Chapter 3: Entity Comparisons

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

INTRODUCTION

Choosing and maintaining a form of business organization is one of the most essential elements of tax planning. New tax laws and interpretations have a dramatic impact on the viability or advantages of one business entity over another. Tax planning must be dynamic and requires continuous monitoring of recent developments. This chapter compares and analyzes the different types of business entities.

The appendix at the end of the chapter lists the various factors of each entity to allow for easy comparison.

OWNERSHIP

Before deciding which type of entity to chose, the ownership of the entity must be considered. Various entities have different restrictions on who can own an interest in the entity.

Ownership

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
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. (Number of partners governed by a state's Uniform Partnership Act)	Same as partnerships unless some restriction applies under state law for a type of corporation, e.g., professional corporation. (No limit on shareholders)	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 partnership.

SOLE PROPRIETORSHIP

Just as its name implies, a sole proprietorship is owned by a single individual. This unincorporated entity is the simplest form of entity. The proprietor is directly responsible for all debts, and his personal assets are at risk since he has unlimited liability. The owner of the entity is called a proprietor.

There is no requirement for the proprietor to keep business accounts separate from personal accounts. As long as the proprietor can determine the income and expense of the business at year end, the IRS will be satisfied in the event of an audit. If the proprietor wishes to operate his business in a name other than his own, he may do so. This may require filing a fictitious name report with the applicable local or state government. This name will be his "doing business as" name or DBA.

One disadvantage of a sole proprietorship is that there is no continuity of existence. If the proprietor dies, the business terminates. While the assets of the business may transfer to the individual(s) named in the proprietor's will, the inheritors will need to form their own business.

Another disadvantage is that all of the profits of the business are subject to both income and self-employment taxes. In some type of entities, it may be possible to split profits between those derived from the work of the owner and those derived as a return on the owner's investment in the business. Only the returns from labor are subject to self-employment tax. Although some entities are able to take a deduction for fringe benefits, this deduction is not available to sole proprietors.

For many individuals, a sole proprietorship is the perfect entity selection. If there are no employees and only moderate profits, there may not be a need for some of the advantages that another entity type could bring to the business.

PARTNERSHIPS

A partnership consists of two or more individuals or entities working as co-owners of the business. The partners personally share the risks and rewards of the business. Each partner is considered to own a share of the assets. An owner of a partnership is called a partner.

Partnerships may be one of two types. One is a general partnership and the other is a limited partnership. The difference between the two types is the amount of liability the partnership can incur in the business. In a general partnership, each partner is a general partner. As such, the partner has joint and several liability with each partner for all except nonrecourse liabilities.

In a limited partnership, there must be at least one general partner. The limited partners are treated as investors in the business. As such, they are not allowed to be involved in the management of the business. Therefore, their liability is limited to their investment in the limited partnership.

An advantage of a partnership is that it may be easier to secure financing, since the lender has more individuals as potential guarantors. If a partnership changes 50% or more of its partners within a 12-month period, it is dissolved and a new partnership is formed.

C CORPORATIONS

C corporations are entities created under respective state law. They can hire employees, sign contracts, and build net worth. They are not limited as to what type of entities own their stock or in the number of shareholders. Unlike a proprietorship or partnership, there is no change in the entity at the death of a shareholder. The owner of a corporation owns stock rather than having title to a portion of the assets of the corporation. This continuity of life can be very advantageous for some businesses. The owner of a corporation is called a shareholder.

The shareholders may own one or more types of stock. Any increase in equity of the corporation is reflected in the value of the common stock. Some shareholders may desire preferred stock. If dividends are paid by the corporation, they are paid to the preferred stock owners first.

Corporations are managed by corporate officers who are elected by the shareholders. In a closely held corporation, these may be the same people.

Finances of the corporation must be kept separate from the finances of the shareholders, even in a one person corporation. Failure to do so can result in adverse tax consequences.

S CORPORATIONS

An S corporation is a C corporation that has made an election to have it profits and losses flow through to the shareholders for taxation purposes. They are similar to partnerships for tax purposes, but similar to C corporations for liability purposes. S corporations are limited to 75 shareholders and the owners can only be individuals and certain types of trusts. Non-resident aliens are not allowed to be S corporation shareholders. The owner of an S corporation is also called a shareholder.

One difference from a general partnership is that the profits that pass to the shareholders are not liable for self-employment tax. A difference from a C corporation is that only one class of stock is allowed. Another difference is that the S corporation is generally restricted to choosing a calendar yearend.

LIMITED LIABILITY COMPANIES

A limited liability company (LLC) is a hybrid entity in that it has features of many different types of entities. It is important for the LLC to choose how it wishes to be taxed. Since the Internal Revenue Code does not cover LLCs as a separate entity, the tax laws relate to the tax election made by the LLC. If a tax election is not made, the IRS will default the LLC to a partnership if there are two or more members and to a sole proprietorship if there is only one member. However, by making a tax election, the LLC can chose to be taxed as either a C or an S corporation. The owner of an LLC is called a member.

Once the tax election is made, the LLC becomes bound by the tax laws regulating that type of entity. For example, if it chooses to be taxed as an S corporation, it can not have a C corporation as a member. Unlike a limited partnership, the member of an LLC can maintain limited liability, even though they are active in the management of the entity.

Under the various states' laws, some types of occupations may not be allowed to be limited liability companies.

LIMITED LIABILITY

Liability is always a concern for business owners. Any time a business has employees, they are at risk for actions their employees take on their behalf. Some forms of entities offer a greater protection to the business owners for these actions.

Limited Liability

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
None.	General partners are personally liable for obligations of partnership, not limited partners.	Shareholders not generally personally liable for a corporation's obligations unless personally guaranteed and payments are required.	Same as C corporation.	None unless member has personally guaranteed obligation of LLC.

Note. No form of entity should be considered as a replacement for a high-limit liability insurance policy.

SOLE PROPRIETORSHIPS

Proprietors have unlimited personal liability for debts and obligations associated with their business. Their personal assets are also at risk. Married proprietors who co-own property with their spouses place their spouses' assets at risk.

Proprietors must personally guarantee all the debts of their business. Proprietorships with employees have additional risks and may want to consider converting to a different entity form. They should choose an entity form that protects them from unlimited liability as proprietors and also from potential liability associated with employees. As defined by the IRS, a proprietorship is a "disregarded entity," which does not provide liability protection to individual taxpayers. While some sole proprietors may not need the tax savings that other forms of business organization can provide, it may be wise for them to form single member LLCs that provide limitations on personal liability.

PARTNERSHIPS

General partnerships have the same liability problems as proprietorships. All partners of general partnerships are jointly and severally liable for the debts of their partnerships. Nonrecourse debts, which are defined as debts where the lender only looks toward the partnership for payment of the debt, are an exception.

Since personal assets of all partners are at risk, general partnerships should avoid creating large amounts of nonrecourse debt. There is some protection if partners are corporations or LLCs. While those types of entities are liable for debts of the partnership, their owners and shareholders are protected by their individual limited liability status.

Creating a limited partnership can limit the risk of most of the partners. However, there must be one general partner with unlimited liability in every limited partnership. Naming a corporation as this general partner may limit liability to the assets of the corporation.

Note. In some cases, the courts have deemed limited partners who materially participate in the overall operation of the business may be liable.

C CORPORATIONS

There are no differences in the liability protection offered by S and C corporations. State laws determine the liability of corporations. In many situations, lenders will require the individual shareholders to guarantee the debt of the corporation.

Caution. When corporations obtain financing and guarantors are required to consummate the transactions, a large amount of specific language is placed in the contracts. This language typically states that guarantors waive many of their rights by guaranteeing the debt. A financial institution may have the right to go directly to the guarantors for payment of the debt whenever the debtor is delinquent. Guarantors should be cautioned about the merits of guaranteeing corporations. They should realize the possible negative impact that such debt could have on them if the corporation defaults.

S CORPORATIONS

The election to become an S corporation is primarily for income tax purposes. The election does not provide liability protection.

LIMITED LIABILITY COMPANIES

LLC members have limited liability protection similar to that held by the shareholders of corporations. In most situations, members are not liable for the debts of the LLC. However, there are some instances where members may be held liable. Usually these situations also apply to corporations. Examples of situations where members may be liable follow:

- Debts personally guaranteed by individual members.
- Fraudulent or illegal acts committed by a member.
- Assertions of malpractice in states that allow professional LLCs.
- Wrongful distributions. (If an LLC is insolvent, any unauthorized distributions could be deemed the responsibility of the culpable member.)
- Taxes are not remitted or there are IRS trust fund assertions on employment taxes.

In CCA 200235023, the IRS establishes its position that the members of LLCs may be liable for the trust fund recovery penalty under IRC §6672. The Opinion further states that an assessment made against a disregarded LLC is also a valid assessment against a single-member owner. It states that due to the close relationship between a disregarded LLC and its single-member owner, an assessment against the disregarded LLC is tantamount to an assessment against the single-member owner. The legal memorandum cites specific examples and summarizes the government's position regarding trust fund penalties. LLCs do not protect their members from responsibility or payment of the penalties in appropriate situations.

MANAGEMENT AND CONTROL

The management and control of the business is of great concern to individuals that are forming a business. Some business owners wish to have complete control of the decision-making process, while others seek the advice of others to help analyze the situation and offer suggestions. There may be considerable differences in the decision-making process between the different entity types.

Management and Control

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
No entity continuity if sold, abandoned, or owner dies.	General partnership has limited life. Partnership dissolves when majority of partners withdraw or die. Partnership agreement can keep business in existence. Limited partnership interests easily transferable.	Indefinite life; death or retirement does not terminate.	Same as C corporation.	May have a limited life or be perpetual.

SOLE PROPRIETORSHIPS

Proprietorships give individual business owners the most control. If the proprietor wishes to obtain help in making a decision, he will look to a consultant in the applicable field. Ultimately though, he has sole responsibility for the decision.

Proprietorships have no continuity as legal entities. When a proprietor dies or abandons the business, the entity ceases to exist. If the business is sold to another individual or business entity, it assumes the identity of its new owner. The physical assets of a proprietorship can be sold, but the business itself is not transferable. Since this entity type has only one owner, a proprietorship may evolve into a different entity if its business grows.

PARTNERSHIPS

There is a substantial amount of standardized language used in partnership agreements. It is imperative for partners to reach agreement when they are determining how their partnership will be formed and controlled. In a general partnership, the general partners are responsible for making the decisions. This management may be delegated to a specific partner(s) or decisions may be made at a meeting of all of the partners. In a limited partnership, limited partners cannot be a part of the decision-making process.

C CORPORATIONS

C corporations have indefinite life. They are perpetual in nature. Corporations have an advantage over other forms of business organization, because they have more management resource opportunities.

Shareholders

C corporations may have one or thousands of shareholders since there is no limit to the number of shareholders. The shareholders of a corporation elect the corporate directors who in turn elect the corporate officers. The same is true for a sole stockholder organization except there is only one shareholder who may be the only director and officer.

Transfer of ownership, death, retirement, or bankruptcy of individual shareholders does not dissolve C corporations. There are some actions that may cause C corporations to be dissolved. If none of those specific actions is taken, corporations can exist indefinitely.

Unless there is a shareholder agreement limiting the transfer of closely held stock, such stock can be easily transferred to others. Several negative factors make transfers of closely held stock difficult. For example, stock may be difficult to sell because:

- Closely held stock is not available on the stock market for purchase.
- Brokers don't represent closely held corporations in order to facilitate transfers of stock.
- Closely held stock is difficult to value.

The assistance of a trained professional will be required to determine the closely held stock's FMV.

S CORPORATIONS

S corporation language is similar to that used for C corporations. However, there is a difference in who is qualified to be a shareholder of S corporations. Nonresident aliens and corporations cannot be S corporation shareholders. It is imperative that shareholders of S corporations develop some type of agreement that limits transferability of shares.

It may sometimes be wise to terminate an S election based upon decisions regarding management, control, and ownership. However, if an S corporation terminates its election and becomes a C corporation, it must wait five years before it can elect to become an S corporation again. There is a relief provision under IRC §1362(g) where a former S corporation can request permission from the IRS to reelect S corporation status within the 5-year period. The IRS will make a determination regarding the basis for the request. If the request seems purely tax motivated, the IRS may not approve it.

An S corporation may not have more than 75 shareholders. A husband and wife are treated as a single shareholder under IRC §1361(c)(1). When a husband and wife divorce, they are no longer treated as a single shareholder.

If an LLC has one only owner, the S corporation election is possible. The owner must file Form 8832 with the S election.

Proportionate Ownership

An S corporation may have only one class of stock. Common and preferred stock with differing rights for distribution of profits and assets in liquidation constitutes multiple classes of stock. S corporations operate proportionately based on individual shareholders' percentages of ownership in the company. Corporations secure their capital pro rata from their shareholders. Distributions of profits and losses are also based on percentage of stock ownership. Upon liquidation of a corporation, any proceeds are distributed to the shareholders based upon their stock ownership.

Shareholders may authorize disproportionate voting rights of the stock to specific shareholders through proxy agreements or other shareholder agreements. It is permissible for the stockholder, president, or another designated individual to control the day-to-day operations of the corporation.

Inadvertent Termination

There may be situations where an inadvertent action causes the termination of an S election. For example, if a shareholder transfers his stock ownership to a nonresident alien, corporation, or nonqualifying trust, the corporation's S status terminates. Therefore, it is very important for the corporate agreement to limit the transferability of shares. Another example of an action that terminates an S election is if a corporation violates a passive income test.

The IRS has authority to waive the effect of a terminating event for any period provided the corporation corrects the event and the shareholders agree to be treated as if the election had been in effect for the period involved.[1] The taxpayer needs to request a private letter ruling from the IRS to maintain its S corporation status. The IRS analyzes the situation to determine if the action was truly inadvertent and not merely to avoid tax.

