

CHAPTER 13

CHOICE OF BUSINESS ENTITY - PART I

2017 Edition	Topic	Status
Questions		
1	Nontax factors to consider in forming a business	Unchanged
2	Compare and contrast characteristics of various forms of business	Unchanged
3	Compare using a general partnerships with a limited partnership	Unchanged
4	When will a corporation not shield an owner from liability	Unchanged
5	Nontax difference between corporation and S corporation	Unchanged
6	Requirements to elect an S corporation	Unchanged
7	Discuss difference between limited liability company and corporation	Unchanged
8	Discuss difference between limited liability partnership and partnership	Unchanged
9	Compare the incidence of taxation for different entities	Unchanged
10	Tax differences between corporation and personal service corporation	Unchanged
11	How a distribution is taxed by different entities	Unchanged
12	Entities subject to double taxation	Unchanged
13	Importance of an owner being classified as an employee	Unchanged
14	Discuss the entities that recognize owners as employees	Unchanged
15	Tax treatment of guaranteed payments	Unchanged
16	Tax treatment of fringe benefits for different entities	Unchanged
17	Discuss whether all compensation paid to an employee is deductible	Unchanged
18	Explain the tax treatment of health insurance premiums under different forms of business	Unchanged
19	Rationale for not taxing transfers of property in exchange for an ownership interest	Unchanged
20	Tax treatment on exchange of ownership interest for services	Unchanged

2017 Edition	Topic	Status
21	Compare the requirements for a tax-free exchange of property for an ownership interest between a corporation and a partnership	Unchanged
22	Basis of ownership interest in exchange for property	Unchanged
23	Effect liabilities have on the basis of a partner's ownership interest	Unchanged
24	Explain the difference between recourse and nonrecourse debt	Unchanged
25	Rationale for allowing partners to add partnership debts to their basis	Unchanged
26	Tax effect of a corporation assuming the debt of a shareholder on exchange of property for an ownership interest	Unchanged
27	Explain why a shareholder might recognize gain on the exchange of property for an ownership interest but not a partner	Unchanged
28	Effect liabilities have on a shareholder's basis in an S Corporation	Unchanged
29	Explain what organizational costs are deductible	Unchanged
30	Difference between a calendar year and a fiscal year	Unchanged
31	Restrictions on selection of taxable year by a partnership and an S corporation	Unchanged
32	Discuss which entities cannot use the cash method	Unchanged
Problems 33-COMM	Explain the advantages and disadvantages of incorporating a business	Unchanged
34	Discuss the nontax factors to consider in forming a business	Unchanged
35	Determine the tax liability of an owner operating a business under different forms of business	Unchanged
36	Compare the tax liability of a corporation and a sole proprietorship if salary is paid (relates to #33)	Unchanged
37	Determine the tax liability of two owners operating a business under different forms of business	Unchanged
38-COMM	Determine the tax liability of two owners operating a business as a personal service corporation (relates to #37)	Unchanged
39	Determine the tax liability of a personal service corporation	Unchanged

2017 Edition	Topic	Status
40	Compare the tax liability of an S corporation and a corporation	Unchanged
41	Compare the tax liability of an S corporation and a corporation when dividends are paid (relates to #40)	Unchanged
42-COMM	Explain the effect of not distributing dividends has on double taxation	Unchanged
43	Determine the income two partners have from a partnership	Unchanged
44-COMM	Discuss how a majority partner can reduce their income from the partnership while maintaining control	Unchanged
45	Determine an owner-employee's taxable income and tax liability under different forms of business when receiving a salary	Unchanged
46	Determine the tax treatment of health and accident premiums to an owner-employee under different forms of business	Unchanged
47	Compare tax treatment of Social Security paid by owner-employee under different organizational forms of business	Unchanged
48-COMM	Compare tax treatment of employee benefits to an owner-shareholder of a corporation with an owner-shareholder of an S corporation	Unchanged
49	Compare tax treatment of meals provided to an employee, an owner-shareholder of a corporation with an owner-shareholder of an S corporation	Unchanged
50	The tax effect of transfers of property under different forms of business	Unchanged
51	Determine the owner and entity's basis in assets contributed in forming an entity (all types of entities are discussed)	Unchanged
52	Determine the owner and entity's basis in assets contributed in forming an entity (all types of entities are discussed)	Unchanged
53	Determine the owner and entity's basis in assets contributed for a 20% interest in the entity (all types of entities are discussed)	Unchanged
54	Determine the owner and entity's basis in assets contributed for a 20% interest in the entity (all types of entities are discussed) and the property is encumbered (relates to #53)	Unchanged
55	Determine the owner and entity's basis in assets contributed in forming an entity (all types of entities are discussed)	Unchanged

2017 Edition	Topic	Status
56-COMM	Deduction for organizational costs	Unchanged
57	Deduction for organizational costs	Unchanged
58	Explain the tax year the taxpayer must use (five scenarios)	Unchanged
59	Explain the tax year an S corporation must use (three scenarios)	Unchanged
60	Explain the method a accounting the taxpayer must use (four scenarios)	Unchanged
61-COMM	Explain the tax year and method if accounting under different forms of business	Unchanged
62-IID	Form of business	Unchanged
63-IID	Determining proper taxable income	Unchanged
64-IID	Tax treatment of corporation versus S corporation	Unchanged
65-IID	Tax associated with switching from corporation versus sole proprietorship	Unchanged
66-IID	Fringe benefits from S corporation	Unchanged
67-IID	Contribution of property to corporation tax-free	Unchanged
68-IID	Ability to recognize a loss on contribution of property to corporation	Unchanged
69-IID	Effect of debt on contribution of property to corporation	Unchanged
70	INTERNET	Unchanged
71	INTERNET	Unchanged
72	Research Problem	Unchanged
73	Research Problem	Unchanged
74-DC	Choosing the best form of organization	Unchanged
75-DC	Effect of debt on choice of entity (corporation versus S corporation)	Unchanged
76-TPC	Choice of entity	Unchanged
77-TPC	Use of guaranteed payments as a compensation tool in a partnership	Unchanged
78-EDC-COMM	S Corporation limit on the number of shareholders and an inadvertent termination - focuses on SSTs #1 and #8	Unchanged

CHAPTER 13

CHOICE OF BUSINESS ENTITY- GENERAL TAX AND NONTAX FACTORS/FORMATION

DISCUSSION QUESTIONS

1. What are the primary nontax factors to consider when choosing a form for doing business?

When choosing a form for doing business, the number of owners, ability to limit personal liability of the owners, the ease with which ownership can be transferred, the anticipated life of the business, the degree of management control desired, the cost of organizing the entity, and the ability to raise capital are the nontax factors that should be considered.

2. Compare and contrast the characteristics of sole proprietorships, partnerships, corporations, S corporations, limited liability companies, and limited liability partnerships.

A sole proprietorship is a one owner business, giving the owner complete managerial control. Because the sole proprietor and the business entity are not treated as separate entities by state law, a sole proprietor is liable for all debts of the business (unlimited liability). A sole proprietorship is easy (least costly) to form and ownership is easily transferable. However, a sole proprietorship often finds raising large amounts of capital difficult.

A corporation is a separate legal entity formed under state law. As such, a corporation can enter into contracts, purchase assets, and conduct business in its own name. The separation of the corporation from its owners allow corporations to have an unlimited life, free transferability of ownership interests, and centralized management structures. More importantly, the owners of a corporation have limited liability. The costs of organizing a business as a corporation can be extensive. However, corporations can raise additional capital easily by selling additional stock.

A partnership exists when two or more individuals engage collectively in an activity with the expectation of generating profits. Each partner is personally responsible for any partnership obligations that arise during the existence of the partnerships. Unlike a sole proprietorship, a partnership can transact business and own property in its name separate from the partners. General partners legally have equal ability to contribute to managing the partnership.

An S corporation has the basic legal characteristics of a corporation combined with conduit entity taxation. However, the number of owners is restricted to 100, only certain types of entities can be owners, the corporation can have only one class of stock, and all of the owners must consent to the S corporation election.

A limited liability company (LLC) combines limited liability with conduit tax treatment. It has many of the features of a corporation with a few significant exceptions. An LLC can create special income (loss) allocations (i.e., allocations based on factors other than ownership percentage) and controls who can be an owner (free transferability of interest does not exist). LLCs also have greater flexibility in determining management structures than a corporation.

A limited liability partnership (LLP) is a general partnership with limited liability for its partners. Partners in an LLP are not liable for general business contractual obligations, but remain liable for their own acts. This differentiates an LLP from an LLC where no single owner has unlimited liability. Because it is a partnership, an LLP generally must have more than one owner.

A summary of the characteristics of all the entity forms is provided in Table 13-1.

3. Discuss the comparative advantages and disadvantages of general partnerships and limited partnerships.

A general partnership is characterized as follows for tax purposes: a partner's liability is not limited; the life of the partnership depends on the life of the partner(s); all partners share in the partnership management; and partnership interests are not freely transferable. Lack of limited liability dictates that a partner's personal assets are not shielded from claims against the partnership. Another disadvantage is that a partner cannot transfer his or her interests without the consent of the other partners (opposite of the freedom owners of a corporation enjoy). The partnership may have to be dissolved if the partners do not agree on the transfer. However, an advantage is that a partner has some say in the decisions made by the partnership.

Certain types of partnerships can take on the corporate characteristic of limited liability in order to make capital acquisition easier. These limited partners have at least one partner whose liability is limited to the amount of his or her investment in the partnership (a measure of safety for the limited partner's personal assets). To obtain the limited liability attribute, limited partners give up any right to participate in the management of the business. Management is left to at least one general partner whose liability is not limited and who is responsible for the on-going activities of the business.

4. Limiting the liability of the owner(s) of a business is often the primary motive for using the corporate form. Under what circumstances may the use of a corporation not shield the owner(s) from all liabilities of the business?

Because bankers and other creditors want assurance that the money they loan to a corporation is secure, they often require owners of closely held corporations to personally guarantee loans made to the corporation. Therefore, owners of small corporations are often only shielded from product liability and malpractice type judgments brought against the business.

5. What are the nontax differences between a corporation and an S corporation?

An S corporation retains the legal characteristics of a corporation. However, the qualifications for an S corporation election restrict some of the corporate characteristics: The subchapter S election is available only to domestic corporations, the number of owners is restricted to 100 shareholders, only certain types of entities can be shareholders, the S corporation can have only one class of stock, and all shareholders must consent to the subchapter S election.

6. What are the requirements to qualify for the S corporation election?

To qualify for the S corporation election, a corporation 1) must be a domestic corporation, 2) can have no more than 100 shareholders, 3) can have only individuals, estates, tax-exempt organizations, and certain trusts as shareholders, 4) cannot have a nonresident alien as a shareholder, 5) must have only one class of stock outstanding, and 6) must have the consent of all shareholders to the election.

7. How is a limited liability company different from a corporation?

A limited liability company (LLC) shares most of the legal characteristics of a corporation, but is taxed as a conduit entity. However, an LLC is a more flexible ownership arrangement due to its ability to create special allocations of income to its owners (i.e., based on factors other than ownership percentage) and to control who owns an interest (free transferability of interest does not exist for an LLC). In addition, an LLC has greater flexibility in organizing its management structure.

8. How is a limited liability partnership different from a partnership?

The main difference is that the partners in a limited liability partnership (LLP) have limited liability for the debts of the LLP. However, this extends only to the general business liabilities of the LLP; partners remain liable for any personal acts. In a partnership, partners have unlimited liability for all debts of the partnership.

9. Compare the incidence of taxation for each of the following entities:

- a. Sole proprietorship

A sole proprietorship is not separate from its owner. The owner of the sole proprietorship is taxed on its income. A sole proprietor is not taxed on amounts withdrawn from the business.

- b. Partnership

A partnership is a conduit entity; it does not pay tax on its income. The income of the partnership flows through to the owners of the partnership and each partner is taxed on their share of the entity's income. Partners are not taxed on withdrawals from the partnership; withdrawals are nontaxable returns of capital.

- c. Corporation

A corporation is a separate taxable entity. A corporation pays tax on its taxable income. Shareholders are taxed on dividends received from the corporation.

- d. S corporation

An S corporation is a conduit entity; it does not pay tax on its income. The income of the S corporation flows through to the shareholders and each shareholder is taxed on their share of the entity's income. Shareholders are not taxed on dividends received from an S corporation; dividends are nontaxable returns of capital.

10. What are the tax differences between a corporation and a personal service corporation?

The main difference is that the benefit of the graduated corporate rate schedule is not available to a personal service corporation. The income from a personal service corporation is taxed at a flat rate of 35%.

11. Armand is an owner of Content Company. During the current year, he receives a \$15,000 cash distribution from Content. What is the tax effect of the receipt of the \$15,000 if Content is organized as

- a. A partnership

A partnership is a conduit entity. Partners are taxed on their share of the income of the partnership. Withdrawals from a partnership are nontaxable returns of capital. Armand is not taxed on the \$15,000.

- b. A limited liability company

A limited liability company (LLC) is a conduit entity. The owners of an LLC are taxed on their share of the company's income. Distributions received from an LLC are nontaxable returns of capital. Armand is not taxed on the \$15,000.

