Choice

Of

Entity

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Meet George

George is a new client. He comes to your office one sunny Saturday morning. You are happy to have a new client and excited to face the challenges that new client's often bring.

George is timely for his appointment. You offer him a cup of coffee, he takes both cream and sugar, and you sit down to just chat in order to learn more about this new client.

George tells you that:

- **He is self-employed as a plumber.**
- **He is married.**
- **His wife is a school teacher and has family insurance coverage.**
- **He and his wife have three children, ages 5, 14 and 17.**
- **George and his wife, Nancy, rent but hope to buy a home in the next few years.**
- **They do not have credit card debt but he does have a truck he uses for business and there is a note on it. He even has a sign on the truck – George's Plumbing Company – The Best Place to Take a Leak!**
- **His plumbing business was started a few years ago and seems to be coming along nicely. Reviewing his prior year tax return you see he grossed $55,000 and netted, after expenses, $33,000. He has several possibilities in the years ahead and thinks his business will really take off.**
- **There is a possibility that his wife will quit her job and just do some substitute teaching which pays well but does not provide health insurance or other benefits.**
- **He is concerned that with two of his children in high school and nearing the age for college that he is not able to afford to pay for their higher education costs.**

You learn from George that:

- **George is a pretty uncomplicated guy and he likes it that way.**
- **George uses hand written invoices and writes them in a book to keep track of income.**
- **George brings his receipts in a shoe box consisting of his expenses for the year and the return preparer has always added them up for him. He does not keep a mileage log but does document on the invoice he writes how far he travels for the job from his home office where he makes the appointments and keeps his inventory of plumbing products.**
- **George is thinking about hiring someone to perform office duties, answer the phone, make appointments, keep his books and order parts and supplies.**

- **George's brother, Boris, who has just immigrated to the United States from the Soviet Union and is not yet a U.S. citizen, wants to go into business with George.**
- **George is also concerned about his own retirement as he is sure social security will not be quite enough to take care of him in his golden years.**

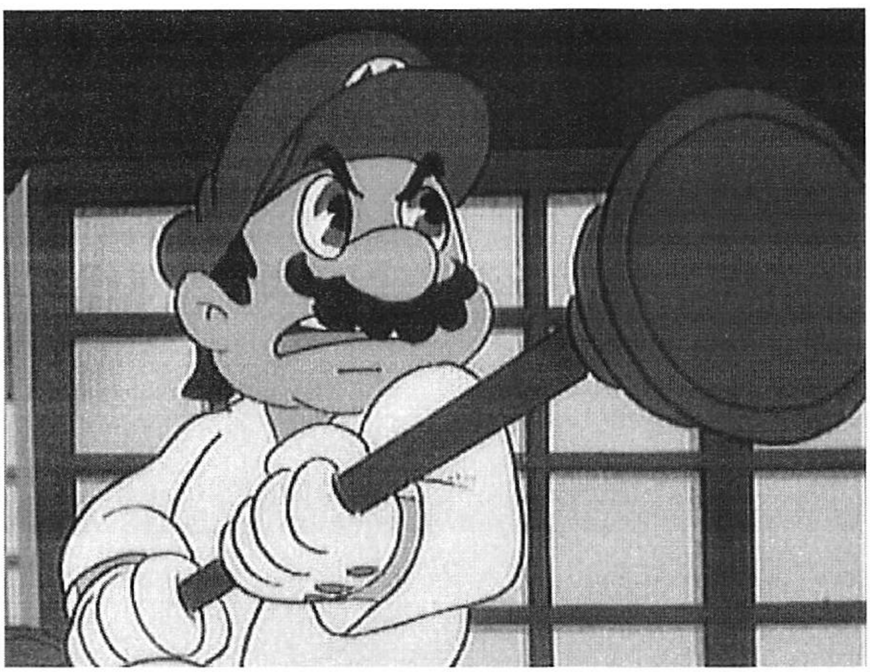
George is currently taxed as a sole proprietor, filing a Schedule C in his tax return.

You tell George you want to consider his situation and follow up with another meeting to discuss recommendations that you think will assist him as he builds his business.

You make another appointment with George for next Saturday.

You also tell George that you have a leak under your kitchen sink and ask could he come by and repair it next Monday.

You soon learn that George's hourly fee is larger than the one you charge.



Let's examine what benefits George currently has as a Sole Proprietor and how he might maximize the benefits of this least complex form of business entity.

Part I. – The Sole Proprietor

I. The Sole Proprietor

The majority of all small business start out as sole proprietorships. These firms are owned by one person, usually the individual who has day-to-day responsibility for running the business. Sole proprietors own all the assets of the business and the profits generated by it. They also assume complete responsibility for any of its liabilities or debt. In the view of the law and the public, you are one in the same with the business. The owner needs to secure the necessary licenses, tax identification numbers, and certifications in his or her name, and they are now in business.

A. As a sole proprietor, there are a number of tax deductible fringe benefits that can reduce income and self-employment taxes.

B. In the case of a married sole proprietor, especially one with children, these benefits can be substantial, with only a nominal amount of additional effort required.

<u>Practitioner's Alert:</u> Correct implementation and documentation are critical to making these benefits pass IRS scrutiny, so tax advice should be very specific prior to implementing.

C. Employee Benefits:

All employees need to be covered under any of the following benefits. Often these programs are not generally applicable if the business has other employees due to the cost.

1. Medical Insurance Plan

It is possible to make the payment of medical and dental insurance plan premiums for a sole proprietor's family deductible as a business expense, a pre-tax benefit.

The sole proprietor employs his/her spouse to provide services to the business and pays the spouse a salary based upon the services performed.

As an employee benefit, the business provides medical insurance, which could include dental and vision insurance, to all employees of the company and the coverage includes the family of the employee.

Since the sole proprietor is a family member of the spouse, the premiums of the sole proprietor then become a tax deductible expense to the business.

Practitioner's Alert: ***Health insurance is inclusive of long-term care insurance.***

2. **Medical expense Reimbursement Plan - §105(b)**

Health Reimbursement Accounts

It is possible to reimburse the spouse of a sole proprietor for all medical and dental expenses incurred by the spouse and the spouse's family, including the sole owner/owner, as a deductible expense to the business, a pre-tax benefit.

In addition to the medical insurance plan outlined, a sole proprietor can offer a medical expense reimbursement plan to the employee whereby the employer reimburses the employee for all medical, dental, and vision costs not covered by the medical insurance policy for the employee and the employee's family.

This creates a tax deductible expense to the business.

Practitioner's Alert: ***There needs to be some caution exercised in the limit on the amount of the reimbursement, so the combination of the salary and the medical reimbursement equates to a reasonable salary for the services rendered by the spouse. Reasonable Compensation is deemed to be both the actual salary paid and benefits received.***

3. **Dependent Care Assistance Expense Reimbursement Plan**

It is possible to reimburse the spouse of a sole proprietor for all childcare expenses paid as a deductible expense to the business, a pre-tax benefit.

A sole proprietor can offer a dependent care reimbursement plan to its employees, including a spouse.

The plan reimburses the employee for dependent care costs incurred for a child or for a parent, as allowed by the IRS guidelines.

The typical use of this program is for day care costs while the employee/spouse is working for the sole proprietor.

4. Retirement Plans

It is possible for a sole proprietor to establish a retirement plan and make tax deductible contributions to the plan for a spouse, a pre-tax benefit.

Under a SEP plan, a SIMPLE plan, or a Keogh plan, the sole proprietor can deduct the amounts contributed by the business to the retirement plan on behalf of the employee/spouse.

These amounts are limited based upon the wages paid to the spouse.

Under a SIMPLE plan, the spouse can also contribute on a pre-tax basis to increase the funds going into the retirement plan.

5. Life Insurance Policy of Up to $50,000

It is possible for a sole proprietor to pay the insurance premiums on a life insurance policy of up to $50,000 on a spouse as a deductible expense, a pre-tax benefit.

A sole proprietor can provide company paid life insurance of up to $50,000 on each employee, and the cost is tax deductible with no income to the employee for the premiums paid.

6. Employment of Your Child if Under 18 Years of Age

A sole proprietor can engage the service of his/her child under age 18, pay the child a tax-deductible wage, pay no employment taxes on the wages, and the child does not have to pay income taxes on the wages.

The wages need to be paid for work actually performed by the child for the business, payments need to be actually made to the child, wages must be reasonable in relationship to the services rendered, and records need to be maintained.

<u>Example</u>: The sole proprietor parent is in the 37% tax bracket and pays his/her child $6,000 for services rendered, saving $2,220 in federal income taxes. The child, in 2025, has a standard deduction of $6,450, (earned income + $450). Child may qualify for an IRA contribution up to $6.000. Child will pay no income tax and the sole proprietor may still be able to claim the child as a dependent.

Example: The child can participate in a SIMPLE retirement plan implemented by the employer. The child makes $15,000 per year and claims only the standard deduction of $15,000 in 2025. The child puts $15,000 into a SIMPLE retirement plan. The sole-proprietor/employer matches the SIMPLE contribution at a rate of 3% for $450 ($15,000 X 3%). The sole proprietor may still be able to claim the child as a dependent and still save federal income tax and self-employment tax on $15,450.

The child has $15,450 in its SIMPLE. In only five years, with contributions of the same amount, the SIMPLE has a corpus of $77,250 plus earnings. The child is ready to go to college, rolls the SIMPLE into a traditional IRA and begins to make withdrawals with no penalty for early withdrawal because the funds are used for higher education. Any taxable income will be taxed at the child's rate.

Other strategies may implement traditional IRA's and/or Roth IRA's.

There should be no problem with the "kiddie tax" as there is with investment income being taxed at the parent's higher rate.

7. Reimburse the Spouse for Auto Expenses

A sole proprietor can reimburse an employee/spouse or employee/child for mileage driven on company business at the current rate of 70 cents a mile.

The sole proprietor can deduct the payment as a business expense.

The employee does not report any income.

Practitioner's Alert:* *This is known as an "accountable plan" and the employee must keep mileage records in order to be reimbursed without a tax implication.

8. Qualified transportation fringes provided by an employer to an employee, excluded from the employee's income, up to the monthly dollar limit include:

Summary insert

II. The Sole Proprietor – Advantages

A sole proprietorship has the following advantages:

- **Easiest and least expensive form of ownership to organize.**
- **Sole proprietors are in complete control, and within the parameters of the law, may make decisions as they see fit.**
- **Sole proprietors receive all the income generated by the business to keep or reinvest.**
- **Profits from the business flow through directly to the owner's personal tax return.**
- **The business is easy to dissolve, if desired.**

III. The Sole Proprietor – Disadvantages

- **Sole proprietors have unlimited liability and are legally responsible for all debt.**
- **May be at a disadvantage in raising funds and are often limited to using funds from personal savings or consumer loans.**
- **May have a hard time attracting high-caliber employees, or those that are motivated by the opportunity to own a part of the business.**
- **Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income, only partially deductible as an adjustment to income.**
- **May be Schedule A Medical Deduction, subject to exclusion, if insurance cost exceeds income from business.**

IV. The Selling of a Sole Proprietorship

Selling a sole proprietorship is more difficult than selling a corporation. The prevalent characteristic of a sole proprietorship is that the owner is inseparable from the business. Because they are the same entity, the owner of a sole proprietorship has complete control over the business, its operations, and is financially and legally responsible for all debts and legal actions against the business.

V. The Sole Proprietor and Taxes

Another aspect of the "same entity" is that taxes on a sole proprietorship are determined at the personal income tax rate of the owner. In other words, a sole proprietorship does not pay taxes separately from the owner.

<u>Practitioner's Alert:</u>* *If the sole proprietor dies, the business assets are treated as part of their estate.

