Various Business Forms

- Sole proprietorships
- Partnerships
- S corporations
- Regular corporations (also called C corporations)
Sole Proprietorship

- Not a separate taxable entity
- Income reported on owner’s Sch. C
Partnership

- Separate entity, but does not pay tax
- Allocates partnership income to partners
  - Partners report partnership income on personal tax returns
- Files information return (Form 1065)
S Corporation

- Separate entity, only pays special taxes (e.g., built-in gains)
- Allocates entity income to shareholders
  - Shareholders report entity income on personal tax return
- Files information return (Form 1120S)
C Corporation

- Separate tax-paying entity
  - Reports income and expenses on Form 1120 (or Form 1120-A)
- Income taxed at corporate level and again at owner level when distributed as a dividend
## Corporate Income Tax Rates

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 or less</td>
<td>15%</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>Over $75,000 but not over $100,000</td>
<td>34%</td>
</tr>
<tr>
<td>Over $100,000 but not over $335,000</td>
<td>39%</td>
</tr>
<tr>
<td>Over $335,000 but not over $10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>Over $10,000,000 but not over $15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>Over $15,000,000 but not over $18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>Over $18,333,333</td>
<td>35%</td>
</tr>
</tbody>
</table>
Nontax Issues in Selecting Entity Form (slide 1 of 3)

• Liability
  – Sole proprietors and some partners have unlimited liability for claims against the entity

• Capital-raising
  – Corporations and partnerships to a lesser extent can raise large amounts of capital for entity ventures
Nontax Issues in Selecting Entity Form (slide 2 of 3)

- **Transferability**
  - Corporate stock is easily sold, but partners must approve partnership interest transfer

- **Continuity of life**
  - Corporations exist indefinitely
Nontax Issues in Selecting Entity Form (slide 3 of 3)

- Centralized management
  - Corporate actions are governed by a board of directors
  - Partnership operations may be conducted by each partner without approval by other partners
Limited Liability Companies (LLC)

• LLCs have proliferated since 1988 when IRS ruled it would treat LLCs as partnerships
  – Major nontax advantage
    • Allows entity to avoid unlimited liability
  – Major tax advantage
    • Allows qualifying business to be treated as a partnership for tax purposes, thereby avoiding double taxation associated with C corporations
Entity Classification Prior To 1997  

- Sometimes difficult to determine if entity will be taxed as a corporation
  - If entity has a majority of corporate characteristics, it is taxed as a corporation
  - Most entities have the following characteristics:
    - Associates
    - Objective to carry on business and share profits
• If entity has a majority of the following relevant corporate characteristics it is treated as a corporation:
  – Continuity of life
  – Centralized management
  – Limited liability to owners
  – Free transferability of ownership interests
Entity Classification After 1996
(slide 1 of 2)

• Check-the-box Regulations
  – Allows taxpayer to choose tax status of entity without regard to corporate or noncorporate characteristics
  – Entities with > 1 owner can elect to be classified as partnership or corporation
  – Entities with only 1 owner can elect to be classified as sole proprietorship or as corporation
Entity Classification After 1996
(slide 2 of 2)

• Check-the-box Regulations (cont’d)
  – If no election is made, multi-owned entities treated as partnerships, single person businesses treated as sole proprietorships
  – Election is not available to:
    • Entities incorporated under state law, or
    • Entities required to be corporations under federal law (e.g., certain publicly traded partnerships)
Comparison of Corporate and Individual Tax Treatment (slide 1 of 2)

• Similarities
  – Gross Income of a corporation and individual are very similar
    • Includes compensation for services, income from trade or business, gains from property, interest, dividends, etc.
    • Corp taxpayers are allowed fewer exclusions
    • Nontaxable exchange treatment is similar
    • Depreciation recapture applies to both but corp may have additional recapture under §291
Comparison of Corporate and Individual Tax Treatment (slide 2 of 2)

• Dissimilarities
  – Different tax rates apply
  – All deductions of corp are business deductions
    • Corp does not calculate AGI
    • Corp does not deduct standard deduction, itemized deductions, or personal and dependency exemptions
    • Corp does not reduce casualty and theft loss by $100 statutory floor and 10% of AGI
Accounting Periods and Methods
(slide 1 of 2)