- c. A corporation

A corporation is a taxable entity and pays tax on its taxable income. Shareholders are taxed on dividends received from the corporation. Armand must include the \$15,000 in his gross income.

- d. An S corporation

An S corporation is a conduit entity. Shareholders are taxed on their share of the income of the S corporation. Distributions (dividends) received from an S corporation are nontaxable returns of capital. Armand is not taxed on the \$15,000.

12. Which entity(ies) is/are subject to double taxation?

The only entity subject to double taxation is a corporation. This occurs because a corporation is a separate taxable entity. Dividends paid to shareholders are not deductible by the corporation because they are considered to be distributions of earnings. As a distribution of earnings, the dividends are taxed to the shareholders (they are not returns of capital investment as in a conduit entity).

13. Why is it important for an owner to also be classified as an employee of the business for tax purposes?

If an owner is considered to be an employee, the owner can receive a tax deductible salary and nontaxable fringe benefits. This allows money and benefits to be transferred to the owner without double taxation of the entity's income. In addition, the payment of salaries and the provision of fringe benefits is a valuable planning tool to reduce the total tax liability of the entity and its owners.

14. Which entity form(s) recognize owners as employees of the business?

Only owners of corporations (including S corporations) can be employees of the business. This treatment occurs because a corporation is the only entity that is considered to be separate from its owners.

15. What is the tax treatment for a guaranteed payment?

A guaranteed payment is treated as if it were paid to a self-employed individual other than a partner. The payment is deductible by the partnership and is included in the partner's gross income.

16. Compare the tax treatment of fringe benefits provided to an owner of a corporation with the treatment of fringe benefits provided to an owner of

Due to the separate entity status of the corporation, an owner of a corporation can be an employee of the corporation. Generally, an owner/employee can receive the same nontaxable fringe benefits that are available to all employees of the corporation. The benefit of being able to provide fringe benefits to an owner/employee is that the cost of the benefits are deductible by the entity, but are nontaxable for the owner/employee.

- a. A sole proprietorship

A sole proprietor cannot be an employee. Therefore, the benefit of nontaxable fringe benefits is not available to a sole proprietor.

- b. A partnership

A partner cannot be an employee. The provision of fringe benefits to a partner is treated as a guaranteed payment. The cost of the fringe benefits is deductible by the partnership, but the partner must include the cost in her or his gross income.

- c. An S corporation

An owner of an S corporation can be an employee. However, owners of more than 2% of an S corporation are treated as partners for fringe benefit purposes. The cost of the fringe benefits is deductible by the S corporation, but the owner/employee must include the cost in her or his gross income.

17. Is all compensation paid to an employee deductible? Discuss the circumstances in which employee compensation cannot be deducted.

The tax law provides for the deduction of reasonable compensation paid to employees. Compensation is subject to two basic tests for deductibility. First, the payments must be for services actually performed by the employee. Second, the total payment for services of the employee must be reasonable in amount. The determination of whether total compensation is excessive is made for each employee. If the IRS disallows a deduction for salary paid to an individual who is an owner of the corporation, the payment is usually treated as dividend income to that individual.

Because only the salary received by an owner-employee of an S corporation is subject to Social Security tax, employee-owners would rather receive a minimal amount of salary and report a larger portion of the S corporation's profits as ordinary income. The IRS often challenges the compensation paid to an owner-employee because the salary is unreasonably low.

18. What is the tax treatment of health insurance premiums paid on behalf of

- a. A sole proprietor

A sole proprietorship is not a separate taxable entity. Because sole proprietors cannot be employees of their business, salary and fringe benefits (i.e., health insurance premiums) paid on behalf of a sole proprietor are not deductible by the business. As a self-employed taxpayer, a sole proprietor can deduct the cost of health-care premiums as a deduction for adjusted gross income.

- b. A partner

All partners in a partnership are treated as owner-partners for fringe benefit purposes. The partnership is allowed to deduct the cost of certain fringe benefits as a guaranteed payment and the partners are required to include the guaranteed payment as income on their tax return. As a self-employed taxpayer, a partner can deduct the cost of health-care premiums as a deduction for adjusted gross income.

- c. An owner-employee of a corporation

A corporation is considered a separate taxable entity. Assuming that the health and accident plan is not discriminatory, the corporation is allowed a deduction for the health premiums paid on behalf of an employee-owner and the employee-owner does not recognize income.

- d. An owner-employee of an S corporation

The tax treatment of fringe benefits paid by an S corporation to an employee-owner depends on the employee's ownership percentage. If an employee-owner owns 2 percent or less of an S corporation, the fringe benefits are deductible by the corporation and are not included in the employee's gross income. If a shareholder owns more than 2 percent of the S corporation stock, the tax treatment of the fringe benefits is similar to the tax treatment for a partner. The cost of the fringe benefit is deductible by the S corporation as salary expense, and the owner-employee must include the cost of the fringe benefit as income. As with a partner, an employee-owner can deduct the cost of health-care premiums as a deduction for adjusted gross income.

19. What is the rationale for not taxing transfers of property in exchange for an ownership interest?

The rationale for not taxing transfers of property in exchange for an ownership interest is that the transferors are merely exchanging direct ownership of property for indirect ownership through their ownership interest in the entity. In addition, such transfers of property do not provide the transferor with the wherewithal-to-pay tax on any gain realized in the exchange.

20. What are the tax consequences of receiving an ownership interest in an entity in exchange for services rendered to the entity?

The exchange of services for an ownership interest is not an exchange of a direct property interests for an indirect property interest. Rather, the receipt of the ownership interest is a payment for services rendered. Therefore, income must be recognized as the services are provided.

21. Compare the requirements for a tax-free exchange of property for an ownership interest in a partnership with the requirements for a corporation.

Any exchange of property solely for an ownership interest in a partnership is tax-free. This treatment allows tax-free exchanges at formation and throughout the life of the partnership. For an exchange of property solely for an owner interest in a corporation to be tax-free, the transferors must control the corporation immediately after the exchange. To control the corporation, the transferors must own at least 80% of the corporation. The corporation control requirements are more restrictive than the partnership requirement and can result in transfers of property in exchange for an ownership interest in a corporation being taxable when the transferors do control the corporation immediately after the exchange.

22. Discuss the basis of an ownership interest received in exchange for property and the basis of the property received in exchange for an ownership interest in the hands of the entity.

Following the general rationale for gain deferral, the basis of an ownership interest received in a tax-free exchange for property is the adjusted basis of the property. That is, the basis of the property is substituted for the basis of the ownership interest. If gain recognition occurs in the exchange, any gain recognized is added to the basis of the ownership interest. Likewise, the basis of the property received in the exchange by the entity is equal to the transferor's adjusted basis. If gain recognition occurs in the exchange, any gain recognized is added to the basis of the property received by the entity.

23. How do liabilities affect the basis of a partner's interest in a partnership?

Basis is increased by a partner's share of partnership liabilities, or partnership debt. Partnership debt assumed by a partner and the partner's share of partnership debt are deemed to be additional cash contributions by the partner to the partnership. Decreases in debt are deemed cash distributions to partners. Therefore, basis is decreased by any partner's debt that is assumed by the partnership and by any decreases in the partner's share of partnership liabilities.

24. Explain the difference between a recourse debt and a nonrecourse debt.

A recourse debt is a loan for which the borrower remains liable until repayment. If the borrower defaults on the loan payment, the lender can seize any property financed by the loan and require the borrower to pay the difference between the value of the property and amount of the loan, which was not repaid.

A nonrecourse debt is a loan that is secured only by the underlying property. The borrower is not personally liable for the debt if payment on the loan is not made. The lender can seize the property financed by the debt, but it has no recourse against the borrower if the amount of the loan that was not repaid is greater than the value of the property securing the debt.

25. Why are partners allowed to add their share of partnership debts to their bases?

Because partners are liable for debts of the partnership, individual partners have a risk of loss from any debts that the partnership incurs. Because of this liability feature, a partner's share of the partnership's debt is deemed to be the equivalent of a cash contribution to the partnership. When a debt of a partnership decreases, the partners are freed of the liability. This is deemed to be a cash distribution to the partners and basis is reduced.

26. What is the tax effect of a corporation's assuming the debt of a shareholder on property that is exchanged for an ownership interest in the corporation?

A liability of a shareholder on property that is exchanged for an ownership interest is not considered boot, and is not taxable to the shareholder. However, to ensure that the tax-free assumption does not go untaxed in the future, the basis of the ownership interest must be reduced by the amount of the debt assumed by the corporation.

27. Why might a shareholder recognize a gain on an exchange of property for an ownership interest when a partner making the same exchange with a partnership would not recognize a gain?

For an exchange of property solely for an ownership interest in a corporation to be tax-free, the transferors must control the corporation immediately after the exchange. To control the corporation, the transferors must own at least 80% of the corporation. Any exchange of property solely for an ownership interest in a partnership is tax-free. The corporation control requirements are more restrictive than the partnership requirement and can result in transfers of property in exchange for an ownership interest in a corporation being taxable when the transferors do not own at least 80% of corporation immediately after the exchange.

28. How do S corporation liabilities affect the basis of an S corporation shareholder's stock?

There is no effect on the basis of stockholders in an S corporation for corporate debt. Although the S corporation is taxed similar to a partnership, the debt liability rules for partnerships do not apply to S corporations. The rationale for adjusting partners' bases for debts of the partnership stems from the partners' liabilities for the debts of the partnership. Because the owners of an S corporation enjoy the limited liability of the corporate form, they are not liable for the debts of the S corporation and a basis adjustment is not necessary.

29. Which of the following are organizational costs?

- a. State fees for incorporation
- b. Legal and accounting fees incident to organization
- c. Expenses for the sale of stock
- d. Organizational meeting expenses

Any costs incurred to get the entity ready to operate are organizational costs. Expenditures related to issuance of stock are selling expenses and reduce the equity from the sale of stock. Item c is a selling expense; items a, b, and d are organizational costs incurred to get a corporation ready to operate.

30. What is the difference between a calendar year and a fiscal year?

The annual accounting period concept requires all tax entities to report the results of their operations on an annual basis (taxable year). A taxable year may be either a calendar year (ending on December 31) or a fiscal year. A fiscal year is defined as a period of 12 months ending on the last day of any month other than December, or a 52- to 53-week taxable year. The 52- to 53-week fiscal year ends on the same day of the same week each year. The year must end either the last time a particular day occurs during the month (e.g., the last Wednesday in October) or the day that occurs closest to the end of a particular month (e.g., closest Friday to October 31 even if that Friday is in November).

31. Why are restrictions placed on the selection of a tax year by partnerships and S corporations?

Without any restrictions on the selection of a taxable year, owners of conduit entities could obtain a tax deferral benefit by having the entity select a taxable year different from that of the owners' taxable year. Income from a conduit entity (partnership and S corporation) is deemed to be earned on the last day of the entity's tax year. If a conduit entity's taxable year is a fiscal year, for example January 31, and the conduit entity's owners use a calendar year, the owners would receive their income from the conduit entity on the last day of the fiscal year, January 31. The entity owners would not report the income on their individual returns until December 31 and results in a deferral of income for the owners.

32. Which types of tax entities generally cannot elect to use the cash method of accounting?

Taxpayers who have inventories of goods must use the accrual basis to account for sales and cost of goods sold. This requires taxpayers with inventories to select either the accrual method or hybrid method to compute their taxable income. In addition, three types of entities must use the accrual method: corporations; partnerships that have at least one partner that is a regular corporation; and any tax shelter activity.

PROBLEMS

33. Herman, who is unmarried and has two dependent children, owns and operates a used car lot as a sole proprietorship. The net income from the business is consistently \$120,000 annually. Herman's friends have told him that he should incorporate his business, but he does not understand how this would give him any advantage. He has come to you for advice. Write Herman a letter explaining the advantages and disadvantages of incorporating his business.

One advantage of the corporate form is limited liability for the owners of the corporation. Limited liability refers to an owner's liability extending only to the amount invested in the entity. This would shelter Herman's personal assets from any claims related to the business.

Another advantage of incorporating is the ability to split income between Herman and the corporation. Shifting income to the entity with the lowest marginal tax rate can reduce the overall tax liability. Because the corporation is a taxable entity, Herman can receive a salary that is taxable to him and deductible by the corporation.

Another consideration in choosing the corporate form of doing business is the effect on a stockholder who also serves as a corporate employee. The value of the benefits is generally excludable from taxation for the owner-employee who receives them, and the corporation receives a tax deduction.

If Herman incorporates and the corporation distributes dividends to him, he will incur additional income taxes. This situation is a case of double taxation that may mitigate the tax advantage of incorporating. Double taxation occurs when dividends of a corporation (which are paid out of earnings that have previously been taxed) are taxed again to the shareholders receiving the dividends.

34. Lydia and Paulo agree to become equal owners in a pizza delivery business. Lydia will manage the delivery side of the business, and Paulo will be in charge of kitchen operations. They will borrow most of the money they need to get the business started. Considering only the nontax factors associated with the business, what business entity(ies) would be appropriate for the new business? Discuss the positive and negative factors of each business entity that would be appropriate.