A sole proprietor reports his or her business profit to tax authorities on a simple one or two page form called Schedule C. For many sole proprietorships, in fact, all the IRS requires is a crude listing of revenue and expenses. No balance sheet is required as is required by corporate tax return filings.

More required complex accounting, such as corporate tax returns; force the taxpayer to use full-blown accounting software such as QuickBooks.

Steps in Selling a Sole Proprietorship

The following steps should be taken in order to sell a sole proprietorship:

1. Determine the selling price.
    - Estimate the total value of the business based on forward earnings.
    - Retain the services of a qualified appraiser to determine the fair market value of the business, including the equipment and inventory.
2. Find a buyer.
    - Retain the services of a business broker to assist in finding a buyer.
    - Advertise the business in the local classified, online, or in related trade publications.
    - Prepare a marketing brochure for potential buyers highlighting the strengths and financials of the business.
3. Negotiate with potential buyers.
    - Hold meetings with potential buyers to negotiate terms.
    - Reinforce to potential buyers how the valuation of the business was determined.
    - Explain that a sole proprietorship is easily transferable.
4. Review offers.
    - Select the best option based on total price and lump-sum payments.
5. Create a sales agreement.
    - A qualified lawyer may assist in creating a sales agreement.
    - The agreement should include the sale price, what assets are being transferred, and the intent of the buyer in purchasing the business.
6. Transfer assets.
    - Upon completion of the sales agreement, the assets of the sole proprietorship may be transferred to the new owner.
    - The seller is still responsible for the business' debts and obligations.
    - The seller should contact their local secretary of state and inform them about the sale of the business.

Residual method

The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under section 743(b) of the Internal Revenue Code. Section 743(b) applies if a partnership has an election in effect under section 754 of the Internal Revenue Code.

A group of assets constitutes a trade or business if either of the following applies.

- Goodwill or going concern value could under any circumstances, attach to them.
- The use of the assets would constitute an active trade or business under section 355 of the Internal Revenue Code.

The residual method provides for the consideration to be reduced first by the cash and general deposit accounts (including checking and savings accounts but excluding certificates of deposits). The consideration remaining after this reduction must be allocated among the various business assets in a certain order. To find out more about how to make the allocation among assets in proportion, refer to Publication 544, Sales and Other Dispositions of Assets.

<u>Practitioner's Alert</u>: The sale of a business usually is not a sale of one asset. Instead, all the assets of the business are sold. Generally, when this occurs, each asset is treated as being sold separately for determining the treatment of gain or loss.

A business usually has many assets. When sold, these assets must be classified as capital assets, depreciable property used in the business, real property used in the business, or property held for sale to customers, such as inventory or stock in trade. The gain or loss on each asset is figured separately. The sale of capital assets results in capital gain or loss. The sale of real property or depreciable property used in the business and held longer than 1 year results in gain or loss from a section 1231 transaction. The sale of inventory results in ordinary income or loss.

What is Form 8594 and 4797?

Form 8594 is the Asset Acquisition Statement, which the buyer and seller must complete and submit to the IRS. Form 4797 is the Sales of Business Property form that helps you determine whether you have a gain or loss on the sale of the assets.

Residual Method. Under the residual method, the purchase price is first allocated to Class I assets (cash and cash equivalents). The remaining amount is then allocated in the following order:

a. Class II assets including certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency;

b. Class III assets include mark-to-market assets and certain debt instruments.

c. Class IV assets including stock in trade and inventory;

d. Class V assets, including all other assets other than Class I, II, III, IV and VII assets;

e. Class VI assets including Section 197 intangibles, except goodwill or going concern value (Section 197 intangibles include workforce in place, copyrights, and covenants not to compete); and

f. Class VII assets include goodwill and going concern value. Reg. § 1.1060-1(c) and Reg. § 1.338-6. – Capital Gain or Loss.

The buyer and seller may agree in writing to allocations of part or all of the considerations involved in the transaction and of the fair market value of any assets transferred.

This allocation generally is binding on both parties, unless the IRS determines that the allocation is inappropriate. Code Sec. 1060(a)

<u>Practitioner's Alert:</u> Generally, the purchaser and the seller must both file Form 8594, Asset Acquisition Statement to report the sale of assets used in a trade or business when the purchaser's basis in the assets is determined wholly by the amount paid. The forms are attached to the tax returns for the year in which the sale took place.

Transfer ownership

Many small business owners will face a time when they need to transfer their ownership rights to another person or entity. You'll have a few different options available for doing so.

Option	Scenario	Benefit
Outright sale	**Ann owns a local clothing boutique that hasn't performed well. With several other businesses on her plate, she can no longer afford to continue running it. She needs a quick exit and quick cash.**	**By selling a business in full, you will transfer ownership immediately and receive payment right away.**
Gradual sale	**Tom owns a market near his home. After the birth of his granddaughter, he now spends most of his time at his daughter's home several hours away. After transferring business ownership, Bill no longer has to worry about running his business but is still receiving a monthly income.**	**This option often benefits individuals that can't afford an outright sale, but instead are able to finance a long-term payment plan. A gradual sale is a flexible option for transferring a business.**
Lease	**Mary has decided to take a year-long**	**By transferring your business**

Option	Scenario	Benefit
agreement	cruise around the world. To take care of her day care center she's decided to transfer ownership to a friend through a lease.	ownership through a lease, you'll commit to a contract that details the conditions and payments you'll receive for the temporary rights to the business.

Other considerations

Transferring ownership of a family business may have legal impacts, such as estate and gift tax obligations imposed by the IRS. A transfer of property would also likely require taxation.

File for bankruptcy or liquidate

A forced exit has implications for your employees, assets and tax obligations.

During a bankruptcy case, you need to stay up to date with all filing requirements and taxes. Reference the IRS Bankruptcy Tax Guide online for information on debt cancellation, tax procedures, and considerations for different types of business structures.

Liquidating assets usually comes as a last-resort strategy after no buyers, merges, or successors appear on the horizon. This process of redistributing assets to creditors and shareholders still requires a sound plan of action.

Before terminating your lease, selling equipment, and disconnecting utilities, talk to your lawyer and accountant. They'll help you develop a plan to present to creditors, whose cooperation you need during this process.

Reference these steps in the asset liquidation process.

1. Prepare an inventory and determine assets for sale
2. Secure your merchandise
3. Set liquidation value of assets with a qualified appraiser
4. Use that value to estimate net sale proceeds and re-evaluate your decision
5. Choose sale type: negotiated, consignment, internet, sealed bid, or retail
6. Select the best time and location for your sale
7. Hire an auctioneer, dealer, broker, or other expert to conduct

8. Use a non-recourse bill of sale so buyer accepts the associated risk

The Small Business Administration's counseling tool connects small business owners with local guidance.

IV. The Sole Proprietor – Concerns

The sole proprietor has two major concerns.

A. Self-employment tax.

B. Unlimited liability.

What if George brings his brother Boris into the plumbing business?

Part II. – Partnerships

I. Subchapter K of the Internal Revenue Code, §§701-761 and the Treasury regulation pertaining thereto determine the taxation of partners and partnerships.

A. A Partnership itself is not a taxable entity; rather it passes through to the partners their respective shares of items of income and loss, which are then reported on their tax returns.

B. Subchapter K governs the ways in which this can be accomplished.

II. What constitutes a partnership?

A. A business partnership is a form of business in which more than one owner has financial stakes in the outcome of that business.

B. Taxation of business partnerships in the United States are regulated by U.S. Internal Revenue Code title 26 sections 701-709 in addition to other sections of that title.

C. There are a number of forms of partnerships provided for under state law, including:

General partnerships;
Limited partnerships;
Limited liability companies; and
Limited liability partnerships.

III. Forming a Partnership

A. The formation of a partnership rarely results in a gain or loss for the partners. This is because taxpayers contributing property to a partnership are viewed as merely changing the form of its ownership to a partnership interest, not as having disposed of it.

B. Significant provisions of the Code with respect to formation of a partnership are:

- Section 721: Nonrecognition. In general, this protects partners or the partnership from having to recognize any gain or loss upon exchange of property for a partnership interest.
- Section 722: Outside Basis. The basis of the partnership interest received by a partner is that taxpayer's basis in contributed property at the time of contribution, plus any cash contributed, less cash or basis of property received, plus any gain recognized. In general, the holding period of contributed property in a partner's hands carries over to the partnership interest received in return.
- Section 723: Inside Basis. The partnership's basis in contributed property is equal to that of the contributing partner and the partnership can add the contributing partner's holding period to its own.
- Precontribution Gain or Loss. Under §704(c)(1)(A) precontribution gain or loss associated with property must be allocated to the contributing partner.
- Contributions of Depreciable Property. §§1245 and 1250 protect a contributing partner against recapture of depreciation on contributed property. The partnership will be subject to recapture of depreciation at a later date in an amount equal to the depreciation taken by the contributing partner and any depreciation taken by the partnership. The partnership, in essence, steps into the shoes of the contributing partner on property for depreciation purposes.
- Section 752: Liabilities. Each partner is given credit in his outside basis for his share of the partnership liabilities. As a general rule, non-recourse indebtedness is allocated among the partners in the same fashion as profits. This is based on the theory that repayment of the non-recourse partner is relieved of a portion of his obligation. Depending upon circumstances this deemed distribution might be considered taxable income to the contributing partner.
- Partnership Tax Years. The partnership must choose a tax year. Under §706, in most cases, the partnership will have a tax year ending on the same date a majority, partners representing over

50% of profits and capital) of partners' tax years end. Alternate rules exist which may be applied in certain circumstances.

IV. Partnership Allocations

A. Under §704(a) the general rule of thumb is that all income, gains, losses, deductions, or credits are allocated to partners based upon the partnership agreement. However, the partnership agreement is not permitted to make allocations totally unfettered by Subchapter K.

B. In general, under §704(a) "special allocations" will be respected.

C. In order to be respected, under §704(b) the partnership have to show that the reallocations of income and loss among themselves has "substantial economic effect", SEE. In other words, the partners may choose to allocate taxable income and loss among themselves in a way which is economically advantageous to themselves, given their differing tax positions, however the partners need to be able to show that the reallocations they made have SEE independent of any tax savings that may be realized.

Practitioner's Alert: ***The evolution of the concept of SEE was based on Congress's stated intention that while special allocations should not be made for tax avoidance or evasion, they would be respected if they have SEE and are not merely a way of reducing certain partners' income tax liabilities without affecting their shares of partnership income. Although technically SEE is not required to prove no intent to avoid paying taxes, it provided the courts with a practical benchmark against which to judge the issue of whether or not tax avoidance was the motivating factor in special allocations within a partnership.***

D. Recent guidance by IRS allows the allocation of income to the departing partner up to the date of separation or dissolving of the partnership interest.

IV. Benefits of Partnerships

A. If a partnership employes the spouse of a partner or manager, such as is done by a sole proprietorship, then the entity can utilize the tax-deductible benefits for:

- Medical Insurance Plan;
- Medical Expense Reimbursement Plans;
- Dependent Care Assistance Expense Reimbursement Plan;
- Retirement Plans, and
- Life Insurance Policy of up to $50,000.

<u>Practitioner's Alert</u>: Distributions of partnership interest can be tax free to partners if cash paid is not in excess of basis.

Partnership – No gain or loss is recognized by a partnership on a distribution of property to a partner, including money, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Code Sec. 731(b)(1)

1. Loss is not recognized by the partner, except upon a distribution in liquidation of a partner's interest in a partnership.

