CHAPTER 47

INCORPORATION

*Note:* This discussion deals with the general treatment of corporations. In the case of corporations that have elected special status under Subchapter S, different rules may apply (see Chapter 46). A checklist of issues to consider when choosing an entity, such as a proprietorship, partnership, Limited Liability Company (LLC), C corporation, or S corporation, appears at the end of this chapter as Figure 47.4.

INTRODUCTION

For federal tax purposes a business entity with two or more owners is classified as either a corporation or partnership. A business entity with only one owner may elect to be classified as a corporation or elect to be treated as a sole proprietorship (however, even if the owner elects to be treated for tax purposes as a sole proprietorship, the business can still qualify as an LLC). Under regulations, an organization that is incorporated under Federal or state law is treated as a corporation for tax purposes and is not eligible to elect a different classification under the so-called “Check-the-Box” rules.[[1]](#endnote-1)

In addition, the “Check-the-Box” rules generally permit unincorporated organizations to elect to be treated as associations taxable as corporations for federal tax purposes without regard to the number of corporate characteristics (limited liability, continuity of life, centralized management, and free transferability of interest) they possess.

Under the regulations the term corporation means:

(1) A business entity organized under a federal or state statute, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association;

(3) A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) Certain state-chartered business entities conducting banking activities;

(6) A business entity wholly owned by a state or a political subdivision of a state;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than Section 7701(a)(3); and

(8) Certain foreign entities.

All entities included in the above list are classified as corporations for income tax purposes. An entity not on the above list with two or more owners may elect to be taxed as a corporation or as a partnership for income tax purposes. In addition, an entity not on the above list with only one owner may also elect to be taxed as a corporation or as a sole proprietorship.[[2]](#endnote-2)

WHEN IS USE OF SUCH A DEVICE INDICATED?

1. When the individual owners desire limited liability. Legally, a corporation, not its individual shareholders, is responsible for corporate obligations. The limited liability protection is the primary reason to operate a business in the form of a corporation. Therefore, if this protection is desired, it is important to follow the formalities of how the corporation must operate. (Note, as a practical matter, in the case of most smaller corporations, the owners may be required to personally sign for corporate debts – thus negating to some extent the protection of corporate liability.)

2. When the individual owners desire a relatively simple and inexpensive means of transferring ownership. It is relatively easy to provide for a new owner’s entrance and an existing owner’s exit merely by endorsing shares of stock. This is especially important in making gifts, particularly with respect to transfers to minors.

3. When the individual owners desire to take advantage of the wide range of fringe benefits that the corporation can provide. These benefits are, within limits, tax deductible by the corporation and generally not currently taxable to the employee – including shareholder-employees. These fringe benefits may include:

* pension/profit-sharing plans,
* 401(k) plans
* group life insurance,
* group health insurance,
* disability income coverage,
* medical reimbursement plans,
* cafeteria plans, and
* auto and travel costs.

4. When the applicable corporate tax rate is lower than the stockholder-employee’s personal rate. For instance, assuming a corporation does not need to pay out substantial dividends, the overall tax result may be lower federal income taxes than if the enterprise were run in the form of a sole proprietorship or partnership. It might be easiest to illustrate this point by comparing partnership with corporate tax treatment. If a partnership were formed, owners would be taxed on all the income earned as partners at their individual rates (which may be higher than the applicable corporate rate) – even if they did not actually withdraw all partnership earnings from the firm. However, as stockholder-employees, they would be taxed only on salaries (assuming no dividend had to be paid). A lower federal income tax may result under the corporate form as compared to the partnership form.

Because the corporation’s tax rate may be lower than the individual’s tax rate, this income splitting can yield a lower overall current tax. This is especially true on the first $50,000 of corporate income, which is taxed at only a 15% rate. Given this relatively low threshold of income, this approach may not be applicable to many individuals.

It may be more expensive tax-wise to be a corporation when it comes down to selling the business. Under the rules, there may be two taxes as a result of a corporate sale of assets (followed by liquidation) instead of one tax when the seller is a proprietorship or partnership. Thus, if the corporation has assets that are likely to appreciate, the income-splitting benefit may be more than offset by the additional taxes at liquidation.

The rates on corporate taxable income (Corporate Tax Table), including worksheets for computing the tax, are shown below:[[3]](#endnote-3)

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| --- |
| **CORPORATE TAX TABLE** |
|  |  |  |  |
| **Taxable****Income** | **Base****Amount** | **Base****Tax Owed** | **% on****Excess** |
| 0 | 50,000 | 0 | 15 |
| 50,000 | 75,000 | 7,500 | 25 |
| 75,000 | 100,000 | 13,750 | 34 |
| 100,000 | 335,000 | 22,250 | 39 |
| 335,000 | 10,000,000 | 113,900 | 34 |
| 10,000,000 | 15,000,000 | 3,400,000 | 35 |
| 15,000,000 | 18,333,333 | 5,150,000 | 38 |
| 18,333,333 | ........ | 6,416,667 | 35 |
|  |  |  |  |
| **CORPORATE TAX****CALCULATING WORKSHEET** |
|
|  |  | Example |
| Step 1: | List Taxable Income  | $200,000 |
| Step 2: | List Base Tax  | 22,250 |
| Step 3: | Compute “Excess” OverBase Amount  | $100,000 |
| Step 4: | List % on “Excess”  | .39 |
| Step 5: | Multiply Step 3 x Step 4  | 39,000 |
| Step 6: | Total Steps 2 and 5  |  61,250 |

Figure 47.1 compares the tax payable by various taxpayers on $100,000 of taxable income based on the 2013 rates.

**Figure 47.1**

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| **TAX COMPARISON 2013** |
|  | **Taxable****Income** | **Tax** | **Net****Income** | **Marginal****Rate (%)** | **Overall****Rate (%)** |
| Corporate\* | $100,000 | $22,250 | $77,750 | 34 | 22 |
| Personal Service Corporation | $100,000 | $35,000 | $65,000 | 35 | 35 |
| Joint | $100,000 | $17,250 | $82,750 | 25 | 17 |
| Single | $100,000 | $21,617 | $78,383 | 28 | 22 |
| Separate | $100,000 | $22,035 | $77,965 | 28 | 22 |
| Head/Household | $100,000 | $19,767 | $80,233 | 25 | 20 |
| Trust/Estate | $100,000 | $33,965 | $66,035 | 35 | 34 |
| \*Not a Personal Service Corporation. |

Note that personal service corporations are taxed at a flat rate of 35 percent.[[4]](#endnote-4) The term “qualified personal service corporation” means one in which (a) substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (b) substantially all of the stock of which is held by employees, retirees, their estates, or persons acquiring stock due to the death of an employee or retiree (but only for a two-year period following the death).[[5]](#endnote-5)

A corporation can generally declare and pay dividends – as well as salaries – in such a manner as to avoid a “bunching” of income at the entity level in those years when personal income is highest. On the other hand, if the business were established in the partnership form, the owners would have little control over the receipt and taxation of income. This ability to “time” income is important because, if income can be timed, the ultimate taxes payable can be lowered.