Because of the large amount of debt they will be using and the potential for lawsuits arising from their business (e.g., liability for a delivery person's accident), Lydia and Paulo will want to use an entity that offers limited liability. They should also consider whether they desire free transferability of interest. Since each owner will be in charge of a separate part of the business, if one owner leaves it could put the remaining owner at a disadvantage. They should also consider the cost of organizing and operating each entity. Their choices are a corporation, an S corporation, a limited liability company, and a limited liability partnership (LLP). It should be noted that in all of these entities, lenders may mitigate the limited liability feature for loans to the business by requiring the owners to take personal liability for the loan.

Corporation: This is generally the most costly entity to organize and operate. A corporation's free transferability of interest would allow either owner to sell her or his interest without the consent of the other.

S Corporation: S corporations have the same nontax characteristics as a corporation with the additional restrictions that it may only have one class of stock (which limits access to additional capital) and all owners must consent to the S corporation election.

Limited Liability Company: Generally, a corporation with conduit tax treatment. However, unlike a corporation, the owners control the ability to transfer an ownership interest. Also, an LLC can make special allocations of income and expense, allowing the income (expenses) to be directed to the owner(s) who will benefit most from a particular item of income or expense.

Limited Liability Partnership: A general partnership with a form of limited liability. The partners are not liable for the contractual obligations of the business, but remain liable for their own actions. As a general partnership, it has limited life (if one partner dies or leaves the partnership, the partnership is technically dissolved). Partnership interests are not freely transferable.

35. Rollo and Andrea are equal owners of Gosney Company. During the current year, Gosney's taxable income before considering salaries paid to Andrea and Rollo is \$140,000. Rollo is single, his salary is \$30,000, and he has net taxable income of \$20,000 from other sources. Andrea is also single, her salary is \$40,000, and she has net taxable income of \$30,000 from other sources. What is the total income tax liability if Gosney is organized as

a. A partnership

A partnership is a conduit entity. Partners cannot be employees, so the salaries are not deductible by the partnership and would not be income to Rollo and Andrea. Rollo and Andrea will recognize their proportionate shares of the income from Gosney. Rollo and Andrea each have \$70,000 (\$140,000 x 50%) of income from the partnership. Rollo's taxable income is \$90,000 (\$70,000 + \$20,000). Andrea's taxable income is \$100,000 (\$70,000 + \$30,000). The total income tax liability if Gosney is organized as a partnership would be \$39,308:

Rollo's tax - \$5,183.75 + [25% x (\$ 90,000 - \$37,650)]	\$ 18,271
Andrea's tax - \$18,558.75 + [28% x (\$100,000 - \$91,150)]	21,037
Total income tax liability	<u>\$ 39,308</u>

b. A corporation

A corporation is a separate taxable entity. Rollo and Andrea are taxed on the salaries they receive from the corporation. Rollo's taxable income is \$50,000 (\$30,000 + \$20,000). Andrea's taxable income is \$70,000 (\$40,000 + \$30,000). The corporation deducts the \$70,000 in salaries and has a taxable income of \$70,000 (\$140,000 - \$30,000 - \$40,000). The total income tax liability of operating Gosney as a corporation is \$34,042:

Gosney's tax - \$ 7,500 + [25% x (\$70,000 - \$50,000)]	\$12,500
Rollo's tax - \$ 5,183.75 + [25% x (\$50,000 - \$37,650)]	8,271
Andrea's tax - \$ 5,183.75 + [25% x (\$70,000 - \$37,650)]	13,271
Total income tax liability	<u>\$34,042</u>

c. An S corporation

An S corporation is a conduit entity. Rollo and Andrea can be employees of an S corporation. The corporation deducts their salaries, reducing its taxable income to \$70,000. Rollo and Andrea each have \$35,000 (\$70,000 x 50%) of income from the S corporation in addition to the income from their salaries. Rollo's taxable income is \$85,000 (\$35,000 + \$30,000 + \$20,000). Andrea's taxable income is \$105,000 (\$35,000 + \$40,000 + \$30,000). The total income tax liability of operating Gosney as an S corporation is \$39,458:

Rollo's tax - \$5,183.75 + [25% x (\$ 85,000 - \$37,650)]	\$ 17,021
Andrea's tax - \$18,558.75 + [28% x (\$105,000 - \$91,150)]	22,437
Total income tax liability	<u>\$ 39,458</u>

36. Return to the facts of problem 33. Compare the total income tax liability of Herman's incorporating his business versus operating it as a sole proprietorship. Assume that he is paid a \$60,000 salary and has income from other sources that is \$14,000 more than his allowable deductions.

A sole proprietor is taxed on the income of the business using the individual tax rate tables. The salary paid to Herman is not deductible by the business nor is it taxable to Herman. Herman's taxable income is \$134,000 (\$120,000 + \$14,000). Herman qualifies as a Head of Household. Herman's tax liability using the Head of Household tax rate schedule is \$27,913:

Tax on \$134,000 - \$26,835.00 + [28% x (\$134,000 - \$130,150)] = \$ 27,913

A corporation is a separate taxable entity. Herman can be an employee of the corporation. He is taxed on the \$60,000 salary and the corporation can deduct the salary. The corporation's taxable income is \$60,000 (\$120,000 - \$60,000). Herman's taxable income is \$74,000 (\$60,000 + \$14,000). The total tax liability is \$22,798:

Corporation	- \$7,500.00 + [25% + (\$60,000 - \$50,000)]	\$ 10,000
Herman's tax	- \$6,897.50 + [25% + (\$74,000 - \$50,400)]	12,798
Total tax liability		<u>\$ 22,798</u>

Herman will save \$5,115 (\$27,913 - \$22,798) by operating his business as a corporation. Note that this assumes that the corporation does not pay any dividends. If the corporation pays dividends, the total tax liability will increase by the additional tax that Herman will have to pay on the dividends he receives.

37. Polly owns CopyEdit, a sole proprietorship. The net income from CopyEdit is consistently around \$200,000. Polly is considering making Kevin, one of her employees, an owner of the business. He would continue to be paid his \$40,000 salary and own a 25% interest in the business. Polly would receive a salary of \$100,000 from the new entity. She has asked you to determine the total income tax liability for each of the entities listed below. Assume that both Polly and Kevin have income from other sources that offset their allowable deductions and that they are both single.

a. Partnership

A partnership is a conduit entity. Partners cannot be employees, so the salaries are not deductible by the partnership and would not be income to Polly and Kevin. Polly and Kevin will recognize their proportionate shares of the income from CopyEdit, \$150,000 (\$200,000 x 75%) for Polly and \$50,000 (\$200,000 x 25%) for Kevin. The total income tax liability if CopyEdit is organized as a partnership would be \$43,308:

Polly's tax -	\$18,558.75 + [28% x (\$150,000 - \$91,150)]	\$ 35,037
Kevin's tax -	\$ 5,183.75 + [25% x (\$ 50,000 - \$37,650)]	8,271
Total income tax liability		<u>\$ 43,308</u>

b. Corporation

Polly and Kevin can be employees of the corporation, which is a separate taxable entity. They will be taxed on the salaries they receive and the corporation deducts the salaries in calculating its taxable income of \$60,000 (\$200,000 - \$100,000 - \$40,000). The total income tax liability if CopyEdit is organized as a corporation would be \$36,808:

Corporate tax -	\$ 7,500 + [25% x (\$ 60,000 - \$50,000)]	\$10,000
Polly's tax -	\$18,558.75 + [28% x (\$100,000 - \$91,150)]	21,037
Kevin's tax -	\$ 5,183.75 + [25% x (\$ 40,000 - \$37,650)]	5,771
Total income tax liability		<u>\$36,808</u>

c. S corporation

An S corporation is a conduit entity. Polly and Kevin can be employees of the corporation and will be taxed on the salaries they receive. Polly and Kevin will be taxed on their proportionate shares of the S corporation's \$60,000 taxable income. Polly's taxable income is \$145,000 [\$100,000 + (\$60,000 x 75%)]. Kevin's taxable income is \$55,000 [\$40,000 + (\$60,000 x 25%)]. The total income tax liability if CopyEdit is organized as an S corporation would be \$43,158:

Polly's tax -	\$18,558.75 + [28% x (\$145,000 - \$ 91,150)]	\$ 33,637
Kevin's tax -	\$ 5,183.75 + [25% x (\$ 55,000 - \$ 37,650)]	9,521
Total income tax liability		<u>\$ 43,158</u>

38. Return to the facts of problem 37. Upon giving your tax calculation results to Polly, you learn that CopyEdit's primary business is the provision of copyediting services to corporate clients. Polly and Kevin perform all the work. Write a letter to Polly explaining the effect of this information on the calculations you performed in problem 37.

Polly should be advised that if she elects the corporate form for Copyedit, the corporation will be a Personal Service Corporation (PSC). The entity is treated a personal service corporation (PSC) because the principal activity of the corporation is the performance of personal services (i.e., copyediting) and these services are performed by owner employees who together own more than 50% (in this case all) of the stock in the corporation. The taxable income of a PSC is taxed at a flat rate of 35%. The corporate liability will increase from \$36,808 to \$47,808:

Corporate tax - \$60,000 x 35%	\$21,000
Polly's tax - \$18,558.75 + [28% x (\$100,000 - \$91,150)]	21,037
Kevin's tax - \$ 5,183.75 + [25% x (\$ 40,000 - \$37,650)]	5,771
Total income tax liability	<u>\$47,808</u>

The PSC tax takes away the tax advantage that the corporate form had versus the partnership and the S corporation. The effect of the 35% PSC rate can be mitigated by paying out more of the income in salaries, but Polly should be advised that the salary payments must be reasonable or they will be recast as dividends, resulting in double taxation.

39. Kelly, Gwen, and Tuoi incorporated their accounting business and own all its outstanding stock. During the current year, the corporation's taxable income is \$300,000 after deducting salaries of \$60,000 for each shareholder-employee. Assume that all three owners are single and that each of them has other income that offsets their allowable deductions.

- a. What is the corporate income tax liability?

The entity is treated a personal service corporation (PSC) because the principal activity of the corporation is the performance of personal services (accounting) and these services are performed by owner employees who together own more than 50% (in this case all) of the stock in the corporation. PSC's are subject to a flat tax rate of 35%. Therefore, the tax liability of the corporation is \$105,000 ($\$300,000 \times 35\%$). If each of the owners is single and they have other income that offsets their allowable deductions, they will each pay a tax of \$10,771 $\{\$5,183.75 + [25\% \times (\$60,000 - \$37,650)]\}$ on their \$60,000 salaries.

- b. What could the shareholders do to lower the corporate income tax liability in the future?

The purpose of the 35% flat tax rate is to force the owner-employees of PSC's to take most, if not all, of the corporate income out of the entity in the form of salary. Because the marginal tax rate is 28% for a married taxpayer who files a joint tax return with a taxable income of less than \$231,450 (\$191,150 filing single, \$210,800 head of household) the three shareholders should increase their salary levels up to the maximum income level in the 28% tax bracket. This strategy mitigates the impact of the flat 35% corporate tax rate.

Example: Assume that each owner is single and receives a salary of \$100,000 (an increase of \$40,000 per owner) reducing corporate taxable income to \$180,000 ($\$300,000 - \$120,000$). The total tax liability is \$126,111:

Corporate tax - $\$180,000 \times 35\%$	\$ 63,000
Owner's tax - $\{\$18,558.75 + [28\% \times (\$100,000 - \$91,150)] \times 3\}$	63,111
Total tax liability	<u>\$126,111</u>

The current total tax liability is \$137,313 $[\$105,000 + (\$10,771 \times 3)]$. Increasing the salaries paid to the owners saves \$11,202 $(\$137,313 - \$126,111)$ in taxes.

40. Drew is the sole owner of Morris, Inc., a corporation. Morris's net income for the current year is \$150,000 before considering Drew's \$85,000 salary. Assume Drew is single and has income from other sources that is \$30,000 more than his allowable deductions. What is the total income tax liability if Morris is:

a. A corporation

Drew can be an employee of the corporation, which is a separate taxable entity. He will be taxed on the salary he receives and his taxable income will be \$115,000 (\$85,000 + \$30,000). The corporation deducts his salary in calculating its taxable income of \$65,000 (\$150,000 - \$85,000). The total income tax liability if Morris is organized as a corporation is \$36,487:

Corporate tax -	\$ 7,500 + [25% x (\$ 65,000 - \$50,000)]	\$ 11,250
Drew's tax -	\$18,558.75 + [28% x (\$115,000 - \$91,150)]	25,237
Total income tax liability		<u>\$ 36,487</u>

b. An S corporation

An S corporation is a conduit entity. Drew can be an employee of the corporation and is taxed on the salary he receives. As the sole owner, Drew will also include the S corporation's \$65,000 (\$150,000 - \$85,000) income in his taxable income. Drew's taxable income is \$180,000 (\$65,000 + \$85,000 + \$30,000) and he will pay a tax of \$43,437 if Morris is organized as an S corporation:

Drew's tax -	\$18,558.75 + [28% x (\$180,000 - \$91,150)]	<u>\$ 43,437</u>
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41. Return to the facts of problem 40. Assume that late in the year, Drew needs extra cash to pay off gambling debts and has the corporation declare a \$25,000 dividend to provide the cash. What is the effect of the dividend payment on the total income tax liability if Morris is

a. A corporation

The dividend will be taxable to Drew and cannot be deducted by Morris. The dividend, while subject to double taxation, is taxed at the long-term capital gains rate. Drew's taxable income increases to \$140,000 and the total income tax liability increases to \$40,237:

Corporate tax - \$ 7,500.00 + [25% x (\$65,000 - \$50,000)]	\$ 11,250
Drew's tax -	
Ordinary income - \$115,000 (from problem #40)	\$ 25,237
Dividend income - \$ 25,000 x 15%	<u>3,750</u>
Total income tax liability	<u>\$ 40,237</u>

b. An S corporation

The dividend paid to Drew is not taxable (return of capital investment) and cannot be deducted by Morris. There is no effect on the total tax liability; it remains \$43,437.