LIMITED LIABILITY COMPANIES

Members

LLCs have **members** rather than partners or stockholders. LLCs are not included in the Internal Revenue Code per se. Instead, the IRS treats them as a sole proprietorship, partnership, corporation, or S corporation depending on the taxing election they make at the time of formation. If an election is not made, the default election is to be treated as a partnership if there are two or more members. Owning a membership interest in an LLC is similar to owning stock in a corporation.

Laws in most states allow LLCs to have membership interests in different classes of ownership. LLCs do not have the same limitations as S corporations. Individuals, corporations, trusts, partnerships, and other LLCs may be members of LLCs.

Articles of Organization

Articles of organization vary from state to state. Some states require specific provisions dealing with issues such as who qualifies to be a member and the method to be used to add members.

Operating Agreements

Operating agreements are similar to partnership or shareholder agreements. They govern how an organization is managed and list the responsibilities of various members. LLCs can delegate the responsibility for the day-to-day management of their organization to specific members.

LLC Existence

LLCs may be perpetual or terminate after a definite period of time as specified in the LLC's operating agreement. The agreement spells out how members can dissolve an LLC. In some states the consent to dissolve an LLC must be unanimous, and in other states the decision may be made by majority vote. Also, an LLC terminates if it fails to maintain compliance with their respective state authority. An example of this might include not paying the required fee to the Secretary of State to keep the organization in existence.

Various states give LLC members certain rights. These rights can include the right to inspect records like financial statements, names and addresses of other members, and tax returns.

FORMING THE ENTITY

Care must be taken when an entity is formed. With the exception of a sole proprietorship, there are possible tax consequences of formation. A major problem occurs if assets and liabilities are contributed to the new entity and the basis of these assets is less than the liabilities. Although the FMV of the contributed assets is higher than the liabilities, this is considered a taxable transaction. Another possible taxable transaction at the time of formation occurs when services are contributed in exchange for stock or an interest in a partnership or LLC.

Any expenses incurred prior to the commencement of the business are known as startup expenses. A business must capitalize these costs. IRC §709 deals with these expenses for a partnership, as does IRC §248 for a corporation. For an individual, IRC §195 allows these expenses to be amortized over a 60-month period beginning with the month the business commences. These expenses are considered ordinary and necessary expenses under IRC §162, even though they were incurred prior to the actual commencement of the business. Types of expenses may include advertising, training, travel, investigation of franchises, and fees paid to attorneys, tax consultants, and other professionals.

Treas. Reg. §1.195-1 is harsh. If a taxpayer deducts start-up expenses as a current deduction, the start-up expenses could be denied. The expenses then become capital expenses and are not deductible because the required election was not made. A tax return that lists start-up expenses must contain a description of the types of expenses, amounts, dates they were incurred, and the specific month in which the business activity commenced.

> **Example 2.** James is starting a home inspection service. He incurs expenses traveling from Iowa to New Jersey to meet with a national franchiser. Since James must provide the franchiser with a financial statement, he hires an accountant to prepare the statement for him. After he submits the documents, he is approved as a franchisee.
>
> **Question A.** Are any of James's expenses deductible as ordinary and necessary business expenses under IRC §162?
>
> **Answer A.** The expenses James incurred to explore the feasibility of acquiring a franchise and the expenses that he paid to the accountant to prepare his financial statement are start-up costs and should be amortized over 60 months. After the business commences its activity, any of the expenses James paid to the accountant will be deductible as ordinary and necessary business expenses. James should segregate the amounts that were paid for these start-up expenditures.

Forming the Entity

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
No formal registration, but establishing a protected business trade name (DBA) is advisable.	No formal registration required for a general partnership. Exception may apply for limited partnership.	Articles of Incorporation and Bylaws required.	Same as C corporation, filing Form 2553 also required.	Filing of Articles of Organization required, and other state-required forms.

Tax Impact of Forming Entity

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
None.	Assets transfer to partnership; no recognition of gain unless liabilities greater than basis of property transferred.	No recognized gain or loss if stockholder has control upon transfer. Exception: liabilities exceed the basis of assets transferred. May not receive any other consideration besides stock.	Same as C corporation.	Same as partnership, unless election as a corporation.

SOLE PROPRIETORSHIPS

It is relatively easy to start a sole proprietorship. The proprietorship must be engaged in business activity that has an expectation of making a profit. A three-part test was developed from a Supreme Court case, *Pierre S. duPont,*[2] to determine if a taxpayer is engaged in a trade or business. **All** three of these tests must be met. The taxpayer must be:

1. Engaged in the activity for a profit,
2. Continuously involved in the operation of the business, and
3. Offering goods or service to the public.

In another Supreme Court case, *Robert P. Groetzinger,*[3] the court ruled the activity must be conducted regularly for the intent of earning a profit. The Court further stated that a hobby does not qualify as a trade or business.

The cost of creating a sole proprietorship is minimal. Usually, federal and state identification numbers are required only if the business has employees or taxable sales. Otherwise, the proprietor uses his social security number.

Some states require the registration of assumed business names (DBA — Doing Business As). Unlike corporations and LLCs, sole proprietorships do not have statewide recognition of their names. The proprietor usually registers the business name in one county. Registering in one county does not give the proprietor unlimited use of the name throughout the state. Therefore, the proprietor must register the name in each county in which he conducts business.

PARTNERSHIPS

In many states there is **no formal registration for general partnerships. Limited partnerships** that offer prospectuses **may have to register** with applicable governmental authorities.

Every partnership should have a partnership agreement. It is highly recommended that this agreement be in writing. The written partnership agreement should include the following elements:

- **Name.** Agreement on a name for the business and whether the business will operate under an assumed business name.
- **Term.** A clause stating how long the partnership will exist. It can last through perpetuity or as long as the partners are alive.
- **Purpose.** Agreement on the entity's purpose so there is clear understanding of the rationale for the entity's creation.
- **Capital Contributions.** Stipulation of each partner's initial contribution in cash and property. It is possible for partners to contribute services or tangible property in lieu of monetary contributions.

- **Profits, Losses, and Drawings.** Stipulation of how partners will be compensated. Language should be specific regarding periodic draws against a share of the profits. Provisions should be made for guaranteed payments and the payment of expenses.
- **Management Responsibilities.** Stipulation of how the business will be managed and supervised. This will include voting rights of the partners, whether delegated authority is given to a specific partner, and demarcation between major and minor decisions allowing a designated partner to make minor decisions.
- **Partners' Outside Business Activities.** Stipulation that partners must have a covenant not to compete in similar types of businesses, since such competition could negatively impact on the partnership's success.
- **Termination of Partnership Interest.** Stipulation of how to handle a partner who leaves voluntarily, becomes incapacitated, or dies. Planning for these potential situations is very important. Usually, if partners terminate their interests due to an event, the remaining partners have the right to buy the interests of the terminating partner before it is offered to an outside party. This stipulation acts as a protection for the remaining partners.

  The agreement also stipulates how a new partner's share is computed. Computation methods can be based on:

  - Market value of the assets,
  - Book value,
  - Set dollar method (predetermined buyout price),
  - Post departure appraisal done by an independent appraiser, or
  - The capitalization of earnings method.

  The agreement stipulates the terms of purchase for a departing partner's interest, including whether it may be financed over a period of time or is payable immediately.
- **Continuity of the Partnership.** A provision stating that during the period of time when one partner has terminated a relationship, the partnership will still exist.
- **Resolving Partnership Disputes.** Stipulation of how disagreements between partners are resolved.

Note. The use of mediation or arbitration is more cost effective than using the court system.

A partnership can usually be formed without any tax consequences. IRC §721 covers the contribution of assets to a partnership.

C CORPORATIONS

Formation

To form a C corporation it is necessary to file Articles of Incorporation with the appropriate state authority. Generally, the Secretary of State's Office has responsibility for approving new corporations. Articles of incorporation create an entity. Illinois State Articles of Incorporation Form BCA-2.10 follow. The form is fairly simple to complete.

Form **BCA-2.10**

(Rev. Jan. 1999)

Jesse White
Secretary of State
Department of Business Services
Springfield, IL 62756
http://www.sos.state.il.us

Payment must be made by certified check, cashier's check, Illinois attorney's check, Illinois C.P.A's check or money order, payable to "Secretary of State."

ARTICLES OF INCORPORATION

This space for use by Secretary of State

SUBMIT IN DUPLICATE!

This space for use by Secretary of State

Date

Franchise Tax $

Filing Fee $

Approved:

1. CORPORATE NAME: **Dentum Auto Body Inc.**

(The corporate name must contain the word "corporation", "company," "incorporated," "limited" or an abbreviation thereof.)

2. Initial Registered Agent:

Initial Registered Agent:	**John**	**A.**	**Dentum**
	First Name	*Middle Initial*	*Last name*
Initial Registered Office:	**101**	**Main Street**	
	Number	*Street*	*Suite #*
	Somewhere IL	**Any Co**	**66666**
	City	*County*	*Zip Code*

3. Purpose or purposes for which the corporation is organized:
(If not sufficient space to cover this point, add one or more sheets of this size.)

Restoration of auto bodies.

4. Paragraph 1: Authorized Shares, Issued Shares and Consideration Received:

Class	Par Value per Share	Number of Shares Authorized	Number of Shares Proposed to be Issued	Consideration to be Received Therefor
Common	$ **NONE**	**5,000**	**500**	$ **1,000**
			TOTAL = $	**1,000**

Paragraph 2: The preferences, qualifications, limitations, restrictions and special or relative rights in respect of the shares of each class are:
(If not sufficient space to cover this point, add one or more sheets of this size.)

N/A

(over)

5. *OPTIONAL:* (a) Number of directors constituting the initial board of directors of the corporation: ________ .

(b) Names and addresses of the persons who are to serve as directors until the first annual meeting of shareholders or until their successors are elected and qualify:

Name	Residential Address	City, State, ZIP

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6. *OPTIONAL:*

(a) It is estimated that the value of all property to be owned by the corporation for the following year wherever located will be:	$
(b) It is estimated that the value of the property to be located within the State of Illinois during the following year will be:	$
(c) It is estimated that the gross amount of business that will be transacted by the corporation during the following year will be:	$
(d) It is estimated that the gross amount of business that will be transacted from places of business in the State of Illinois during the following year will be:	$

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7. *OPTIONAL:* *OTHER PROVISIONS*

Attach a separate sheet of this size for any other provision to be included in the Articles of Incorporation, e.g., authorizing preemptive rights, denying cumulative voting, regulating internal affairs, voting majority requirements, fixing a duration other than perpetual, etc.

8.

NAME(S) & ADDRESS(ES) OF INCORPORATOR(S)

The undersigned incorporator(s) hereby declare(s), under penalties of perjury, that the statements made in the foregoing Articles of Incorporation are true.

Dated **July 15**, **2003**
(Month & Day) *Year*

Signature and Name	**Address**		
1.	1. **222 High Street**		
Signature	*Street*		
	Sometown	**IL**	**66666**
(Type or Print Name)	*City/Town*	*State*	*ZIP Code*
2.	2.		
Signature	*Street*		
(Type or Print Name)	*City/Town*	*State*	*ZIP Code*
3.	3.		
Signature	*Street*		
(Type or Print Name)	*City/Town*	*State*	*ZIP Code*

(Signatures must be in **BLACK INK** on original document. Carbon copy, photocopy or rubber stamp signatures may only be used on conformed copies.)
NOTE: If a corporation acts as incorporator, the name of the corporation and the state of incorporation shall be shown and the execution shall be by its president or vice president and verified by him, and attested by its secretary or assistant secretary.

FEE SCHEDULE

- The initial franchise tax is assessed at the rate of 15/100 of 1 percent ($1.50 per $1,000) on the paid-in capital represented in this state, with a minimum of $25.
- The filing fee is $75.
- The **minimum total due** (franchise tax + filing fee) is **$100.**
  (Applies when the Consideration to be Received as set forth in Item 4 does not exceed $16,667)
- The Department of Business Services in Springfield will provide assistance in calculating the total fees if necessary.

Illinois Secretary of State Springfield, IL 62756
Department of Business Services Telephone (217) 782-9522 or 782-9523

C-162.20

Prior to incorporating, it is essential to determine availability of the corporation name. In many states it is possible to complete a name search on-line.

The corporation's address should be registered. If later there is a change of address, it is essential to inform the appropriate governmental authorities.

A corporation must have a registered agent. This agent must reside in the state where the corporation is formed. Since the agent can be served with process (contacted when legal action or other administrative reporting is required), the agent must provide a street address rather than a post office box.

The corporation designates the number of shares of stock it authorizes to be issued. (Illinois also requests that the proposed number of shares be listed.) **Authorization of stock** is **not** the **issuance of stock.** If at some later date the corporation wishes to **authorize** more shares, it **must amend** its articles of incorporation.

In order to conduct business, most states require an annual Board of Directors meeting. Minutes of these meetings are recorded in the corporate minutes book. Other important documents included in the book are:

- Articles of Incorporation and
- Bylaws.

The Board of Directors can decide to allow corporations to issue stock, dividends, or distributions and to manage the overall operation of the corporation.

Tax Impact

As a general rule there is no recognition of gain or loss for property that is contributed to a corporation if the stockholder has control, or is part of the control, of the transfer of the property. IRC §351 states no gain or loss is recognized when property is transferred in exchange for stock. The basis rules under IRC §§358 and 362 state that recognition of gain will be deferred but may be recognized at a later date.

The three basic requirements relative to IRC §351 are:

1. The transfer must consist of property.
2. The property transaction must be made in exchange for stock.
3. The stockholder must be in control of the corporation.

Under IRC §351 the definition of property is very broad. Property includes many types of assets including cash, accounts receivable, inventories, furniture and fixtures, copyrights, and patents. IRC §351 stipulates that only corporate stock can be provided in exchange for the property. The transfer of other forms of securities such as notes does not qualify. The receipt of other items besides corporate stock is considered "boot." A small amount of boot may not disqualify the entire transaction from IRC §351. Any gain, however, must be recognized to the extent of the lesser of the realized gain or the FMV of the boot received.[4]

Note. Losses are never recognized under IRC §351.