- Accounting periods
  - Most C corporations can use calendar year or fiscal year ending on last day of a calendar month (or 52-53 week year)
  - S corps and Personal Service Corporations (PSC) are limited in available year ends
Accounting Periods and Methods

(slide 2 of 2)

- Accounting methods
  - Cash method can’t be used by C corp. unless:
    - In farming or timber business
    - Qualified PSC
    - “Ave. Annual Gross receipts” ≤ $5,000,000
Capital Gains and Losses
(slide 1 of 2)

• Individuals
  – Net capital gains subject to the following preferential tax treatment
    • Net short-term gains subject to regular tax rates
    • Net long-term gains max tax rate 20%
  – Net capital losses deductible up to $3,000 with remainder carried to future years
Capital Gains and Losses
(slide 2 of 2)

• Corporations
  – No special tax rates apply to capital gains
    • Entire gain is included in income subject to normal corporate tax rates
  – Corp cannot take a deduction for net capital losses
    • Capital losses can be used only to offset capital gains
    • Unused capital losses are carried back 3 years and carried forward for 5 years
      – Carried over losses are treated as short-term
Passive Losses

• Passive loss rules apply to:
  – Individuals and personal service corps
    • Cannot offset passive losses against active or portfolio income
  – S corps and partnerships
    • Passive income and loss flows through to owners and rules applied at owner level
  – Closely held C corps
    • May offset passive losses against active income, but not portfolio income
Charitable Contributions
(slide 1 of 5)

• Both corporate and noncorporate taxpayers may deduct charitable contributions in year paid
  – Exception for accrual basis corporations allows deduction in year preceding payment if:
    • Approved by board and
    • Paid within 2 1/2 months of year end
Charitable Contributions
(slide 2 of 5)

• Amount deductible for property contributions depends on type of property contributed

• Long-term capital gain property deduction = fair market value of property
  – Exception: Corp may only deduct basis if tangible personal property contributed and not used by charity in its exempt function
• Long-term capital gain property deduction = fair market value of property (cont’d)
  – Exception: Deduction for property contribution to certain private nonoperating foundations is limited to basis in property
Charitable Contributions
(slide 4 of 5)

- Ordinary income property deduction = basis in property
  - Exception: Basis plus 50% of appreciation can be deducted if inventory or scientific property is contributed which is used by charity as required by Code
Charitable Contributions
(slide 5 of 5)

• Corporate charitable contribution deduction is limited to 10% of taxable income before:
  – Charitable contribution deduction,
  – NOL or capital loss carryback, and
  – Dividends received deduction
• Contributions in excess of 10% limit can be carried forward for 5 years
Net Operating Loss

• Net operating loss of corporation and individual may be:
  – Carried back two years
  – Unused portion carried forward 20 years
Dividends Received Deduction

(slide 1 of 2)

- If corporation owns stock in another corporation and receives dividends, a portion of dividends may be deducted from income:

<table>
<thead>
<tr>
<th>% owned</th>
<th>Deduction Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 20%</td>
<td>70%</td>
</tr>
<tr>
<td>≥ 20% but &lt; 80%</td>
<td>80%</td>
</tr>
<tr>
<td>80% or more, and affiliated</td>
<td>100%</td>
</tr>
</tbody>
</table>
Dividends Received Deduction
(slide 2 of 2)

1. Multiply dividends received by deduction percentage
2. Multiply taxable income by deduction percentage
3. Subtract 1. from taxable income
   - If entity has income before DRD, but DRD creates NOL, amount in 1. is DRD
   - If DRD does not create NOL, deduction is limited to lesser of 1. or 2.
Z Corp owns 60% of X Corp’s stock in years 1, 2 & 3. Dividend of $200 is received each year. Limit (Step 1) is 80% x $200 = $160.