42. In January of the current year, Josh purchases all the stock of Ballpark Corporation for \$100,000. Ballpark's taxable income for the current year is \$200,000, and it pays \$61,250 in income tax. None of the earnings is distributed as dividends. Josh believes that if he sells his stock two years later for \$238,750, he will avoid double taxation. Write a memo to Josh explaining why he is not avoiding double taxation just because he receives no dividends.

Josh does not avoid double taxation because the amount he received for the sales price of his stock consists of two components: part is the original cost of his investment (\$100,000) and the remainder is the built up value as a result of operations less the taxes paid by the corporation on the earnings (\$61,250). Josh will have to pay capital gains taxes (15%) on the \$138,750 gain from his investment. Therefore, tax has been paid twice on the gain, once at the corporate level and once at the individual level.

43. Antonio and Michaela are equal partners in A&M Booking Services. Antonio manages the business and receives \$40,000 per year for his management services. He and Michaela each withdraw \$30,000 in cash during the current year. A&M's ordinary income is \$80,000 before considering any payments to the partners. How much income do Michaela and Antonio have from A&M during the current year?

A partnership is a conduit entity. The partners cannot be employees of the partnership and any salaries they receive cannot be deducted by the partnership. Partners are not taxed on withdrawals; they are returns of capital investment.

The \$40,000 Antonio receives for management services is a guaranteed payment because it is paid without regard to the profit of the business. Antonio must include the guaranteed payment in his income and the partnership can deduct the payment. The partnership ordinary income is \$40,000 (\$80,000 - \$40,000), which is shared equally by Antonio and Michaela. Antonio's income is \$60,000 [$\$40,000 + (\$40,000 \times 50\%)$] and Michaela's income is \$20,000 ($\$40,000 \times 50\%$):

Partnership income - \$80,000 - \$40,000		<u>\$40,000</u>
Antonio's income:		
Guaranteed payment	\$40,000	
Share of income - $\$40,000 \times 50\%$	<u>20,000</u>	<u>\$60,000</u>
Michaela's income:		
Share of income - $\$40,000 \times 50\%$		<u>\$20,000</u>

44. Estel and Raymond own the GoalLine Partnership. Estel owns 70% of the business. She provided the capital for it and consults with Raymond on overall business strategy. Raymond is responsible for the daily operation of the business and owns the remaining 30%. The business consistently produces net income of \$200,000 per year. Each year, Estel withdraws \$30,000 from the partnership and Raymond withdraws \$70,000. Although Estel believes that Raymond is entitled to receive more cash each year because of his daily involvement in the business, she is concerned that she is taxed on 70% of the income. Estel has come to your firm for advice on how to improve their situation. Leonard, your supervisor, has assigned you the task of coming up with a strategy that will result in Estel's having less income from GoalLine. Write Leonard a memorandum explaining a strategy that GoalLine can use to reduce the income taxed to Estel without altering the current profit-sharing ratio.

A partnership is a conduit entity. The partners are taxed on their proportionate share of the partnership's income. Withdrawals from a partnership are not taxable to the partners (nontaxable recovery of capital) and are not deductible by the partnership. Estel is currently being taxed on \$140,000 ($\$200,000 \times 70\%$) in income from the partnership. Raymond's income from the partnership is \$60,000 ($\$200,000 \times 30\%$).

If Estel wants to keep the business as a partnership, she could make Raymond's \$70,000 withdrawal a guaranteed payment. The \$70,000 would then be taxable to Raymond and deductible by the partnership. Partnership income would be \$130,000 ($\$200,000 - \$70,000$) and Estel would have \$91,000 ($\$130,000 \times 70\%$) in income from the partnership. Raymond's income will be \$109,000 [$\$70,000 + (\$130,000 \times 30\%)$]. This will shift more of the income to Raymond without changing the profit sharing ratio.

A similar result can be obtained by changing the partnership to an S corporation and paying Raymond a salary of \$70,000. By keeping the stock ownership percentages in the current ratio, the income to each owner will be identical to using a partnership with a guaranteed payment.

45. Artis owns 40% of the Rhode Island Chile Parlor (RICP). During the current year, Rhode Island gives Artis fringe benefits worth \$4,000 in addition to his \$30,000 salary. RICP's net taxable income before considering the payments to Artis is \$160,000. Assume Artis is single and has income from other sources that offset his allowable deductions. What are Artis's taxable income and income tax liability if RICP is organized as

- a. A partnership, and the salary is a guaranteed payment

A partnership is a conduit entity. Partners cannot be employees of a partnership and any salaries they receive cannot be deducted by the partnership. A guaranteed payment is taxable to the partner receiving the payment and deductible by the partnership. Fringe benefits paid on behalf of a partner are treated as guaranteed payments. The partners are taxed on their proportionate share of the partnership's income.

Artis must include the \$30,000 guaranteed payment and the \$4,000 in fringe benefits in his income. These payments reduce the partnership ordinary income to \$126,000 (\$160,000 - \$30,000 - \$4,000). Artis's share of the partnership income is \$50,400 (\$126,000 x 40%) and his total income from the partnership is \$84,400 (\$50,400 + \$30,000 + \$4,000). Artis's tax liability is \$16,871:

$$\text{Tax on } \$84,400 - \$5,183.75 + [25\% \times (\$84,400 - \$37,650)] = \$16,871$$

- b. A partnership, and the salary is not a guaranteed payment

Artis must include the \$4,000 in fringe benefits in his income. The partnership ordinary income is \$156,000 (\$160,000 - \$4,000). Artis's share of the partnership income is \$62,400 (\$156,000 x 40%) and his total income from the partnership is \$66,400 (\$62,400 + \$4,000). Artis's tax liability is \$12,371:

$$\text{Tax on } \$66,400 - \$5,183.75 + [25\% \times (\$66,400 - \$37,650)] = \$12,371$$

- c. A corporation

Artis can be an employee of the corporation, which is a separate taxable entity. He will be taxed on the salary he receives and he can exclude the value of the fringe benefits received. His taxable income will be \$30,000. The corporation deducts his salary and the cost of the fringe benefits in calculating its taxable income of \$126,000 (\$160,000 - \$30,000 - \$4,000). Artis's tax liability is \$4,036:

$$\text{Tax on } \$30,000 - \$927.50 + [15\% \times (\$30,000 - \$9,275)] = \$4,036$$

- d. An S corporation

An S corporation is a conduit entity. Artis can be an employee of the corporation and is taxed on the salary he receives. The fringe benefits are also taxed to Artis. The S corporation deducts his salary and the cost of the fringe benefits in calculating its ordinary income of \$126,000 (\$160,000 - \$30,000 - \$4,000). Artis's taxable income is \$84,400 [(\$126,000 x 40%) + \$30,000 + \$4,000]. Artis's tax liability is \$16,871:

$$\text{Tax on } \$84,400 - \$5,183.75 + [25\% \times (\$84,400 - \$37,650)] = \$16,871$$

46. Enterprise Business Systems, pays the \$5,000 health and accident insurance policy of its owner Gena. The business's net operating income for the year is \$60,000 before considering Gena's benefit. Determine the business's net income for the year and the tax effects for Gena for each of the following entities:

a. A sole proprietorship

Because sole proprietorships are not separate taxable entities, sole proprietors cannot be employees of their businesses. Therefore, salaries and fringe benefits paid to a sole proprietor are not deductible by the business.

Self-employed individuals pay self-employment tax of 15.3 percent on the first \$118,500 of net self-employment income and 2.9% on the excess. A self-employed individual may deduct for adjusted gross income one-half of self-employment taxes paid (see Chapter 6). Gena's self-employment tax is \$8,478:

Income from Enterprise Business System	\$60,000
Self employment tax rate	x 92.35%
Net self-employment income	<u>\$55,410</u>
Self-employment tax rate	x 15.3%
Self-employment tax	<u>\$ 8,478</u>

Self-employed taxpayers are allowed to deduct the cost of their health insurance premiums as a deduction for adjusted gross income.

Gena includes Enterprise Business System's \$60,000 net income in her gross income. Gena's adjusted gross income is \$50,761:

Gena's gross income	\$60,000
Deduction for self-employment tax (\$8,478 x 50%)	(4,239)
Deduction for medical premiums	(5,000)
Gena's adjusted gross income	<u>\$50,761</u>

b. A partnership

Partners cannot be employees of a partnership. Fringe benefit payments on behalf of a partner are treated as a guaranteed payment. Gena must include the \$5,000 health and accident insurance payment in her gross income. Partnership income is reduced to \$55,000 (\$60,000 - \$5,000) by the payment of the fringe benefits. The \$55,000 of partnership income flows-through to Gena and she has \$60,000 of gross income (\$55,000 + \$5,000).

Partnership income is subject to the self-employment tax. Gena pays \$8,478 in self-employment tax on the partnership income. One-half of the tax is deductible for adjusted gross income. She can also deduct the health and accident insurance payment for adjusted gross income. Gena's results are identical to that of the sole proprietorship.

c. A corporation

Because Gena can be an employee of the corporation, the cost of the health and accident insurance (fringe benefits) is deductible by the corporation. The value of this benefit is generally excludable from taxation for the owner/employee. Therefore, Enterprise Business System's net income for the year is \$55,000 (\$60,000 - \$5,000) and Gena is not taxed on her fringe benefit. Gena will only be taxed on income from the corporation as she receives distributions (i.e., dividends) from it.

d. An S corporation

Owner/employees of an S corporation (those who own more than 2% of the S corporation) are not treated the same as other employees. The S corporation may deduct owner/employee salaries and fringe benefit payments. However, the owner/employees must include salaries and fringe benefits in their gross income. An S corporation shareholder is not considered to be self-employed and income from an S corporation is not subject to the self-employment tax. She can also deduct the health and accident insurance payment for adjusted gross income. The tax treatment for individuals who have less than a 2% interest in the S corporation is similar to that of a corporation.

The cost of an owner/employee's fringe benefits is deductible by the corporation and taxable to the corporation. Enterprise Business System's net income is \$55,000. Gena is the sole owner and the \$55,000 flows-through to her individual return. Gena must also add \$5,000 to her gross income from the insurance premiums.

47. Colleen, Rosemary and Suzanne are owners of a software development firm. Colleen owns 45% of the business, Rosemary 30%, and Suzanne 25%. The net operating income from the business is \$220,000. Assume Suzanne is paid a salary of \$45,000. For each of the following situations determine who is responsible for paying the Social Security and self-employment taxes on the income from the business and who is allowed a deduction for the Social Security and self-employment taxes paid:

- a. The business is formed as a partnership. Suzanne's salary is not a guaranteed payment.

Because the software development firm is a partnership, the individual partners cannot be employees of the entity. Therefore, each partner must pay the self-employment tax on their net self-employment income. Net self-employment income is their pro rata share of the partnership's net income times 92.35%. Each partner is allowed a deduction for AGI for one-half of the self-employment taxes paid.

For example, Suzanne's pro rata share of the partnership income is \$55,000 ($\$220,000 \times 25\%$) and her net self-employment income is \$50,793 ($\$55,000 \times 92.35\%$). Her self-employment tax is \$7,771 ($\$50,793 \times 15.3\%$) and her deduction for AGI is \$3,886.

- b. The business is formed as a corporation.

Each employee is responsible for paying Social Security taxes on their salary. To the extent one of the owners salary exceeds the maximum of \$118,500, she will pay a tax of 6.20% on the first \$118,500 of her salary and 1.45% on all of her salary. The corporation is responsible for matching the amount of the Social Security taxes paid by each employee. The company can deduct the amount it pays in Social Security taxes as an ordinary and necessary business expense. The amount each owner pays in Social Security taxes on their salary is not deductible.

Suzanne must pay \$3,443 [$(\$45,000 \times 6.20\%) + (\$45,000 \times 1.45\%)$] and the corporation also is required to contribute \$3,443. The corporation is allowed to deduct that amount as an ordinary and necessary business expense. Suzanne does not receive a deduction for the amount she pays in Social Security.

- c. The business is formed as an S corporation.

The amount of income that flows through to each owner is not subject to self-employment tax. Therefore, neither the software firm nor the individual owner pays Social Security tax. However, to the extent that each owner receives a salary from the software firm, the rules governing the amount of Social Security that must be paid, who is responsible for the payment of the tax, and the deductibility of the tax is the same as for a corporation.

Suzanne must pay \$3,443 [$(\$45,000 \times 6.20\%) + (\$45,000 \times 1.45\%)$] and the corporation also is required to contribute \$3,443. The corporation is allowed to deduct that amount as an ordinary and necessary business expense. Suzanne does not receive a deduction for the amount she pays in Social Security.

