class) and the kind (generally individuals) and number (no more than 75) of shareholders.

All of the corporations' current year profits, whether distributed or not, are taxed to shareholders. Tax-free fringe benefits are generally not available to more than 2% S corporation shareholder employees. S corporations generally cannot choose a fiscal year in order to defer income.

As indicated earlier, most new corporations timely file Form 2553 to elect the 1120-S status. A proper election for the first year of the corporation needs to be submitted 75 days from incorporation. If the corporation cannot qualify as an S operation, the limited liability company could be considered. An established business entity, whether a regular corporation or partnership, needs to consider all factors before making an S corporation election.

For example, shareholders of a regular C professional service corporation operating as an accounting practice decide that filing for S status would save several thousand dollars annually in taxes.

Question. Can the accounting practice file a Form 2553?

Answer. Yes, but the accounting practice is probably on the cash method of accounting which will mean the so called "built-in gains" tax will come in to play and the newly elected S corporation will pay taxes computed at regular corporate rates. Even if a C corporation were on the accrual method of accounting, it is possible that the company may have appreciated property on hand at time of conversion to the S corporation which triggers the built-in gains tax. Taxpayers need to be reminded to have their tax practitioner review all potential tax ramifications before changing from an existing entity to an S corporation form of operation.

Contributions of Property by an S Corporation

The same rules apply to S corporations for the contributions of property as with regular C corporations. The same considerations remain at time of incorporation and affect a tax-free incorporation under I.R.C. §351. Property transferred into a corporation with liabilities exceeding basis, will result in taxable gain to the transferring shareholder as provided for under I.R.C. §357.

Charitable Contributions by S Corporations

Charitable contributions made by the S corporation are not deducted at the corporate level, but are deducted by the shareholders as an itemized deduction. The deduction is equal to the basis the property donated. The accrual rule and the ability to deduct more than the basis of such property are specifically denied to S corporations even though permitted in, certain circumstances, to regular C corporations.

Passive Income of S Corporation

Passive income is never an issue for an S corporation if the organization has always operated as an S corporation. However, there can be major tax traps if the S corporation had previously operated as a C corporation and had accumulated earnings and profits from that period of operation. If this is the case, the gross receipts from passive investment income cannot exceed 25% of its gross receipts from all sources, or they could trigger two adverse results.

The S corporation will pay a corporate level tax on 35% on its excess net passive income (I.R.C. §1375), and if the situation persists for three consecutive years, the corporation loses its S election as of the first day of the next year.

I.R.C. §179

The additional first year depreciation, as provided for under I.R.C. §179, is computed at the corporation level for S corporations but not deducted on the corporate tax return. This depreciation is a separate line item on the Form K-1 and flows to the individual shareholder's tax return. Care must be taken to insure that I.R.C. §179 depreciation that is claimed at the corporate level can be used by the shareholder. The total of available first year depreciation claimed cannot exceed the allowable limit for the individual regardless of the source of the bonus depreciation.

Health Benefits

In the area of health insurance, the S corporation occupies a middle ground between the partnership and a C corporation. The shareholder employees are limited to the tax treatment of partners with certain fringe benefits, including accident and health insurance premiums. The S corporation shareholders are required to report the benefit as gross income. The proper way to report is for the corporation to include the value of the premiums as a noncash compensation on each shareholder-employee's Form W-2.

However, this additional wage is not subject to FICA or Medicare taxes, and the full amount of the health insurance paid is deducted on the S corporation tax return. For 2002, the shareholder can then deduct 70% of the health insurance premiums on page one of his/her return with the balance deducted as a medical expense on Schedule A.

Observation. Many tax preparers ignore the additional W-2 income rule for the amount of health insurance premiums paid, and merely make a note on the 1120-S K-1 Form for the amount of premiums. From this available information, the preparer of the individual income tax return can take 70% of the health insurance amount and deduct it on the front page of Form 1040. The danger is that if the shareholder employee had no wages, no deduction for the health insurance premium will be allowed.

RETIREMENT PLANS

Retirement plans for S corporation shareholders are like those maintained by C corporations. Shareholder-employees of an S corporation can establish a pension plan in the corporation and corporation pension payments made on their behalf can be deducted on the Form 1120-S tax return.