Example 3. Robert transferred a building to Sunset Corporation in exchange for 100% of its stock and an $80,000 10-year bond. The building has an FMV of $1,000,000 and a basis of $600,000 at the time of transfer. The transfer of this property qualifies for the IRC §351, but Robert's receipt of the bond constitutes "boot." Robert recognizes a gain of $80,000 at the time of the transfer.

There are instances when property transferred to a corporation is subject to liability. Transfers to controlled corporations often contain transfer of liability. IRC §357 provides relief by not treating the transfers of liabilities as boot, unless the liability exceeds the adjusted basis of the property transferred. The entire transaction qualifies under IRC §351.

Another exception would be when the sum of all liabilities assumed by the corporation exceeds the adjusted basis of the property transferred to the corporation by the transferor. IRC §357(c) discusses situations where the transferor must recognize the gain on these types of transfers. If the gain is not recognized, the stockholder has a negative basis. Since the transaction results in a taxable transaction, the transferor's basis in the stock is zero.

> **Example 4.** Larry transferred a building with an adjusted basis of $300,000 and an FMV of $3,000,000 to Premier Property Corporation in return for 100% of the company's stock. Premier assumed the building's $500,000 mortgage. This stockholder must recognize a gain of $200,000, which is equal to the difference between the mortgage and the adjusted basis of the building.

IRC §357(c) identifies situations relating to cash basis taxpayers. If a shareholder incorporates a cash basis proprietorship and transfers unrealized accounts receivables and unrealized accounts payables to the corporation, the action may result in a taxable event. In this situation, the corporation has zero bases in the accounts receivable and the accounts payable. The accounts receivable are not taxable to the individual because he is on a cash basis. When the corporation pays the accounts payable, it has a deduction as a business expense.

Good tax planning dictates that cash basis taxpayers should not transfer zero basis receivables. When income is received from receivables, it should be included as income to the corporation. It is likely reimbursements will be paid to the shareholder because the income was earned while it was a proprietorship. This creates double taxation. The income is taxed at the corporate level and to the shareholder as a dividend when distributed.

Professional Corporations

Due to the nature of respective state law, specific entities must publicly present themselves as being measured by different standards. Professional corporations include entities such as law firms, accounting firms, architectural firms, medical clinics, and other entities licensed by specific authorities. If these entities incorporate, they may use the designation of "PC" (professional corporation) or "Ltd." (Limited) instead of "Incorporated" or "Inc." in their names. This designation lets clients know that these entities are personally held to higher standards. Individuals who practice in these areas can be sued for personal liability.

When a professional corporation is formed, the incorporators must procure certifications of licensure from their respective licensing authority. The certification is submitted with the articles of incorporation. The entity is then designated as a professional corporation or a PC. The taxability of professional corporations will be discussed later in this text.

S CORPORATIONS

Formation procedures for S corporations are the same as those for C corporations. At the time its stock is issued, a corporation must determine whether it will be a taxable entity (C corporation) or a small business corporation (S corporation) which is a pass-through entity. When S corporation status is elected, the income flows through to shareholders based upon their stock ownership. The corporation files an election Form 2553 with the IRS. This election allows income from an S corporation to be taxed to the corporation's shareholders rather than to the corporation itself.

The election form must be filed in a timely manner. It is considered timely if it is filed:

- Before the 16th day of the third month of the tax year, if filed during the tax year that the election is to take effect, or
- During the preceding tax year.

An election that is made no more than two months and 15 days after the beginning of a tax year that is less than two and a half months long will be treated as being timely for that tax year. Any election that is made **after the 15th day of the third month but before the end of the tax year** is effective for the next tax year. For example, if a calendar-year corporation makes the election on April 21, 2003, the election will not be effective until the corporation's 2004 tax year. Form 2553 follows.

Form **2553**
(Rev. December 2002)
Department of the Treasury
Internal Revenue Service

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 Election Information

Please Type or Print

Name of corporation (see instructions): **Dentum Auto Body, INC.**

A Employer identification number 21 ⋮ 1111111

Number, street, and room or suite no. (If a P.O. box, see instructions.): **101 Main St.**

B Date incorporated: 7-25-03

City or town, state, and ZIP code: **Somewhere IL 66666**

C State of incorporation: IL

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its name ☐ or address ☐

E Election is to be effective for tax year beginning (month, day, year) . . . . ▶ 7 / 25 / 03

F Name and title of officer or legal representative who the IRS may call for more information: **John A. Dentum**

G Telephone number of officer or legal representative (217) 555.5555

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 . . . . ▶ 7 / 25 / 03

I Selected tax year: Annual return will be filed for tax year ending (month and day) ▶ 12/31

If the tax year ends on any date other than December 31, except for a 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 a 52–53-week tax year, write "52–53-week year" to the right of the date.

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.)		**L** Stock owned		**M** Social security number or employer identification number (see instructions)	**N** Share-holder's tax year ends (month and day)
	Signature	Date	Number of shares	Dates acquired		
John A. Dentum 222 High St. Sometown, IL 66666			500	7/25/03	111-22-3333	12/31

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.

Signature of officer ▶ **Title ▶** Pres **Date ▶** 7/25/03

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 18629R Form **2553** (Rev. 12-2002)

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 automatic approval provisions of Rev. Proc. 2002-38, 2002-22 I.R.B. 1037, to request **(1)** a natural business year (as defined in section 5.05 of Rev. Proc. 2002-38) or **(2)** a year that satisfies the ownership tax year test (as defined in section 5.06 of Rev. Proc. 2002-38). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ▶ ☐ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year as defined in section 5.05 of Rev. Proc. 2002-38 and has attached a statement verifying that it satisfies the 25% gross receipts test (see instructions for content of statement). I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2002-38 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ▶ ☐ I represent that shareholders (as described in section 5.06 of Rev. Proc. 2002-38) 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, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2002-38. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2002-38 from obtaining automatic approval of such adoption, retention, or change in tax year.

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. See instructions for details including payment of a user fee. 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 prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?
☐ Yes ☐ No

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.

Relief Provision

An election that is made after the due date will be accepted as being filed timely if the corporation can show that its failure to file on time was due to reasonable cause. According to Part 20, Penalties Handbook, of the *Internal Revenue Manual*, reasonable cause can be described as, but not limited to, the following examples:

- Health situation of a shareholder causing a delay
- Ignorance of the law
- Catastrophic event causing inaccessibility to records

Usually, the IRS is receptive to requests for late filing. If an election is filed within 24 months of its due date and the original due date for filing the corporation's initial Form 1120-S return has not passed, the IRS can make the approval very informally.

Note. When filing the election late, the taxpayer must write at the top of page one of Form 2553: "Filed pursuant to Rev. Proc. 2003-43." The taxpayer must also attach a statement explaining the reasons for failing to file the election on time.

There is further relief available to taxpayers who fail to make a timely election. The corporation may request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2002-1. The IRS generally allows the effective date to become retroactive based upon the taxpayer's assertion of reasonable cause.

The Service Center notifies the corporation if its election is accepted and the date the election takes effect. The IRS also notifies the corporation if it does not accept the election. Instructions on Form 2553 state the corporation will usually receive a determination within 60 days of filing the form.

Note. The corporation must ensure the IRS receives the election. Mailing the election as "certified" or "registered" with a return receipt requested will verify that the IRS has received it.

Where to File

Form 2553 must be filed with the Service Center according to the corporation's location. Service Center addresses are provided in Form 2553 instructions.

Instructions for Filing Form 2553

Form 2553 requires an effective date for its election. It is very important that the election date is the beginning date of the tax year of its first year of operation. The tax year of a new corporation starts on the date it has shareholders, acquires assets, or begins doing business, whichever occurs first. The effective date shown on the form will be determined by when the election was filed and whether it was filed timely.

Each shareholder who owns or is deemed to own stock at the time the election is made must consent to the election. Every person who owns stock during the corporation's first tax year is required to consent to the election.

Note. Once the election is made, new shareholders are not required to consent to the election, and the corporation does not need to file a new Form 2553.

Before the corporation is formed, it requests authorization to issue shares from its state authority. After its first Board of Directors meeting, the corporation is authorized to issue shares. The election on Form 2553 is made simultaneously, or in close proximity to, the actual first issuance of stock.

Form 2553 requires all shareholders to sign the election form indicating the number of shares each owns and the date acquired. The president, or another authorized corporate officer, must also sign the Form 2553 for the corporation.

Election on a Fiscal Year — Part 2 of Form 2553

Part 2 of Form 2553 is completed when an election is made to have the tax year end on any date other than December 31 (other than a 52–53 week tax year ending with reference to the month of December). Some corporations may have operating cycles that necessitate having a fiscal year for good accountability. The IRS requires taxpayers to include substantial detail with their election forms to justify their need for a fiscal year end.

Note. Rev. Proc. 2002-39 describes information that is necessary to establish the business purpose.

Form 2553 contains several tests to justify the election. If the corporation is making its election based on what the IRS perceives to be a business purpose, the corporation will be directed to pay a fee of $600 for a ruling. The form also includes an IRC §444 election and explains the need to prepare a Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year,* and attach it to the Form 2553.

The IRC §444 election for fiscal year reporting is generally available to S corporations with fiscal years ending on September 30, October 31, or November 30. Form 8716 must be filed by the earlier of the:

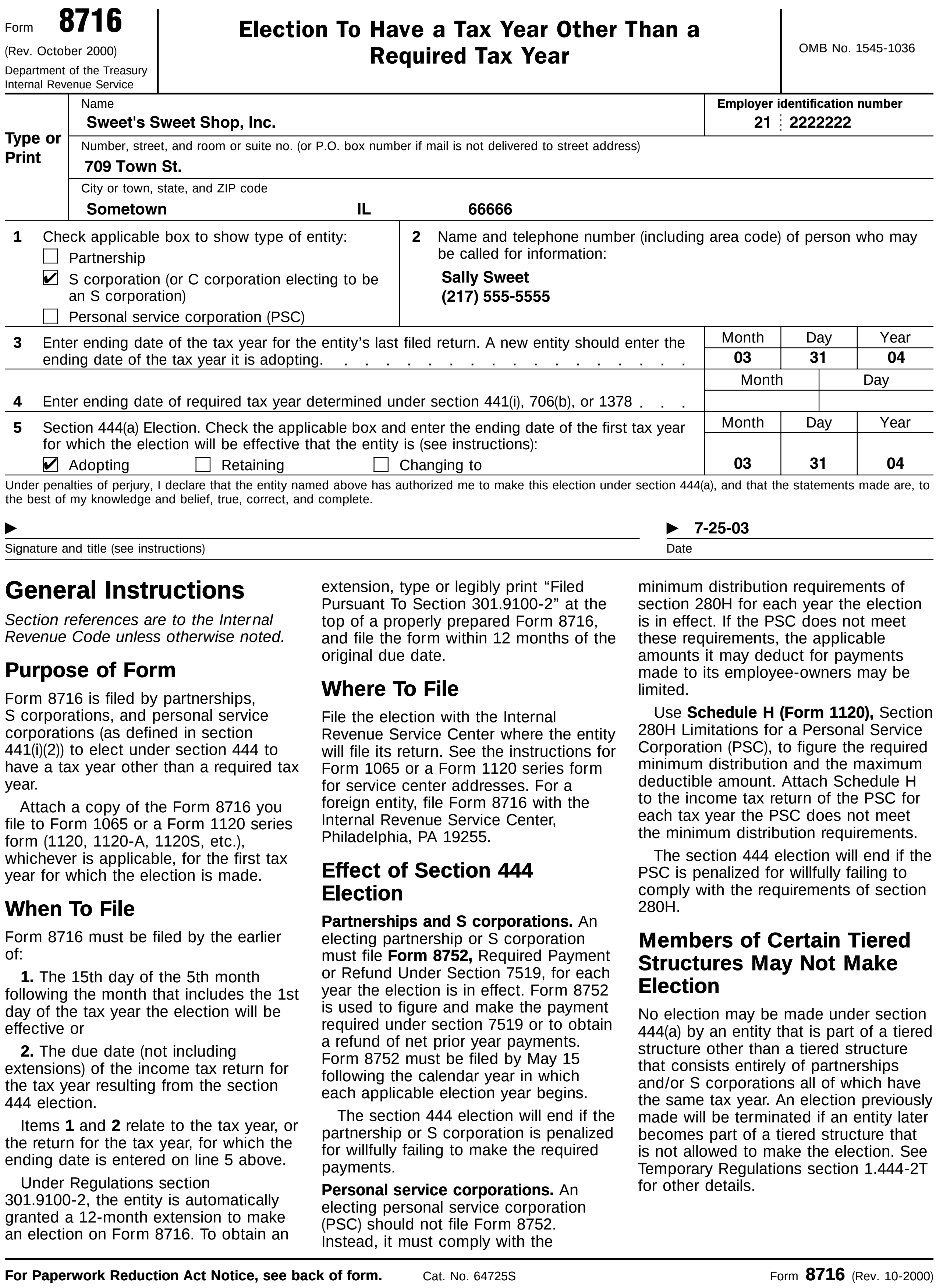
- 15th day of the fifth month following the month that includes the first day of the fiscal year for which the election will be effective, or
- Due date determined without regard for extensions for the S corporation income tax return for the short tax year resulting from the IRC §444 election.[5]

IRC §7519 requires a deposit to be made with Form 8752, *Required Payment of Refund Under §7519*. It also requires the form to be filed each year the IRC §444 election is effective, even if no payment is due for a particular year. These deposit payments approximate the tax deferral benefit gained by shareholders from the use of the alternative year end. The computation is based on the highest individual rate plus 1% applied to an approximation of the deferred taxable income. The deposit is required every year the IRC §444 election is in effect except for first-year S corporations. New corporations making this election are not required to make the IRC §7519 payment for their first taxable year if the first tax year ends prior to December 31. The election itself is still required on Form 8716.