2. If no property other than money and certain securities is distributed to such partner, loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of any money distributed and the basis to the partner of any unrealized receivables and inventory. Code Sec. 751(c) and 751(d)

3. If a distribution of money exceeds a partner's basis for his interest, gain is recognized by the partner as though he had sold or exchanged his partnership interest. Code Sec. 731(a)

4. This applies both to current distributions (that is, those not in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Reg. §1.731-1(a)

<u>Example:</u>

Jean purchases a partnership interest for $100,000. During the first year, Jean receives a cash distribution of $100,000 and a distribution of property with a fair market value of $30,000. She recognizes no gain on the distributions since the amount of money distributed does not exceed Jean's basis for her partnership interest ($100,000.)

If she had received a cash distribution of $130,000, a $30,000 gain would have been recognized.

<u>Practitioner's Alert:</u> Where gain is determined by reference to money and marketable securities, the securities are valued at their fair market value on the date of the distribution.

Distributions of property encumbered by a liability may cause a partner's share of partnership liabilities to decrease, resulting in a "deemed distribution" of money to that partner.

5. Loss is recognized only if the distribution terminates the partner's interest and then only if the distribution is limited to money, unrealized receivables, or inventory items.

6. The amount of the recognized loss is the excess of the adjusted basis of the partner's interest over the sum of any money distributed and the basis to him, which is ordinarily the same as the basis to the partnership of any unrealized receivables or inventory items. Code Sec. 731(a)(2)

Example:

Jean, whose basis for her partnership interest is $100,000 retires from the partnership, receiving $50,000 in cash and inventory items having a basis to the partnership of $30,000. Jean has a capital loss of $20,000.

7. The basis of property received in a distribution, other than in liquidation of a partner's interest, is ordinarily the same as the basis in the hands of the partnership immediately prior to distribution.

8. In no case may the basis of property in the hands of the distributee exceed the basis of his partnership interest reduced by the amount of money distributed to him in the same transaction. Code Sec. 732(a)

Example:

Jean has a basis of $100,000 for her partnership interest. She receives a non-liquidating distribution of $40,000 in cash and property with a basis to the partnership of $80,000. The basis to Jean of the distributed property is $60,000 ($100,000 minus $40,000).

9. The partnership can recover the $20,000, in the example, by making an election under Code Secs. 734, 754, and 755, adjusting the basis of the remaining assets of the partnership.

B. These benefits can be provided tax-free to the partners on the same basis as other employees:

- Qualified educational assistance program, IRC Sec. 127. Limited for more-than-5% owner or shareholder to 5% of benefits.
- Qualified dependent care assistance program, IRC Sec. 129. Limited to more-than 5% owner to 25% of the benefits.
- No-additional-cost services, IRC Sec. 132(b) and Reg. 1.132-1(b)(1).

- Qualified employee discounts, IRC Sec. 132(c) and Reg. 1.132-1(b)(1).
- Working condition fringe benefits, IRC Sec. 132(d) and Reg. 1.132-1(b)(2)(ii). These include the business-use portion of a company-provided vehicle, business-use portion of company-paid country club dues, even though nondeductible by the company, company-paid job-related education expenses, and job placement assistance.
- *De minimis* fringe benefits, IRC Sec. 132(e) and Reg. 1.132-1(b)(4).
- On-premises athletic facilities, IRC Sec. 132(j) and Reg. 1.132-1(b)(3). The facility must not primarily benefit officers, owners, or highly-compensated employees.
- Qualified retirement planning services, IRC Sec. 132(m). The services must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.

V. Compensation to Partners

A. Partners in a partnership who receive "guaranteed payments" are subject to self-employment tax on the guaranteed payment.

B. Medical insurance paid by the partnership on behalf of the partner is also considered a guaranteed payment and fully subject to self-employment tax.

C. If the partnership agreement allows for bifurcation of a partnership interest the partner can have both an investor's share and a managerial share of ownership or interest.

Practitioner's Alert: ***The investor's share of partnership profits is not subject to self-employment tax.***

Practition9r's Alert 2: ***The general partners' distribution is subject to self-employment tax unless otherwise exempted.***

D. Proposed Regulations, Section 1402(a)(13) apply to LLC's and partnerships in general.

1. On January 13, 1997, the proposed regulations dealing with the IRC Section 1402(a)(13) term "limited partner" were issued. The new regulations now include partnerships and LLC's.

2. The new regs apply to all entities classified as partnerships for federal income tax purposes.

3. The proposed regulations allow individuals who participate in the partnership trade or business to bifurcate their distributive share of income from the partnership and treat the portion attributable to return on capital as not subject to self-employment tax.

E. Multi-Member LLC's taxed as Partnerships

1. A member's share of an LLC is subject to self-employment taxes if the member is a general partner of the LLC. A member's share of LLC income is not subject to self-employment taxes if the member is a limited partner except for guaranteed payments.

Practitioner's Alert: ***All guaranteed payments are fully subject to self-employment tax.***

2. Members of an LLC who actively engage in the business of the LLC are treated as general partners for self-employment tax purposes. Their distributive shares of trade or business income from the LLC are treated as net earnings from self-employment unless a bifurcation is allowed.

Practitioner's Alert: ***LLC Members who are passive investors and who are not managers of the LLC should not be subject to self-employment taxes on their distributive share of income. This should be stated in the operating agreement.***

3. Section 1.1402(a)(13) remains a proposed regulation and applies to individuals who are members of multi-member LLCs classified as partnerships.

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

   a. The member is classified as a limited partner.

   b. The member owns more than one class of membership interest.

   c. The member bifurcates his distributive share between earnings from self-employment and non-earnings from self-employment.

Practitioner's Alert: ***Self-employment taxes are not an issue if none of the members is an individual.***

Example:

Tom, Beanna and Marilyn each have their own LLC. Their LLCs own the members interest in Taxation with Representation, LLC. Only individuals pay self-employment tax. Would Tom, Beanna and Marilyn still be required to take a reasonable compensation from their LLC if they perform work for the LLC?

5. Limited partner classification under Proposed Regulation 1.1402(a)(13) and also Subsection 2(h)(i), (2),(3), and (4) of the general definition of a limited partner.

6. A member is not liable for self-employment taxes under the proposed regulations if the member is a limited partner. A member will always be treated under Section 1402(g)(13) as a limited partner if he or she meets all three of the following:

   a. The member has no personal liability for the debts of or claims against the LLC by reason of being a member.

   b. The member lacks authority to sign contracts on behalf of the LLC under the statute or law pursuant to which the LLC is organized.

   c. The member works for the LLC for 500 or fewer hours during the tax year.

7. **More than one class of interest.**

   a. A member who is not a limited partner may nevertheless exclude from self-employment earnings a portion of his distributive share if he owns more than one class of membership interest when the partnership's, LLC's, operating agreement provides for at least two classes of interests.

   b. The member may divide his or her share of LLC income between self-employment income and non self-employment income.

   c. The member will be treated as a limited partner, and will be exempt from self-employment taxes, with respect to one of the classes of membership interests if, immediately after acquiring the interest:

      - Members who are treated as limited partners own a substantial, continuing interest in the same class of membership interest.

Practitioner's Alert: ***Ownership of 20 percent or more of the class is substantial.***

- And the member's rights and obligations with respect to that class of membership interest are identical to the rights and obligations of the same class held by members who are limited partners.

Practitioner's Alert: ***When both are met, even persons who are active as partners will be treated as a Section 1402(a)(13) limited partner with respect to their distributive shares of partnership, LLC, income in respect to each investment class in which they own an interest.***

Practitioner's Alert: ***The multiple class exception can be applied to an LLC provided the LLC operating agreement is properly drafted to create specific classes of ownership interests.***

V. Sample Operating Agreement – For Discussion

Sample Operating Agreement

For Discussion Only

***Seek competent legal assistance when advising clients on drafting Operating Agreements for Limited Liability Companies, LLC's.**

Proposed Regulation 1.1402(a)(13) – John M. Cunningham's book – "Drafting Limited Liability Company Operating Agreements" Aspen Publishing (800-638-8437).

- **Two classes of interest. Operating agreement for the LLC shall have two classes of interest. One shall be called the Manager Class and the other the Investor Class. For purposes of allocating profits, losses and distributions under this Agreement, these interests shall be divided in units.**
- **Manager Class. Only individuals who have contract authority for the LLC shall be entitled to hold units of the Manager Class.**
- **Allocations of profits and losses to holders of units of a Manager Class. The LLC shall allocate the first $ ______ of its profits for each calendar year to holders of units of the Management Class in proportion to their holdings of these units.**
- **Issuance of one unit of Manager Class to ______ .**

Upon its formation the LLC shall issue one unit of the Manager Class to   in exchange for $.

- **Rights of members of Investor Class, including rights to allocations of profits and losses; restrictions on issuance of units of Investor Class. The rights of holders of units of the Investor Class shall be as follows:**

  General rule. Except as otherwise provided in the second point, holders of units of the Investor Class shall have the right of nonmanager members under this Agreement.

  Votes. Only holders of units of the Investor Class may vote on LLC matters. Holders of units of the Investor Class shall have one vote on each LLC matter for each such unit.

  Allocations of profits and losses. Except as provided in the third point, the LLC shall allocate all of its profits for each calendar year (or, if it incurs losses, all of it losses) to holders of units of the Investor Class in proportion to their holdings of these units.

  Restrictions on ownership of units of Investor Class. At least 20 percent of all outstanding units of the Investor Class shall at all times during the term of this Agreement be issued and outstanding to persons:

  1. **Who lack authority to sign contracts on behalf of the LLC;**
  2. **Who have no personal liability (except liabilities in the form of personal guarantees) for obligations of the LLC; and**
  3. **Who provide no more than 500 hours of service to or on behalf of the LLC in any calendar year.**

- **Issuance of units of Investor Class. Upon its formation, the LLC shall issue 80 units of the Investor Class to**
  In exchange for $ and 20 units of the Investor Class to   in exchange for $.

VI. Professional Services

A. A member who performs services for an LLC is not a limited partner if substantially all of the activities of the LLC involve the performance of services in the field of:

1. Health;

2. Law;

3. Engineering;

4. Architecture;

5. Accounting;

6, Actuarial science, or

7. Consulting

B. All of the income from those professional LLCs is subject to self-employment taxes.

<u>Example of what can be done:</u> ***Tom, Marilyn and Beanna form Taxation with Representation, LLC. They also form another LLC, You Rent from Us, LLC and they contribute all their office furniture, equipment and law libraries to You Rent from Us, LLC. Taxation with Representation, LLC rents the items from You Rent from Us, LLC receiving the deduction for the rental. You Rent from Us receives the income but because it is not a service LLC, Tom, Marilyn and Beanna will be able to utilize the newer regulations excluding all of their distributive shares from self-employment tax.***

<u>Practitioner's Alert</u>: §754 Election by the Partnership
At the death of a partner, the partnership may make a §754 election to "step up the basis" in the underlying assets of the partnership.

§754 is only allowed for the deceased interest in the partnership and is applicable to the heir(s) of the deceased partner.

Election can also be made by partnership if new partner purchases partnership interest to make inside capital and outside capital equal.

An IRC Section 754 election allows a partnership to adjust the basis of the property within a partnership under IRC Sections 734(b) and 743(b) when one of two triggering events occur: 1) a distribution of partnership property or 2) certain transfers of a partnership interest.

Unreimbursed Partnership Expenses – Partner

A. The following checklist will help determine if you have unreimbursed partnership expense:

Does the partnership have a written agreement stating expenses will be reimbursed, or a routine partnership practice that amounts to an agreement?

Does not cover situations where flow-through owner is picking up entity expenses directly. If yes, the expenses are treated as additional capital contributions and increase owner's overall basis.

Can you substantiate such expense?