SALE OF CORPORATE ASSETS

Business assets of the S corporation, sold during the year, are first reported on Form 4797 of the corporate tax return and then reflected on respective Forms K-1 of the individual shareholder(s). The tax is paid by the shareholder as a result of any gain on the sale of business assets and any ordinary loss from the sale of business assets is deducted on the personal tax return of the shareholder in the S corporation.

The S corporation can be subject to a "built-in gains" corporate level tax if it were formerly a C corporation. The built-in gains tax applies to assets held at the time of the S election and sold within ten years of the date of the election. This rule also applies to S corporations that have acquired assets from C corporations or from former C corporations in a tax-free reorganization or liquidation. This built-in gains tax was enacted as a companion provision to the 1986 liquidation rules providing for the recognition of gains and losses in corporate liquidations. The purpose is to prevent C corporations from avoiding the tax on liquidating distributions by becoming S corporations before they liquidate.

DISTRIBUTIONS

If the S corporation was formerly a C corporation, with accumulated earnings and profits, it may be subject to an additional tax. I.R.C. §1368 provides a **three-tiered hierarchy of distribution** rules to help determine if the tax is due.

The S corporation's **Accumulated Adjustment Account (AAA)** is the first source of distributions. The distributions that do not exceed AAA are tax-free to each shareholder to the extent of his/her stock basis. Any excess distribution is treated as gain from the sale of stock.

Once AAA is exhausted, distributions are treated as taxable dividends, to the extent of corporation's accumulated earnings and profits. These dividends are taxed in the same manner as those from a C corporation, and are treated as ordinary portfolio income and have no effect on any shareholder basis.

After accumulated earnings and profits are exhausted, the corporation is subject to the rules for S corporations with no accumulated earnings and profits. Distributions are tax free reductions of shareholder basis to the extent thereof, with any excess treated as a gain from the sale of stock. These AAA computations are unique to S corporations.

SHAREHOLDER BASIS

Perhaps the **greatest tax trap**, and a prime **source of tax adjustments** by Internal Revenue Service agents, is in the area of **determination of a shareholder's basis in the stock**. In a C corporation, stock basis is usually the shareholder's original cost. If additional contributions are made, they increase the basis. If distributions, exceeded earnings and profits are made, they reduce the basis.

A shareholder's basis should be routinely maintained, to determine gain or loss on the sale of stock, to determine the limit on the amount of tax-free distributions from the S corporation, and to provide the dollar limit that each shareholder can deduct of his/her portion of the S corporation's loss. The latter is probably the most litigated problem in the entire S corporation area. The amount of the shareholder loss cannot exceed the shareholder's basis in stock and debt (I.R.C. §1366(d)(1)).

Each year, the shareholders must adjust their tax basis to reflect their portion of the S corporation's income items, including:

- ordinary income;
- separately stated income and gains; and
- tax exempt income.

They must also adjust loss and deduction items, which include:

- ordinary losses;
- separately stated loss and deduction items;
- nondeductible expenses, such as meal and entertainment expenses; and
- distributions, excluding distributions that are treated as dividends for tax purposes. This would be the case if the S corporation was formerly a C corporation and had earnings and profits.

In a partnership, loans incurred by the partnership serve to increase an individual partner's basis, but loans made to an S corporation do not generally increase the basis of S corporation shareholder. The major exception are direct loans made by the shareholder to the S corporation. As these loans are repaid by the S corporation, the shareholder's basis **is decreased** by the amount of such repayment. The guarantee of a corporation's loan does not add to the shareholder's basis.

Example 8. Using the information from **Example 3**, Alex would only be able to deduct \$5,000 of losses. However, if Alex borrowed \$150,000 directly from the bank and then loaned it to the corporation, his basis for losses would be \$155,000.

REDEMPTION OF STOCK

The S corporation is subject to the same tests as a C corporation on redemption of corporate stock, but the significance often has little or no tax impact to shareholders. If the S corporation has no accumulated earnings and profits (or never operated as a C corporation) and has sufficient AAA to cover the entire redemption distribution, the distribution will be treated as a reduction of shareholder basis to the extent thereof, and any gain thereafter (I.R.C. §§1368(b) and (c)).

If the S corporation has earning and profits, the distribution is first applied against AAA then to earning and profits with the latter allocation resulting in a taxable dividend to the shareholder redeeming the stock.