5. When the estate owner wants to entice family members into the business by giving them a stake in the business without giving them control or the ability to bind the corporation with their actions.

6. When privacy is desired. The transfer of stock in a closely held corporation is not generally a matter of public record. This makes it possible to shield family financial affairs from public scrutiny.

7. When continuity of operation is important. A corporation may, within limits, legally continue its business with little or no hindrance from the probate court. This makes it possible for corporate officers to make major decisions regarding property that the client has contributed to the corporation without the necessity or delay of the judicial process, and with little or no publicity.

8. When gift tax savings are desired. The transfer of a minority interest in a closely held business may result in a discounted value for gift tax purposes. In other words, transfers of property (via its stock) can sometimes be made at discounted values for gift tax purposes. It is also possible to create “non-voting stock”, which is a good asset to gift since doing so will result in a transfer of a portion of the corporation’s value without shifting any control.

9. When estate tax savings are desired. Transfers of stock reduce the donor’s estate by (1) shifting appreciation in value from donor to donee and (2) shifting income on stock (dividends) to the donee. The stock that is ultimately included in the donor’s estate may itself be a minority interest and may therefore (or because of lack of marketability) be valued at a discount.

Disadvantages of the Corporate Form

1. There are a number of additional expenses associated with forming and maintaining a corporation (e.g., attorney fees, accounting fees, corporate supplies, state incorporation fees, and the ongoing expenses of maintaining the corporate form).

2. While some types of income passed through to shareholders are taxed only once (e.g., salaries), dividends are subject to both corporate and shareholder levels of tax.

3. At one time, a corporation could avoid recognizing a gain upon a liquidation or sale (followed by a liquidation) of the business. There was generally only one tax at the shareholder level (except for certain recaptures, receivables, etc.).

For example, under the prior rules, if a shareholder invested $10,000 in a corporation and the corporation invested the cash in a piece of land that was worth $100,000 after 10 years, upon liquidation the corporation would give the land to the shareholder, and the shareholder would receive a $100,000 value in exchange for turning in the stock that cost him $10,000. This would result in a $90,000 capital gain. The corporation generally would not recognize any gain and was not taxed on any excess of value over the cost the corporation had in the land.

The *General Utilities* case doctrine which made that result possible has long since been legislatively abolished. Now, upon liquidation, the corporation is treated as having sold the corporate assets and is taxed on the excess value of the assets over the corporation’s basis in the assets. If the corporation has only a $10,000 income tax basis in the land and the land is worth $100,000, then the corporation first must recognize a $90,000 gain. Whatever is left after the corporation pays the tax will come out to the shareholder in the liquidation and the shareholder is then taxed on that receipt. So taxes have been paid at both the corporate and the individual level.

4. Corporations demand a more complex organizational structure and may have to contend with additional complex issues (e.g., personal holding company tax, accumulated earnings tax, dividend treatment, and collapsible corporation rules).

5. Personal service corporations are taxed at a flat rate of 35 percent from the very first dollar. This 35 percent tax eliminates the benefit of the “run up the brackets” for doctors, lawyers, accountants, architects, and other professionals who practice in the corporate form. If the corporation zeroes out its taxable income through reasonable salary payments to employee shareholders, there will be no taxable income upon which the IRS can impose the 35 percent tax. But this makes it more likely that the IRS will attempt to disallow deductions for salary payments in a personal service corporation under the “reasonableness” test. In other words, the IRS has a strong incentive to claim that payments made as compensation should be recharacterized as nondeductible dividends to shareholder employees. If the IRS is successful with such an attack, the corporation will then be taxed at 35 percent – and then the same dollars will again be taxed to the shareholders upon receipt. One way out of the 35 percent tax trap is to elect S corporation treatment.

6. Corporations must also follow their formalities of operation. For example, the shareholders and board of directors must meet at least once a year. Minutes should be kept which document the significant actions of the corporation. Each of the officers has a specific role to fulfill. Most state laws permit shareholder and director actions to be taken without a meeting but regular updates should occur.

HOW IT IS DONE – AN EXAMPLE

Stevens, Roberts, and Lee are engineers who feel they can develop a relatively inexpensive process for manufacturing an aircraft safety component that is in great demand for new jet airliners.

Stevens is a sole proprietor currently engaged in producing aircraft parts. Roberts, a young man who has a post-graduate degree in business administration and an undergraduate degree in engineering, has worked for Stevens for a number of years. He first started as an engineer and almost by accident moved into the firm’s sales division. Robert’s sales efforts have been so successful that Stevens would like to offer him an interest in a new business venture.

Lee is slightly older than Stevens or Roberts. He is a well-known and highly respected authority in the area of aircraft safety parts. He does quite a bit of consulting work for both government and private enterprise. He met Stevens and Roberts on such a consulting project, and the three men have become good friends. Lee is quite wealthy, and he is interested in keeping both his money and his mind at work.

All three men have something to contribute to a corporation. In return they will want to participate in the control and profits of the business while it is running, or in a distribution of the assets of the business if the corporation’s life ends. In other words, they will expect shares of the corporation. Assume Stevens will contribute his business (his sole proprietorship). Lee will contribute cash or securities. Roberts wants to contribute his services and a small amount of cash in return for his stock.

Assuming this were the case, here is what might happen: If Lee decides that his contribution to the capital of the corporation will be cash, the stock he receives will normally have a value at the time of the exchange equal to the cash. For example, if he transfers $10,000 of cash to the corporation, he will ordinarily receive back stock with a fair market value of $10,000. Because the value of the stock he receives is no more or less than the value of the cash he transfers to the corporation, he realized neither a gain nor a loss. If he later sells his stock, the cash he paid will determine the basis of his stock. If he realizes $21,000 on the sale of the stock, his gain would be $11,000, the difference between his basis for the stock ($10,000) and the amount he realizes on the sale ($21,000).