S corporation owner/employees must use Form 2106 treatment- no above-the-line treatment as with unreimbursed partnership expense. *Note: No 2106 since 2017 TCJA.*
Deduction for certain interest on capital contributions or purchases of interests in flow-through entities, see IRS Notice 89-35 on Schedule E, page 2.

Must be claimed on Schedule E by using a separate line item on page 2 of Schedule E.

B. Tax Court in *The Cropland Chemical Corporation v. Commissioner*, T.C. 288 (1980) aff'd, 665 F.2d 1050 (7th Cir. 1981) agreed that an exception might apply when "a partnership agreement or a routine partnership practice tantamount to an agreement calls for a partner to pay partnership expenses from his or her own funds."

Partners Basis - Capital vs Outside Basis for Tax

A partnership is a relationship between two or more persons who join together to carry on a trade, business, or investment activity.

Each partner has a basis in his partnership interest.

The partner's basis in his partnership interest is separate from the partnership's basis in its assets.

Partnership tax law often refers to "outside" and "inside" basis.

Outside basis refers to a partner's interest in a partnership.

Inside basis refers to a partnership's basis in its assets.

The rules regarding the computation of outside basis apply to all types of partners including general partners, limited partners, and limited liability company (LLC) members. The rules apply to entities which are treated as partnerships for federal income tax purposes including general partnerships, limited partnerships, publicly traded partnerships, limited liability partnerships and limited liability companies (which have at least two owners and which do not elect to be treated as a corporation).

***<u>Practitioner's Alert</u>:* A partner may hold both a general and a limited partnership interest in the same partnership. In this case, the partner is considered to have only one unitary basis equal to the combined interests. Rev. Rul. 84-52.**

Computing a partner's outside basis is necessary when determining:

> The maximum amount of any deduction or loss that passes through to the partner,
>
> The gain or loss from the disposition of a partnership interest,
>
> The tax consequences of cash distributions, and
>
> The tax consequences of property distributions.

A partner's outside basis in his partnership interest can be estimated by adding his tax basis capital account, his share of liabilities, and his section 743(b) basis adjustments (if the partnership made a section 754 election).

An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis.

A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b).

Each partnership liability is part of at least one partner's outside basis.

While a partner's capital account may be negative (due to allocated losses and distributions), a partner's outside basis may never be a negative number.

A partner whose capital account is negative may still have a positive basis in his partnership interest because his share of partnership liabilities is greater than his negative capital account.

Specified Methods to calculate beginning Tax Basis Capital

1. Tax Basis Method

2. Modified outside basis method

3. Modified previously taxed capital method

4. Section 704(b) method

<u>Practitioner's Alert</u>: It is important to note that the capital account shown on the Partner's K-1 is not the same as basis. According to the Partner's Instructions for Schedule K-1, the basis schedule represents outside basis while the capital account represents inside basis. These can differ, even when the partnership maintains its books and records on a tax basis. One way this difference can occur is when a partner buys his partnership interest from another partner, since the purchase price becomes the starting point for his outside basis.

TAX BASIS METHOD

TBM is a transactional approach, applying partnership tax accounting principles:

The TBM **increases** a partner's capital by:

- Money contributed.
- The tax adjusted basis of property contributed.
- Partnership liabilities assumed by the partner.
- The distributive share of income, gain, and tax-exempt income.
- The partner's share Section 734 adjustments.

The TBM **decreases** a partner's capital by:

- Distributions of money.

- The adjusted tax basis of property distributed.
- Partner liabilities assumed by the partnership.
- The distributive share of losses and deductions, depletion items (up to the property basis).
- The distributive share of the adjusted tax basis of charitable property contributions.
- The partner's share Section 734 adjustments.

Practitioner's CAUTION: ***Absent the knowledge of basis, there is none.***

Sale of a partnership interest by a partner is "outside" the partnership and only an issue of the partner.

Sale of partnership assets are a pass-through item to the K-1's of partners.

Part III. – Corporations

I. Corporate Fringe and Welfare Benefits

A. The best choice of entity for implementing and utilizing fringe benefits for the benefit of the business owner is the C Corporation. The C Corporation usually gets a deduction for the fringe benefits, and the employee does not recognize taxable income.

Practitioner's Alert: ***The C Corporation, as an entity, is the "friendliest" to the shareholder.***

B. The S corporation is required to include as income, for more than 2% Owner/employees on their W-2 income, fringe benefits paid on their behalf. Qualified retirement plan contributions are exempt from this rule.

C. Self-employed individuals and partnerships can deduct the costs of various fringe benefits for their employees, ***but not for owner/partners.***

II. Benefit Opportunities to Shareholder/Employees of a C Corporation

A. The Internal Revenue Code offers a variety of benefits for shareholder/employees of C Corporations.

a. Section 74 – Employee achievement awards - $400 cap per employee.

b. Section 79 – Group-term life insurance.

c. Section 101 – Death benefits from life insurance.

d. Sections 104, 105, & 106 – Health and disability coverage and reimbursement programs.

e. Section 119 – Meals or lodging furnished for the convenience of the employer.

f. Section 120 – Qualified group legal services plan.

g. Section 125 – Cafeteria plans.

h. Section 127 – Educational assistance programs.

i. Section 129 – Dependent care assistance program.

j. Section 132 – Certain fringe benefits.

k. No-additional cost service, service must be offered for sale to customers.

    1. Qualified employee discounts – 20% limit for service.

    2. Working condition fringes – must be deductible by employee if paid by employee.

    3. *De minimis* fringes – too small to fool with.

    4. Qualified transportation fringes.

    5. Premises Athletic Facility – must be used by all employees.

i. Section 83 – Property received in performance of services.

j. Section 401 – Qualified pension, profit-sharing, and stock bonus plans.

k. Section 408 – Individual retirement accounts, IRA's.

l. Section 422 – Incentive stock option plans.

m. Section 423 – Employee stock purchase plans.

B. Fringe Benefits that Are Deductible to a Corporation, Tax-Free to the Employee

The following fringe benefits are deductible to a Corporation and tax-free to the employee:

a. Health insurance;

b. Disability insurance;

c. Free parking, limited to $180 per month;

d. Annual medical checkups;

e. Personal liability insurance;

f. $5,000 death benefit;

g. Free housing and meals on company premises including utilities - §119;

h. Small Christmas gifts – limited to $25 per year for an employee;

i. Subscriptions to business periodicals;

j. Payment of professional and business club dues;

k. Cost of business conventions;

l. De minimis fringes too small to account for; and

m. Uniforms and small tools.

***<u>Practitioner's Alert:</u>* The fringe benefits listed above CAN be provided on a "discriminatory basis."**

C. Fringes that Can NOT Be Provided on a Discriminatory Basis that Are Deductible to a Corporation and Tax-Free or Tax-Deferred to the Employee.

Fringe benefits that can not be provided on a discriminatory basis that are tax-deductible to a corporation and tax-free or tax-deferred to the employee are:

a. Recreational and health facilities;

b. Prepaid legal assistance;

c. Section 127 tuition reimbursement plans, even if not job-related;

d. Medical reimbursement plans; (IRC 105 Plans)

e. Child and dependent care up to $5,000 per year;

f. $50,000 of group-term insurance;

g. Discounts on company products and services;

h. No additional-cost service; and

i. Meals provided to employees at cost.

III. Corporate Tax Rates

The current corporate tax rate is 21%.

The 2022 Inflation Reduction Act imposes a corporate alternative minimum tax (AMT) based on financial statement income (book minimum tax or BMT). The BMT is effective for tax years beginning after December 31, 2022.

This provision imposes a 15% minimum tax on adjusted financial statement income (AFS) for corporations with average annual AFS Income over a three-year period in excess of $1 billion.

However, the BMT increases a taxpayer's tax only to the extent that the tentative minimum tax exceeds regular tax plus base erosion and anti-abuse tax (BEAT).

Practitioner's Alert: ***This legislation leaves a number of determinations to Treasury, both explicitly and implicitly. Potentially affected taxpayers should expect extensive regulations interpreting and supplementing these provisions.***

To evaluate the impact of the BMT on its overall tax liability, a taxpayer must determine:

1. Is the company an applicable corporation?
2. What is the company's AFSI?
3. Will the company be required to pay AMT, is tentative minimum tax greater than regular tax plus BEAT?

Watch for controlled groups.

Some exceptions apply.

<u>Practitioners Alert</u>: Running your business as a C Corporation can result in double taxation, meaning your business income gets taxed once at the corporate level and again when liquidated or where dividends are distributed. Corporations do not participate in Capital Gains rates.

IV. Shareholder Compensation

In the C corporation world shareholders who work in and for the corporation are required to take reasonable compensation.

<u>Practitioner's Alert:</u> The Internal Revenue Service has the authority to determine the "reasonableness" of compensation. In the C corporation the compensation is often found to be excessive.

Dividends are taxed currently as qualified dividends unless prohibited by law.

V. Distributions

A. The federal income tax treatment of a corporate distribution to an individual shareholder with respect to his or her stock ownership generally depends on the amount of the corporation's earnings and profits.

B. Distributions up to the amount of the corporation's earnings and profits will generally count as qualified dividends eligible for the current 15% maximum rate.

C. Distributions in excess of earnings and profits reduce the shareholders stock basis; such distributions are tax-free.

D. Distributions in excess of stock basis are treated as capital gains, and will generally qualify for the new rates on long-term capital gains. §301(c), 312 and 316(a).

VI. Sale of the Corporation

A. If the corporation stock is sold the gain on the sale is generally capital gain and receives capital gains treatment.

B. If the assets are sold or if the resulting sale is of goodwill or intangibles, ordinary income may be produced.

C. Distributions of income to shareholders, dividends, are then taxed to shareholders, the second layer of taxation.

***<u>Practitioner's Alert:</u>* Taxation of the sale of corporate assets is often deemed to be double taxation. The assets are sold creating income for the corporation and when the proceeds are distributed to the shareholder the income is taxed at the shareholder level.**

VII. Sale of Stock

A. If shareholder sells all or part of the stock they own in the corporation, the sale is outside the corporation and is reported on their individual tax return as a long-term or short-term gain or loss. Related party rules apply.

B. Seldom is this available for stock in a closely held company unless to a related party.

VIII. Tax Year of Loss

C Corporations do not pass through their losses to the shareholder and tax years reporting net tax losses are held until years of income to offset taxable income.

Part IV. – The S Corporation

The S Corporation

I. S Corporations can take advantage of pass-through taxation, meaning Generally there are no corporate-level federal income taxes to worry about.

Instead, all the company's income, deductions and tax credit items are "passed through" to the shareholders, which they then report on their Form 1040 and pay the taxes.

II. S Corporations Have Strict Qualification Rules

The rules include:

- Only citizens or residents of the US can be shareholders;
- The corporation can only have one class of stock;
- The corporation may have as shareholders only individuals, estates or certain trusts. Partnerships and corporations can not be shareholders.
- There must not be more than 100 shareholders.

b. Major Benefit to S Corporation Shareholders

The major benefit to S Corporation shareholders is the ability for S Corporation shareholder/employees to be paid a "reasonable compensation" for their effort and to receive a distributable share of S corporation income which is subject to federal income tax but void of self-employment tax.

Reasonable compensation is based on numerous factors including but not limited to:

- The employee's qualifications and role in the company, including factors such as hours worked, the employee's position, duties performed, and his overall contributions to the company;
- The character and condition of the company, including factors such as the size of the company, the complexity of its business and the general economic conditions;
- A comparison of the employee's compensation with the compensation paid by similar companies for comparable services;
- Ability and achievements of the employee (would an outside investor have paid the compensation amount based on performance);
- Volume of business handled by the employee;
- Complexities of the business;
- Relationship of compensation to gross and net income of the business;
- Living conditions in locality; and
- The salary policy of the company for all its employees and the particular employee's salary history with the company.