There are penalties if a corporation fails to make IRC §7519 payments. If the corporation fails to make the required payments, a penalty equal to 10% of the difference between the required payments already made and the amount of required payments that should have been made may be imposed. The corporation may also be liable for other penalties including those for negligence or, in extreme situations, for fraud.

Note. Corporations wishing to elect a fiscal year must understand the position the IRS usually takes.[6]

Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year* and Form 8752, *Required Payment or Refund Under Section 7519* follow.



Form **8716**

(Rev. October 2000)

Department of the Treasury
Internal Revenue Service

Election To Have a Tax Year Other Than a Required Tax Year

OMB No. 1545-1036

Type or Print

Name: **Sweet's Sweet Shop, Inc.**

Employer identification number: **21 2222222**

Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address): **709 Town St.**

City or town, state, and ZIP code: **Sometown IL 66666**

1 Check applicable box to show type of entity:
☐ Partnership
☑ S corporation (or C corporation electing to be an S corporation)
☐ Personal service corporation (PSC)

2 Name and telephone number (including area code) of person who may be called for information:
Sally Sweet
(217) 555-5555

3 Enter ending date of the tax year for the entity's last filed return. A new entity should enter the ending date of the tax year it is adopting . . . . Month **03** Day **31** Year **04**

4 Enter ending date of required tax year determined under section 441(i), 706(b), or 1378 . . . Month Day

5 Section 444(a) Election. Check the applicable box and enter the ending date of the first tax year for which the election will be effective that the entity is (see instructions): Month **03** Day **31** Year **04**
☑ Adopting ☐ Retaining ☐ Changing to

Under penalties of perjury, I declare that the entity named above has authorized me to make this election under section 444(a), and that the statements made are, to the best of my knowledge and belief, true, correct, and complete.

▶ Signature and title (see instructions)

▶ **7-25-03** Date

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Form 8716 is filed by partnerships, S corporations, and personal service corporations (as defined in section 441(i)(2)) to elect under section 444 to have a tax year other than a required tax year.

Attach a copy of the Form 8716 you file to Form 1065 or a Form 1120 series form (1120, 1120-A, 1120S, etc.), whichever is applicable, for the first tax year for which the election is made.

When To File

Form 8716 must be filed by the earlier of:

1. The 15th day of the 5th month following the month that includes the 1st day of the tax year the election will be effective or

2. The due date (not including extensions) of the income tax return for the tax year resulting from the section 444 election.

Items **1** and **2** relate to the tax year, or the return for the tax year, for which the ending date is entered on line 5 above.

Under Regulations section 301.9100-2, the entity is automatically granted a 12-month extension to make an election on Form 8716. To obtain an extension, type or legibly print "Filed Pursuant To Section 301.9100-2" at the top of a properly prepared Form 8716, and file the form within 12 months of the original due date.

Where To File

File the election with the Internal Revenue Service Center where the entity will file its return. See the instructions for Form 1065 or a Form 1120 series form for service center addresses. For a foreign entity, file Form 8716 with the Internal Revenue Service Center, Philadelphia, PA 19255.

Effect of Section 444 Election

Partnerships and S corporations. An electing partnership or S corporation must file **Form 8752,** Required Payment or Refund Under Section 7519, for each year the election is in effect. Form 8752 is used to figure and make the payment required under section 7519 or to obtain a refund of net prior year payments. Form 8752 must be filed by May 15 following the calendar year in which each applicable election year begins.

The section 444 election will end if the partnership or S corporation is penalized for willfully failing to make the required payments.

Personal service corporations. An electing personal service corporation (PSC) should not file Form 8752. Instead, it must comply with the minimum distribution requirements of section 280H for each year the election is in effect. If the PSC does not meet these requirements, the applicable amounts it may deduct for payments made to its employee-owners may be limited.

Use **Schedule H (Form 1120),** Section 280H Limitations for a Personal Service Corporation (PSC), to figure the required minimum distribution and the maximum deductible amount. Attach Schedule H to the income tax return of the PSC for each tax year the PSC does not meet the minimum distribution requirements.

The section 444 election will end if the PSC is penalized for willfully failing to comply with the requirements of section 280H.

Members of Certain Tiered Structures May Not Make Election

No election may be made under section 444(a) by an entity that is part of a tiered structure other than a tiered structure that consists entirely of partnerships and/or S corporations all of which have the same tax year. An election previously made will be terminated if an entity later becomes part of a tiered structure that is not allowed to make the election. See Temporary Regulations section 1.444-2T for other details.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 64725S Form **8716** (Rev. 10-2000)

Form **8752**

Department of the Treasury
Internal Revenue Service

Required Payment or Refund Under Section 7519

▶ **Do not attach this form to Form 1065, Form 1065-B, or Form 1120S; file it separately.**

For the applicable election year **beginning** , **2003,** and **ending** , 20

OMB No. 1545-1181

2003

Type or print

Name of partnership or S corporation
Sweet's Sweet Shop, Inc.

Employer identification number
21 2222222

Number, street, and room or suite no. If a P.O. box, see instructions.
709 Town St.

City or town, state, and ZIP code
Sometown, IL 66666

A Check applicable box to show how entity is classified for Federal income tax purposes: **(1)** ☐ Partnership **(2)** ☑ S Corporation

B If this is the entity's first tax year, skip lines 1 through 10, enter -0- on line 11, and check this box . . . . ▶ ☑

C If this form is being filed to claim a full refund of the net required payment balance because of a terminating event, skip lines 1 through 9a, enter -0- on line 9b, complete the rest of the form, and check this box . . . . ▶ ☐

D If the entity had a **short base year** (a base year of less than 12 months), check this box. See the line 1 instructions for the definition of "base year" . . . . ▶ ☐

1	Net income for base year. If the entity had a short base year, increase the net income for the short base year by the applicable payments made during the base year (line 2 below), and multiply the result by the ratio of 12 over the number of months in the short base year. Carry out the ratio to at least 3 decimal places. If zero or less, enter -0-	**1**	
2	Applicable payments made during base year	**2**	
3	Deferral ratio. Divide the number of months in the deferral period by 12 and enter the result as a percentage. Carry out your answer to at least the nearest tenth of a percent	**3**	. %
4	Line 1 deferred amount. Multiply line 1 by line 3 . . . . **Caution:** *If the entity had a short base year, skip lines 5 and 6 and go to line 7.*	**4**	
5	Line 2 deferred amount. Multiply line 2 by line 3 . . . . . . **5**		
6	Applicable payments made during the deferral period of the base year **6**		
7	If the entity had a 12-month base year, subtract line 6 from line 5. If zero or less, enter -0-. If the entity had a short base year, enter the applicable payments made during the deferral period of the applicable election year	**7**	
8	Net base year income. If the entity had a 12-month base year, add lines 4 and 7. If the entity had a short base year, subtract line 7 from line 4. If zero or less, enter -0-.	**8**	
9a	Multiply line 8 by 36% . . . . ▶ **9a**		
9b	If line 9a is more than $500 **or** the required payment for any **prior** tax year was more than $500, enter the amount from line 9a here. Otherwise, enter -0- . . . . ▶	**9b**	
10	Net required payment balance. Enter the excess of the required payments made for all **prior** years over the refunds of any required payments received for all **prior** years by the entity .	**10**	
11	**Required payment due.** If line 9b is larger than line 10, subtract line 10 from line 9b. Enclose check or money order for full amount payable to "United States Treasury." Write the entity's employer identification number and "Form 8752" on it	**11**	0
12	**Refund of net prior year payments.** If line 10 is larger than line 9b, subtract line 9b from line 10	**12**	

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.

Keep a copy of this form for your records.

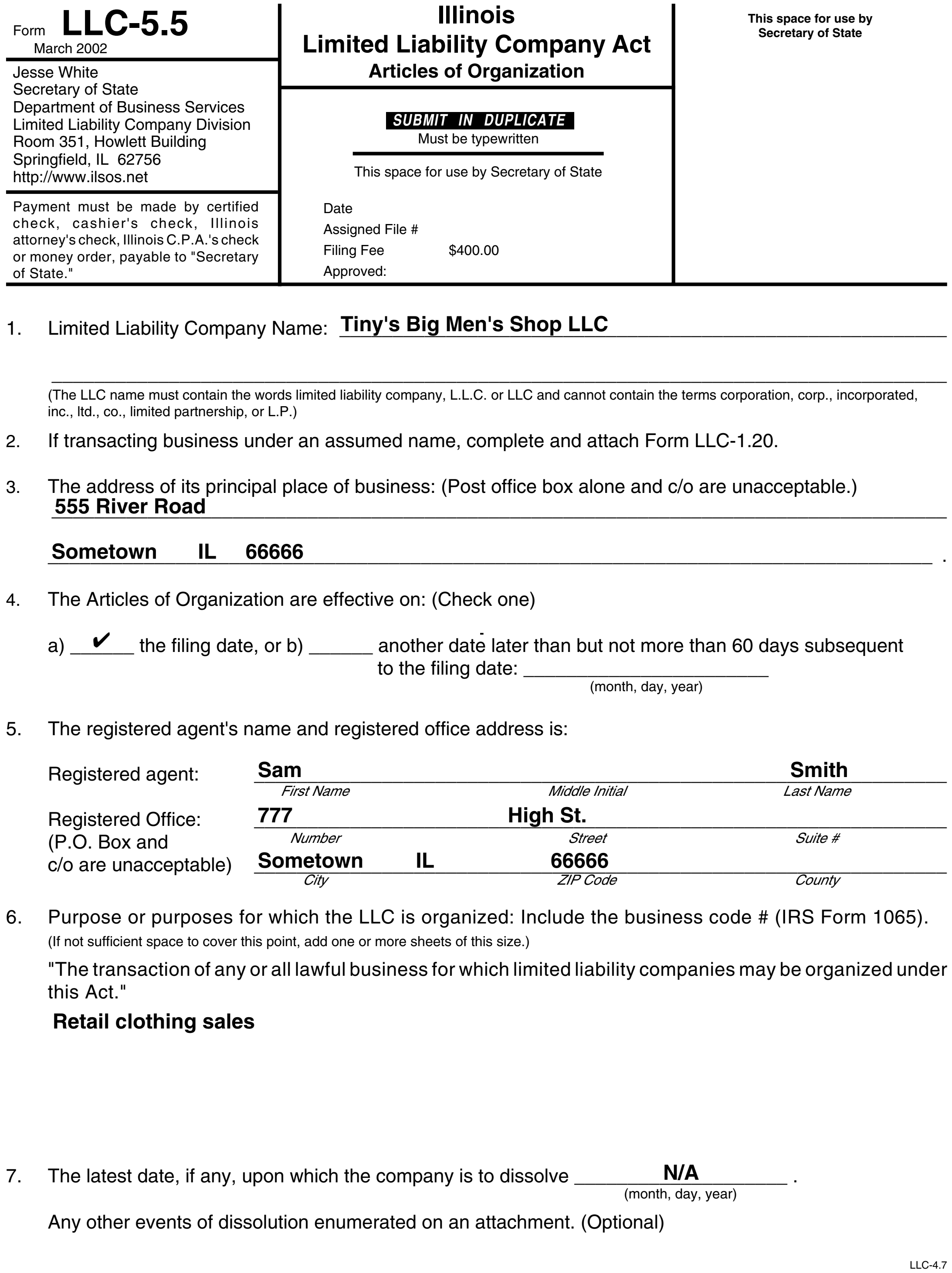
▶ Signature of officer, general partner, or limited liability company member Date ▶ Title

For Paperwork Reduction Act Notice, see back of form. Cat. No. 64988D Form **8752** (2003)

LIMITED LIABILITY COMPANIES

Articles of Organization

An LLC is formed under state law by filing articles of organization with the respective Secretary of State. Laws for each state vary considerably regarding information required to be included with their articles of organization. A sample of Illinois's articles of organization follows.



Form **LLC-5.5**
March 2002

Jesse White
Secretary of State
Department of Business Services
Limited Liability Company Division
Room 351, Howlett Building
Springfield, IL 62756
http://www.ilsos.net

Payment must be made by certified check, cashier's check, Illinois attorney's check, Illinois C.P.A.'s check or money order, payable to "Secretary of State."

Illinois
Limited Liability Company Act
Articles of Organization

SUBMIT IN DUPLICATE
Must be typewritten

This space for use by Secretary of State

Date
Assigned File #
Filing Fee $400.00
Approved:

This space for use by Secretary of State

1. Limited Liability Company Name: **Tiny's Big Men's Shop LLC**

(The LLC name must contain the words limited liability company, L.L.C. or LLC and cannot contain the terms corporation, corp., incorporated, inc., ltd., co., limited partnership, or L.P.)

2. If transacting business under an assumed name, complete and attach Form LLC-1.20.

3. The address of its principal place of business: (Post office box alone and c/o are unacceptable.)
555 River Road
Sometown IL 66666 .