Absent provisions in the tax law to the contrary, if any of the three contributed appreciated property to the corporation in return for its stock, a taxable gain would result. But there is an important exception to that general rule.

The exception was designed to encourage the formation of a new corporation. It enables a taxpayer to transfer appreciated property, or even a going business, into a new corporation without the transferor recognizing income on the appreciation at the very time when his other expenses – the expenses involved in the organization and operation of the corporation – are the highest. The exception provides that even if the transferor realizes a gain when he transfers appreciated property to his new corporation, he does not have to recognize gain for tax purposes.[[6]](#endnote-6)

This exception is conditioned on meeting certain basic requirements. The rule is that where a person or persons transfer *property* to a corporation (a) solely in exchange for the corporation’s own stock, and (b) the transferor(s) control the corporation immediately after the transfer, no gain will be recognized on the appreciated business or securities contributed to the new corporation. Control generally means ownership of 80 percent or more of the corporation’s stock.[[7]](#endnote-7)

Stock can be received in exchange for appreciated assets without the recognition of gain. However, any securities received are treated as “boot.” Gain is recognized to the extent of the lesser of the amount of gain inherent in the assets transferred or the amount of “boot” received.

The tax free exchange for stock is similar to the theory making a like-kind exchange tax free. The transferor who receives stock in exchange for his property has really maintained an interest in the original property. It has merely changed form and now has the physical identity of stock. This continuity of interest concept is a key to nonrecognition of the gain on the appreciated property transferred. (It is important to recognize, however, that for the purposes of corporate law, a shareholder has an undivided interest [shared with all other shareholders] in all corporate property, but that his rights in any specific corporate property [even though originally transferred by him to the corporation in a tax-free exchange] are extremely limited.)

*Example:* Suppose Stevens, who is now operating as a sole proprietor, decides to transfer his going business to the new corporation. If his basis for the sole proprietorship is $100,000, and the fair market value of his business is $500,000 at the time he transfers it to the new corporation, he would probably receive $500,000 worth of stock.

Under the general rule for taxing sales and exchanges, he would realize a $400,000 gain because he transferred his business (with a basis of $100,000) in exchange for stock worth $500,000. However, the nonrecognition provision provides that because he received only stock, and through that stock controlled the corporation (just as he previously controlled his sole proprietorship), what has happened is really only a substitution of stock certificates for his former physical possession of the property.

This rule is logical because to realize gain there must be a taxable event, which usually occurs in the form of a sale, exchange, or other disposition of property. Although technically there may be a sale (a transfer of property in return for money or a promise to pay money) or exchange (a transfer of property in return for other property or services), there has been no economic exchange in substance. Stevens, in the example, has not disposed of his property. He has merely received certificates that evidence that he changed the form of ownership in the original property. This would apply no matter how many people transfer property to the corporation. As long as it was done collectively, if the taxpayers transferring property to the corporation still have both (a) control and (b) interest in the property they originally owned, they would not have to recognize any gain on receipt of the new corporation’s stock. Thus, Stevens would not have to recognize the $400,000 gain until and unless he later sells his stock.

Under the assumed facts, if Roberts were to receive stock in the new corporation in exchange for his services, the value of the stock would be currently taxable to him, as stock issued for services is not considered as issued for property. If Roberts’ stock was issued solely for services, it will not be counted in determining whether the transferors of property control the corporation after the exchange.

In addition, if the property that is contributed is subject to liabilities in excess of basis, gain will be recognized to the extent of such excess.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Stock purchased by an investor in a corporation will take on the character of the assets used to purchase the stock. Thus, if an individual transfers $1,000 to a corporation in return for stock and that $1,000 consists of community property earnings, the stock itself will be community property. Of course, this result could be altered by a written agreement between the spouse and the investor to treat the stock as property other than community property, or by titling the stock in some other fashion, e.g., as joint tenancy or as the separate property of one spouse.

Upon divorce or death of the stockholder, the community property interest of the spouse will become important. It will be necessary to determine what portion of the stock is community property. As discussed in Chapter 40, a common problem is the situation where a person owned all or most of the stock of a corporation prior to marriage, the person works full time for the corporation, and the value of the corporation increases significantly. A portion of the increase in value of the person’s stock may be community property to the extent the increase is attributable to his or her insufficiently rewarded hard work during the marriage, and a portion will be separate property to the extent the increase is the result of the natural increase or earnings of the original stock. The method of valuation cannot be predicted with certainty.

One question that often arises in community property states is the power to manage and control the community property. Until 1975, California law provided that the husband had the management and control over the community property. Under a revision of the community property laws, both spouses now have management power and control over community property. (Similar changes have occurred in the laws of other community property states.) This has implications in connection with the management and control over a corporation. California law provides that a spouse who is operating or managing a business or an interest in a business that is community personal property has the sole management and control of the business or interest. Thus, if an individual owns all the stock in a manufacturing corporation and that individual is also the manager of the business, or a substantial participant in the management of the business, the individual’s spouse will not be able to exercise equal control in regard to the management of that business. This allows people to choose business associates and manage a business without regard to the effect of community property laws.

Note that under federal regulations, an individual will not be considered the owner of an interest in a corporation that is owned by his spouse if: (1) the individual does not directly own an interest in the corp. at any time during the taxable year; (2) the individual is not a member of the board of directors, a fiduciary, or an employee of the corp. and does not participate in it's management at any time during the year; (3) no more than 50% of the corporation's income for the year was derived from royalties, rents, dividends, interest, and annuities; and (4) the interest in the corp. is not, at any time during the year, subject to conditions which substantially restrict or limit the spouse's right to dispose of the interest and which run in favor of the individual or the individual's children who have not reached the age of 21.[[8]](#endnote-8)

FREQUENTLY ASKED QUESTIONS

**Question** – Why do stockholders often finance business needs by lending money to their corporations rather than by increasing their equity (stock) interest?

*Answer* – One of the key advantages of operating a business in the corporate form is that many different types of ownership interests in corporations can be created. The interests of any particular investor can be met by creating a security that fits his special needs and desires. This factor facilitates the acquisition of capital. Suppose that in order to acquire working capital and capital for long-term planning the corporation issued bonds. These are written obligations to repay a definite sum of money on a definite date, usually at least 10, and more often 29 or more, years from the date the bond was issued.