Listed in no particular order of importance and no one factor will determine a particular salary. However, a single factor could be persuasive.

Practitioner's Alert: ***IRS has the ability to reclassify distributions as wages if wages are deemed to be "unreasonable."***

c. 2 Percent Shareholders

Shareholders who own two percent or more of the S Corporation have limited benefits

1. Medical Insurance – Medical insurance paid by the S corporation on behalf of a 2 percent or more shareholder is deemed to be additional compensation reported in box 1 of the W-2. It is not subject to FICA or Medicare.

2. The medical insurance is reported in the W-2 wages on the shareholders Form 1040 and is deducted as an adjustment to income on the front of the return as if the shareholder were self-employed.

<u>Practitioner's Alert:</u> This is a change from the procedure for partners in partnerships who must include the medical insurance premiums in their guaranteed payment fully subject to self-employment tax.

C These benefits can be provided tax-free to the more-than-2% S corporation shareholders on the same basis as other employees:

- Qualified educational assistance program, IRC Sec. 127. Limited for more-than-5% owner or shareholder to 5% of benefits.
- Qualified dependent care assistance program, IRC Sec. 129. Limited to more-than-5% owner to 25% of benefits.
- No-additional-cost services, IRC Sec. 132(b) and Reg. 1.132-1(b)(1).
- Qualified employee discounts, IRC Sec. 132© and Reg. 1.132-1(b)(1).
- Working condition fringe benefits, IRC Sec. 132(d) and Reg. 1.132-1(b)(2)(ii). These include the business-use portion of a company-provided vehicle, business-use portion of company-paid country club dues, even though nondeductible by the company, company-paid job-related education expenses, and job placement assistance.
- *De minimis* fringe benefits, IRC Sec. 132(e) and Reg. 1.132-1(b)(4).
- On-premises athletic facilities, IRC Sec. 132(j) and Reg. 1.132-1(b)(3). The facility must not primarily benefit officers, owners, or highly-compensated employees.
- Qualified retirement planning services, IRS Sec. 132(m). The services must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.

d. Basis Issues

Basis Limitations for K-1 Losses

The basis limitation is a limitation on the amount of losses and deductions that **a partner of a partnership or a shareholder of an S-Corporation can deduct.**

The basis limits are the first of three limitations that are applied to Schedule K-1 losses and deductions.

After the basis limits are applied, the At-risk limits (Form 6198) are applied.

If losses are allowed by the basis and at-risk limits, the passive limits (Form 8582) are applied, if applicable.

Sub Chapter S Shareholders

Per Schedule E (1040), shareholders of S-Corporations are required to attach a basis calculation to their tax return each year.

***Practitioner's Alert:* There is no form for the basis limitation, but a worksheet, and some instructions have been provided in the partner and shareholder instructions for Schedule K-1.**

Computing Stock Basis

In computing stock basis, the shareholder starts with their initial capital contribution to the S corporation or the initial cost of the stock they purchased (the same as a C corporation). That amount is then increased and/or decreased based on the pass-through amounts from the S corporation. An income item will increase stock basis while a loss, deduction, or distribution will decrease stock basis.

A shareholder's stock is **increased** by (using 2023 Form 1120S Schedule K-1 box items):

	Schedule K-1
1. Ordinary income	Box 1
2. Separately stated income items	Boxes 2 -- 10
3. Tax exempt income	Boxes 16A & 16B
4. Excess depletion	Box 15C

A shareholder's stock basis is **decreased**, but not below zero, by:

	Schedule K-1
1. Ordinary loss	Box 1
2. Separately stated loss items	Boxes 2 – 12S and 14P, 14Q
3. Nondeductible expenses	Box 16C
4. Non-dividend distributions	Box 16D
5. Depletion for oil and gas	Box 17R

<u>Practitioner's Alert:</u> Only non-dividend distributions reduce stock basis, dividend distributions do not. The corporation is responsible for telling the shareholder the amount of non-dividend and dividend distributions. Box 16D of Schedule K-1 reflects non-dividend distributions. Form 1099-DIV is used to report dividend distributions; dividends are not reported on the shareholder's Schedule K-1.

Most distributions from an S corporation are non-dividend distributions. Dividend distributions can occur in a company that was previously a C corporation or acquired C corporation attributes in a non-taxable transaction (i.e., merger, reorganization, QSub election, etc.).

The order in which stock basis is increased or decreased is important. Because both the taxability of a distribution and the deductibility of a loss are dependent on stock basis, there is an ordering rule in computing stock basis. Stock basis is adjusted annually, as of the last day of the S corporation year, in the following order:

1. Increased for income items and excess depletion;
2. Decreased for distributions;
3. Decreased for non-deductible, non-capital expenses and depletion; and
4. Decreased for items of loss and deduction.

When determining the taxability of a non-dividend distribution, the shareholder looks solely to his/her stock basis **(debt basis is not considered)**.

For loss and deduction items, which exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's basis in loans personally made to the S corporation. **Debt basis is computed similarly to stock basis but there are some differences.**

Practitioner's Alert: ***If a shareholder has S corporation loss and deduction items in excess of stock basis and those losses and deductions are claimed based on debt basis, the debt basis of the shareholder will be reduced by the claimed losses and deductions.***

If an S corporation repays reduced basis debt to the shareholder, part or all of the repayment is taxable to the shareholder.

Stock Basis Example

Bob, the sole shareholder of an S corporation, has $15,000 of stock basis on January 1, 2022. Bob received a 2022 K-1 reflecting the following:

Box 1	(20,000)	Ordinary business income (loss)
Box 9	4,000	Net section 1231 gain
Box 12 A	5,000	Cash contributions (60%)
Box 16 C	1,000	Non-deductible expenses
Box 16 D	12,000	Distributions

For this example, assume Bob does not have any debt basis.

Using the ordering rule, stock basis is first increased by items of income - so the initial stock basis of $15,000 is increased by the $4,000 net section 1231 gain. The stock basis before distributions is $19,000.

Second, reduce stock basis by distributions of $12,000. Since the shareholder has adequate stock basis before distributions, the distribution will reduce stock basis to $7,000 and the $12,000 distribution is non-taxable.

Third, stock basis is reduced by the $1,000 of non-deductible expenses. Stock basis before loss and deduction items is $6,000.

Bob has ($25,000) of loss and deduction items:

- ($20,000) ordinary loss
- $5,000 charitable contribution

Since loss and deduction items exceed stock basis, look to see if the shareholder had valid debt basis. Since there is no debt basis in our example, the loss and deduction items are pro-rated to determine the amount currently allowable:

- 20,000/25,000 * 6,000 = ($4,800) ordinary loss
- 5,000/25,000 * 6,000 = $1,200 charitable contribution

January 1, 2022 Stock Basis	15,000
Plus: Net section 1231 gain	4,000
Equals: Stock Basis before Distributions	19,000
Less: Non-dividend distributions	(12,000)
Equals: Stock Basis before nondeductible expenses	7,000
Less: Nondeductible expenses	(1,000)
Equals: Stock Basis before Loss and Deductions	6,000
Less: Ordinary business loss {20/25 * 6}	(4,800)
Less: Cash contributions {5/25 * 6)	(1,200)
Equals: December 31, 2022 Stock Basis	0

Therefore, although the corporation allocated Bob a ($20,000) ordinary loss, he should reflect on his 2022 Schedule E only ($4,800) due to the stock and debt basis limitations.

2022 Ordinary business loss	(20,000)
Allowable 2022 Ordinary business loss	(4,800)

Suspended Ordinary business loss	(15,200)

In addition, although Bob was allocated a cash contribution of $5,000, he would only be allowed to take $1,200 on his 2022 Schedule A, subject to the 1040 or 1040-SR contribution deduction limitations.

2022 Cash contribution	5,000
Allowable 2022 Cash contribution	1,200
Suspended Cash contribution	3,800

Practitioner's Alert: ***Under IRC §1366(d)(2), any loss suspended because of lack of stock and debt basis shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.***

For 2023 Bob's K-1 reflected the following:

Box 1	35,000	Ordinary business income (loss)
Box 12 A	1,000	Cash contributions (60%)
Box 16 C	5,000	Non-deductible expenses

Bob's basis in his stock at the beginning of the year is $0. Losses suspended in a previous year are treated as being incurred in the next tax year and can only be deducted when the basis is increased.

Stock basis is computed as follows:

January 1, 2023 Stock Basis	0
Plus: Ordinary Income	35,000

Equals: Stock Basis before Distributions	35,000
Less: Non-dividend distributions	0
Equals: Stock Basis before nondeductible expenses	35,000
Less: Nondeductible expenses	(5,000)
Equals: Stock Basis before Loss and Deductions	30,000
Less: Ordinary business loss – 2022 carryover	(15,200)
Less: Cash contributions – current year	(1,000)
Less: Cash contributions - 2022 Carryover	(3,800)
Equals: December 31, 2023 Stock Basis	10,000

Although the K-1 will only show the current year income items, the shareholder will be allowed to take the losses previously suspended due to the stock basis limitations. Suspended losses should not be combined with amounts but listed on a separate line on **the <u>Form 1040 or 1040-SR, Sch. E</u>** , Supplemental Income and Loss, or the appropriate schedule when possible.

Suspended ordinary loss carryover is not netted with the current year ordinary income when applying the stock basis ordering rules. See Treas. Reg. §1.1366-2(a)(3)(i).

If the stock basis before losses and deductions had only been $17,500 instead of $30,000, the following losses and deductions would have been allowed in 2023.

Equals: Stock Basis before Loss and Deductions	17,500

Less: Ordinary business loss - 2022 carryover {15,200/20,000 * 17,500}	(13,300)
Less: Cash contributions	
Current year {1,000}	
2022 carryover {3.800}	
Total {4,800/20,000 * 17,500}	(4,200)
Equals: December 31, 2023 Stock Basis	0

The carryover to 2024 would be:

2023 Ordinary business loss (based on 2022 carryover)	(15,200)
Allowable 2022 Ordinary business loss	(13,300)
Suspended Ordinary business loss	(1,900)

2023 Cash contribution (based on current year and 2022 carryover)	4,800
Allowable 2023 Cash contribution	4,200

Suspended Cash contribution	600

The loss and deduction items in excess of stock and debt basis:

- retain their character,
- are treated as loss and deduction items incurred in the subsequent tax year and
- will be allowed if stock or debt basis is increased or restored, and
- carryover indefinitely or until all the shareholder's stock is disposed of.

<u>Practitioner's Alert:</u> Once a shareholder disposes of all of their stock, any suspended loss and deduction items are lost and cannot be deducted.

Important Things You Should Know:

- A non-dividend distribution in excess of stock basis is taxed as a capital gain on the shareholder's personal return. It is a long-term capital gain (LTCG) if the S corporation stock has been held for longer than one year.
- Non-deductible expenses reduce a shareholder's stock and/or debt basis before loss and deduction items. If non-deductible expenses exceed stock and/or debt basis, they are not suspended and carried forward.
- If the current year has different types of loss and deduction items, which exceed stock and/or debt basis, the allowable loss and deduction items must be allocated pro rata based on the amount of the particular loss and deduction items.
- A shareholder is not allowed to claim loss and deduction items in excess of stock and/or debt basis. Loss and deduction items not allowable in the current year are suspended due to basis limitations and are carried over to the subsequent year.
- Suspended losses and deductions due to basis limitations retain their character in subsequent years. Any suspended loss or deduction items in excess of stock and/or debt basis are carried forward indefinitely.
- In determining current year allowable losses, current year loss and deduction items are combined with the suspended loss and deduction items carried over from the prior year, though the current year and suspended items should be separately stated on the Form 1040 or 1040-SR Schedule E or other appropriate schedule on the return.
- A shareholder is only allowed debt basis to the extent he or she has personally lent money to the S corporation. A loan guarantee is not sufficient to allow the shareholder debt basis.
- If a shareholder contends, he or she has contributed or loaned substantial funds to the S corporation, consideration should be given to whether the shareholder had the financial means to make the contribution or loan.
- Part or all of the repayment of a reduced basis debt is taxable to the shareholder.
- If a shareholder sells their stock, suspended losses due to basis limitations are lost. Any gain on the sale of the stock does not increase the shareholder's stock basis.