4. The Articles of Organization are effective on: (Check one)

a) ✔ the filing date, or b) ______ another date later than but not more than 60 days subsequent to the filing date: ____________________
(month, day, year)

5. The registered agent's name and registered office address is:

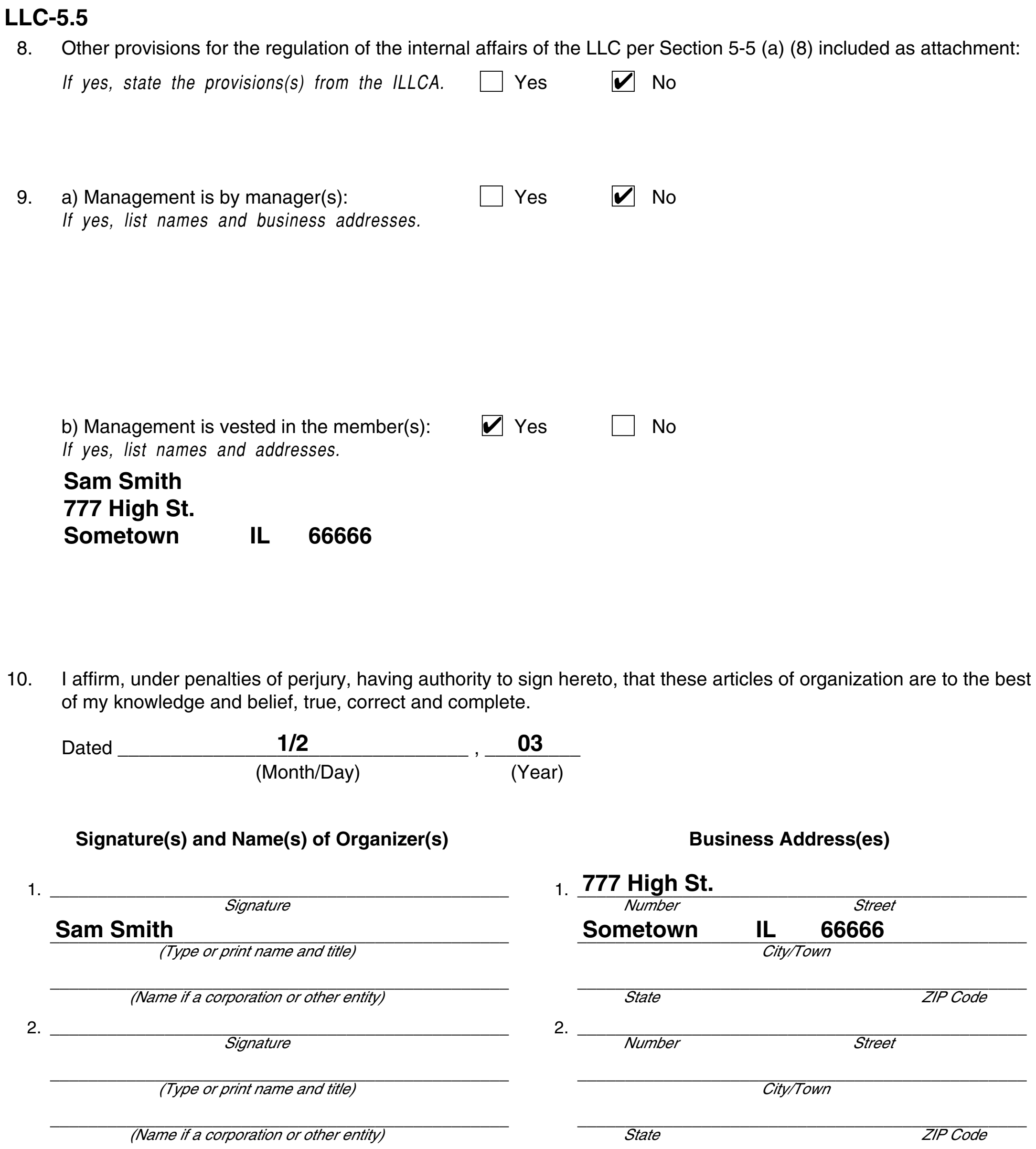
Registered agent:	**Sam** First Name	Middle Initial	**Smith** Last Name
Registered Office: (P.O. Box and c/o are unacceptable)	**777** Number	**High St.** Street	Suite #
	Sometown IL City	**66666** ZIP Code	County

6. Purpose or purposes for which the LLC is organized: Include the business code # (IRS Form 1065).
(If not sufficient space to cover this point, add one or more sheets of this size.)
"The transaction of any or all lawful business for which limited liability companies may be organized under this Act."
Retail clothing sales

7. The latest date, if any, upon which the company is to dissolve **N/A** .
(month, day, year)

Any other events of dissolution enumerated on an attachment. (Optional)

LLC-4.7



LLC-5.5

8. Other provisions for the regulation of the internal affairs of the LLC per Section 5-5 (a) (8) included as attachment:
If yes, state the provisions(s) from the ILLCA. ☐ Yes ☑ No

9. a) Management is by manager(s): ☐ Yes ☑ No
If yes, list names and business addresses.

b) Management is vested in the member(s): ☑ Yes ☐ No
If yes, list names and addresses.

Sam Smith
777 High St.
Sometown IL 66666

10. I affirm, under penalties of perjury, having authority to sign hereto, that these articles of organization are to the best of my knowledge and belief, true, correct and complete.

Dated **1/2** (Month/Day), **03** (Year)

Signature(s) and Name(s) of Organizer(s)	Business Address(es)
1. Signature:	1. Number Street: **777 High St.**
(Type or print name and title): **Sam Smith**	City/Town: **Sometown IL 66666**
(Name if a corporation or other entity):	State ZIP Code:
2. Signature:	2. Number Street:
(Type or print name and title):	City/Town:
(Name if a corporation or other entity):	State ZIP Code:

State laws generally allow LLCs to conduct business that is a legal activity. State law may prohibit some types of businesses from being an LLC, including banking, accounting, legal, and other professional services.

Unless the LLC makes an entity election, by filing Form 8832, the IRS will assign a default classification. For domestic LLCs with at least two members, the IRS will classify it as a partnership. If the entity has a single member, it will be disregarded for federal tax purposes. In this case it will be a sole proprietorship.

Entity Classification Election

An LLC may elect to be taxed as a corporation. The LLC may then choose to have its income flow through by electing S corporation status. For this situation, the LLC needs to file Form 8832, *Entity Classification Election*, in conjunction with its election Form 2553. By filing Form 8832, the entity is declaring its wishes to be classified as an association that is taxable as a corporation. Form 8832 follows.

Form **8832**
(Rev. September 2002)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

OMB No. 1545-1516

Type or Print

Name of entity
Tiny's Big Men's Shop LLC

EIN ▶ 21 3333333

Number, street, and room or suite no. If a P.O. box, see instructions.
555 River Rd.

City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country.
Sometown IL 66666

1 **Type of election** (see instructions):

- **a** ☑ Initial classification by a newly-formed entity.
- **b** ☐ Change in current classification.

2 **Form of entity** (see instructions):

- **a** ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- **b** ☐ A domestic eligible entity electing to be classified as a partnership.
- **c** ☑ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- **d** ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- **e** ☐ A foreign eligible entity electing to be classified as a partnership.
- **f** ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

3 **Disregarded entity information** (see instructions):

a Name of owner ▶ Sam Smith
b Identifying number of owner ▶ 222-33-2222
c Country of organization of entity electing to be disregarded (if foreign) ▶ USA

4 Election is to be effective beginning (month, day, year) (see instructions) . . . . ▶ 1 / 1 / 03

5 Name and title of person whom the IRS may call for more information
Sam Smith

6 That person's telephone number
(217) 555-5555

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this consent statement, and to the best of my (our) knowledge and belief, it is true, correct, and complete. If I am an officer, manager, or member signing for all members of the entity, I further declare that I am authorized to execute this consent statement on their behalf.

Signature(s)	Date	Title
	1/1/03	Members

For Paperwork Reduction Act Notice, see page 4. Cat. No. 22598R Form **8832** (Rev. 9-2002)

LLCs have considerable flexibility in ownership opportunities. However, there is a question of whether an LLC that has a member who normally does not qualify for S corporation ownership could be disqualified for S corporation status. Such an election would appear to require that the entity follow the specific guidelines for S corporations. Having disqualified shareholders could terminate the S corporation election.

> **Note.** It appears the IRS has not clarified this dilemma.

Form 8832 is filed with the IRS at: Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The LLC must also attach a copy of Form 8832 to its federal income tax return for the tax year of election.

BASIS DETERMINATION

Basis rules differ considerably between the various forms of business. For some taxpayers the simple payment of a personal loan to the entity can trigger tax consequences.

Basis Determination

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
Individual basis rules apply.	Basis adjusted by income, losses, and distributions by partnership. Election available to adjust basis to reflect transferred assets in sale or death situations.	No impact on basis to reflect income, losses, and distributions from retained earnings. Basis of assets not impacted by change in basis of transferred stock.	Basis in stock adjusted to reflect income, losses, and distribution. Basis of assets not impacted by change in basis of transferred stock.	Same as partnership.

SOLE PROPRIETORSHIPS

For a sole proprietor just beginning a business, the basis in the assets transferred into the proprietorship is the lower of cost or market. For example, assume Tina uses a computer in her business that she purchased three years ago for personal use. Her depreciable basis will be the current value of the computer, assuming it is lower than her original cost.

PARTNERSHIPS

The basis of a partnership interest is adjusted by the income, losses, and distributions of the partnership. Additional basis in a partnership is acquired when debt is incurred. The individual partners' shares of the debt are treated as cash contributions for basis determination. Partnership recourse debt is allocated to general partners but not to limited partners, because limited partners are not liable for the debts of a partnership.

> **Note.** Nonrecourse debt is very rare in proprietorships, partnerships, and other entities.

Since partners are allowed to increase their basis based on recourse debt, they generally can deduct their losses in excess of their actual cash investments. This possibility usually helps the partners since new partnerships generally have larger tax losses in the early years of operation.

Example 5. Bob and Tom each contribute $30,000 to start a dry cleaning company. These partners also obtain a $100,000 loan, which they use to purchase equipment. Since Bob and Tom are general partners, each of them has a basis of $80,000.

Example 6. Sue contributes assets with an FMV of $100,000, a basis of $60,000, and a liability of $20,000 to a partnership with Jane, who contributes assets with an FMV of $120,000, a basis of $55,000, and a liability of $40,000. They are each 50% partners as each has a net value of $80,000 for their contributed assets. However, their basis in the new partnership differs.

Sue's Basis	
Adjusted basis of assets contributed	$60,000
Sue's liabilities assumed by partnership	(20,000)
Sue's share of partnership liabilities	30,000
Basis of Sue's partnership interest	$70,000
Jane's Basis	
Adjusted basis of assets contributed	$55,000
Jane's liabilities assumed by partnership	(40,000)
Jane's share of partnership liabilities	30,000
Basis of Jane's partnership interest	$45,000

If the partnership borrows money to carry on its operations, the partners can increase their basis for claiming losses by their share of the new debt.

When a partnership is formed, contributions of property exchanged for a partnership interest are transferred with no gain or loss being recognized by the partnership or the partners. IRC §721 states that such transfers may apply to either a new or an existing partnership. The transfer of property to a partnership is merely a change in the legal form of ownership, and no taxable transaction occurs.[7]

"Stepped Up" Basis

When a partnership is formed, the partners may make a special election in their original partnership agreement. This election, which is described in IRC §754, deals with "stepped up basis" of pro rata shares of partnership assets. If the election exists, new acquiring partners may determine their basis on their higher cost basis rather than on the partnership's historical basis. The acquiring partners also benefit from this stepped up basis if property such as depreciable assets is sold. The allocation of gain to the partners is smaller because they use the higher basis acquired during the time of acquisition and not the original basis of the partnership.

Note. Unlike a corporation where the shareholder owns stock, the partners in a partnership own a share of the assets. Consequently, they are entitled to the IRC §754 allocation if the proper election has been made.

IRC §754 states that partnerships can elect to adjust the basis of partnership property in the event of a sale or exchange of a partnership interest or upon the death of a partner. This adjustment of the basis only applies to the transferring partner and not to any other partner. The election is available to the transferring partner for similar transactions in the future.[8] While this type of election is defined in the Code, it can be revoked with the consent of the IRS. A request for a ruling needs to be made to the IRS.

Inside and Outside Basis

The partnership's basis in its assets is referred to as the "inside basis." Each partner's individual basis in the total partnership interest is referred to as the "outside basis." When a partnership is formed, the inside basis is usually equal to the outside basis. As the activity of the entity progresses, the inside and outside bases may differ. Some situations that cause differences in the bases include:

- Partners sell an interest at a price different than the adjusted basis. In such cases, the acquiring member will have an adjusted basis equal to the purchase price, rather than the percentage interest in the adjusted basis of the partnership's assets. The partnership may consider an IRC §754 adjustment on behalf of the incoming partner.
- The partnership makes a cash distribution to a partner in excess of the partner's basis in the partnership.
- The partnership distributes property to a partner when the partnership basis is in excess of the partner's basis in his partnership interest. The basis of the property will be reduced to the partner's basis in the partnership interest rather than the carryover basis.

C CORPORATIONS

A C corporation's basis in property is equal to the transferor's adjusted basis in that property and is increased by any gain recognized by the transferor. IRC §362 discusses this issue. Liabilities assumed by a corporation do not impact on the basis of the assets received from shareholders in IRC §351 transfers.

C corporations do not experience the same kinds of impact on basis that partnerships or S corporations do. There is no impact on basis to reflect income, losses, and distributions from retained earnings. C corporations are taxpayers that pay taxes at their own rates. There are limitations on net operating losses, but the ramifications on basis are different for this type of entity.

S CORPORATIONS

The basis in stock of S corporations is adjusted to reflect income, losses, and distributions. The basis of assets is not impacted by changes in the basis of transferred stock. Unlike a partnership, a shareholder can only increase his basis for deducting losses by directly loaning money to the S corporation. In most cases, a guarantee of a loan will not increase the loss basis. If the corporation sustains losses which reduce the shareholders' loss basis to zero, any repayment of the loan will be treated as taxable income to the shareholder.

LIMITED LIABILITY COMPANIES

Basis and Capital Account

The basis determination for LLCs follows that of the entity form for which they elected taxation. An LLC member's basis is equal to the amount of money and the adjusted basis of any property he contributed to the LLC. The LLC's basis in the assets contributed equals the member's adjusted basis in the assets at the time of the contribution.

The capital account is equal to the value of contributed properties. A member's basis can be different than a member's capital account.

TAXATION

No one form of entity is superior to the others. Selection should be based on the facts and circumstances for the particular client involved. Each entity has is own peculiar tax aspects.

Allocation of Income and Deductions Among Owners

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
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 relates to voting rights.	Same as for partnership.

SOLE PROPRIETORSHIPS

A proprietorship reports its income on Schedule C of the individual's federal tax return. This income is combined with the taxpayer's (and his spouse's) other income to calculate taxable income. If the proprietorship has a loss and the proprietorship is not restricted by IRC §469 passive activity limitations, the loss is combined with other income to reduce the taxpayer's overall tax liability.