Bonds are a favored means of raising corporate capital. One reason for this is that a corporation will obtain a deduction for the interest paid on the indebtedness, but no deduction is allowed for dividends paid on either preferred or common stock. As long as a corporation can earn money at a higher rate (with the cash raised by issuing the bond) than it costs the corporation (in interest necessary to service the debt), it usually makes sense for the corporation to borrow money. This is known as leverage.

Issuance of the bonds generally creates no tax liability to either the corporation or the bondholder. This is because the corporation has merely borrowed money and agreed to return it. Conversely, the bondholders have merely loaned money. When the bond matures, the principal becomes payable and the bondholders are entitled to a tax-free return of their capital investment. In contrast, the return of equity is a taxable dividend, unless the return can qualify as a stock redemption (which is not a dividend).

A distribution by a corporation with respect to its stock is considered a return on the shareholders’ investment and is taxable as a dividend to the extent of corporate earnings and profits – unless the distribution can qualify as a sale or exchange, in which case only the gain in excess of basis is taxable.

Any money bondholders receive in the form of interest, and any money they receive at the maturity of their bonds in excess of their capital investment will be taxed at ordinary income rates. Receiving money in excess of capital investment can occur when bonds are purchased at a discount but are paid off at face value. (When bonds are *issued* at a discount by the issuing corporation, a bondholder must include a ratable portion of the discount in income each year as the bond matures. For example, if a bond with a par value of $1,000 was issued for $800 and is payable in 10 years, the $200 discount would be included in the taxpayer’s income at the rate of $20 a year.)

Another reason bonds are often favored over an increase in equity is that the accumulation of earnings and profits within the corporation to pay debt obligations can be justified more readily than accumulating income to redeem stock. This helps avoid an additional tax on an unreasonable income accumulation.

A final reason for lending money to the corporation as opposed to making a capital contribution concerns asset protection planning for the owners. For example, if the corporation stops operating and wants to dissolve, the corporation’s creditors must be paid before the owners of the business. Therefore, if the owners of the corporation lend money to the corporation, (and to the extent of these loans) the owners will be entitled to receive a pro-rata share of the distributions which are otherwise being made to outside creditors. While attempting to treat contributions to the corporation as a loan is a good strategy, it is important that the loan obligation be properly documented. This will require a loan agreement and security agreement which contain terms that are similar to the same types of terms that would be entered into with an unrelated lender. It is also important to make sure that there is adequate capital in the corporation in order to avoid being considered thinly capitalized.

**Question** – What is thin capitalization?

*Answer* – Because the interest paid on corporate indebtedness is deductible, the cost of borrowing money through long-term corporate debt is substantially reduced. However, some shareholders attempt to overdo it – they contribute almost no equity investment and characterize almost their entire contribution as debt owed to them by the corporation. This is known as thin capitalization, because the capital investment is thin in relation to the debt, but the debt is really disguised stock.

Once the form of the debt is disregarded by the IRS and the substance is treated appropriately, corporate deductions for interest payments to shareholders are disallowed. Second, receipt of interest payments by shareholder-creditors are reclassified and treated as dividends. Third, when the corporation pays off its debt to the shareholders, the payments may be taxed as dividends. This means that instead of treating the amount received as a tax-free repayment of a debt, the shareholder-creditor must report some or all of the distribution as income. Fourth, money that the corporation purportedly was accumulating to pay off the debt may be subject to the accumulated earnings tax (which is discussed below). Finally, a debt that is reclassified as stock could cause a termination of a Subchapter S election, because a Subchapter S corporation is allowed to have only one class of stock.

To determine if a security should be classified as debt rather than equity, the courts usually examine a number of factors such as: Was there an intention by shareholders to enforce payment of the debt? Was there a debt instrument and did it give the shareholders management or voting rights (like stock)? What was the ratio of debt to equity? A general rule of thumb, subject to variation depending upon the industry, is that if the amount of debt exceeds shareholders’ equity by more than four to one, the corporation is thinly capitalized. Basically, the court would examine all the factors relevant to determining if a loan by shareholders was in reality more like an ownership interest (stock) than a debtor-creditor relationship.[[9]](#endnote-9)

Keep in mind that, while bonds are a tax-favored means of obtaining corporate funds, frequently a corporation does not want to become obligated to make fixed payments for interest and debt amortization. To avoid a cash flow problem, therefore, corporations often finance long-term operations or investments by the issuance and sale of common stock, which entail no obligation to pay dividends or preferred stock on which dividend payments can frequently be avoided.

Thin capitalization can also be a problem in protecting the shareholders from claims by the corporation’s creditors. In order for there to be limited liability protection within a corporation, the corporation must have sufficient assets to stand behind its obligations.

**Question** – How is a corporation taxed?

*Answer* – A corporation is taxed as an entity separate from its shareholders. A 15 percent rate is applied to the first $50,000 of corporate taxable income, a 25 percent rate applies to the next $25,000, a 34 percent rate is levied on the next $25,000, 39 percent on the next $235,000, then 34 percent on the next $9,665,000, then 35 percent on the next $5,000,000, then 38 percent on the next $3,333,333, then 35 percent on any additional taxable income.

The 39 percent tax on income between $100,000 and $335,000 includes a 5 percent add-on tax that is designed to phase out the graduated rates below 34 percent.

The 38 percent rate on income between $15,000,000 and $18,333,333 includes a 3 percent add-on tax that is designed to phase out the graduated rates below 35 percent. See Figure 47.2.

**Figure 47.2**

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| **HOW IS A CORPORATION TAXED?** |
| **If Taxable Income is Over:** | **But not Over:** | **Tax is** | **Plus This Percent:** | **Of the Amount****Over:** |
| $0 | $50,000 | $0 | 15% of | $0 |
| $50,000 | $75,000 | $7,500 | 25% of | $50,000 |
| $75,000 | $100,000 | $13,750 | 34% of | $75,000 |
| $100,000 | $335,000 | $22,250 | 39% of | $100,000 |
| $335,000 | $10,000,000 | $113,900 | 34% of | $335,000 |
| $10,000,000 | $15,000,000 | $3,400,000 | 35% of | $10,000,000 |
| $15,000,000 | $18,333,333 | $5,150,000 | 38% of | $15,000,000 |
| $18,333,333 | – | 35% of Taxable Income |  |  |

*Example:* A corporation with $100,000 of taxable income would pay a tax of $22,250 ($50,000 x 15%, plus 25% of $25,000, plus 34% of $25,000). A corporation with $500,000 of taxable income would pay a tax of $170,000 (34% of $500,000). Corporations, like individuals, are liable for a number of other state and local taxes as well. The corporation reports its federal income tax on IRS Form 1120.