Revoke S Election

To revoke a Subchapter S election/small business election that was made on Form 2553, submit a statement of revocation to the service center where you file your annual return.

The statement should state:

- The corporation revokes the election made under Section 1362(a)
- Name of the shareholder(s),
- Address of the shareholder(s),
- Taxpayer identification number of the shareholder(s),
- The number of shares of stock owned by the shareholder(s),
- The date (or dates) on which the stock was acquired
- The date on which the shareholder's taxable year ends
- The name of the S corporation
- The S corporation's EIN
- The election to which the shareholder(s) revokes
- The statement must be signed by the shareholder(s) under penalties of perjury
- Signature and consent of shareholder(s) who collectively own more than 50% of the number of issued and outstanding stock of the corporation, (whether voting or non-voting)
- Indication of the effective date of the revocation (or prospective date)
- Signature of person authorized to sign return

Due Date of Revocation:

- If revoking effective the first day of the tax year, the revocation is due by the 16th day of the third month of the tax year,
- If revoking effective any day other than the first day of the tax year, the revocation must be received by IRS by the requested effective date.
  - For example, the S corporation is on a December 31 tax year ending and requests a revocation effective January 1, the revocation is due March 15.
  - The S corporation is on a December 31 tax year ending and requests a revocation effective February 14, the revocation is due February 14.

Sale of S corp stock is outside the S corporation and only appears on the shareholder's tax return.

If the S corp sells assets, the gain or loss is distributed to the shareholders on the K-1.

If assets of the S corp are distributed to shareholders they are a deemed sale at FMV and a distribution to the specified shareholder.

K-2 & K-3 Reporting

Federal tax classifications have unique characteristics as well as reporting benefits and responsibilities.

Example: While shole proprietors, Partnerships and S corporations may qualify for the Qualified Business Income, QBI, C corporations do not.

Now, comes along a requirement for Partnerships and S corporations – K-2 & K-3 Reporting.

Historically, the K-2 and K-3 reporting requirements began in 2021.

The K-2 is reported in the Form 1065 and 1120S, while the K-3 is reported with the K-1 for the partner and the shareholder.

<u>Practitioner's Alert</u>: The K-2 and K-3 forms are not reporting complex foreign transactions in most situations.

Back to history – 2021 was the "wake-up year " for this new filing requirement. Such was the uproar from the tax professional community that IRS issued notice that an entity did not need to complete K-2 and K-3 if:

1. In 2021 the direct partners in the domestic partnership are not foreign partnerships, foreign corporations, foreign individuals, foreign estates or foreign trusts.
2. The domestic partnership or S corporation had no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated or may reasonably expect to generate foreign source income, Section 1.861-9(g)(3).
3. In the prior year, 2020, the domestic partnership or S corporation did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding the following:
    Line 16, Form 1065, Schedule K and K-1,
    Line 14 for Form 1120-S and
    Line 20c, Form 1065, Schedules K and K-1, Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, Section 250, Section 864(c) (8), Section 721(c) partnerships, and Section 7874, line 17d for Form 1120-S, and
4. The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.

<u>Practitioner's Alert</u>: If a partner or shareholder later requested a K-3 for 2021, then the respective entity was required to prepare the K-2 and K-3.

Most partnerships and S corporations qualified for this exception, but this was only for 2021.

Penalty Relief in 2021

In 2021, and only for 2021, the Internal Revenue Service provided penalty relief when a Partnership or S corporation should have filed a K-2/K-3 but did not.

This relief was not automatic and had certain requirements.

The IRS called 2021 a "transition period" and provided penalty relief if:

The filer established to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules k-2 and K-3 filing requirements per instructions

Without establishment that the filer made a good faith effort to comply with the new requirements the filer would not be eligible for penalty relief under the IRS notice.

<u>Practitioner's Alert</u>: The determination of a good faith effort takes into account the extent to which a Schedule K-2/K-3 filer had made changes to its systems, processes, and procedures for collection and processing information relevant to filing the required Schedules and to the extent the filer has obtained information from partners, shareholders, or the CFP, or applied reasonable assumptions when information is not obtained.

The IRS will also take into account the steps taken by the filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information.

<u>For 2022</u>
Partnerships are not required to File K-2 and K-3 if ALL 4 of these tests are met:

1. No, or limited, foreign activity

<u>Practitioner's Alert</u>: This "limited activity" may be found in Forms 1099 B and 1099 DIV in the ownership of the Partnership reflecting mutual fund activity by management firm in the United States.

Foreign activity includes foreign income taxes paid or accrued, foreign source income, ownership interest in a foreign partnership, ownership of a foreign branch, and ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner.

This test is met if not more than $300 of foreign income taxes allowable for foreign tax credit treated as paid or accrued by the entity.

2. Citizen, or resident alien as partners

<u>Practitioner's Alert</u>: Direct owners of the partnership must be:
U. S. citizens, or

Resident aliens, or
Domestic decedent's estates, or
Domestic grantor trusts and that have solely U. S. citizen and or resident alien individual grantors and solely U. S . citizen and or resident alien individual beneficiaries, or
Domestic non-grantor trusts with solely U. S. citizen and or resident alien individual beneficiaries, or
S corporations with a sole shareholder, or
Single-member LLCs, where the LLC's sole member is one of the persons listed above.

3. Partner notification

<u>Practitioner's Alert</u>: Partners must receive "a notification from the partnership at the latest date the partnership furnishes the Schedule K-1 to the partner. The notice can even be sent as an attachment to the Schedule K-1. The notification states the partner will NOT receive Schedule K-3 from the partnership unless the partner requests the schedule.

<u>Practitioner's Alert</u>: Partnerships should request a W-9 form all partners and a W-8 from non-citizen partners.

4. 1-Month Date to ask for K-3

<u>Practitioner's Alert</u>: The 1-Month Date is a 1 month before the date the partnership Form 1065 is due.

For 2022, calendar year partnerships on extension until September 15th must have the letter by August 15, 2023.

The regulation says 1 month before the return is actually filed so the return which is actually filed on August 31 would have a 1-month date of July 31

If a partnership receives a request after the 1-month date they must provide a K-3 to the requesting partner but do not need to attach a K-2 or any K-3 to the tax return filed with IRS, nor do they need to provide a K-3 to any partner other than the partner requesting it.

On Exception 4, if the partnership meets the first 3 exceptions but a partner requests a K-3 from the partnership, one must be issued to the partner requesting it.

A K-2 also needs to be completed with the Form 1065, but the information on the K-2 only needs to reflect the information of the partner who requested the K-3.

The Form 1116 Exception:

Even if a partnership fails to meet the four exceptions the Form 1116 may apply. This means the partnership does not have a direct or indirect partner that is eligible to claim a foreign tax credit or no direct or indirect partner would have to file a Form 1116 or Form 1118 for an Entity to claim the foreign tax credit.

The exception would include partners not claiming the Foreign Tax Credit or under the $300 or $600, if married filing jointly, limit to file the Form 1116.

***Practitioner's Alert:* The partnership needs to get verification from each partner as to their qualifications for the Form 1116 exception.**

If the partnership does not get verification, then it should determine exemption does not apply to that partner and provide a K-3 to the partner.

The partnership need only provide a K-3, and K-2 to the IRS for the partner, that do not meet the exemption.

***Practitioner's Alert 2:* If the preparer of the Form 1065 also prepares the tax returns of all partners, this is a realistic possibility however, if there are larger partnerships and the preparer does not preparer the tax returns for all partners, this could be problematic.**

For 2024
S Corporations

S Corporations are not required to File K-2 and K-3 if ALL 3 of these tests are met:

1. No, or limited, foreign activity
2. Shareholder notification
3. No K-3 requests by the 1-month date

***Practitioner's Lert:* Partnerships have 4 exceptions where S corporations only have 3. For Partnerships only U.S. citizens and resident alien partners are included in the exemption.**

Since S corporations cannot have non-resident aliens as owners, only resident aliens, so this exception is not applicable to S corporations.

Form 1116 Exception

If the S Corporation does not meet the 3 exceptions to filing, it may avoid the K-2/K-3 filing the same as with a partnership.

Again, works well if the preparer is preparing all the S corp Shareholders personal returns.

If multiple shareholders and preparer does not prepare all returns, this could be problematic.

Failure to File – Penalties

Penalties that may apply:

1. Failure to file a proper entity tax return – Form 1065 or 1120S.
2. Failure to provide information statements – K-3's

<u>Practitioner's Alert</u>: There are two code sections of the law that allow for the penalty to be assessed twice, Section 6721 for not filing with the Internal Revenue Service and Section 6722 for not providing the partner or shareholder with the information documents.

Failure to File Penalties

2025 - $245 penalty per month, per shareholder or partner, up to 12 months.

Penalties for Failure to Provide Information Returns – K-3

IRC 6038 imposes a $10,000 penalty for filing an incomplete return.

<u>Practitioner's Alert</u>: With the ease of software, bearing in mind that the software will perform only as well as the tax profession inputs the information, with the costs of penalties, perhaps we should just complete Schedules K-2 and K-3 as part of our normal filing of Form 1065 and Form 1120S returns.

<u>Practitioner's Alert 2</u>: Add required information to engagement letters, issue W-9's and W-8's to partners and shareholders.

<u>Practitioner's Alert 3</u>: Inquire with your E&O insurance provider to see what they recommend about K-2 and K-3 risk exposure.

<u>Practitioner's Alert 4</u>: Charge for your services.

Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865)

<u>1. What are the Schedules K-2 and K-3? (updated January 9, 2023)</u>

For tax year 2022, please see the 2022 instructions. ***Draft Instructions for 2023 available***

The 2021 Form 1065 Schedule K-2 reports items of international tax relevance and is an extension of the Form 1065, Schedule K. It replaces line 16a-r, portions of line 20, and numerous unformatted statements attached to prior versions of the Schedule K. In general, the Form 1065 Schedule K-3 reports a partner's distributive share of items of international tax relevance and is an extension of the Form 1065 Schedule K-1. It replaces line 16, portions of line 20, and numerous unformatted statements attached to prior versions of the Schedule K-1 Form 1065, Schedule K-1. In tax years beginning in 2021, flow-through entities with items of international tax relevance must complete the new schedules, as described in the instructions and the updates posted on January 18, 2022. International tax relevance is determined under each part of the new schedules. Similar revisions apply for the Forms 1120-S and 8865.

2. Why is the IRS creating Schedules K-2 and K-3 for Forms 1065, 1120S, and 8865? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

The new schedules K-2 and K-3 were created to provide consistency in the reporting to partners and shareholders. Prior versions of schedules K and K-1 did not require any specific format to provide international information, resulting in what could be a confusing array of statements attached to the schedules K and K-1. The new schedules K-2 and K-3 provide greater certainty and consistency, helping partners and shareholders to voluntarily comply with their filing and reporting obligations. The greater certainty also enables the IRS to verify that partnership and S corporation items are properly reported on partners' and shareholders' returns. This should reduce the burden on both taxpayers and the IRS by reducing unnecessary inquiries and examinations that may arise due to inconsistent reporting of partnership and S corporation items.