All income is reported on the proprietor's individual tax return. Taxpayers must include income to the extent it is earned. Proprietorships have limitations on deductible business losses under IRC §465 and are only allowed to take losses to the extent they are at risk. The purpose of the at-risk rules is to limit the amount of trade or business losses to those that the proprietors are actually liable for as recourse debt. The taxpayers are personally liable for the debts of their proprietorships. Losses are also limited by the passive activity rules. A passive activity is any business in which the taxpayer does not materially participate. IRC §469 discusses passive activities in detail and defines material participation as regular and substantial expenditures of time. If one spouse materially participates, the other spouse will also be deemed to materially participate.[9] Material participation also occurs if an individual participates in the activity more than 500 hours during the year.[10]

When property is converted from personal use to business use, the property's basis for depreciation is the lesser of its FMV or its adjusted basis at the time of its conversion.[11]

PARTNERSHIPS

Partnerships are pass-through entities. Partners use Form 1065 Schedule K-1 to report their share of income. Therefore, taxation follows the rules for individuals. There are over 125 different income items, deductions, and credits that can pass through from a partnership.

A partnership is allowed to make disproportionate tax allocations of income, gains or losses, deductions, and credits among its partners. During a partnership's early years of operation when losses often occur, the allocations allow partners to receive larger tax benefits. However, the IRS has established Partnership Allocation Rules under Treas. Reg. §1.704-1(b)(2) to ensure the allocations are not made in an abusive manner. The basic premise is that partners cannot receive allocated tax losses or deductions unless they are truly at risk for the economic losses. Partners' capital accounts must be kept current and properly reflect these special tax allocations. When a partnership is liquidated, the partners receive proceeds according to their respective positive or negative capital accounts. Partners with negative capital accounts may make a contribution of capital that brings their accounts to at least zero.

C CORPORATIONS

The net taxable income of corporations is taxed at the corporate level. Corporations, like individual taxpayers, have a graduated rate system.

With changes made in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (HR2), there will be an immense need for practitioners to help clients determine the proper form of entity. The new dividend tax rates have reduced the double taxation of corporate earnings, but double taxation is still an issue and can have a substantial impact on the viability of one type of entity over another.

Additionally, the maximum individual tax rate is reduced to 35%, which is the same as the corporate tax rate. In the past, high-income taxpayers lacked any incentive to be flow-through entities, because the corporate rates were less than the individual rates. This is no longer the case.

Practitioners must continuously compare the tax ramifications of various entity ownerships to help clients determine if they are still using the right form of entity.

Example 7. Steven and Mary asked their accountant to analyze the impact of the 2003 tax changes on their personal tax computation. Steven and Mary own 100% of the shares of an S corporation. They expect their corporate income, salaries, adjusted gross income, and individual taxable income will be the same as in 2002. (An exception will be the increase in personal exemptions.) They are considering changing their S corporation to a C corporation if the tax benefits warrant it.

Steven and Mary's Facts

S corporation income	$48,000
Salaries received from S corporation	30,000
Distributions/dividends	20,000
Itemized deductions	22,000
Exemptions 2 @ $3050 (2003)	6,100

Tax Comparison as S Corporation

Individual Tax Computation (No corporate tax)

Year	Adj. Gross Income	Taxable Income	Tax
2002	$78,000	$50,000	$7,303
2003	78,000	49,900	6,785
Tax Savings			$518

Tax Comparison as C Corporation

Corporate Tax Computation

Year	Taxable Income	Tax Rate	Tax
2002	$48,000	15%	$7,200
2003	48,000	15%	7,200

Individual Tax Computation

Year	Adj. Gross Income	Taxable Income	Tax
2002	$50,000*	$22,000	$2,704
2003	50,000*	21,900	1,185
Tax Savings			$1,519

*$30,000 salaries + $20,000 dividends

Total Tax Computation

Year	Corporate Tax	Individual Tax	Total
2002	$7,200	$2,704	$9,904
2003	7,200	1,185	8,385

Comparison of C Corporation and S Corporation Tax Consequence

Year	S Corporation	C Corporation	Difference
2002	$7,303	$9,904	$2,601
2003	6,785	8,385	1,600
Reduction in Income Tax Consequence			$1,001

Based on these facts, Steven and Mary had a 2002 tax liability of $7,303. By remaining an S corporation in 2003, using the provisions in the 2003 tax bill, their 2003 tax liability is $6,785. If they became a C corporation in 2002, the combined 2002 corporation and individual taxes are $9,904 and their 2003 combined tax bill is $8,385.

> While the 2003 tax bill reduces the difference between the S and C corporations, in this scenario it is not enough to warrant a change in entity. However, Steven and Mary should evaluate whether there are any other tax advantages for a C corporation, like fringe benefits, that may justify a change. Another factor weighing on a decision to change entity forms is whether the taxpayers plan to withdraw the $28,000 remaining cash. If Steven and Mary withdraw the cash as a C corporation, they will pay tax on it either as a dividend or salary.

C corporations report their income or losses on Form 1120. Dividends are distributed based upon percentages of stock ownership.

C corporations with two classes of stock, common and preferred, are more flexible with their distribution of income. Common stockholders receive dividends on the basis of their ownership. Although preferred stockholders also receive income based on their ownership percentages, a corporation has flexibility in the distribution of its earnings by limiting its number of preferred stockholders.

Accumulated Earnings Tax

The Accumulated Earnings Tax was created to ensure that corporations do not use their retained earnings as a strategy to intentionally avoid paying federal income taxes when distributions are made in liquidations. Liquidations generally create capital gains, which are taxed at lower rates than dividends. The Accumulated Earnings Tax is based on accumulated earnings beyond the reasonable business needs of a corporation. Shareholders often try to avoid double taxation by not distributing dividends.

> **Note.** There may be more of an incentive for corporations to distribute their earnings now that dividends are being taxed at capital gains rates.

Reasonable Needs of Business

The tax law allows corporations to accumulate income for reasonable needs. Treas. Reg. §1.537-2 gives the following reasons for accumulating income:

- Product liability loss reserves
- Distributions in redemption of stock
- Business expansion or facility replacement
- Acquisition of a new business
- Debt retirement
- Working capital needs
- Investments or loans to suppliers to maintain corporate business

A business could have other reasons for accumulating earnings including a need for self-insurance and pending lawsuits. The need for accumulation should be based on reality. There should be sufficient reasons for accumulating the earnings other than the tax avoidance. Corporations should have evidence of plans or documentation to justify their accumulations. For example, if a corporation is contemplating the purchase of a new business, it should document the need for accumulation with evidence of proposals in its corporate minutes.

If a corporation establishes a reserve for self-insurance, it should have some reasonable basis showing its need for this type of insurance. Evidence of previous claims that were paid by the corporation could be justification for accumulation of reserves. Future product liability claims could be another justification.

Various formulas have been developed to determine the amount of accumulated earnings that are necessary for working capital. One very old formula, the Bardahl Formula, is still used today. This formula came from the *Bardahl Manufacturing Corporation Case*[12] and the subsequent *Bardahl International Corporation Case*.[13] Under IRC §533A, corporations bear the burden of proof that their accumulated earnings are not beyond the reasonable needs of the business.

The IRS could also justify the penalty tax by determining that the business made expenditures unrelated to its business purpose. Some of the factors that the IRS considers to be unreasonable accumulations or ploys to avoid the penalty tax are:

- Loans to shareholders,
- Loans, which have no business purpose, made to relatives or friends of shareholders,
- Loans to corporations in unrelated businesses, and
- Unrelated investments.

Note. The Accumulated Earnings Tax is based on an annual determination. The fact that a corporation has paid dividends in the past is not paramount in the determination of whether the accumulation in the current year exceeds reasonable business needs.

Accumulated Earnings Credit

The minimum credit amount that a corporation may accumulate is $250,000 ($150,000 for personal service corporations) before the tax can be asserted. The earnings and profits that had accumulated at the end of the previous year reduce this statutory minimum.

Example 8. Hoosier, Inc., a farm supply company, had accumulated earnings of $170,000 at the end of 2002. Hoosier, Inc.'s 2003 current earnings after income taxes are $140,000. If there is no justification for additional accumulation, its credit will equal $80,000 ($250,000 – 170,000). The penalty tax would be computed on $60,000 ($140,000 – 80,000).

Dividends Paid Deduction

When determining their accumulated earnings tax, corporations are permitted to take a deduction for various types of dividends. These dividends include the following:

- Dividends paid to the stockholders as ordinary income during the year
- Dividends taxed as ordinary income but distributed within 2½ months after the end of the taxable year (described in IRC §563A)
- Consent dividends, which are amounts that shareholders agreed to be taxed on even though the actual cash had not been distributed

Example 9. If Hoosier, Inc. distributed $20,000 in dividends, its penalty tax base would be reduced to $40,000 and be subject to the penalty tax rate. For tax years beginning after 2002 and before January 1, 2009, the penalty tax rate is 15%. Prior to 2002 and after 2008 the penalty rate is the highest tax rate imposed on single individuals.

Tax Avoidance Purpose

The accumulated earnings tax will be imposed if the corporation cannot prove that its accumulations are needed for the operation of the business. The *Donruss Company*[14] case ruled that accumulations, even those that were well intentioned, that exist beyond a reasonable business need are sufficient reason to assert the tax. The court held that while this corporation had some plans, its underlying motivation for the accumulation was to avoid taxes.

Charitable Contributions

The contributions made by C corporations are deductible subject to a specific percentage limit. The maximum amount that a corporation may deduct for charitable contributions is 10% of its adjusted taxable income. Deductions, therefore, are limited to 10% of adjusted taxable income or the total contributions made during the year, whichever is less. The contributions must be given to charities that qualify for deductions under IRC §170. A corporation's unused contributions may be carried forward for five years.

> **Note.** Adjusted taxable income is taxable income before the charitable contribution deduction, the dividend received deduction, net operating loss carryback, and the capital loss carryback.[15]

A very significant tax-planning tool is available to C corporations under IRC §170(e)(3). Corporations may contribute inventory or tangible property to a charity that uses them to care for the ill, the needy, or infants. The charity may not receive any money, property, or consideration for the transfer or use of the qualified inventory. However, the charity is permitted to secure a user fee to help underwrite its costs of distributing the materials. The corporate donor's deduction can be the adjusted basis of the property plus one-half of the appreciation not to exceed twice the amount of the adjusted basis. The ability to obtain an enhanced deduction also qualifies for the donation of depreciable property that has an FMV greater than its adjusted basis.

Example 10. Superior Clothing Store, Inc. donates clothes to a charity that provides free clothing to needy individuals. The store wishes to take an enhanced deduction under IRC §170(e)(3). Superior's computation of its allowable deduction is shown below:

Donation of Inventory

Facts

Fair Market Value (FMV)	$1000
Basis (cost)	$ 200

Step 1 — Ordinary Income
$1000 (FMV) – $200 (Basis) = $800 (Ordinary Income (Appreciation))

Step 2 — ½ Appreciation
$800 (LTG) × 50% = $400

Step 3 — Fair Market Value – ½ Appreciation
$1000 (FMV) – $400 (½ LTG) = $600

Step 4 — Charitable Contribution Limitation
$600 (Step 3) – [2 × $200 (Basis)] = $200

Step 5 — Allowable Deduction
$1000 (FMV) – ($400 [Step 2] + $200 [Step 4]) = $400 or $1000 – $600 = $400 Deduction

Charities must keep the record of donations of this type of property separate from the records of other donations. A corporation that is considering the markdown of some of its inventory could receive an enhanced deduction by donating the inventory to a charity that uses it for the care of the ill, needy, or infants. Not only are the materials used by those who desperately in need of them, but the tax advantages to the corporation are also significant.

S CORPORATIONS

Income, deductions, and credits are distributed based on the percentage of stock ownership. Unlike a partnership, the only flexibility that S corporations have relates to voting rights where specific shareholders can be given decision-making authority.

A corporation's election to be an S corporation will, with some exceptions, result in it paying no taxes at the corporate level. The most significant tax advantage of an S corporation over a C corporation is the S corporation's lack of double taxation. However, as discussed in a previous example, this benefit may not be as significant or even exist due to recent changes in the tax law. S corporations are flow-through entities that allow long-term capital gains, corporate losses, and IRC §179 deductions to pass through to shareholders for reporting on individual tax returns.

S corporations are not subject to the Personal Holding Company Tax or the Accumulated Earnings Tax. These penalty taxes are asserted only on C corporations.

Passive Investment Income

S corporations also may have to pay tax on net passive income, which may be subject to taxation at the S corporation level. However, this tax does not apply unless the S corporation previously was a C corporation that had accumulated earnings and profits at the time the S corporation was created. For it to be taxable, the passive investment income must be more than 25% of the corporation's gross receipts for the taxable year.[16] Passive investment income includes items such as interest, dividends, rents, royalties, annuities, and gains from the sale of stocks or other securities.

Real estate rental income does not generally constitute passive investment income if the S corporation requires material participation from its shareholders and employees and incurs a substantial amount of costs in its operation. In these situations, renting property is considered an active trade or business.[17]

When tax is asserted on excess net passive income, the tax will be at the maximum corporate tax rate, which is currently 35%. The pass through of net passive income for the shareholders' returns is reduced by the amount of tax imposed and is similar to the built-in gains tax situation. S corporations that pay tax on excess net passive income or built-in gains are generally required to make estimated tax payments.

Basis Adjustments

A shareholder's basis has an impact on the amount of loss that can be allocated and deducted by the shareholder. Unlike a partnership, the borrowing of funds by the corporation does not impact on the basis of its shareholders. The only loans of an S corporation that can increase basis are loans made directly by the individual shareholder to the corporation.

IRC §1367 stipulates how stock basis is adjusted. The code section defines the priority of adjustments to basis in this order:

- Increased for pass-through items of income,
- Decreased by distributions, and
- Decreased by pass-through items of loss and deduction.