Graphically, the return might look like the illustration in Figure 47.3.

**Figure 47.3**

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| **THE CORPORATE TAX FUNNEL** |
| **Figure 47-3**  |
| **TAXABLE INCOME\*** |
| (D) 15 percent normal tax rate is applied to the first $50,000 of taxable income |
| (E) 25 percent tax rate is applied to the taxable income on the next $25,000 |
| (F) 34 percent tax rate is applied to taxable income between $75,000 and $100,000 |
| (G) 39 percent tax rate is applied to taxable income between $100,000 and $335,000 |
| (H) 34 percent tax rate is applied to taxable income between $335,000 and $10,000,000 |
| (I) 35 percent tax rate is applied to taxable income between $10,000,000 and $15,000,000 |
| (J) 38 percent tax rate is applied to taxable income between $15,000,000 and $18,333,333 |
| (K) 35 percent tax rate is applied to taxable income in excess of $18,333,333 |
|  |
| \*Note that taxable income of personal service corporations is taxed at a flat 35 percent. |

Gross income includes such items as profit from sales and receipts from services. It also includes gains on sales or exchanges, income from rent, royalties, interest, and dividends.

A corporation is entitled to two types of deductions; ordinary deductions and special deductions. Ordinary deductions include compensation of officers and salaries, bonuses, rent payments, charitable contributions, repair expenses, interest paid on indebtedness, casualty losses, deductions for depreciation and amortization of research and experimental costs, advertising, and corporate contributions to pension and profit-sharing plans. A corporation also receives a carryover deduction for a net operating loss.

Special deductions include a dividends received deduction, which is calculated as follows:

(1) If the recipient corporation owns less than 20 percent of the voting power and value of stock of the issuing corporation, the corporation may deduct 70 percent of the amount of the dividend.

(2) If the recipient corporation holds at least 20 percent and up to 80 percent of the stock of the issuing corporation, the corporation may deduct 80 percent of the dividends received.

(3) If the recipient corporation owns 80 percent or more of the stock of the issuing corporation, a 100 percent deduction may apply to dividends received.[[10]](#endnote-10)

The bottom line is that a closely held corporation that holds the stock of a publicly held corporation will likely be entitled to deduct 70 percent of every dollar it receives in the form of dividends on the stock it holds. It therefore will pay a top tax of 39 percent on 30 percent of each dividend dollar, an effective rate of only 11.7 percent.

A corporation may also deduct up to $5,000 of organizational expenditures. This $5,000 amount is reduced by the amount that organization expenditures exceed $50,000. The remainder of organizational expenditures may be amortized over 15 years.[[11]](#endnote-11) This would also be considered a special deduction.

Taxable income is what is left after taking ordinary and special deductions. It is the amount to which the various percentage tax rates are applied. Certain credits are then directly applied against this tax, such as corporate overpayments of tax in previous years, payments for estimated taxes (paid on a quarterly basis), and credit on certain foreign taxes paid.

**Question** – Many business and estate planning tools are corporate fringe benefits that are deductible to the extent reasonable (as well as ordinary and necessary). What is meant by reasonable?

*Answer* – A corporation is entitled to a deduction for salaries or any other compensation for personal services, but only if the services are actually rendered and the amount paid as compensation for those services is considered reasonable. Reasonable means only that amount which would ordinarily be paid for similar services by other corporations under similar circumstances.

This reasonableness test is imposed most frequently on closely held corporations because of the large degree of coincidence of executive and shareholder interest. It is designed to prevent the shareholders from draining off corporate profits in the disguise of tax-deductible salaries. Corporate profits are usually paid out in the form of dividends that are taxable to the shareholders, but nondeductible by the corporation. The portion of the salary considered unreasonable is usually classified as a disguised dividend and, to that extent, the corporation’s deduction is disallowed. However, even though that amount may not be deducted by the corporation, it is still taxable as a dividend to the shareholder-recipient.[[12]](#endnote-12) Reasonableness is a question of determining the amount that would ordinarily be paid for like services by like enterprises under similar circumstances. Generally, where an executive employee does not own or have options to purchase stock, arm’s length bargaining as to the amount of salary is assumed. One element that could be considered in determining reasonableness is the fact that a given individual was not adequately compensated in prior years. Thus, if high compensation in the current year can be attributed to services rendered in prior years, the total current salary might be considered reasonable.

However, the amount of cash compensation is not the only relevant factor. Corporate contributions to pension and profit-sharing plans are considered business expenses and are allowed as deductions as long as the total amount of all forms of compensation paid on behalf of an individual does not exceed a reasonable total.

Some of the other indirect forms of compensation may be: premiums for life insurance, hospitalization, medical care, and salary continuation plans. Costs of these plans, although generally deductible by the corporation, often do not result in taxable income to the individual. Because the corporation is a separate and distinct tax entity, and because working shareholders would be considered salaried employees, they would be eligible for these forms of indirect compensations. This is true even if in addition to being employees, they are also officers, directors, and shareholders of the corporation.

An employee may exclude from gross income the following fringe benefits: (1) a no-additional-cost service (e.g., free stand-by flights to airline employees); (2) qualified employee discounts (e.g., discounts on the selling price of qualified property or services of the employer); (3) certain working condition fringes (e.g., employer paid subscriptions to business periodicals); and (4) de minimus fringes such as typing of personal letters by the company secretary or the personal use of company copying machines.[[13]](#endnote-13) In addition, the American Taxpayer Relief Act of 2012 extended the increased reimbursement permitted for transit passes and vanpooling (so that these reimbursement levels will be equal to employer provided parking benefits) for any month beginning before January 1, 2014.[[14]](#endnote-14)

In order for the no-additional-cost services and the qualified employee discounts to be excluded from income of officers, owners and highly compensated employees, they must be provided to employees on a nondiscriminatory basis.

**Question** – What is the accumulated earnings tax?

*Answer* – One of the easiest and most common means of financing growth is to accumulate earnings and plow them back into the corporation to purchase new machinery, buildings, and other necessary capital assets. These plowed-back earnings and profits begin to add up very quickly. Because the corporate tax rate may be lower than the rate of tax upon the incomes of individual shareholders, they may attempt to use the corporation as a vehicle for reducing taxes by having the corporation retain earnings rather than make taxable distributions in the form of nondeductible dividends.