3. Why is the IRS creating Schedules K-2 and K-3 now? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

The new schedules accommodate the complex Tax Cuts and Jobs Act (TCJA) (international provisions enacted in 2017). TCJA required a significant increase in the amount and types of information needed to calculate the U.S. tax liability with respect to items of international tax relevance. The TCJA has largely been implemented in several forms, such as the Forms 1040 and 1120 and associated schedules. Having worked through those other changes, the IRS is now making similar changes to flow-through returns to ensure that investors, the ultimate taxpayers in the case of flow-through entities, have the information to accurately complete their returns. The IRS observed in the years following TCJA that items of international tax relevance were not always reported in a clear and standard format on Schedules K and K-1 attachments. Having clear and consistent forms and instructions will ultimately help partnerships and S corporations report in an efficient manner.

4. What are the benefits of the Schedules K-2 and K-3 for taxpayers? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

Having consistent and standardized forms and instructions will help partners and partnerships and shareholders and S corporations to comply with the various complex international tax rules in an efficient manner.

While partnerships and S corporations will initially have transition costs, ultimately, they will benefit from increased transparency of information, and reduced uncertainty about what to report and how to report it.

5. Do Schedules K-2 and K-3 require new information that wasn't previously required for partners or shareholders to accurately complete their own returns? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

Partnerships and S corporations may not have previously reported information in as much detail and for every fact pattern where reporting is required. The new schedules require more detailed and more complete reporting than partnerships and S corporations may have been providing previously to partners and shareholders, which is necessary for partners and shareholders to accurately complete their own returns.

6. What is the authority underlying Schedules K-2 and K-3? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

For the content of the schedules, the IRS relies on provisions of the Internal Revenue Code and regulations thereunder that define a partnership's and partners' obligations in determining their tax liability. For the authority to create and require these schedules, the IRS relies on Treasury Regulation section 1.6031(a)-1(a)(1) and (2), which generally provides that every domestic partnership must file a return of partnership income under section 6031 (partnership return) for each taxable year on the form prescribed for the partnership return. The partnership return must contain the information required by the prescribed form and the accompanying instructions.

11. Notwithstanding the exception as provided in FAQ 15, why would a domestic partnership or S corporation with no foreign activities and no foreign partners be required to complete schedules K-2 and K-3? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

In many instances, a partnership or S corporation with no foreign partners, foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. For example, if the partner or shareholder claims the foreign tax credit, the partner generally needs certain information from the partnership on Schedule K-3, Parts II and III, to complete Form 1116. This information should have been reported in prior years, including before the Tax Cuts and Jobs Act, on the Schedules K and K-1, and is information the partner or shareholder needs to compute the foreign tax credit limitation, which determines the amount of foreign tax credit available to the partner or shareholder.

This information was requested in the June 2021 instructions which stated, "this requirement [to complete Parts II and III] applies regardless of whether the partnership pays or accrues foreign taxes because other information, such as the source of the partnership's income and the value of its assets, are relevant in determining the partner's foreign tax credit."

Section 904 generally limits the foreign tax credit to the taxpayer's U.S. tax rate multiplied by its foreign source taxable income. Foreign source taxable income is foreign source gross income less allocable expenses. In general, the partnership or S corporation must complete the Schedules K-2 and K-3, Parts II and III because the source of certain gross income is determined by the partner or shareholder. In addition, some expenses of the partnership or S corporation are allocated and apportioned by the partner or shareholder. Because of this partner- or shareholder-level determination, it is not possible for the partner or shareholder to assume that all income of the partnership or S corporation is U.S. source and all expenses of the partnership or S corporation reduce U.S. source income. Also, the allocation and apportionment of certain partner- or shareholder-level expense take into account distributive shares of assets and income of the partnership and S corporation that are not otherwise reported on the Schedule K-1.

- For example, for sourcing purposes, personal property sold by the partnership is treated as sold by the partners. See section 865(i)(5). Generally, income from the sale of certain personal property (excludes inventory) is sourced according to the residence of the seller. In cases in which the partner is a pass-through entity, the partnership will not know the ultimate residence of the seller partner. The partnership's or S corporation's gain on the sale of personal property is not separately stated on Schedules K and K-1, but is reported on Schedules K-2 and K-3, Part II.

- As another example, the partner's research and experimental ("R&E") expense (which includes the distributive share of the partnership's R&E expense) is allocated and apportioned by the partner or shareholder. Section 1.861-17(f). R&E expense is allocated and apportioned based on the gross receipts by SIC code. R&E expense by SIC code is not reported on Schedules K and K-1, but is reported on Schedules K-2 and K-3, Part II. Also, the partner or shareholder needs Schedule K-3, Part III, Section 1 for the partner's or shareholder's share of the partnership's or S corporation's gross receipts by SIC code for purposes of allocating and apportioning R&E expense.
- In some cases, the partner or shareholder will be able to use the information reported on Parts II and III to increase the foreign tax credit limitation, and the amount of available foreign tax credit to the partner or shareholder. For example, Part II, Section 2 and Part III, Section 2 provides the partner or shareholder with the interest expense and tax book value of the assets of the partnership or S corporation, respectively. In general, a partner or shareholder apportions interest expense to reduce U.S. source gross income or foreign source gross income based on the tax book value of its assets, including its distributive share of the partnership's or S corporation's interest expense and assets. Sections 864(e)(2) and 1.861-9(e). Taking into account the assets of a domestic partnership or S corporation generating solely U.S. source income would result in more expense allocated to U.S. source gross income and less expense allocated to reduce foreign source gross income. Having more foreign source income increases the partner's or shareholder's foreign tax credit limitation, and the ability of the partner or shareholder to claim foreign tax credits. The regulations provide exceptions to certain rules for the asset method of apportionment for less-than-10% limited partners, and the instructions take this into account by excepting the partnership from completing certain portions of the Schedules K-2 and K-3 with respect to these partners. Schedules K and K-1 do not report the partnership's or S corporation's interest expense, or the tax book value of the assets as required by section 1.861-9(e). See the instructions to Schedules K-2 and K-3 for further guidance.
- If the domestic partnership with no foreign activity or foreign partners has direct or indirect domestic corporate partners, Part IV (Foreign-derived intangible income), and Part IX (base erosion anti-abuse tax). Further, if a domestic partnership has an indirect partner that is a foreign partner, Part X (effectively connected income), and Part XIII (section 864(c)(8)) may also need to be completed. See the instructions to Schedules K-2 and K-3 for further guidance.

12. Notwithstanding the exception as provided in FAQ 15, can you provide some examples highlighting the need for K-2 and K-3 reporting when the domestic partnership or S corporation has no foreign partners or foreign activities? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

- Example #1
    - U.S. citizen A and U.S. citizen B own equal interests in domestic partnership, which uses a calendar taxable year. In Year 1, domestic partnership has no foreign source income and no assets that generate foreign source income. Domestic partnership does not pay or accrue foreign taxes. In Year 1, A pays $2,000 of foreign income taxes on passive category income other than capital gains which was reported to A on a qualified payee statement. A does not pay or accrue any other foreign taxes and has no other foreign source income. B does not pay or accrue foreign income taxes. In Year 1, because B paid no foreign taxes for which it can claim a foreign tax credit, and such information was provided to domestic partnership by B, with respect to B, domestic partnership need not complete Schedule K-3.
    - Because A must complete Form 1116 to claim a foreign tax credit, domestic partnership must complete the relevant portions of Parts II and III of Schedules K-2 and K-3 (for A). The tax book value of domestic partnership's assets is $100,000 and A's share of those assets is $50,000. Not including its distributive share of the assets of domestic partnership, the tax book value of A's assets is $50,000. Of A's assets, $10,000 generate foreign source income and $40,000 generate U.S. source income. A has interest expense of $5,000 and domestic partnership does not have interest expense. A has passive category foreign source taxable income before interest expense of $8,000. A's U.S. effective tax rate is 25%.
    - A's interest expense is apportioned between U.S. source and foreign source income ratably based on the tax book value of A's U.S. source and foreign source assets. Without taking into account the distributive share of domestic partnership assets, the amount of A's interest expense that would reduce foreign source gross income is $1,000 ($5,000 x $10,000 / $50,000). Therefore, A's foreign source taxable income would be $7,000 ($8,000 - $1,000). At a 25% U.S. tax rate, A may only use $1,750 (25% x $7,000) of the $2,000 of foreign taxes in Year 1 pursuant to section 904(d).
    - Taking into account the distributive share of domestic partnership assets, the amount of A's interest expense that reduces foreign source gross income is $500 ($5,000 x $10,000 / $100,000). Therefore, A's foreign source taxable income would be $7,500 ($8,000 - $500). At a 25% U.S. tax rate, A may use $1,875 (25% x $7,500) of the $2,000 of foreign taxes in Year 1 -- an additional foreign tax credit amount of $125 after taking into account A's share of the tax book value of the partnership assets.
    - Similar rules apply with respect to S corporations.
- Example #2
    - U.S. citizen A and U.S. citizen B own equal interests in domestic partnership, which uses a calendar taxable year. In Year 1, domestic partnership has no foreign source income and no assets that generate foreign source income. Domestic partnership does not pay or accrue foreign taxes. In Year 1, A pays $2,000 of foreign income taxes on passive category income other than capital gains which was reported to A on a qualified payee statement. A does not pay or accrue any other foreign taxes and has no other

foreign source income. B does not pay or accrue foreign income taxes. In Year 1, because B paid no foreign taxes for which it can claim a foreign tax credit and such information was provided to domestic partnership by B, domestic partnership need not complete Schedule K-3 for B.

- Because A must complete Form 1116 to claim a foreign tax credit, domestic partnership must complete the relevant portions of Parts II and III of Schedules K-2 and K-3 (for A). Neither A nor domestic partnership have interest expense or R&E expense. Therefore, domestic partnership need not complete Part III. Domestic partnership does not have any gross income the source of which is determined by the partner. A has $5,000 of expenses described in section 1.861-8(e)(9) which must be ratably apportioned based on A's gross income (including its distributive share of the income of domestic partnership). See section 1.861-8(c)(3). Therefore, domestic partnership must complete Schedule K-2, Part II and Schedule K-3, Part II (for A). Both A and domestic partnership have no other expenses.
- A's share of domestic partnership's gross income (before expenses) is $50,000. Not including its distributive share of the income of domestic partnership, A's gross income (before expense) is $50,000. Of A's gross income, $5,000 is foreign source gross income and $45,000 is U.S. source gross income. A's U.S. effective tax rate is 25%.
- Before taking into account the distributive share of domestic partnership gross income, the amount of A's expenses described in section 1.861-8(e)(9) that reduce foreign source gross income is $500 ($5,000 x $5,000 / $50,000). Therefore, A's foreign source taxable income would be $4,500 ($5,000 - $500). At a 25% U.S. tax rate, A may only use $1,125 (25% x $4,500) of the $2,000 of foreign taxes in Year 1 pursuant to section 904(d).
- Taking into account the distributive share of domestic partnership gross income, the amount of A's expenses described in section 1.861-8(e)(9) that reduce foreign source gross income is $250 ($5,000 x $5,000 / $100,000). Therefore, A's foreign source taxable income would be $4,750 ($5,000 - $250). At a 25% U.S. tax rate, A may use $1,187.50 (25% x $4,750) of the $2,000 of foreign taxes in Year 1 -- an additional foreign tax credit amount of $62.50 after taking into account A's distributive share of the gross income of domestic partnership.
- Similar rules apply with respect to S corporations.
- Note. A partner or shareholder of an S corporation may need the distributive share of the partnership's gross income for purposes of allocating and apportioning expenses other than those described in section 1.861-8(e)(9).