Shareholders often do not know how much they should withdraw as distributions until early in the next year. By following the above order, S corporation shareholders may withdraw from the ending tax basis without creating the risk of not being able to deduct a current year loss. This could occur if the distribution reduced the basis to an amount where the current year loss became nondeductible.

Each individual shareholder is responsible for determining his stock basis. The corporation annually prepares an analysis with its Form 1120S that includes the accumulated adjustment account (AAA), other adjustments account (OAA), and previously taxed income (PTI). These accounts are summarized on Schedule M-2 of the tax return. One additional account that is not tracked on the M-2 is the accumulated earnings and profit account (AEP). The AEP will only occur in C corporations that had undistributed AEP prior to making an S corporation election. If the corporation has AEP, it may be liable for tax imposed on excess net passive income. Basis can usually be determined from internal transactions. However, if one shareholder purchased stock from another shareholder, the transaction can have an impact on the acquiring shareholder's outside basis.

The AAA is an S corporation account that generally reflects the accumulated, undistributed net income of the corporation for post-1982 years. S corporations must maintain this account to determine the tax effects of distributions during their years as an S corporation and the post-termination transition period. An S corporation without AEP does not need to maintain the AAA in order to determine the tax effects of distributions.

The AAA starts at zero. It is adjusted in future years by the addition of income and decreased by the following:

- Losses and expenses
- Nondeductible expenses
- Property distributions (other than dividend distributions from AEP unless the corporation elects to reduce AEP first)

Note. The AAA may have a negative balance at year's end.[18]

The PTI account applies to S corporations that were in existence prior to the Subchapter S Revision Act of 1982. PTI is an S corporation's taxable income that was earned prior to January 1, 1983, but was never distributed to the corporation's shareholders. PTI increases the basis of stock held by the shareholders.

Distributions from the various S corporation accounts are handled in a hierarchical order, which is listed in the instructions to Form 1120S. There are general rules and elections that can be made. One election is meant to distribute AEP first, only if a prior C corporation earned the earnings and profits. Another election is to make a deemed dividend, which is a dividend payable to specific affected shareholders who have consented to the action. Still another election is to forego distributions from PTI, which also requires the consent of all the affected shareholders.[19]

If any of the above elections are made, the corporation must attach a statement to its tax return for the year in which the election is made. It must state that each shareholder consents to the election and a corporate officer must sign on behalf of the corporation.

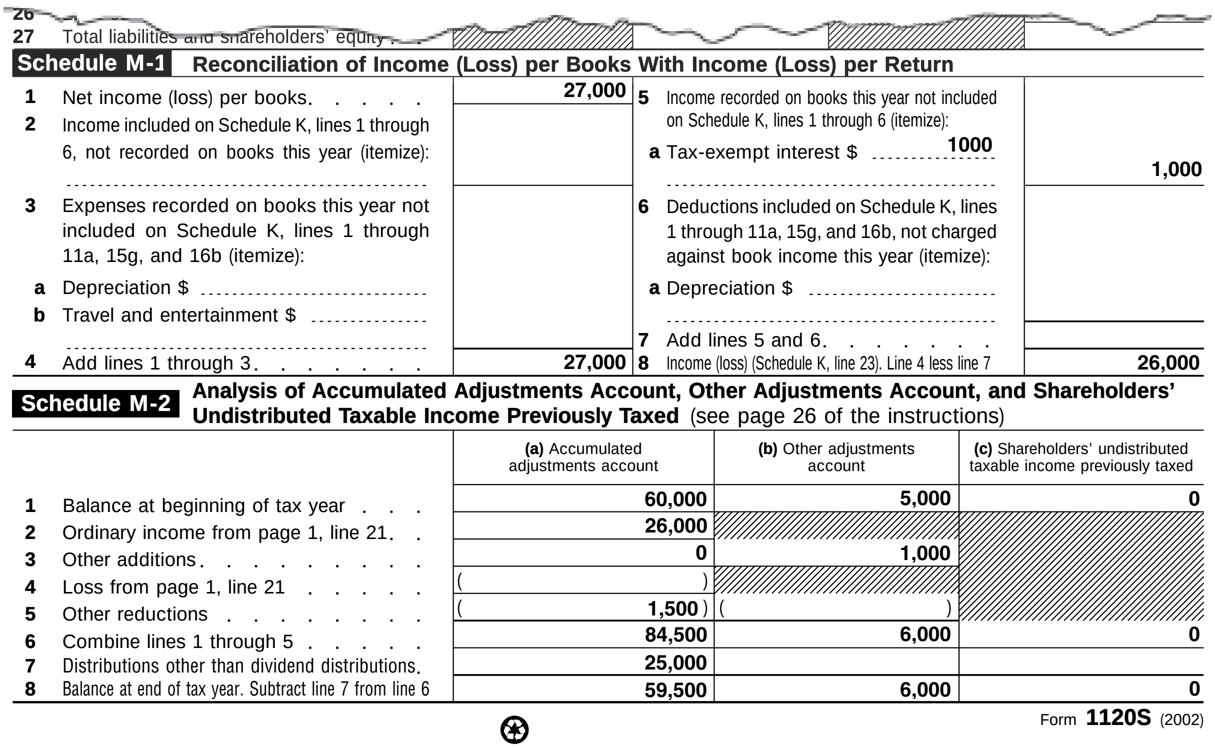
Example 11. Thomas Food Store, Inc. was formed on January 1, 1995, and its S corporation election was made effective on the same date. The corporation has one shareholder who devotes 100% of his time to the business.

At the beginning of the 2002 tax year the corporation has $65,000 of retained earnings. On January 1, 2002, the balance in its AAA is $60,000.

Thomas Food Store has ordinary income (line 21 on Form 1120S) of $26,000 and net income, per its books, of $27,000. The corporation has $1,000 of tax-exempt interest. During the year, it contributes $1,500 to a public charity and makes a cash distribution of $25,000 to its shareholders.

The Schedule M-1, *Reconciliation of Income (Loss) per Books with Income (Loss) per Return*, and the Schedule M-2, *Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed*, for this Thomas Food Store, Inc. follows.

For Example 11



26
27 Total liabilities and shareholders' equity

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

1 Net income (loss) per books	27,000	5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize): a Tax-exempt interest $ 1000	1,000
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):			
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15g, and 16b (itemize): a Depreciation $ b Travel and entertainment $		6 Deductions included on Schedule K, lines 1 through 11a, 15g, and 16b, not charged against book income this year (itemize): a Depreciation $	
		7 Add lines 5 and 6	
4 Add lines 1 through 3	27,000	8 Income (loss) (Schedule K, line 23). Line 4 less line 7	26,000

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see page 26 of the instructions)

	(a) Accumulated adjustments account	**(b)** Other adjustments account	**(c)** Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year	60,000	5,000	0
2 Ordinary income from page 1, line 21	26,000		
3 Other additions	0	1,000	
4 Loss from page 1, line 21	( )		
5 Other reductions	(1,500)	( )	
6 Combine lines 1 through 5	84,500	6,000	0
7 Distributions other than dividend distributions	25,000		
8 Balance at end of tax year. Subtract line 7 from line 6	59,500	6,000	0

Form **1120S** (2002)

Loss Limitations

While a shareholder with insufficient basis cannot deduct a loss in a current year, he may not lose the benefit of the loss. Losses can be carried forward indefinitely to be utilized when stock or debt basis is increased. Stock or debt bases can increase when the corporation has profits, if the shareholder adds additional capital, or if the shareholder makes direct loans to the corporation. Shareholders may lose their ability to deduct carryover losses if one of the following three situations occurs[20]:

1. S corporation election is terminated — Shareholders could, however, increase their bases to take the suspended losses.
2. Shareholder disposes of all his stock.
3. Shareholder dies.

Built-In Gains Tax

A major issue that impacts S corporations is the built-in gains tax. The built-in gains tax applies to S corporations that were formerly C corporations and whose S elections were made after 1986. This built-in gains tax does not apply to S corporations that have always been S corporations. The built-in gains provisions apply for a period of 10 years or 120 months commencing with the S election.

A corporation is subject to the built-in gains tax if there was a disposition of assets that were on hand at the time the S election became effective. The tax can apply to the collection of accounts receivable and the sale of inventory. Additionally, the sale of transferred appreciated assets to a shareholder can be subject to the built-in gains tax. The assets are subject to tax if, at the time the S election is made, the assets have an FMV in excess of their basis. Assets that did not exist at the time of the election are not impacted by this provision.[21]

When a C corporation elects to become an S corporation, it should determine the value of its assets at the time of the election. Items such as accounts receivables and goodwill must be appraised. A formal appraisal will protect the taxpayer from unexpected increases in value that could give the appearance that built-in gains were present.

For a built-in gain to be subject to the built-in gains tax, the gain must be realized during the 10-year recognition period. The amount of gain that is subject to tax in any year is **limited** to the **smallest** of:

- Net unrealized built-in gain less amounts previously recognized during the 10-year recognition period for those assets,
- The amount that will be the corporation's taxable income for the year if only recognized built-in gains and losses are taken into account, or
- The corporation's taxable income computed as if it is a C corporation.[22]

The maximum built-in gain is the net unrealized built-in gain, which equals the excess of the FMV over the adjusted basis of the assets on hand at the time the S election is made. Built-in losses are applied against the built-in gains to calculate net built-in gains.

The built-in gains tax is treated as being sustained by the S corporation during the tax year.[23] This results in each built-in gain item being reduced by the proportionate share of the built-in gains tax. The net amount is reflected on the shareholders' Schedule K-1 for the year.

Example 12. After operating for 10 years as a C corporation, Wyse Corporation made an election for S corporation status. The S election is made at the beginning of 2003. At the time the election is made, Wyse owns land with a basis of $80,000 and an FMV of $100,000. During 2003 the land is sold for $125,000. The recognized gain for this land is $45,000, and $20,000 is subject to the built-in gains tax. The tax will be applied at the highest corporate tax rate imposed by IRC §11, currently 35%. Wyse Corporation will incur a $7,000 built-in gains tax ($20,000 × 35%). The shareholders will report $38,000 ($45,000 – $7000) built-in gains tax. The built-in gains tax can be avoided by holding the appreciated property for a minimum of ten years.

FMV	$100,000
Basis	(80,000)
Built-in gain	20,000
Sale price	$125,000
Basis	(80,000)
Gain recognized	45,000
Amount subject to built-in gains	$ 20,000
Tax rate	35%
Built-in gain tax	$ 7,000
Gain recognized	$ 45,000
Built-in gain tax	(7,000)
Gain reported to shareholder (subject to individual tax rate)	$38,000

Observation. Upon audit, the IRS may question why the FMV was only $100,000 at the time of the S election, but was worth $125,000 at the time of sale, less than one year later.

LIMITED LIABILITY COMPANIES

The taxation issues for the LLC will depend on the election it made when it filed Form 8832.

COMPENSATION AND PAYROLL TAX

Compensation issues for the various entities range from concerns about inadequate compensation to concerns about excess compensation. For some entities, compensation is not an issue.

Compensation and Payroll Tax Issues

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
Self-employment tax payable on net business income.	Generally self-employment tax payable on general partners' share of trade or business income.	Reasonable nonexcessive compensation for services rendered. Payroll taxes incurred on salaries.	Reasonable compensation for services rendered. Distributions in lieu of salaries for shareholder-employees. Payroll taxes could be incurred.	Same as partnership.

SOLE PROPRIETORSHIPS

The income of a proprietorship is taxable to the proprietor for both regular income tax and self-employment tax. Self-employment tax is asserted on the net income derived from the business. Net self-employment income less than $400 is not subject to self-employment tax. If a proprietor also has wages subject to FICA tax, only the self-employment income in excess of FICA wages limited by the income ceiling is taxed. The ceiling is $87,000 in 2003 and applies to a taxpayer's combined wages and other self-employment income.

Employing Spouses and Dependent Children

Proprietors can benefit by employing their dependent children and paying them wages, because the proprietorship may not incur any FICA or Unemployment (FUTA) payroll tax liability. A proprietor's children under age 18 are exempt from FICA, and those under age 21 are exempt from FUTA.

A proprietor may employ his spouse as long as the spouse performs services and is paid reasonable compensation. The spouse could have a health insurance policy in her name that also covers the proprietor under a family plan.[24] The taxpayer deducts the expense on the Schedule C or F which reduces self-employment tax.

Note. The self-employed health insurance deduction was increased to 100% in 2003. Consequently this strategy is not as advantageous as in prior years.

PARTNERSHIPS

All ordinary income from partnership activities is allocable to the partners. Guaranteed payments for services rendered are subject to self-employment tax on the individual partners' returns. There are exceptions, however, and certain types of income are not taxed as self-employment taxes. Real estate partnerships, investment clubs, and other passive activities are generally not subject to self-employment taxes.

Limited Partners

Limited partners are not subject to self-employment tax on partnership income. Guaranteed payments made to limited partners for specific services rendered are an exception.[25]

Individuals are deemed to be limited partners and not subject to self-employment tax unless one of the following applies:

- Partner has personal liability for the debts.
- Limited partner has authority to contract under state law on behalf of the partnership.
- Individual participated in the partnership trade or business for more than 500 hours during the partnership's tax year.

Limited partners are subject to self-employment if the following apply:

- Guaranteed payments to limited partners are for services subject to self-employment tax.
- Partner in a service type business, e.g., law and accounting, is treated as a general partner
- If a limited partner, who participates more than 500 hours, owns more than one class of interest in the partnership, i.e., both a limited partner and a general partner, he will not be subject to self-employment tax on the limited partner class of interest.

> **Note.** Treas. Reg. §§1.1402A-2(g) through 1.1402A-2(j) are proposed regulations. Therefore, they should not be cited alone as precedent by taxpayers or the IRS. At this time, it appears to be the best authority available regarding limited partners and the applicability of self-employment tax.