48. Natalie operates her bookkeeping service as a corporation. She is the sole shareholder and is an employee functioning as the chief operating officer. The corporation employs several other individuals and offers them good fringe benefits: group term life insurance, health insurance, disability insurance, and a 12% qualified pension plan. Natalie's good friend, Ricci, operates a custom software development company. The business is an S corporation, and Ricci is the sole shareholder. She is also an employee who serves as the manager. Upon Natalie's recommendation Ricci copied the fringe-benefit package of Natalie's corporation. Assume both businesses are quite profitable.
- a. How do the employee benefits affect the tax bills of Natalie and her corporation?

Natalie operates her business as a regular corporation. Unlike the owners of an S corporation, the owners of a regular corporation do not face restrictions as to whether employee benefits are taxable. Most of the fringe benefits provided by a corporation are deductible by the corporation and nontaxable to the employee.

- b. How do the employee benefits affect the tax bills of Ricci and her corporation?

Ricci may want to rethink her corporate election of S corporation status. Because she owns more than 2% of the S corporation, she is effectively treated as a partner. That is, she must include the value of the following fringe benefits as income: employer-provided term life insurance coverage, employer-sponsored accident and health-care plans, cafeteria plans, and meals and lodging furnished for the convenience of the employer. Because the tax law mentions only these fringe benefits, contributions to a qualified pension plan and all other fringe benefits appear to be deductible by the S corporation as an ordinary business expense and are not income to the owner-employee. The S corporation is allowed to deduct the cost of the fringe benefits as compensation expense. Ricci can deduct the cost of the health insurance premiums for AGI on her individual tax return. Ricci needs to do a cost-benefit analysis on the tax savings of using a regular corporation as compared to remaining as an S corporation.

- c. Write letters to both Natalie and Ricci explaining these tax ramifications.

The letters should be in good business form and contain the points discussed in parts a. and b.

49. Billy Bob is employed by the Pony Ranch Corporation and owns 1% of the corporation's stock. The corporation provides excludable meals and lodging for Billy Bob at a cost of \$12,000 annually.

- a. Can the Pony Ranch Corporation deduct the costs of the meals and lodging provided to Billy Bob?

The cost of meals and lodging provided to an employee are deductible by a corporate employer and if certain conditions are met (see Chapter 4) are excludable by the employee who receives them. This exclusion is allowed for shareholder employees. Billy Bob pays no tax on the value of the meals and lodging and no additional costs are incurred from providing the benefits.

- b. How are the meals and lodging treated for tax purposes if Pony Ranch is an S corporation?

If an employee-shareholder owns 2 percent or less of an S corporation, the fringe benefits are deductible by the corporation and are not included in the employee's gross income. The tax result is the same as discussed in part a.

- c. Assume the same facts as in part b, except that Billy Bob owns 5% of the Pony Ranch Corporation.

Because he owns more than 2% of the S corporation, Billy Bob is effectively treated as a partner for certain fringe benefits, one of which is meals and lodging furnished for the convenience of the employer. That is, he must include the value of the meals and lodging furnished by the employer in gross income. The S corporation is allowed to deduct the cost of the fringe benefits as compensation expense.

50. Miko and Mona form M&M Beverages in the current year. Miko contributes \$20,000 in cash and delivery trucks worth \$70,000 for a 30% interest. Miko's basis in the delivery trucks is \$80,000. Mona contributes \$30,000 and land worth \$130,000 (basis = \$100,000) and provides services in organizing the business worth \$20,000 in exchange for her 70% interest. What are the tax effects of the transfers and the bases of the owners and the entity if M&M is organized as

a. A partnership

Transfers of property to a partnership solely in exchange for a partnership interest are nontaxable. An exchange of services for a partnership interest is a payment for services. Mona will recognize the \$20,000 of services income as she performs the services. Miko cannot recognize the loss on the transfer of the trucks. The basis of the partnership interest received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. The partnership's basis in the property is equal to the partner's adjusted basis in the property. Miko's partnership basis is \$100,000 (\$20,000 + \$80,000) and Mona's partnership basis is \$150,000 (\$30,000 + \$100,000 + \$20,000). M&M will have \$50,000 in cash, delivery trucks with a basis of \$80,000, land with a basis of \$100,000, and organizational costs of \$20,000.

b. A corporation

Transfers of property to a corporation solely in exchange for stock are nontaxable if the transferors control the corporation immediately after the transfer. Miko and Mona own more than 80% of the stock after the transfers and control the corporation. An exchange of services for stock is a payment for services. Mona will recognize the \$20,000 of services income as she performs the services. Miko cannot recognize the loss on the transfer of the trucks. The basis of the stock received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. The corporation's basis in the property is equal to the shareholder's adjusted basis. Miko's basis is \$100,000 (\$20,000 + \$80,000) and Mona's basis is \$150,000 (\$30,000 + \$100,000 + \$20,000). M&M will have \$50,000 in cash, delivery trucks with a basis of \$80,000, land with a basis of \$100,000, and organizational costs of \$20,000.

c. An S corporation?

An S corporation is an election to be taxed as a conduit entity. As a corporation, it must meet the same control requirements as a corporation. Thus, the results are identical to that for a corporation.

51. John and Katerina form JK Enterprises in the current year. John contributes \$200,000 in cash for a 40% interest. Katerina contributes real estate valued at \$480,000 and encumbered by a mortgage of \$180,000 that is assumed by the business. Katerina's basis in the real estate is \$100,000. She receives a 60% interest in the business. What is each owner's basis in his or her interest and the entity's basis in the assets acquired if JK Enterprises is organized as

a. A partnership

Transfers of property to a partnership solely in exchange for a partnership interest are nontaxable. The basis of the partnership interest received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. Neither Katerina nor John will recognize income from the transfers. The partnership's basis in the property is equal to the partner's adjusted basis in the property.

Any partnership debt assumed by a partner and the partner's share of partnership liabilities increase the partner's basis. Any partner's debt assumed by the partnership decreases the partner's basis. Katerina's basis is reduced by the \$180,000 mortgage assumed by the partnership and increased by her \$108,000 ($\$180,000 \times 60\%$) share of the partnership debt. John's basis is increased by his \$72,000 ($\$180,000 \times 40\%$) share of the partnership debt. Katerina's basis is \$28,000 and John's basis is \$272,000:

	<u>Katerina</u>	<u>John</u>
Basis of property contributed	\$ 100,000	\$ 200,000
Mortgage assumed by partnership	(180,000)	
Share of partnership debt	108,000	72,000
Basis of partnership interest	<u>\$ 28,000</u>	<u>\$ 272,000</u>

The partnership's basis in the property is equal to the partner's adjusted basis in the property. JK Enterprises will have \$200,000 in cash, real estate with a basis of \$100,000, and a liability for the mortgage of \$180,000.

b. A corporation

Transfers of property to a corporation solely in exchange for stock are nontaxable if the transferors control the corporation immediately after the transfer. Katerina and John own more than 80% of the stock after the transfers and control the corporation and therefore, do not recognize any gain on the transfers. The basis of the stock received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. The corporation's basis in the property is equal to the shareholder's adjusted basis.

A liability of a shareholder assumed by the corporation is not considered boot, and the shareholder is not taxed on the liability assumption. Any liability of a shareholder assumed by a corporation reduces the shareholder's basis. In this case, the mortgage is \$80,000 greater than Katerina's basis in the real estate. A shareholder's basis cannot be negative. Katerina's basis is reduced to zero by \$100,000 of the debt. The additional \$80,000 is a capital recovery in excess of basis and she is taxed on the \$80,000 excess of liability over the basis of the property. The \$80,000 would be a capital gain. John's basis is equal to the \$200,000 in cash he contributed. The corporation will have \$200,000 in cash, real estate with a basis of \$180,000 and a liability for the mortgage of \$180,000.

c. An S corporation

An S corporation is an election to be taxed as a conduit entity. As a corporation, it must meet the same control requirements as a corporation. Thus, the results are identical to that for a corporation.

52. Emmon and Darcy are equal owners of Golf Instruction Academy (GIF). The business has been profitable, and they would like to expand their operations. Tiger owns Power Golf. Emmon and Darcy will make Tiger an equal owner of GIF (i.e., each will have a 1/3 interest) in exchange for Tiger's business assets. Tiger's business assets are worth \$100,000 and have an adjusted basis of \$70,000. What are the tax effects of Tiger's exchange of assets for the ownership interest if GIF is organized as

a. A partnership

Transfers of property to a partnership solely in exchange for a partnership interest are nontaxable. The basis of the partnership interest received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. Tiger is not taxed on the exchange and he has a basis in his partnership interest of 70,000. The partnership has a basis in the assets received in the exchange of \$70,000.

b. A corporation

Transfers of property to a corporation solely in exchange for stock are nontaxable if the transferors control the corporation immediately after the transfer. Because Tiger owns only 1/3 of the stock after the transfer, he does not control the corporation and he is taxed on the \$30,000 (\$100,000 - \$70,000) gain on the asset transfers. The basis of the stock received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. Tiger's basis in the stock of the corporation is \$100,000 (\$70,000 + \$30,000). The corporation has a basis in the assets received in the exchange of \$100,000.

53. Toby exchanges property worth \$80,000 (basis of \$55,000) for a 20% interest in Landscape Developers. What are the tax effects of the exchange if Landscape is organized as

a. A partnership

Transfers of property to a partnership solely in exchange for a partnership interest are nontaxable. The basis of the partnership interest received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. Toby is not taxed on the exchange and he has a basis in his partnership interest of \$55,000. The partnership has a basis in the property received in the exchange of \$55,000.

b. A corporation

Transfers of property to a corporation solely in exchange for stock are nontaxable if the transferors control the corporation immediately after the transfer. Because Toby owns only 20% of the stock after the transfer, he does not control the corporation and he is taxed on the \$25,000 (\$80,000 - \$55,000) gain on the asset transfers. The basis of the stock received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. Toby's basis in the stock of the corporation is \$80,000 (\$55,000 + \$25,000). The corporation has a basis in the property received in the exchange of \$80,000.

c. An S corporation

An S corporation is an election to be taxed as a conduit entity. As a corporation, it must meet the same control requirements as a corporation. Thus, the results are identical to that for a corporation. Toby recognizes a \$25,000 gain on the asset transfers and has an \$80,000 basis in the stock he receives. The corporation has a basis in the assets received in the exchange of \$80,000.

54. Return to the facts of problem 53. Assume that the property Toby contributes is encumbered by a \$20,000 mortgage that is assumed by Landscape Developers. How does this affect the tax results for each of the entity forms?

Partnership:

Any partnership debt assumed by a partner and the partner's share of partnership liabilities increase the partner's basis. Any partner's debt assumed by the partnership decreases the partner's basis. Toby's basis is reduced by the \$20,000 mortgage assumed by the partnership and increased by his \$4,000 ($\$20,000 \times 20\%$) share of the partnership debt. The remaining partner's bases are increased by their proportionate share of the \$20,000 mortgage assumption. Toby's basis is \$39,000:

Basis of property contributed	\$ 55,000
Mortgage assumed by partnership	(20,000)
Share of partnership debt	4,000
Basis of partnership interest	<u>\$ 39,000</u>

The partnership's basis in the property is equal to the partner's adjusted basis in the property. Landscape Developers will have property with a basis of \$55,000 and a liability for the mortgage of \$20,000.

Corporation/S corporation:

A liability of a shareholder assumed by the corporation is not considered boot, and the shareholder is not taxed on the liability assumption. Any liability of a shareholder assumed by a corporation reduces the shareholder's basis. Toby's basis is reduced to \$60,000 by the assumption of the mortgage:

Basis of property contributed	\$ 55,000
Gain recognized on exchange	25,000
Mortgage assumed by corporation	(20,000)
Basis of stock	<u>\$ 60,000</u>

Landscape Developers will have property with a basis of \$80,000 and a liability for the mortgage of \$20,000.

55. Myron, Al, and Janda make the following transfers from their sole proprietorships, to a newly formed business, each receiving a 1/3 ownership interest.

Owner	Asset Transfers	Basis of Property Transferred	Fair Market Value of Property/Services Transferred	Liabilities Assumed by Business
Myron	Building	\$ 60,000	\$ 110,000	\$ 30,000
Al	Equipment	90,000	80,000	-0-
Jandra	Vehicles	30,000	60,000	10,000
	Legal services		30,000	

In addition, the business borrows \$60,000 from a local bank for working capital. The loan is a nonrecourse debt. Determine the gain or loss the owners must recognize from the transfers and their basis in the ownership interest received under the assumptions set forth here. Also, determine any gain or loss recognized by the business entity from the transfers and its basis in the property received:

- a. The business is organized as a partnership.

Transfers of property to a partnership solely in exchange for a partnership interest are nontaxable. An exchange of services for a partnership interest is a payment for services. Jandra will recognize the \$30,000 of legal services income as she performs the services. Jandra cannot recognize the loss on the transfer of the vehicles. Myron and Al will not recognize any gain on the transfer of their assets to the partnership.

The basis of the partnership interest received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. The partnership's basis in the property is equal to the partner's adjusted basis in the property.