22. When must a Forms 1065, 1120-S, or 8865 filer complete Section 1 of Part III, Schedules K-2 and K-3 (Forms 1065, 1120-S, and 8865), lines 15 and 16, Section 3 of Part IV, Schedules K-2 and K-3 (Forms 1065 and 8865), line 5, Section 3 of Part X, Schedules K-2 and K-3 (Form 1065)? (updated January 9, 2023)

For tax year 2022, please see the 2022 instructions.

A filer is not required to complete Section 1 of Part III, lines 15 and 16, Section 3 of Part IV, and line 5, Section 3 of Part X unless either (1) the partnership or S corporation incurs research & experimental expense or (2) the partner or shareholder is expected to license, sell, or transfer its intangible property to the partnership or S corporation (as provided in §1.861-17(f)(3)). This clarification will be added to the tax year 2022 instructions. However, filers may choose to follow this clarification for tax year 2021.

<u>Practitioner's Alert</u>: These K-2/K-3 FAQs can be found at IRS.gov.

Is there a 5th alternative?

Part V. – The Limited Liability Company

At the formation of a business, it is difficult to determine the business structure which will meet the needs of your client.

It is often difficult to incorporate your taxpayers when you are not quite sure they will be in business next week.

Is there a better way to assist your clients?

Offering business structure benefits with limited liability – the LLC may be the answer to the question your clients have been asking.

The Limited Liability Company – Illustration of flexibility.

Four Federal Tax Classifications are available to the LLC.

Limited Liability Company §721

Sole Proprietorship Form 1040 Schedules C, E or F	C Corporation Form 1120
Partnership Form 1065	S Corporation Form 1120S Form 2553

Defaults **Elections**

Part VI. Small Business

I. Small Business

A. The Office of Advocacy generally defines a small business as an independent business having fewer than 500 employees.

B. There are 31.7 million small businesses in the U.S.

C. 81 percent, or 25.7 million, have no employees; 19 percent or 6 million have paid employees.

D. There are 20,139 large businesses.

E. The number of non-employers has gradually increased from 15.4 million in1997 to 25.7 million in 2017.

F. From 1994-2018, an average of 67.6% of new employer establishments survived at least two years.

1. From 1994-2024, the five -year survival rate was 48.8%.;
2. The ten-year survival rate was 33.6%;
3. The fifteen-year survival rate was 25.7%.

G. In 2024, 1 million business establishments opened, and 898,000 establishments closed.

H. Approximately 13 percent of business establishments are startups and In 2017, startup employment averaged 4.4 employees per firm.

I. Average employment at firms of all ages in 2024 was 22.2 employees per firm.

Demographic	2024 Employers	Percent	2024 Non-employer
Total	5,744,643	100%	24,813,000
Female	1,134,549	19.7%	10,140,000
Minority	1,014,958	17.7%	7,643,000

Asian	555,638	9.7%		1,866,000
Veteran	351,237	6.1%	(2012)	2,079,000
Hispanic	322,076	5.6%		3,338,000
Black or African American	124,004	2.2%		2,806,000
Equally minority/nonminority	88,611	1.5%		73,000
American Indian /Alaska Native	24,503	0.4%		78,000
Native Hawaiian/Pacific Islander	6,847	0.1%		36,000

J. According to Census Bureau data, the share of self-employed Americans, including incorporated and unincorporated, age 30 or under increased slightly from 6.7% in 2019 to 7.4% in 2024. During the same time frame, the share of self-employed age 75 and over increased from 14.09% to 16.3%.

K. About one in three firms with employees, 31%, were family owned in 2024. Family-owned firms averaged 14 employees per firm, making them slightly larger than non-family-owned firms which employed 10 employees per firm.

L. The industries with the highest share of family-owned firms were Agricultural Services, 46%; Management of Companies and Enterprises, 46%, while Health Care and Social Assistance, 18%, was the lowest.

M. Approximately a quarter of employer firms, 24%, were home-based in 2024. By industry, almost half of construction firms, 47%, and business services, 45%, were home based.

N. The amount of Home-based employer firms decreases as the firm age increases.

<u>Example:</u> 32% for firms 2 years or younger vs. 17% for firms 16 and over.

O. About half of all businesses are home-based.

P. 86.6% of non-employers are sole proprietorships while only 17% of small employer firms are sole proprietorships.

Q. More than half of small employer firms are S-corporations.

Legal Form of Organization, 2024

Type of Business	Non-employer	Small Employer	Large Employer

Sole-Proprietorship	86.6%	12.9%	1.4%
Partnership	7.4%	11.8%	9.3%
S-corporation	4.6%	50.5%	8.1%
C-corporation & other	1.5%	24.8%	81.2%
Corporation		16.8%	74.2%
Government		0%	0.1%
Nonprofit		7.8%	6.2%
Other		.2%	.7%
Total	100%	100%	100%

II. Capital

A. The most common source of capital to start a business is personal and family savings, 64.4%.

B. Followed by a business loan from a bank or financial institution, 16.5%.

C. Personal credit cards, 9.1%, and personal family assets other than savings of the owner, 8.7% then follow.

III. Small Business Use of Professional Assistance

A. When you own a small business, the money matters never end. You have your accounts payable, accounts receivable, sales figures, annual statements, payroll, projections, cash flow and taxes, to name a few considerations. The hours can really add up, especially on the taxes.

B. Sometimes, when a business is just starting out, by financial necessity those tasks fall squarely on the owner's shoulders. It can be tempting to maintain that arrangement once the money starts to flow, not only to avoid paying someone else to do it but also to avoid allowing someone else to do it. Few entrepreneurs love giving up control.

C. When you're trying to handle every aspect of the business yourself, details can get overlooked, especially as your business grows and your finances get more complex.

D. Chances are, unless you own an accounting business, your business's financial picture will stretch the limits of your expertise quickly.

E. Accounting errors, especially tax-related accounting errors, can get expensive.

F. You could probably argue taxes alone justify the cost of handing over your finances. That cost may end up being less than the cost of doing the work yourself; remember, you are paying yourself for all those hours you spend recording, sorting, calculating, inputting, researching the latest changes in tax law, etc. Even if the accountant's hourly rate is higher than yours, it takes the accountant significantly less time to complete the work, and they do it more accurately.

***Practitioner's Alert:* Accounting is not just about taxes. It's also record-keeping, analyzing, financial planning and forecasting, and complying with state and federal regulations. To reap all the possible benefits of good accounting practices, a strong accounting system should be set up, keep it thoroughly up to date with all relevant data and effectively use that data to understand the financial state of your company as the business changes and grows.**

As your company grows, so will the complexity of the financial recording, analysis, compliance, and reporting required to keep it on track and in good standing, at which point accounting tasks will take a lot longer than a few hours a week.

An excellent tax professional/accountant can "see the forest for the trees" and bring issues to light in your business.

They may not make you money, but they can keep your hard-earned money from walking out the door.

Part VII. – Conclusion

I. What Type of Questions Do You Ask New and Old Business Owners?

A. Do you want investors as shareholders in your company?

B. Do you want to maintain control of the company if you have investors involved?

C. Do you anticipate losses in the early stages that can be taken as tax benefits by shareholders?

D. Do you want to avoid double taxation?

E. Is there a great risk of liability associated with your specific business?

***<u>Practitioner's Alert:</u>* You and your client should think through these questions carefully since their answer to each will help guide you to the right structure and steer you away from the wrong one.**

II. When You Start a New Business . . .

A. When you set up a new business, you must decide on a legal structure.

B. Understanding the advantages and disadvantages is critical.

C. Usually you will choose either a:

a. Sole proprietorship;

b. Partnership;

c. C Corporation; or

d. S Corporation.

D. You will want to take into account the following:

a. The client's vision regarding the size and nature of the business;

b. The level of control they wish to have;

c. The level of "structure" they are willing to deal with;

d. The business's vulnerability to lawsuits;

e. Tax implications of the different ownership structures;

f. Expected profit or loss of the business;

g. Whether or not they need to re-invest earnings into the business; and

h. Their need for access to cash out of the business for themselves.

***<u>Practitioner's Alert:</u>* Tax practitioners assisting their clients with choice of entity determination should always keep notes as a record of conversation with their taxpayers should the taxpayer later decide that the choice of entity was not correct.**

Prudence and practice indicate that the tax practitioner may need to remind the client of why they made decisions that affected the taxability of their business entity and their own individual taxation.

Resources that follow:
Choice of Entity Checklist
Choice of Entity Agreement

CHOICE OF ENTITY CHECKLIST

CONSIDERATIONS	1040	1065	LLCs	1120S	1120	PSCs
Legal Risk	HIGH	HIGH	LOW?	LOW	LOW	LOW
Compliance Burden	LOW	MEDIUM	MEDIUM	HIGH	HIGH	HIGH
Securities Law Concern	NONE	NONE/YES	MAYBE	MAYBE	MAYBE	MAYBE
Dividends Received Deduction	NO	NONE/YES	NO	NO	YES	YES
Deduct Passive Activity Losses	NO	NO	NO	NO	YES	YES
Itemized Deductions	NO	NO	NO	NO	YES	YES
Exotic C Corp Issues	NO	NO	NO	NO	YES	YES
Fiscal Year	NO	NO	NO	NO	YES	NO
Cash Basis	YES	YES	YES	YES	MAYBE	YES
Pass-Through	YES	YES	YES	YES	NO	NO
Special Allocations	NO	YES	YES	HARD	HARD	HARD
$75,000 Pocket	NO	NO	NO	NO	YES	NO
AMT Exposure	NO	NO	NO	NO	YES	NO
Double Tax on Liquidation	NO	NO	NO	NO	YES	NO
Separate State Taxes	NO	MAYBE	MAYBE	MAYBE	YES	YES
ESOPs	NO	NO	NO	YES	YES	MAYBE
Owner Fringe Benefits	NO	NO	NO	NO	YES	YES
Owner in Cafeteria Plan	NO	NO	NO	NO	YES	YES
Constructive Dividends	NO	NO	NO	NO	YES	YES
Basis Problem for Losses	NO	MAYBE	NO	MAYBE	NONE	NONE
Deduct Investigatory Expenses	NO	NO	NO	MAYBE	YES	YES
Control Social Security Taxes	NO	NO	NO	MAYBE	YES	YES
Estate Planning Ease	LOW	LOW	LOW	LOW	HIGH	MEDIUM
*May have BIG tax						

Choice of Entity Agreement

On this date   20XX,   (Client's name) ,
Representing (Name of Company) met with (Your Name) and (Firm) concerning the formation of a business.

The various Federal Tax Classifications were discussed and explained by (Your Name) and after due consideration (Client's Name) made the decision to :
Choose one:
Form as a Sole Proprietor,
Form as a Partnership,
Form as a Corporation,
Form as a Corporation and make the S Election. OR
Form a Limited Liability Company and default to be taxed as:
    A Sole Proprietor or
    Partnership
Form a Limited Liability Company and elect to be taxed as:
    A C Corporation or
    S Corporation

I, (Client's Name) agree and declare that the business of (Name of Business) will be taxed under the Federal Tax Classification of (what was chosen from above).

I further understand that business conditions or personal circumstances may necessitate the changing of federal tax classification and I agree to review and discuss any such changes with (your name and firm) should issues arise.

______________________________   ______________________
Name   Date

A similar agreement could be made should the client wish to change the federal tax classification in the future,

You attorney should be consulted regarding any agreements in your practice.