C CORPORATIONS

Excessive compensation is an issue that may be raised in an examination of a C corporation. The IRS can claim that an excess amount of salary (an amount that is not ordinary and necessary) is a nondeductible constructive or preferential dividend. This can create an assessment of additional corporate tax.[26] Compensation will be considered reasonable if the amount of the compensation is what like businesses pay under like circumstances. The reasonableness of compensation depends on the facts in the individual situation. The tax court case *Mortex Manufacturing Company*[27] determined that **five factors** constitute the **basis for reasonable compensation.** These five factors are:

1. Financial status of corporation,
2. Work performed by officer-employee shareholders,
3. Analysis of compensation to the respective taxpayer,
4. External compensation levels for similar types of business, and
5. Conflicts of interest in setting salaries.

The reasonableness of compensation will often be based on the return of equity. The IRS uses the following questions to determine reasonableness of compensation:

- Would an independent investor be satisfied with the compensation levels paid to an employee shareholder?
- Is there money left for distribution to the other shareholders?

When corporations pay excessive salaries in a current year, they sometimes use the argument that employees were under-compensated for services in past years. The case of *Alpha Medical, Inc.*[28] ruled that a corporation may deduct current compensation payments if they also represent payment for prior years' services. The total cost of prior and current salaries must be reasonable based on the factors shown previously in this text.

Note. For a recent court case, see Chapter 15, Rulings and Cases for information on the *Devine Brothers.*

When corporations pay compensation for prior service, their decisions should be based upon a consensus of the directors that the payments are reasonable. Such decisions should be documented in the corporate minutes.

S CORPORATIONS

The shareholder-employees of S corporations have a dilemma. Since the income of S corporations is taxed only to their shareholders, the excessive compensation issue of C corporations does not apply. The alternative issue that S corporations face is that the IRS believes that they pay unreasonably low compensation to their shareholder-employees. The IRS can determine distributions paid to the shareholder-employees in lieu of salaries are an attempt to eliminate the payment of payroll taxes.

S corporations and its employees pay payroll taxes on wage income. Distributions, however, are not subject to payroll tax. In recent years the IRS has taken the position that distributions made to S corporation shareholder-employees can be reclassified as wages, making them subject to payroll taxes if the distributions are later deemed to be compensation for services rendered by employees.

In *J. Radtke,*[29] the court determined a shareholder-employee must take wages, as well as distributions from the earnings of an S corporation, and the salaries must be reasonable for services rendered. In another case, *Wiley L. Barron,*[30] the court ruled that the IRS has the authority to use statistical data to determine reasonableness of compensation. Since the corporation treated Mr. Barron as an employee in a previous year, the taxpayer was denied relief under §530 of the Revenue Act of 1978 (Safe Harbor Provisions).

In still another case, *Judith W. Davis v. Commr.*,[31] loans that were not fully documented were deemed to be the basis for compensation to a controlling shareholder. The taxpayer claimed the payments were made on a loan but had no documents to evidence the loan. The court ruled that these payments were actually disguised salary.

After it studies the facts and circumstances of a case, the IRS makes a subjective determination. In most cases when the IRS recategorized distributions as wages, **no** salaries were paid. Also, the shareholder-employee was the only person providing service to the corporation. When an S corporation is profitable, it should pay reasonable salaries. Otherwise the corporation can potentially be subject to scrutiny by the IRS and a reclassification of its distributions as wages. Such a reclassification can result in sizable tax, penalties, and interest.

LIMITED LIABILITY COMPANIES

LLCs file Form 8832, *Entity Classification Election*, to determine their tax status. If an LLC elects to be taxed as a proprietorship or partnership, its members may be subject to self-employment tax. If the LLC elects to be taxed as a C corporation, the language cited previously relating to excessive compensation will apply. However, if the LLC elects to be a corporation by filing Form 8832 and later files for the S corporation election on Form 2553, *Election by a Small Business Corporation,* the law and issues stated for S corporations apply.

An LLC's decision to make itself taxable as an S corporation with flow-through income and losses can subject the entity to IRS scrutiny. An LLC can be formed with members who do not meet S corporation guidelines. LLCs with corporations or nonresident aliens as members are not eligible to be S corporations. If an LLC does not maintain the specific requirements of S corporations set by the Internal Revenue Code, the IRS can question the validity of the entity's S corporation election. LLCs should consider this issue before they make the S election.

LIQUIDATION OR DISSOLUTION

SOLE PROPRIETORSHIP

A sole proprietorship can sell or transfer the assets of the business to someone else. However, it cannot transfer the business itself. The new owner must establish her own sole proprietorship and file her own Schedule C or F. To terminate the business, the proprietor will file a final schedule with her Form 1040. This will report the income and expense of the business that occurred during the year prior to transfer. If the assets are sold, any gain or loss will be reported on Forms 4797 and or Schedule D. If the assets are given away, a gift tax return may be required.

It the proprietor dies while running the business, any income and expense from the date of death until the transfer of the assets will be reported by the estate on its Form 1041. If the proprietor chooses to stop doing business, there are no tax consequences until the disposal of the assets.

PARTNERSHIP

The termination of a partnership is called a dissolution of the partnership. Termination of a partnership is regulated by IRC §708. Dissolution can occur by choice of the partners or it will automatically occur if there is a change of 50% or more of the owners in a twelve month period.[32]

Example 13. Craig, Chris, Rachel, and Jamie each own 25% of CCH Partnership. Craig decides to sell his partnership interest to Stan on September 10, 2002. On May 5, 2003, Rachel decides to sell her partnership interest to Susan. Since 50% or more of the partnership interests transferred within twelve months, the partnership is dissolved and a new partnership is formed.

Example 14. Use the same facts as **Example 13,** except Stan chooses to sell his partnership interest and Rachel doesn't sell her interest. This will not result in the dissolution of the partnership since only 25% of the partnership interests have transferred.

Note. IRC §708 distinguishes between general and limited partnerships. The interests of a limited partnership can be transferred without the limitation of the 50% rule.

The dissolution of a partnership does not generally result in tax to the partners provided the assets are proportionately distributed to the partners. The assets will take on the basis the partner has in her capital account, adjusted by any debt relief received or debts assumed.

If the assets are distributed in a manner where each partner does not receive her proportionate share of assets that would result in ordinary income upon sale, the IRS will treat the distribution as a deemed sale.[33] This will cause the partnership to recognize gain which will flow-through to the partners.

C CORPORATION

The liquidation of a C corporation will result in double taxation. The liquidation is treated as if the corporation sold its assets at FMV to the shareholders for their stock. Simultaneously, the shareholders are treated as if they sold their stock to the corporation for the fair market value of the assets received.

The corporation will recognize gain based upon the difference between the FMV of the assets and their remaining basis in the corporation. The shareholder recognizes gain based on the difference between the FMV of the assets received and their basis in their stock.

Example 15. Joe is the sole shareholder of JoeCo, a C corporation. He decides to cease operating as a corporation and liquidates JoeCo. The assets of JoeCo are valued at $500,000 and have a basis of $200,000. There are no liabilities in the corporation. Joe originally paid $100,000 for his stock in JoeCo. The tax consequences of the liquidation are as follows:

JoeCo	
FMV assets	$500,000
Basis of assets	(200,000)
Gain recognized by corporation	$300,000
Joe	
FMV assets	$500,000
Basis of stock	(100,000)
Gain recognized by shareholder	$400,000

This gain must be reported on the returns of JoeCo and Joe, even though no cash is transferred or received.

Observation. This double taxation feature makes it important to give thought to the assets transferred to a corporation upon formation or the assets purchased by a corporation.

S CORPORATION

The liquidation of an S corporation is similar to a C corporation. Since the S corporation is a pass-through entity, the tax consequences will be reported on the tax return of the shareholder. The pass-through increases the basis of the shareholders stock, leaving less gain to be reported from the transfer of the stock. As a result, the S corporation effectively has only a single tax.

Note. This can lead the shareholders of a C corporation to consider making an S corporation election. However, as discussed previously, this results in a built-in gain that must be recognized on any assets disposed of within 10 years of the S election date.

LIMITED LIABILITY COMPANY

The liquidation/dissolution of a limited liability company will have the same tax consequences reported above, depending on the tax election made. For example, if the LLC elected to be taxed as a partnership, it would use the same process for a partnership dissolution.

APPENDIX

Federal Taxation of Business Income

Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
Income and expenses of business are reported on individual 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.

Comparison of Business Entities*

Factor	Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
Forming the Entity	No formal registration, but establishing a protected business trade name (DBA) is advisable	No formal registration required for a general partnership	Articles of Incorporation and Bylaws required	Same as C corporation, filing of Form 2553 also required	Filing of Articles of Organization required
Ownership	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. (Number of partners governed by a state's Uniform Partnership Act)	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.
Management and Control	No continuity as an entity if sold, abandoned, or owner dies	General partnership has limited life. Partnership dissolves when majority of partners withdraw or die. Partnership agreement can keep business in existence. Limited partnership interests easily transferrable	Indefinite life; death or retirement does not terminate	Same as C corporation.	May have a limited life or be perpetual
Limited Liability	None	General partners are personally liable for obligations of partnership; limited partners are not	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.
Tax Impact of Forming Entity	None	Assets transfer to partnership; no recognition of gain unless liabilities greater than basis of property transferred	No recognized gain or loss if stockholder has control upon transfer. Exception: liabilities exceed the basis of assets transferred	Same as C corporation.	Same as for partnership.

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

Comparison of Business Entities (continued)

Factor	Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
Basis Determination	Individual basis rules apply.	Basis adjusted by income, losses, and distributions by partnership. Election available to adjust basis to reflect tranferred assets in sale or death situations.	No impact on basis to reflect income, losses, and distributions from retained earnings. Basis of assets not impacted by change in basis of transferred stock.	Basis in stock adjusted to reflect income, losses, and distribution. Basis of assets not impacted by change of basis of transferred stock.	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.	
Compensation and Payroll Tax Issues	Self-employment tax payable on net business income.	Generally self-employment tax payable on general partners' share of trade or business income.	Reasonable non-excessive compensation for services rendered. Payroll taxes incurred on salaries.	Reasonable compensation for services rendered. Distributions in lieu of salaries for shareholder-employees. Payroll taxes could be incurred.	Same as for partnership.
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.

Comparison of Business Entities (continued)

Factor	Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
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.
Related Party Losses and Deductions	Losses not allowed between individual and stipulated parties listed in IRC §267.	Same as sole proprietorship.	Losses and deductions between incorporation and parties listed in IRC §267 not allowed. Attribution rules apply for stock ownership.	Same as C corporation except limitations of 2% shareholder-employees.	Same as for partnership.
Changing to Another Type of Entity	Generally can change to another entity type without tax effect.	May incorporate and transfer assets to C or S corporation without tax effect unless liabilities assumed are greater than total basis of transferred assets.	Gain/loss will be recognized upon liquidation and assets transferred to partnership or LLC. No gain/loss recognized if S election is made except if LIFO is used. Built-in gains tax if appreciated assets are sold after S election is made.	May change to C corporation without recognition of gain/loss. Generally conversion to partnership or LLC is tax free. Gain could result if value of assets exceeds basis of stock.	Same as for partnership.
Accumulated Earnings Tax	Not applicable	Not applicable	Imposed at 15% rate on accumulated taxable income if corporation has tax avoidance purpose and earnings exceed statutory provisions.	Not applicable	Not applicable
Statute of Limitations	3-year normal statute of limitation; 6-year statute for 25% omission of income.	3-year statute from when partner files return. Tax Matter Partner Rules apply to large partnership.	Same as sole proprietorship.	3-year statute of limitation for shareholders from when shareholders file tax return.	Same as for partnership.

Comparison of Business Entities (continued)

Factor	Sole Proprietorship	Partnership	C Corporation	S Corporation	LLC
Contributions	Deductible as itemized deduction	Not deductible to partnership. Partner allowed distributive share of contributions subject to limitations	Deductions generally limited to 10% of taxable income. Allowed IRC 170(e)(3) deduction for qualified inventory and tangible property donations	Not deductible to corporation. Shareholder allowed distributive share of contributions subject to limitations	Same as for partnership.
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: 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.

ENDNOTES

1 IRC §1362(f)

2 *duPont, Pierre S.*, 308 US-CT-APP-3 [39–1 USTC]

3 *Groetzinger, Robert P.*, US-Sup-CT [87-1 USTC] 107 Sct 980, 480 US 23

4 IRC §351(b)

5 Temporary regulation §1.444-3T(b)1

6 Rev. Proc. 2002-38

7 Treas. Reg. §1.721-1(a)

8 Treas. Reg. §1.754-1A

9 IRC §469(h)(5)

10 Treas. Reg. §1.469-5

11 Treas. Reg. §1.167(a)-5

12 *Bardahl Manufacturing Corporation*, 24 TCM 1030, TC Memo 1965-200

13 *Bardahl International Corporation*, 25 TCM 935, TC Memo 1966-182

14 *Donruss Company*, 69-1 USTC

15 IRC §170(b)(2)

16 IRC §1375

17 Treas. Reg. §1.1362-2(c)(5)

18 IRC §1368e

19 IRC §1368(e)(3)(b)

20 IRC §1366(d)(2)

21 IRC §1374

22 IRC §1374(c)(2)

23 IRC §1366(f)(2)

24 Rev. Rul. 71-588

25 IRC §1402(a)(13)

26 Treas. Reg. §1.162-7(b)(3)

27 *Mortex Manufacturing Co., Inc., TC Memo 1994-110*, 67 TCM 2412 (1994)

28 *Alpha Medical, Inc.*, 172 F. 3d 942, 83 AFTR 2d 99-1922, 99-1 USTC 50461 (6th Cir. 1999)

39 *Radtke, S.C., Joseph v. United States*, 712 F. Supp. 143, 89-2 USTC 9466, 63 AFTR 2d 1469 (ED Wis. 1989), aff'd. 895 F. 2d 1196, 90-1 USTC 50113 (7th Cir. 1990)

30 *TC Summary Opinion, 2001-10*

31 *Davis, Judith W., v. Commr., TC Memo 1997-80*

32 IRC §708(b)(1)

33 IRC §751(b)