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>400</td>
<td>301</td>
<td>299</td>
</tr>
<tr>
<td>Dividend rec’d</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Expenses</td>
<td>(340)</td>
<td>(340)</td>
<td>(340)</td>
</tr>
<tr>
<td>Income before DRD</td>
<td>260</td>
<td>161</td>
<td>159</td>
</tr>
<tr>
<td>80% of income</td>
<td>208</td>
<td>129</td>
<td>127</td>
</tr>
</tbody>
</table>

Year #1 $208 > $160, so $160 DRD
Year #2 $129 < $160, so $129 DRD
Year #3 DRD causes NOL ($159-$160), so $160 DRD is used.
$2 less income results in $31 more DRD.
Organizational Expenditures

- Corporation may elect to amortize organizational expenditures over period of 60 months or more
  - Costs of issuing or selling stock and transferring assets to the corporation reduce the amount of capital raised and are not deductible
<table>
<thead>
<tr>
<th>Step</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
</tr>
<tr>
<td>Less: Deductions (except charitable, Div. Rec’d, NOL carryback, STCL carryback)</td>
</tr>
<tr>
<td>Taxable income for charitable limitation</td>
</tr>
<tr>
<td>Less: Charitable contributions ($\leq 10%$ of above)</td>
</tr>
<tr>
<td>Taxable income for div. rec’d deduction</td>
</tr>
<tr>
<td>Less: Dividends received deduction</td>
</tr>
<tr>
<td>Taxable income before carrybacks</td>
</tr>
<tr>
<td>Less: NOL carryback and STCL carryback</td>
</tr>
<tr>
<td>TAXABLE INCOME</td>
</tr>
</tbody>
</table>
Tax Liability of Related Corporations

• Subject to special rules for computing income tax
  – Limits controlled group’s taxable income in tax brackets below 35% to amount corporations in group would have if they were one corporation

• Controlled group includes:
  – Parent-subsidiary groups
  – Brother-sister groups
  – Combined groups
Parent-Subsidiary Controlled Group

• Consists of one or more chains of corporations connected through stock ownership with a common parent
  – Ownership is established through either:
    • Voting power test: requires ownership of stock with at least 80% of total voting power of all classes of stock entitled to vote
    • Value test: requires ownership of at least 80% of total value of all classes of stock
Parent-Subsidiary Controlled Group

Brown is the common parent of a parent-subsidiary controlled group consisting of Brown, Green, Blue, and White Corporations. *

*Reg. § 1.1563-1(a)(2).
Brother-Sister Controlled Group

• Exists if five or fewer persons meet an 80\% and a 50\% test:
  – 80\% test:  group owns 80\% of vote or value of all classes of each corporation’s stock
  – 50\% test:  smallest amount owned by each shareholder in one of the entities is determined
    • Amounts are summed for all shareholders and must be > 50\%
## Brother-Sister Group Example

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>&gt;50% test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bob</td>
<td>60%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Alice</td>
<td>20%</td>
<td>60%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Ted</td>
<td>20%</td>
<td>20%</td>
<td>60%</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;80% test</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

1. The group, combined, owns 100% of each entity’s stock, so meets 80% test.

2. The lowest amount owned by Bob in any entity is 20%; same for Alice and Ted. Sum the 20% amounts for 60%. This is > 50% so 2nd test met.
Combined Groups

• Exist if all of the following conditions are met:
  – Each corp is member of either a parent-subsidiary or brother-sister controlled group,
  – At least one of the corps is parent of a parent-subsidiary controlled group,
  – Parent corp is also member of a brother-sister controlled group
Application of §482

- §482 permits IRS to reallocate income, deductions, and credits between two or more businesses owned or controlled by the same interests.
- Used to prevent avoidance of taxes or to reflect income properly.
  - Controlled groups of corps are especially vulnerable to §482.
Consolidated Returns

- Members of a parent-subsidiary affiliated group may be able to file a consolidated income tax return
Corporate Filing Requirements
(slide 1 of 2)

- Must file Form 1120 (or Form 1120-A) on or before the 15th day of third month following close of tax year
  - Automatic 6 month extensions are available by filing Form 7004
Corporate Filing Requirements
(slide 2 of 2)

• Must make estimated tax payments equal to lesser of:
  – 100% of corporation’s final tax, or
  – 100% of tax for preceding year
  – No estimated tax payments required if tax liability expected to be less than $500
Schedule M-1

- Corporations must reconcile financial accounting income with taxable income on Sch M-1, Form 1120
  - Common reconciling items include:
    - Federal tax liability
    - Net capital losses
    - Income reported for tax but not book income (e.g., prepaid income) and vice versa
    - Expenses deducted for book income but not tax (e.g., excess charitable contributions) and vice versa
Schedule M-2

- Corporations must reconcile retained earnings at beginning of year with retained earnings at end of year using Sch M-2, Form 1120
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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Colorado State University-Pueblo