LIQUIDATION OF AN S CORPORATION

The liquidation of an S corporation has substantial tax advantage for the shareholders in the S corporation, over a C corporation. If a C corporation liquidates, two levels of tax can result. Tax is assessed at the corporate level, and then at the shareholder level on the liquidating distribution. S corporation liquidations are similar to partnership liquidations in that gain or loss from the sale of assets flows to the individual shareholder's tax return. Gain at the corporate level that passes directly to the shareholder serves to increase his/her basis in stock in the S corporation. As a result, the increased basis of the shareholder will give rise to a lesser gain, if any, on the final liquidating distribution from the S corporation.

2002 Workbook

COMPARISON OF BUSINESS ENTITIES*

<u>Factor</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
Owners	Individuals	Any person may be a partner, e.g., individuals (including nonresident aliens), corporations (C or S), other partnerships, trusts, estates, and tax-exempt entities. (500 maximum partners)	Same as for partnerships unless some restriction applies under State law for a type of corporation, e.g., professional corporation. (No limit on shareholders)	Generally any individuals who are U.S. citizens or resident aliens, estates, and certain trusts that are owned by a U.S. citizen or resident. (75 maximum shareholders)	Same as for partnership.
Limited Liability	None	General partners are personally liable for obligations of partnership, not limited partners	Shareholders not generally liable personally for a corporation's obligations unless they require guaranteed payments.	Same as C corporation.	None unless member has personally guaranteed obligation of LLC.
Allocation of income and deductions among owners	Must report all business items on individual tax return	Partners may allocate income and deductions by agreement if the agreement has substantial economic effect.	Preferences as to dividends can be given by issuing preferred stock but losses are deductible only at corporate level.	No allocation of income and losses allowed since only difference allowed in classes of stock is in voting rights.	Same as for partnership.
Income-splitting among family members.	Sole proprietorships may employ family members, but otherwise there is no income-splitting potential.	Family partnership rules limit ability to split income.	Income can generally be split by gifts of stock.	If stock is given to family members, adjustments may be made to corporation income to reflect reasonable compensation for services rendered.	Same as for partnership.
Federal taxation of business income	Income and expenses of the business are reported on the individual income tax return.	No tax imposed on partnership - income is passed through to partners.	Income is taxed first at corporate level and then to shareholders when distributed as dividends.	No tax imposed on S corporation (except for excess net passive income and built-in-gains on certain assets) - income is passed through to shareholders.	No tax imposed on LLC - income is passed through to members or taxed as a corporation.
<u>Factor</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
Deductibility of business losses	Losses are fully deductible for up to five years. Losses beyond this period are deductible only to the extent of business income.	Losses are passed through to, and are deductible by, partners to the extent of basis in partnership interest limited by at risk rules.	Losses for a tax year are not deductible by owners but may only be carried back or forward.	Generally same as partnership, but amount of basis and at risk is often less favorable for S shareholders than for partners.	Same as for partnership or C corporation based on election.
Taxable years	Sole proprietorship must use the same tax year as the proprietor.	Must conform to that of the principal partners' calendar year unless IRS consents.	Any year ending on last day of a month and a 52-53 week year may be used.	Generally restricted to a calendar year unless IRS consents: Code Sec. 444 allows certain uses of a year other than a calendar year.	Same as for partnership or C corporation based on election.
Fringe benefits for owner employees	N/A	Fringe benefits for partners generally not deductible in computing taxable income of partnership (or partners).	Fringe benefits for shareholder-employees generally deductible by C Corporation and not includable in income of shareholder-employees.	Shareholder employees with more than 2% of stock are treated as partners.	Same as for partnership or C corporation based on election.
Changing to another type of entity	Can generally change to another type of entity without any tax effect.	May be incorporated by transferring assets to an S or C corporation without recognizing taxable gain or loss unless liabilities assumed by corporation are more than aggregate basis of transferred assets.	Gain or loss will be recognized if it is liquidated and assets transferred to partnership or LLC; no gain or loss will be recognized except if LIFO inventory method is used, but S corporation may be subject to built-in gains tax if appreciated assets are sold after the S election is made.	May be changed to C corporation without taxability; can be changed to partnership or LLC by liquidating corporation and distributing assets to shareholders who then contribute assets to partnership or LLC - gain could be recognized on transfer to shareholder.	Same as for partnership.

*The following chart is provided by and printed with the permission of Stuart P. Sobel of Stuart Sobel Consulting, Inc.

2002 Workbook