If a corporation reasonably allows earnings to accumulate in order to fund current or anticipated needs or projects that the corporation has planned, there should not be a problem. However, once earnings are allowed to accumulate beyond the reasonable needs of the business, those earnings may be subject to an additional tax, the accumulated earnings tax.[[15]](#endnote-15)

The accumulated earnings tax is imposed on every corporation that is formed or used for the purpose of avoiding personal income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being distributed. The purpose of the tax is to discourage the use of a corporation as an accumulation vehicle to shelter its individual stockholders from taxation at personal income tax rates. As a regulative device, the accumulated earnings tax was designed to force the distribution of retained earnings at the point where they no longer serve a legitimate business purpose. Without such a tax on improper accumulations, stockholders could arrange to have dividends paid in years when their incomes were low or they could indefinitely accumulate earnings and profits inside the corporation until the corporation was liquidated.

An accumulated earnings credit of $250,000 ($150,000 in the case of personal service corporations) is allowed that will be presumed to be for the reasonable business needs of the corporation.[[16]](#endnote-16) A controlled group of corporations is allowed one accumulated earnings credit, not one per corporation. Thus, if a corporation begins to accumulate amounts in excess of $250,000, it should be prepared to show a bona fide business reason for not distributing these earnings in the form of dividends.

The accumulated earnings tax is designed to tax only earnings retained beyond the reasonable needs of the business. The question then becomes: “What reasonable needs would a corporation have for accumulating profits?” The regulations state that working capital needs and capital for building expansion or for the replacement of plant or equipment are among the needs that would allow a business to properly accumulate earnings.[[17]](#endnote-17) In addition to these needs, a sinking fund to retire corporate bonds at maturity has often been found to be a reasonable need to accumulate cash. In other cases, funds set aside to acquire minority interests or quarreling stockholders’ interests were also deemed to be retained for reasonable business needs. The term reasonable needs of the business includes the IRC Section 303 redemption needs of the business (see Chapter 41), although specific protection from the tax (within limits) is provided only in the corporation tax year in which the stockholder dies and in subsequent years.[[18]](#endnote-18) The reasonableness of accumulations in years prior to a year in which the shareholder dies is to be determined solely upon the facts and circumstances existing at the times the accumulations occur.[[19]](#endnote-19)

The tax, if applicable, is imposed only on accumulated taxable income; an amount that is derived from the taxable income of the corporation for the particular year in question. Thus, the tax does not apply to all of the accumulated earnings and profits of the corporation, but only to the accumulated taxable income of the year or years as to which the tax is asserted. To the extent that the tax is applicable, it is equal to 20 percent of the accumulated taxable income.

This tax on a corporation’s accumulated taxable income is payable in addition to the regular tax payable by the firm. Accumulated taxable income generally means the corporation’s taxable income for the year in question with certain adjustments (such as a reduction for federal income taxes paid) minus the sum of (a) distributions from current earnings and profits that the shareholders have reported as ordinary income (dividends paid), (b) amounts from earnings and profits that the shareholders have reported as dividends even though no actual distribution was made (disguised dividends), and (c) the accumulated earnings credit.

In determining whether or not the current year’s accumulated taxable income has been retained for the reasonable needs of the business, the availability of prior years’ accumulated earnings must also be considered. If past years’ accumulations are sufficient to meet current needs (i.e., this year’s business needs) there is no justification for accumulating current earnings.

**Question** – Will corporate-owned cash value life insurance purchased for key person, split dollar, or deferred compensation financing cause an accumulated earnings tax problem?

*Answer* – That depends on whether or not the insurance answers a valid corporate business need. There must also be a close correlation between the type of policy and amount of death benefit and the alleged corporate need. Generally, hedging against the loss of a key employee’s service because of unexpected death is considered to be a reasonable business need.[[20]](#endnote-20)

Key person life insurance is insurance that is owned by the corporation insuring the life of a key employee. The purpose of such a policy is to provide a fund at the employee’s death that will compensate the corporation for the financial loss resulting from the unavailability of the employee to render services to the corporation. Often, key person insurance death proceeds are also used to help in finding and compensating a suitable replacement. Therefore, the purchase of life insurance and the earnings used to pay policy premiums should not, per se, be subject to the penalty tax. The point is that it is not the amount, but the purpose of the accumulation, that is important.

The same question often arises as to the effect of a split dollar plan. If a corporation attempts to prevent taxation of income to shareholders by accumulating its earnings rather than distributing them, the existence or nonexistence of a split dollar policy will not, by itself, deter the imposition of the tax penalty provided by the law. Conversely, the existence of a split dollar policy will not, per se, incur the accumulations tax penalty if the corporation is not, in fact, accumulating earnings beyond the reasonable needs of the business.

This provision exists to deter tax evasion and not to prevent a business from operating in a normal businesslike manner. The same principle applies in cases where the corporation has obligated itself to make pre-retirement death benefits to a key executive under a deferred compensation agreement. An accumulation of corporate earnings to meet obligations under such an agreement is generally considered a reasonable business need (just as the funds accumulated to retire an outstanding corporate bond would be considered reasonable).

A third area where this question often arises is the use of accumulated earnings to provide surplus cash for the redemption of stock. In this case, if the redemption is to be utilized to shift partial or complete control to the remaining shareholders without depleting their personal funds (as for example, where, by shareholder agreement, the corporation will retire shares on the death of a shareholder), it is doubtful that accumulations to reach this result would be found to be a reasonable need. However, if a business purpose can be found, such as an accumulation to purchase the shares of a dissenting minority, then the accumulation may be found to be reasonable.[[21]](#endnote-21) The primary purpose must be a corporate, rather than an individual, benefit from the stock redemption.

**Question** – What is the personal holding company tax?

*Answer* – IRC Section 541 imposes a 20%tax on companies classified as personal holding companies. The tax applies to undistributed personal holding company income and is designed to discourage the use of corporations as incorporated pocketbooks wherein income from securities, real property, or personal talents is taxed at corporate rates rather than individual rates.

To be classified as a personal holding company, the corporation must meet both of the following tests: (1) at any time during the last half of the taxable year more than 50% of the value of its stock is owned by five or fewer individuals, and (2) at least 60% of its adjusted ordinary gross income is “personal holding company income.”[[22]](#endnote-22) Personal holding company income consists of (1) passive income, such as rents, royalties, dividends, and interest, and (2) income from personal service contracts under which the corporation is to furnish personal services but the corporation does not have the right to select the individual who will perform the services, and the individual selected by the client owns directly or indirectly 25% or more of the stock in the corporation.[[23]](#endnote-23)

For more on personal holding companies, see Chapter 45.