Any partnership debt assumed by a partner and the partner's share of partnership liabilities increase the partner's basis. Any partner's debt assumed by the partnership decreases the partner's basis. Myron's basis is reduced by the \$30,000 liability assumed by the partnership and Jandra's basis is reduced by the \$10,000 liability assumed by the partnership. Each partner's basis is increased by 1/3 of the \$40,000 of liabilities assumed by the partnership and by 1/3 (assumed profit sharing ratio) of the nonrecourse debt. Myron's basis is \$63,333, Al's basis is \$123,334 and Jandra's basis is \$83,333:

	Myron	Al	Jandra
Basis of property contributed	\$ 60,000	\$ 90,000	\$ 30,000
Liability assumed by partnership	(30,000)		(10,000)
Share of partnership debt	13,333	13,334	13,333
Share of nonrecourse debt	20,000	20,000	20,000
Income recognized on transfer			30,000
Basis of partnership interest	\$ 63,333	\$123,334	\$ 83,333

The partnership's basis in the property is equal to the partner's adjusted basis in the property. The partnership will have a building with a basis of \$60,000, equipment with a basis of \$90,000, vehicles with a basis of \$30,000, organizational costs (legal services) with a basis of \$30,000, and liabilities of \$10,000 and \$30,000.

- b. The business is organized as a corporation.

Transfers of property to a corporation solely in exchange for stock are nontaxable if the transferors control the corporation immediately after the transfer. Myron, Al, and Jandra own more than 80% of the stock after the transfers and therefore, control the corporation and do not recognize any gain or loss on the transfers. An exchange of services for stock is a payment for services. Jandra will recognize the \$30,000 of legal services income as she performs the services. The basis of the stock received is equal to the adjusted basis of the property contributed plus any gain (income) recognized on the exchange. The corporation's basis in the property is equal to the shareholder's adjusted basis plus any gain recognized by the shareholder.

A liability of a shareholder assumed by the corporation is not considered boot, and the shareholder is not taxed on the liability assumption. Any liability of a shareholder assumed by a corporation reduces the shareholder's basis. Myron's basis is \$30,000, Al's basis is \$90,000 and Jandra's basis is \$50,000:

	Myron	Al	Jandra
Basis of property contributed	\$ 60,000	\$ 90,000	\$ 30,000
Liability assumed by corporation	(30,000)		(10,000)
Income recognized on transfer			30,000
Basis of stock	<u>\$ 30,000</u>	<u>\$ 90,000</u>	<u>\$ 50,000</u>

The corporation's basis in the property is equal to the shareholder's adjusted basis in the property plus any gain recognized by the shareholder. The corporation will have a building with a basis of \$60,000, equipment with a basis of \$90,000, vehicles with a basis of \$30,000, organizational costs (legal services) with a basis of \$30,000, and liabilities of \$10,000 and \$30,000.

- c. The business is organized as an S Corporation.

An S corporation is an election to be taxed as a conduit entity. As a corporation, it must meet the same control requirements as a corporation. Thus, the results are identical to that for a corporation.

56. Big C Corporation, a calendar-year corporation, is formed during the current year and begins business operations on September 1. Big C pays \$8,000 to attorneys, accountants, and state regulatory agencies to organize the corporation. Big C pays 6,000 in commissions on the sale of corporate stock. Write a letter to Big C Corporation's controller explaining how much of the \$14,000 expenditure is deductible.

A corporation may elect to expense up to \$5,000 of qualified organizational expenses in the year in which the corporation begins operations. The \$5,000 deduction is phased-out when the expenditures exceed \$50,000. Any remaining expenses must be amortized over 60 months. If the election to amortize these expenses is not made on the tax return for the first taxable year, the costs are not deductible until the corporation ceases business and liquidates. Organizational expenditures may include the following: (1) legal services incident to organization, such as drafting the corporate charter, bylaws, minutes of organizational meetings, terms of original stock certificates; (2) necessary accounting services; (3) expenses of temporary directors and of organizational meetings of directors or shareholders; and (4) fees paid to the state of incorporation.

If Big C Corporation elects to deduct and amortize its organizational costs, it may deduct \$5,068 (\$5,000 immediate expense + \$68 amortization of remaining \$3,000 or organizational costs) during the current year:

Total organizational costs	\$ 8,000
Current year deduction	(5,000)
Remaining costs to be amortized over 180 months	<u>\$ 3,000</u>
Minimum time to amortize organizational costs (in months)	<u>÷ 180</u>
Monthly amortization for 60 months (rounded)	\$ 17
Months in current year (September through December)	x 4
Amortization for current year	<u><u>\$ 68</u></u>

None of the \$6,000 in commissions paid on the sale of the stock is deductible currently. These commissions qualify as neither organizational expenses nor ordinary business expenses (See Chapters 5 and 6). They are reductions in the proceeds from the sale of the stock.

57. Shree is considering opening a travel agency. She spends \$47,000 investigating the profitability of the business and potential locations and \$5,000 for legal and other fees incident to the organization of the business. Although the costs are high, Shree believes that she will recover them quickly. What is the proper treatment of the costs? Will the treatment be different if she organizes the business as a sole proprietorship or a corporation?

If Shree opens the travel agency, the \$52,000 in costs incurred before the business begins operations are start-up (organizational) costs. Because these costs are incurred before Shree is in a trade or business, they are capital expenditures.

An election can be made to deduct up to \$5,000 of qualified start-up/organizational costs in the year in which the business begins operations. The \$5,000 deduction is phased-out when expenditures exceed \$50,000. Any remaining expenditures must be amortized over 180 months. Therefore, Shree will be able to deduct \$3,000 [$\$5,000 - (\$52,000 - \$50,000)$] immediately and amortize the remaining \$49,000 ($\$52,000 - \$3,000$) over 180 months. If the election to amortize these costs is not made on the tax return for the first taxable year, the costs are not deductible until the business terminates and is sold or otherwise liquidated.

The treatment will not be different if she operates the business as a sole proprietorship or as a corporation or an S corporation. Shree can deduct \$3,000 in the year in which she begins operating the travel agency and can amortize \$272 ($\$49,000 \div 180$ months) of the start-up/organizational costs each month.

58. What tax year must each of the following taxpayers use? Explain.

- a. Brayanth works for Gippsland Corporation. His income for the year includes salary, interest, dividend income, and a long-term capital gain. Although he itemizes his deductions, he keeps no formal books or records, relying instead on his wage statement, canceled checks, and other formal documents furnished to him for preparing his tax return.

A taxable entity establishes a taxable year by keeping its books on the basis of that year and filing its first tax return based on that taxable year. This requires the entity to formally close its books on that date and file a timely tax return for the selected year. If the entity does not close its books on that date or if it does not keep formal books, it must use a calendar year. Taxpayers are generally free to choose which accounting period they will use as their tax year. Brayanth does not keep any formal books or records and therefore, he must use a calendar year.

- b. Assume the same facts as in part a, except that Brayanth is self-employed as a plumber and keeps meticulous books and records.

Taxpayers are generally free to choose which accounting period they will use as their tax year. Because Brayanth maintains a separate set of books and records, he could establish a tax year other than a calendar year. However, the method must be used consistently from period to period and must clearly reflect the income of the taxpayer. Taxpayers wishing to change their methods of accounting must generally obtain prior approval from the IRS. Upon consent, the taxpayer must make any transitional adjustments to income and/or deductions as required by the Internal Revenue Service.

Instructors Note: Most individual taxpayers initially file their return on a calendar year basis. While it is technically possible for Brayanth to file on a fiscal year basis, the IRS probably will not grant his request to change his tax year.

- c. Cindy and Derek are partners in a pet shop. Cindy owns 55%, and Derek owns 45%. Cindy reports her income using a July 31 fiscal year, whereas Derek uses a calendar year.

The selection of a taxable year for a partnership is done on a hierarchical basis that attempts to match the tax years of the partnership to the partners. The partnership must use the same tax year as that used by those partners having a majority interest (more than 50 percent), called the majority-interest tax year, in partnership profits and capital. Because Cindy has a majority interest (55 percent) and uses a fiscal tax year ending on July 31, the business must use Cindy's July 31 tax year to report its income.

- d. Syme, Inc., is an S corporation wholly owned by Jeremiah. He uses a calendar year to report his income.

In general, an S corporation must use a calendar year. In this case, Syme receives no relief from this provision because the tax year of more than 50 percent of the owners of the S corporation (Jeremiah owns 100 percent) uses a calendar year. If more than 50 percent of the owners of an S corporation use a fiscal year, Syme could choose either a calendar or fiscal year.

- e. Assume the same facts as in part d, except that Syme, Inc., is a corporation.

Corporations are generally free to choose which accounting period they will use as their tax year. Syme, Inc., may elect either a calendar or fiscal year. If Syme, Inc. has both peak and slow periods, Syme may want to elect a fiscal year. This gives Syme, Inc. the flexibility to close its books and prepare its tax returns after the end of peak seasons, increasing Syme's ability to comply with the tax law in a more timely and efficient manner.

59. Determine the tax year(s) each of the following S corporations must use. Explain.

- a. Will, Dan, and Tom are equal owners of Rheen Corporation, and each has a different fiscal year. Will has a fiscal year that ends April 30, Dan's ends May 31, and Tom's ends November 30.

In general, an S corporation must use a calendar year. However, it can choose an alternate year under the ownership tax year. The ownership tax year is the tax year used by shareholders owning more than 50% of the corporation's stock. Because each shareholder owns an equal share of the business and they do not have the same tax year, Rheen must use a calendar year.

- b. Assume the same facts as in part a, except that Tom and Dan each own a 20% interest in Rheen and Will owns the remaining 60%.

Because Will owns more than 50 percent of Rheen (60 percent), Rheen has the option of either selecting a calendar or a fiscal year ending April 30 (Will's tax year).

- c. Assume the same facts as in part b. Rheen's business is seasonal; the heaviest revenue months are July and August. Revenues for 3 years are as follows:

	July and August	12-Month Period
Current year	\$90,000	\$300,000
1st preceding year	\$80,000	\$260,000
2nd preceding year	\$60,000	\$230,000

An S corporation also has the option of electing a fiscal year under the natural business year exception. In order to take advantage of this exception, an S corporation must have peak and off-peak business periods. An annual accounting period qualifies as a natural business year if the gross receipts from sales or services for the final two months of the current year and each of the two preceding years equal or exceed 25 percent of the gross receipts for the entire 12-month period. Rheen's gross receipts in each of the year's equal or exceed 25 percent as follows:

Current year	$\$90,000 \div \$300,000$	=	30.00%
1st preceding year	$\$80,000 \div \$260,000$	=	30.77%
2nd preceding year	$\$60,000 \div \$230,000$	=	26.09%

Therefore, Rheen has the option of adopting a fiscal year end (either August 31 or April 30) or a calendar year end.

60. Which accounting method must each of the following taxpayers use?

Taxpayers are required to use the method of accounting that they regularly use for their books. The method must be consistently used from period to period and must clearly reflect the income of the taxpayer.

- a. Fax, Inc., is an S corporation wholly owned by Helena. She uses a calendar year to report her income.

Fax, Inc., must use the accounting method used by Helena (since Helena is the sole owner). This assumes that Fax does not maintain inventories. Otherwise, Fax must use the accrual method or a hybrid method to compute taxable income.

- b. Assume the same facts as in part a, except that Fax, Inc., is a corporation. Its annual revenues have never exceeded \$1,000,000.

Corporations are generally required to use the accrual method. However, corporations may still elect the cash method if their average annual gross receipts for the previous three years is \$5 million or less. Fax's annual revenues have never exceeded \$1,000,000. Therefore, Fax (assuming it has no inventories) has the option of electing the cash or accrual method of accounting. If Fax does have inventories, it must use the accrual method or a hybrid method.

- c. Assume the same facts as in part b, except that Fax's annual revenues usually are between \$7,000,000 and \$8,000,000.

Since Fax's annual revenues are usually between \$7,000,000 and \$8,000,000, Fax is not entitled to an election of accounting methods and must use the accrual accounting method.

- d. Spoke and Pedal Cyclery is organized as a partnership. It is owned by John and Gloria as equal partners.

A requirement imposed on taxpayers who have inventories of goods is that they must use the accrual method to account for sales and cost of goods sold. This requires that Spoke and Pedal Cyclery, which has inventories, to select either the accrual or hybrid method.

61. Kim and Brendan, who are longtime friends, have decided to buy a golf equipment store and go into business together as equal partners. Kim reports his income by calendar year, and Brendan uses a fiscal year that ends September 30. One attraction of owning the golf equipment store is that the business is seasonal and will let them take long vacations. The peak revenue months are June and July. The owner gives them the following information:

	<u>June and July</u>	<u>12-Month Period</u>
Current year	\$200,000	\$500,000
1st preceding year	\$280,000	\$700,000
2nd preceding year	\$325,000	\$850,000

Write a memo to Kim and Brendan discussing each alternative below.

- a. If Kim and Brendan form a corporation, what options, if any, do they have in choosing their tax year and method of accounting?

Corporations are generally free to choose which accounting period they will use as their tax year. Kim and Brendan may elect either a calendar or fiscal year. If they believe the business will have both peak and slow periods, they may want to elect a fiscal year (e.g., July). This gives them the flexibility to close their books and prepare their tax returns after the end of peak seasons, increasing the company's ability to comply with the tax law in a more timely and efficient manner.