**Question** – What problems may a personal service corporation with only one significant customer face from the Internal Revenue Service where the primary purpose of incorporating was to obtain tax benefits?

*Answer* – IRC Section 269A specifically authorizes the IRS to reallocate between an employee-owner of a personal service corporation (defined as a corporation whose principal activity is the performance of personal services, with such services substantially performed by employee-owners) and the personal service corporation all income, deductions, credits, exclusions and other allowances to the extent necessary to prevent tax avoidance or evasion or to reflect clearly the income of the personal service corporation or any of its employee-owners. The authority to reallocate applies only in the event that substantially all of the services of the personal service corporation are performed for or on behalf of one other corporation, partnership or other entity and the personal service corporation was formed for the principal purpose of avoiding or evading federal income tax by reducing the income of the employee-owner or by securing for him a significant tax benefit not otherwise available. The typical corporation affected by this law is a corporate partner in a partnership of personal service corporations.

The potential impact of Section 269A has been greatly reduced by the parity created between corporate and Keogh plans, because the tax benefits of a corporate qualified plan are now available to non-corporate entities.

**Question** – What is the corporate Alternative Minimum Tax (AMT) and how does it affect corporate owned life insurance?

*Answer* – The corporate AMT is a tax imposed in addition to the regular corporate income tax and may be imposed on a corporation with tax preferences. Technically, the tax is the excess, if any, of a tentative minimum tax over the regular corporate income tax.[[24]](#endnote-24) Life insurance proceeds and inside buildup on a life insurance contract are among the tax preferences added to a corporation’s ordinary taxable income to determine its Alternative Minimum Taxable Income (AMTI) and, therefore, its alternative minimum tax.

Certain small corporations are exempt from the AMT. In general, a small corporation is defined as one that had average gross receipts of $5,000,000 or less for the three-taxable-year period that ended with the first tax year after 1996. After this initial test, applicable for tax year 1997, in order to continue to qualify, the three-taxable-year average is raised to $7,500,000. It is important to note that if a corporation does not qualify under the 1997 test of $5,000,000, it can never qualify later, even if it is later able to meet the three-taxable-year average gross receipts test of $7,500,000.[[25]](#endnote-25)

To determine a corporation’s alternative minimum tax, the corporation must first compute a Tentative Alternative Minimum Taxable Income (TAMTI) equal to its regular taxable income plus certain disallowed deductions. The corporation must then compute its Adjusted Current Earnings (ACE). The ACE adjustment is designed to approximate the corporation’s pre-tax net book income as measured for financial accounting purposes and is calculated by beginning with AMTI, adding earnings and profits income items (including life insurance proceeds and inside buildup on a life insurance contract), subtracting certain deductible items, and recalculating certain depreciation deductions. The corporation then increases or decreases its TAMTI by 75% of the amount by which ACE exceeds or falls short of TAMTI to arrive at the final alternative minimum taxable income. The tax itself is a flat 20% of AMTI. A corporation receives a $40,000 exemption that is reduced by 25% of the amount by which AMTI exceeds $150,000 (thus phasing out completely at $310,000).[[26]](#endnote-26)

The AMT can be considered a prepayment of the corporation’s regular tax because a credit is allowed that reduces the regular tax of the corporation in future years. This credit is equal to the amount by which the AMT exceeds the regular tax. The amount of AMT credit that may be taken in a subsequent year may not exceed the amount by which that year’s regular tax exceeds the AMT.[[27]](#endnote-27)

*Example:* A calendar year corporation has ACE of $400 in 2012, $300 in 2013 and $200 in 2014. Unadjusted AMTI is $300 for each of those years. In 2012, ACE exceeds unadjusted AMTI by $100, 75 percent of which ($75) must be included as an additional item of AMTI. In 2014, unadjusted AMTI exceeds ACE by $100, creating a potential negative adjustment to AMTI of $75. As the aggregate increases to AMTI for prior years equals $75 (the amount added to alternative minimum tax in 2012) and there are no aggregated reductions, the full amount of the potential negative adjustment will reduce AMTI for 2014.

Aside from affecting a corporation’s ACE adjustment, corporate-owned life insurance is taxed as follows:

* The premiums are not tax deductible.
* The annual premium reduces earnings and profits to the extent the premium exceeds the annual increase in the cash surrender value of the policy. If the increase exceeds the premium, then that difference will increase earnings and profits.
* The insurance proceeds are income tax free (for regular corporate purposes assuming §101(j) is complied with).
* Upon receipt of the policy proceeds, earnings and profits are increased by the excess of the amount received over the cash surrender value of the policy at the close of the immediately preceding taxable year.

There are several ways of dealing with the AMT. The easiest is merely to make up the difference through additional life insurance coverage. The following calculation shows how to determine the approximate amount of additional life insurance necessary to compensate the corporation for the effect of the AMT:

|  |  |  |
| --- | --- | --- |
| Step 1: | State the face amount before the AMT tax: | $1,000,000 |
| Step 2: | Divide the face amount by .85: | $1,176,471 |

This amount, $1,176,471, is (roughly) the before-AMT amount necessary for the corporation to net $1,000,000 after the AMT. Conservative planners will round up this amount.

Another alternative to the purchase of more life insurance is an S corporation election. Had the same business elected S status with no taxable income, there would be no tax at either the corporate or individual level.