Corporations are generally required to use the accrual method. Although corporations may still elect the cash method if their average annual gross receipts for the previous three years is \$5 million or less, this provision is only applicable to a business that does not have inventory. Because Brendan and Kim are selling golf equipment, they will be maintaining inventory and are required to use the accrual method or a hybrid method.

- b. If Kim and Brendan form a partnership, what options, if any, do they have in choosing their tax year and method of accounting?

Because Kim and Brendan are equal partners and do not have the same tax year, the partnership must use the tax year that results in the least aggregate deferral of income of the partners. The deferral for each tax partner is determined by the number of months that fall between the end of the partnership's tax year and the end of the partner's tax year.

<u>Using September 30 Year-End</u>		<u>Using December 31 Year-End</u>	
Kim (3 months x 50%)	1.5	Kim (0 months x 50%)	-0-
Brendan (0 months x 50%)	-0-	Brendan (9 months x 50%)	4.5
Total deferral	<u>1.5</u>	Total deferral	<u>4.5</u>

The business must report its income using a September 30 fiscal year.

The partnership also has the option of electing a fiscal year under the natural business year exception. In order to take advantage of this exception, a partnership must have peak and off-peak business periods. An annual accounting period qualifies as a natural business year if the gross receipts from sales or services for the final two months of the current year and each of the two preceding years equal or exceed 25 percent of the gross receipts for the entire 12-month period. Their gross receipts in June and July for each of the year's equal or exceed 25 percent as follows:

Current year	\$200,000 ÷ \$500,000	=	40.00%
1st preceding year	\$280,000 ÷ \$750,000	=	40.00%
2nd preceding year	\$325,000 ÷ \$850,000	=	38.23%

The IRS will approve their request for a natural business year, only if the requested tax year does not create a significant deferral of income. Because the two possible tax years are close, (July 31 versus September 30), the IRS would probably approve their request for a natural business year. Therefore, Kim and Brendan have the option to adopt a fiscal year ending July 31 or September 30.

A requirement imposed on taxpayers who have inventories of goods is that they must use the accrual method to account for sales and cost of goods sold. This requires that the business select either the accrual or hybrid method.

- c. If Kim and Brendan form an S corporation, what options, if any, do they have in choosing their tax year and method of accounting?

In general, an S corporation must use a calendar year. However, it can choose an alternate year under the ownership tax year or if it qualifies, a natural business year. The ownership tax year is the tax year used by shareholders owning more than 50% of the corporation's stock. Because they each own an equal share of the business and do not have the same tax year, Brendan and Kim cannot qualify under this option. However, they can use a natural business year (see part b. above) ending on July 31. Therefore, Brendan and Kim have the option of using either July 31 or a calendar year.

A requirement imposed on taxpayers who have inventories of goods is that they must use the accrual method to account for sales and cost of goods sold. This requires that the golf business, which has inventories, to select either the accrual method or the hybrid method.

ISSUE IDENTIFICATION PROBLEMS

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

62. A former clergyman with a degree in counseling decides to go into business for himself. He contracts with four large corporations to provide alcohol, drug, and psychological analysis for their employees. The contracts require him to be available on a weekly basis to see employees who need help. He also contracts with other organizations to provide therapy for patients in hospitals, and members of churches and other non-profit organizations. He anticipates that he will need two offices and will need to hire staff to help with phone calls, appointments, and other administrative functions.

The issue in this case is selecting the appropriate form for the new business. This is a case where the nontax factors (personal liability) may be more of a factor in the choice of entity than the tax factors. Because of the type of business he is engaged in, he is probably interested in limiting his personal liability exposure. Therefore, he should choose to incorporate as either an S corporation or a C corporation. He probably will not want to subject himself to double taxation, so selecting S corporation status will provide him with limited liability, not subject him to double taxation, and allow any losses that might occur in the earlier years of operation to pass through to him.

63. Raquel is an employee of Jones Company and owns a 30% interest in the company. Her salary is \$44,000. She also receives a \$10,000 cash distribution from Jones. During the current year, Jones's operating income is \$130,000.

The issue in this case is determining Raquel's taxable income. The correct amount depends on whether Jones Company is a C corporation or an S corporation. If it is an S corporation, then Raquel must include as income her salary and the ratable share of Jones's income. The cash distribution is not taxable. Assuming that the operating income is after deducting Raquel's salary, she will report \$70,000 [$\$44,000 + (\$130,000 \times 20\%)$] of income from Jones.

However, if Jones is a C corporation, Raquel will be taxed on her salary of \$44,000 and the pro rata share (\$2,000) of the cash (i.e., dividend) distribution. The fact that the corporation has \$130,000 earnings for the year is not relevant in determining Raquel's taxable income.

64. Rolf owns 20% of Chaminade Corporation. During the current year, Chaminade reports operating income of \$240,000 and pays \$60,000 in cash dividends.

The issue in this case is determining Rolf's taxable income based on his ownership of 20% of Chaminade Corporation. The correct amount depends on whether Chaminade is a C corporation or an S corporation. If Chaminade is an S corporation, then Rolf must include his ratable share of the earnings in income and the subsequent cash distribution is not taxable. On the other hand, if Chaminade is a C corporation, Rolf will be taxed on his pro rata share of the dividend distribution.

65. Miriam is a self-employed computer consultant. Her business nets \$120,000 annually, and she takes \$85,000 of the earnings in salary. Miriam is considering incorporating her computer consulting business.

There are two issues Miriam needs to consider before incorporating. The first issue is the tax treatment of her salary. As a sole proprietor, her salary is not deductible and she must pay self-employment tax on her net self-employment income. If she incorporates, her salary is deductible and it reduces the corporation's taxable income. The second issue Miriam needs to consider is whether her incorporated business will be taxed as a personal service corporation.

66. Robbie is the vice president of Mailer Corporation. He owns 40% of Mailer, which is organized as an S corporation. Robbie's salary is \$75,000, and he receives group-term life insurance and health and accident insurance that costs \$3,000. Mailer's operating income without considering any payments or benefits that Robbie receives is \$180,000.

The issue is determining Robbie's income from the S corporation. Because Robbie owns more than 2% of the S corporation he is treated as an owner-employee and he must include the value of his fringe benefits in income. Therefore, Robbie must include his salary of \$75,000, the fringe benefits of \$3,000 and his pro rate share from the S corporation of \$40,800 $[(\$180,000 - \$75,000 - \$3,000) \times 40\%]$. His income from the S corporation is \$118,800.

67. Rikki and Rhonda are equal owners of LilMark Corporation. To expand their operations, Marsha will contribute a building worth \$80,000 for which she will receive a one-third ownership interest in the corporation. Marsha's basis in the building is \$30,000.

The issue is determining whether Marsha's contribution of the building is a taxable event or if the contribution qualifies as a tax-free transfer in exchange for an ownership interest. Because this is an existing corporation, Marsha's contribution does not qualify as a tax-free transfer and she must recognize a gain of \$50,000 $(\$80,000 - \$30,000)$. Another issue is determining what Marsha's basis is in her ownership interest. Because Marsha must recognize the gain as income she can increase her basis in the property to \$80,000 $(\$30,000 + \$50,000 \text{ gain})$.

68. Ben and Pete form a corporation to run a real estate investment management company. Ben contributes cash of \$40,000 to the corporation in exchange for 50% of its stock. Pete obtains his 50% ownership interest by contributing land with a fair market value of \$40,000 and a basis of \$60,000. The land has the potential to be more valuable to the business in the future. Ben is aware of the nonrecognition rules for contributions to corporations and wants to use the corporate form. Pete realizes that if he contributes the land, he will not be able to recognize the unrealized loss.

The issue is how to structure the contributions by the respective shareholders to allow for the recognition of Pete's realized loss on the contribution of the land. Pete would like to take advantage of the unrealized loss if possible. This could be accomplished by selling the property for \$40,000 and taking a loss on the sale. Subsequently, Pete could contribute the cash for his share of the stock and the corporation could be formed tax-free to all parties

69. Ariel and Mia agree to combine their business assets to form the A&M corporation. Ariel's business assets are worth \$135,000 and have a basis of \$80,000. Mia's business assets are worth \$200,000, have a basis of \$165,000, and are encumbered by a \$90,000 mortgage, which A&M will assume. Mia will also contribute \$25,000 in cash to equalize their contributions.

The primary issue is to determine if the contributions of property encumbered with debt will qualify for a tax-free exchange in forming the corporation. The debt is not considered boot and Mia is not taxed on the exchange. However, she must reduce her basis in the stock by the amount of the mortgage assumed by the corporation, Mia's basis in the stock is \$75,000 (\$165,000 - \$90,000).

70. **INTERNET ASSIGNMENT** The IRS has established procedures to simplify taxpayers' choice of entity for tax purposes. The procedures are referred to as the "check-the-box" regulations. Use the Internet to find articles or discussions about these rules and how they are applied. Trace the steps you use in locating such sources (search engine, tax directory, or website, etc.). Write a summary of the information you find, including the URL of the World Wide Web site that contains the information you use for your summary.

Several methods may be used for searching for information dealing with the "check-the-box" regulations. One approach is to search using Google (www.google.com). By entering the phrase "check-the-box regulations", 384,000 hits were found. One article that explains the regulations is "Check-the-Box: Entity Classification Made Simple" found at (http://www.ciremagazine.com/article.php?article_id=694).

INSTRUCTOR'S NOTE: Information on the Internet is constantly changing, so this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

71. **INTERNET ASSIGNMENT** Recently, there has been a lot of discussion about what is commonly referred to as "corporate tax shelters" as a means of corporations' avoiding paying income tax. Discussions in Congress may lead to legislation aimed at closing corporate "loopholes" in the tax system. Using the Internet, locate articles and discussions regarding this issue. Trace the steps you use in locating such sources (search engines, tax directory, or website, etc.). Write a summary of the information you find and specifically identify the issues you find associated with "corporate tax shelters."

An excellent discussion of this topic can be found using the Google search engine and entering "corporate tax shelters". Google linked to www.findarticles.com, which listed several articles and discussions on corporate tax shelters. Two articles appear in the *Journal of Accountancy*. The first article appears in the August, 2000 issue while the second article appeared in the October 2001 issue.

INSTRUCTOR'S NOTE: Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

72. **RESEARCH PROBLEM** Ruiz and his two brothers founded a social club called the Last Snake Inn in 1995. They want to take advantage of a new state law that lets them serve beer, liquor, and wine to their patrons on Sundays. To do so, the club must obtain a special liquor license that is required of all retail businesses wishing to serve alcohol on Sundays. Ruiz and his brothers want to incorporate the Club specifically to acquire the special license. The club will continue to be operated by the three brothers as before, with each paying for supplies and other materials as needed out of his own pocket. The three brothers will serve as the corporation's officers. Ruiz is designated as the president. He has learned that to form a corporation, it must have a clear business purpose, and wonders whether forming a corporation merely to acquire a special liquor license satisfies the business purpose requirement. Write a letter to Ruiz that addresses his concern about having sufficient business purpose for his planned incorporation of the club.

For tax purposes, the doctrine of business purpose is a prerequisite for recognizing an entity as a corporation. In general, a corporation has officers, elects directors, has regular board meetings, conducts business on an ongoing basis, keeps accounting records, and distributes earnings over the ordinary course of business. Business purpose generally does not exist when a corporation is formed merely to avoid income taxes. Business purpose also contemplates that a corporation is a separate entity unto itself different from its owners and that it should have its own accounting records and methods in place. In Ruiz's case, the corporation's sole purpose is to obtain a special liquor license. Therefore, given the facts it probably lacks a business purpose. In *Yelding, Jr. v. Commissioner*, TC Memo 1991-287, 61 TCM 3017 (1991), the court noted that a corporation must be engaged in the activities listed above to meet the business purpose doctrine.

73. **RESEARCH PROBLEM** Shirley and Roseann form Rosa Corporation with each contributing assets and cash in exchange for all of the corporation's stock. Shirley and Roseann each own 50% of the stock immediately after the exchange. Shortly thereafter, Shirley sells all her stock to Don per a written agreement executed before the formation of Rosa Corporation. Prepare a memorandum discussing the effect of this prearranged agreement.

Rev. Rul. 79-70, 1979-1 C.B. 144, holds that control does not exist when a prearranged binding contract requires the transferor to sell 40% of the stock of the transferee corporation at a later date. Also see, *InterMountain Lumber Company v. Comm.* 65 T.C. 1025 (1975) and Rev. Rul. 70-522, 1970-2 C.B. 81 that support similar positions as described in Rev. Rul. 79-70 cited above. Therefore, Shirley and Roseann do not have "control" immediately after the exchange and the formation of Rosa Corporation does not fall under Section 351 which provides for tax-free formation. The prearranged agreement to sell Shirley's stock to Don precludes counting Shirley's stock to meet the control test.

DISCUSSION CASES

74. Jacqui and Joanne plan to buy a bed-and-breakfast inn for \$200,000. Jacqui will contribute \$20,000 toward the purchase and operate the enterprise. Joanne's primary role is that of investor. She will contribute \$100,000. However, she will be an active participant because of her involvement in management decisions. They will borrow the balance of the purchase price from a local bank. Advise Jacqui and Joanne on a choice of business form. Consider that the enterprise is expected to realize operating losses of \$50,000 annually for the first 3 years. During the 4th year, the inn should realize a meager profit.