CHAPTER ENDNOTES

1. . Treas. Reg. §301.7701-2(b). [↑](#endnote-ref-1)
2. . Treas. Reg. §301.7701-3(a). [↑](#endnote-ref-2)
3. . IRC Sec. 11(b)(1). [↑](#endnote-ref-3)
4. . IRC Sec. 11(b)(2). [↑](#endnote-ref-4)
5. . IRC Sec. 448(d)(2). [↑](#endnote-ref-5)
6. . IRC Sec. 351. [↑](#endnote-ref-6)
7. . IRC Sec. 368(c); Treas. Reg. §1.351-1(a)(1). [↑](#endnote-ref-7)
8. . Treas. Reg. § 1.414(c)-4(b)(5)(ii)(A). [↑](#endnote-ref-8)
9. . IRC Sec. 385. [↑](#endnote-ref-9)
10. . IRC Sec. 243. [↑](#endnote-ref-10)
11. . IRC Sec. 248. [↑](#endnote-ref-11)
12. . In *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Comm*., 109 AFTR 2d 2012-2140 (680 F. 3d 867), 05/17/2012, the Court of Appeals for the Seventh Circuit upheld a decision to recharacterize payments to entities related to the shareholders as dividends. The court noted that “whether the deduction that the corporation takes for the owner-employee’s salary really is a dividend can usually be answered by comparing the corporation’s reported income with that of similar corporations, the comparison being stated in terms of percentage return on equity”.. This approach is known as the “independent investor test” and creates a rebutable presumption. In the case at hand, an accounting firm paid “consulting fees” to entities owned by the founders of the firms. There were no services provided for these fees. The court disallowed the deductions. [↑](#endnote-ref-12)
13. . IRC Sec. 132. [↑](#endnote-ref-13)
14. . IRC Sec. 132 (f). [↑](#endnote-ref-14)
15. . IRC Secs. 531, 532. [↑](#endnote-ref-15)
16. . IRC Sec. 535(c). [↑](#endnote-ref-16)
17. . Treas. Reg. §1.537-2. [↑](#endnote-ref-17)
18. . IRC Secs. 537(a)(2), 537(b)(1). [↑](#endnote-ref-18)
19. . Treas. Reg. §1.537-1(e)(3). [↑](#endnote-ref-19)
20. . *Bradford-Robinson Printing Co. v. Comm*., 1 AFTR 2d 1278 (D. Colo. 1957). [↑](#endnote-ref-20)
21. . *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952). [↑](#endnote-ref-21)
22. . IRC Sec. 542. [↑](#endnote-ref-22)
23. . IRC Sec. 543. [↑](#endnote-ref-23)
24. . IRC Sec. 55(a). [↑](#endnote-ref-24)
25. . IRC Sec. 55(e). [↑](#endnote-ref-25)
26. . IRC Secs. 55, 56, 57. [↑](#endnote-ref-26)
27. . IRC Sec. 53.

**Figure 47.4**

|  |
| --- |
| **CHOOSING AN ENTITY – A CHECKLIST OF ISSUES TO CONSIDER** |
| **PROPRIETORSHIP** |
| (1) | One person owner | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (2) | Few employees | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (3) | Relatively low income | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (4) | Relatively low start up costs | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (5) | No double tax on business earnings | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (6) | Not possible to "time" or "split" income | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (7) | Administration of estate difficult | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (8) | Valuation freezing techniques not available | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (9) | Should not be operated as part of a trust | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (10) | No shield against personal liability | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (11) | Income reportable on owner’s individual income tax return | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (12) | Funds in Keogh plan generally not safe from creditors | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (13) | Generally may avoid franchise tax imposed by many states on operating as a corporation | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (14) | Self employment (payroll) tax now equal to total of employer and employee federal payroll tax | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| **PARTNERSHIP & LLC** |
| (1) | Sharing of net profits | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (2) | Presence of loss sharing | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (3) | Pass through of losses | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (4) | Avoidance of double taxation on profits | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (5) | Relatively low start up costs | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (6) | Relatively economical operation costs | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (7) | Taxable years must match those of partners or members | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (8) | No restrictions on who can invest or number of investors | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (9) | Easy to convert to another form of entity | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (10) | No accumulated earnings tax | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (11) | No personal holding company tax | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (12) | Unlimited personal liability unless limited partnership or LLC used to |  |
|  | protect limited partners or members | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (13) | Subject to "at risk" limitations | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (14) | Losses not deductible in excess of basis | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (15) | Interest deduction limits at personal level | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (16) | Equity received for services creates income | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (17) | On contribution of encumbered property, generally, only liabilities assumed by other partners or members in excess of contributing partner’s basis is taxable | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (18) | Income splitting – wealth shifting potential | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (19) | IRS can reallocate income if member of family renders services without reasonable compensation | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (20) | Partners who render services are treated as employees for certain fringe benefit purposes but tax law typically precludes nontaxable fringe benefits for most partners or members | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (21) | Separate income tax return required | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (22) | Funds in Keogh plan generally not safe from creditors of partner | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (23) | Franchise tax imposed on partnerships or LLCs by some states | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| **CORPORATIONS – "C"** |
| (1) | Limited liability to creditors if capital is adequate and corporate amenities observed | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (2) | Shareholder-employees can exclude certain fringe benefits from income | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (3) | Income taxed at corporate level subject to tax again at shareholder level on payment of dividend or on liquidation | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (4) | Reasonableness of compensation an issue | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (5) | Accumulated earnings and alternative minimum tax liability | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (6) | Losses trapped at corporate level | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (7) | Passive loss rules avoided at corporate level (except for certain closely-held C corporations and personal service corporations) and deductions at corporate rates | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (8) | Flexibility in terms of numbers of shareholders | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (9) | Can have more than one class of stock | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (10) | Stock can be used as compensation | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (11) | Ability to form subsidiaries | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (12) | Must be adequately capitalized | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (13) | Decision making centralized through management structure | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (14) | Possible to retain earnings without tax at personal level but taxed at corporate level | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (15) | Dividends received deduction | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (16) | Low federal income tax rate on first $75,000 of income | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (17) | 35 percent flat rate on certain professional service corporations | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (18) | Subject to double taxation upon liquidation | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (19) | Separate income tax returns required | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (20) | Franchise tax imposed by many states | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (21) | Non-calendar fiscal year end may be chosen by regular corporations, permitting some shift of income from one year to next by timing of salaries – not for personal service corporations in many circumstances | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (22) | Possible for employees to borrow up to $50,000 from their accounts in corporate retirement plans | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (23) | Employees’ funds in corporate retirement plans generally safe from creditors | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| **CORPORATION – "S" – DIFFERENCES FROM "C" CORPORATION** |
| (1) | Restrictions on who can hold stock | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (2) | Limits on number of investors | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (3) | Only one class of stock (common) allowed | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (4) | Only limited subsidiaries permissible | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (5) | Some states do not recognize pass through of income or losses | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (6) | Limited liability as with "C" corporation | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (7) | Decision making centralized through management structure | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (8) | Pass through of income, losses, and credits | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (9) | Difficult to do estate planning since certain trusts cannot own S stock | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (10) | Limits on type of business an S corporation can be | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (11) | Potential for accidental or nonvoluntary termination of S election | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (12) | Limits on employee benefits for owners | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |

 [↑](#endnote-ref-27)