Choosing a business form does not have a simple formula. All facts and circumstances must be considered.

Conduit/flow-through principles. Because the owners expect the enterprise to generate losses for the first 3 years, a conduit entity will provide losses to offset the owner's other sources of income. However, Joanne may not be a material participant in the operation of the business and her loss deductions could be limited by the passive activity loss rules. Jacqui is a material participant and will be able to deduct her losses against other income, subject to the basis and at-risk limitations.

For any conduit entity owner to be able to recognize a loss, adequate basis must exist. Joanne's initial basis is \$100,000 and Jacqui's initial basis is \$20,000. Because their initial bases are less than the anticipated losses, a partnership offers the best alternative. The basis in a partnership interest equals the amount of cash and property contributed and a pro-rata share of partnership debt assumed. Because they will borrow the remaining \$80,000 to finance the inn, each partner will be able to increase her basis by \$40,000. Joanne's basis would be \$140,000 (\$100,000 + \$40,000) and Jacqui's basis would be \$60,000 (\$20,000 + \$40,000). S corporation shareholders cannot add debts of the corporation to their basis. Because the debt is related to the purchase of real estate, each partner's at-risk amount will be equal to her basis, allowing greater amounts of loss to be deductible.

Limited liability. Because of the large debt assumption, limited liability should be present to protect the owners' personal assets. Since both owners desire to be active in the management of the inn, a limited partnership is not the desired type of entity. However, they could use a limited liability company (LLC) or a limited liability partnership (LLP). LLCs, like S-corporations, have fairly costly organization, registration, and reporting requirements. LLPs generally do not have as costly organizational and reporting requirements as do LLCs and S-corporations.

75. Nan wants to incorporate her sole proprietorship and will transfer cash of \$5,000 and property with a fair market value of \$60,000 and a basis of \$20,000. The corporation will assume the \$55,000 mortgage on the property. Nan will be paid a salary of \$40,000. She has been advised by her cousin that she might want to be a corporation for tax purposes because its income is taxed at a lower rate and her salary can be deducted as a business expense to lower overall taxes. However, she recently read an article in a small business owners' journal extolling the virtues of using an S corporation. Discuss the income tax consequences for Nan if she structures her business as an S corporation versus a corporation.

First, the advice that Nan's cousin gave her is partially correct. The tax rate for a corporation is less at lower levels of income than it is for a single individual (15% for the first \$50,000 of income versus a 25% rate for individuals with income between \$37,650 and \$91,150). However, because a corporation is a separate taxable entity from Nan when the corporation distributes the income to her as a dividend, she will again be taxed on the income. In essence, this subjects the same income to double taxation. This is not the case if the entity of choice is an S corporation because there an S corporation is not a separate taxable entity but rather a conduit entity. Nan can be treated as an employee for whether she forms a corporation or an S corporation. Therefore, her salary is deductible for both types of entity. The corporation would be able to reduce its taxable income by \$40,000 and save \$6,000 ($\$40,000 \times 15\%$) of corporate income tax. No such savings are available for the S corporation. Nan would pay individual income taxes on her salary of \$40,000 whether she operates as an S corporation or a regular corporation. Her tax liability under both scenarios would be \$5,771 $\{\$5,183.75 + [25\% \times (\$40,000 - \$37,650)]\}$. In addition to her salary, Nan would have to pay taxes on her share of the S corporation's income after deducting her salary. However, this amount would be taxed at Nan's marginal rate of 25%. This rate is higher than the regular corporation's tax rate. If the corporation distributes any of the remaining profits as dividends, this income would be taxed at the long-term capital gains rate (15%). In addition to the income taxes, the corporation would be required to pay \$3,060 ($\$40,000 \times 7.65\%$) in payroll taxes (Social Security) on Nan's salary. Nan would be required to pay a matching amount of Social Security tax. The same result would occur if Nan operated as an S corporation. In both cases, the corporation could deduct the payroll taxes paid. The amount Nan pays is not deductible. However, the amount of income that flows through to Nan from the S corporation (other than salary) is not subject to self-employment taxes.

Second, under the wherewithal-to-pay concept and the capital recovery concept, debt assumption by the entity in the formation stage is usually tax-free. However, if Nan incorporates as a regular corporation, some gain will be triggered because the amount of the aggregate debt assumed exceeds the aggregate basis of the assets transferred (\$30,000 versus \$55,000). In this case, the excess liabilities assumed by the corporation will trigger gain recognition of \$25,000 by Nan. This occurs because Nan "cashed out" part of her investment in the form of cash received from the loan proceeds that exceeded her "investment" in the assets transferred. Her basis in the stock is reduced to zero and the amount in excess of her basis is an excess capital recovery and treated as income.

TAX PLANNING CASES

76. Tony and Susan are starting a retail business selling formal wear for men and women. They estimate profits and losses for the next five years to be: (\$20,000), (\$10,000), (\$5,000), \$10,000, and \$50,000 respectively. Susan will work full time in the store while Tony will be involved in managing the operations. Susan is married to Tom and is in the 28% marginal tax bracket. Tony is single and has other sources of income that puts him in the 28% marginal tax bracket. Susan will be paid a salary of \$30,000 for the first five years, after which her compensation will be reviewed. Tony and Susan each contribute \$50,000 to get the business started. The remaining question facing Tony and Susan is which business form to use for the business. They believe they should operate as a partnership but have been informed that forming a corporation might be a better option since it would limit their liability. Prepare an analysis to determine which type of entity would be best for Tony and Susan.

In general, the desirable choice of business form is a conduit entity for the early years of the business so that high tax rate individuals like Tony and Susan (28% marginal tax rates) can pass through the losses so that they can be deducted on their individual income tax returns. Losses are projected for the first three years of operation which would provide a tax benefit to each partner of their respective share of the loss times the marginal tax rate (i.e., 28%). This tax benefit would yield \$5,600 in year one, \$2,800 in year two, and \$1,400 in year three for each partner. If the business is considered a high risk operation, then the limited liability issue may negate the use of a partnership.

If the business is operated as a corporation, none of the early year losses will flow through to the Tony or Susan, but would build up net operating losses that could be used to offset income tax from the anticipated net profits in years four and five. This would mean there would be no income taxes at the corporate level to pay in any of the first five years and neither Tony or Susan would have any income taxes to pay on these earnings unless a dividend was paid. Susan would have to pay income taxes on her salary and the corporation would have to pay payroll taxes (i.e., Social Security) on her salary each of the first five years. In addition, Susan also would have to pay her share of Social Security taxes on her salary. Under the partnership form, the business would not be liable for the employment taxes on Susan's taxes as she would be self-employed and would have to pay all of the self-employment taxes on her salary.

Once the business becomes profitable, it may be desirable to incorporate the business to provide the limited liability that comes from growth of the business. This means that Tony and Susan would only be taxed on the income of the corporation but only if it pays dividends. However, because the corporation is a separate taxable entity, it will have to pay taxes on its earnings in years four and five. This could be desirable because the corporation's marginal tax rate might be lower than that of either Tony or Susan (15% versus 28%).

77. Tory, Becky, Hal, and Jere form TBHJ Partnership as equal owners. TBHJ Partnership rents heavy tools and equipment. Becky and Hal are married to each other while Tory and Jere are brothers but are not related to Becky or Hal. Because Becky and Hal have other jobs, Tory and Jere are to be the full-time managers of the business. Although Tory and Jere will run the business full-time, Becky will help in the store on weekends and some evenings. Hal will lend his financial expertise to the firm by doing the bookkeeping and preparing the tax returns. Even though the four have equal ownership interests, it is not clear how each owner is to be compensated so that there is equity among the partners yet reward those engaged in specific tasks. Hal has told the others that they cannot receive deductible salaries. However, he suggests that guaranteed payments be made to each partner/employee for an agreed-upon amount based on the value of the services each provides and/or the time spent at the store. Discuss the ramifications of employing this plan and whether this is an equitable way to allocate compensation among the partners. What are the implications of this arrangement for the partners and the partnership?

A guaranteed payment is a payment made to a partner for specific services performed by the partner is made without regard to the income of the partnership. These payments are compensation to the partner but are treated as payments to a self-employed individual, separate from the partnership. Therefore the partnership would be able to deduct these payments against the operating income of the business. This has two effects. First the recipient partner must include guaranteed payments in his income apart from his share of the partnership income. Second, the impact of the guaranteed payment is to reduce the allocable amount of partnership income to all partners even if the sum of the guaranteed payments drives income to be negative or an operating loss. This has ramifications for all concerned.

Fringe benefits that are paid to partners are considered guaranteed payments and therefore treated the same. In the present case, the fact that Tory and Jere are full-time employees will require that the partnership make arrangements to adequately compensate them for their efforts. Guaranteed payments seem to be equitable in this case. For Becky and Hal the need to make guaranteed payments is not as clear. Because their time and effort are more sporadic and unpredictable, it is harder to determine whether they should be compensated in the same manner as the full-time partners. Therefore, guaranteed payments are one way in which planning for uneven contributions of service to the partnership can be compensated.

ETHICS DISCUSSION CASE

78. Assume that you are a CPA and a tax specialist. Your clients include Ale and Grains, Inc., an S corporation, and Gustav and Heidi Lager, a married couple who are shareholders and the operators of Ale and Grains. The S corporation has expanded to include 100 qualified shareholders this year. Gustav and Heidi have told you that they have just obtained a divorce. Both individuals will continue to operate Ale and Grains for the ownership group, and neither party plans to dispose of her or his ownership interest. They know that certain rules govern the number of shareholders allowed in an S corporation, but they tell you not to be concerned because only their mailing addresses will change. They refer to the doctrine of substance over form and how it fits this situation. Write a letter to Gustav, Heidi, and the other shareholders offering your advice. Refer to the AICPA Code of Professional Conduct and the Statements on Standards of Tax Services (SSTS, which can be found at www.cengagebrain.com) where necessary.

The divorce of Heidi and Gustav causes the termination of the S corporation election as of that date. A maximum of 100 shareholders are allowed in an S corporation. However, married individuals who are both shareholders are deemed to be one shareholder. Therefore, the divorce adds one shareholder, resulting in a total of 100 shareholders. Two entities exist during the current year. For example, if the official divorce date was June 1 of the current year, the corporation is a conduit through May 31 and a taxable corporation from June 1 through December 31 (assuming a calendar-year corporation).

An inadvertent termination will not result in the discontinuance of the S corporation election if the disqualifying action is quickly corrected. However, in the present scenario it is doubtful that Heidi and Gustav will remarry just to correct the termination of the S corporation status.

Another alternative is to try to get one of the shareholders (preferably Heidi or Gustav) to dispose of her or his stock. However, that could be difficult too.

The AICPA Code of Professional Conduct Rule 202 requires compliance with the tax rules. Disregarding the divorce, which causes termination of the S election is a violation of these rules. SSTS No. 1 provides that a position should not be taken on a tax return unless that position has a realistic possibility of being sustained if challenged. There does not exist a reasonable basis for Ale & Grain to ignore the fact that the S corporation should be terminated due to exceeding the number of allowable shareholders. However, SSTS No. 8 recommends that a CPA inform clients of errors and does not require the CPA to disclose the error to the IRS, unless required by legal proceedings. In the present scenario, the shareholders of Ale and Grains (all are clients) should be notified of the problem, but not the IRS.

Chapter 13

Check Figures

- | | | |
|-----|--|--|
| 33. | N/A | |
| 34. | N/A | |
| 35. | a. R - \$18,271; A - \$21,037
c. R - \$17,021; A - \$22,437 | b. G - \$12,500; R - \$8,271 A - \$13,271 |
| 36. | Proprietor - \$27,913 Corporation - \$22,798 | |
| 37. | a. P - \$35,037; K - \$8,271
c. P - \$33,637; K - \$9,521 | b. C - \$10,000; P - \$21,037; K - \$5,771 |
| 38. | C - \$21,000; P - \$21,037; K - \$5,771 | |
| 39. | C - \$105,000; Each owner - \$10,771 | b. Increase salaries to owners |
| 40. | C - \$11,250; D - \$25,237 | b. \$43,437 |
| 41. | C - \$11,250; D - \$28,987 | b. \$43,437 |
| 42. | Can't avoid double taxation | |
| 43. | P - \$40,000; A - \$60,000; M - \$20,000 | |
| 44. | Use guaranteed payment | |
| 45. | a. TI - \$84,400; Tax - \$16,871
c. TI - \$30,000; Tax - \$ 4,036 | b. TI - \$66,400; Tax - \$12,371
d. TI - \$84,400; Tax - \$16,871 |
| 46. | a. AGI - \$50,761
c. NI - \$55,000 | b. GI - \$60,000
d. \$60,000 if > 2% owner |
| 47. | \$7,771; \$3,886 deduction for AGI
c. Not subject to tax | b. \$3,443 employee and employer |
| 48. | a. Most fringes deductible
c. N/A | b. Certain fringes deductible |
| 49. | a. Deduction
c. Income and deduction | b. Deduction |
| 50. | a. Basis - \$100,000 (Miko); \$150,000 (M)
c. Basis - \$100,000 (Miko); \$150,000 (M) | b. Basis - \$100,000 (Miko); \$150,000 (M) |

