CHOICE OF ENTITY FOR A SMALL BUSINESS

Basic Tax Conference
OSBA/CLE Institute
Cleveland, Ohio
February 2, 2000

By: Gary A. Zwick
Chair, Tax Department
Walter & Haverfield PLL
Cleveland, Ohio
216-781-1212
gaz@walterhav.com

I. INTRODUCTION

A. Scope of this outline

1. The term "small business" has a different meaning to different people. The term "closely-held" comes to mind but this can mean any business that is not publicly traded. If that is the definition, the size of the business can vary greatly. There are many non-publicly traded companies that are larger than some publicly traded companies.

2. Businesses that are operating companies where the owners are active in the business have different considerations than those that have passive investors or are passive investment companies.

3. This outline will consider all of the above and that is why choice of entity is sometimes a confusing subject. There are often vast differences of opinion between and among professional advisors as to how to structure a new or existing businesses.

B. Potential Choices

1. There are a limited number of potential entities.

a. The usual choices include:

i. proprietorships

ii. general partnerships

iii. limited partnerships

iv. regular corporations

v. “S” corporations

b. Some of the less usual choices include:

i. business trusts

ii. tax exempt entities (trusts or corporations)

iii. foreign corporations

iv. other foreign entities

2. There are an unlimited number of combinations and permutations of entities for the operation of a small business.

a. Some of the potential combinations include:

i. parent/subsidiary combinations

ii. brother/sister entities

iii. tiered structures

iv. joint ventures

C. Considerations in choosing an entity

1. Types of owners

a. “S” Corporations cannot have certain types of foreign and non-individual owners.

b. Flow through entities with foreign owners have tax withholding and foreign tax credit issues.

c. “C” Corporations with corporate owners may be able to take advantage of dividends received deductions

d. Certain out of state owners may be treated differently for state tax purposes than other types of owners, depending on which state the company is located in.

e. There are others not mentioned here.

2. Accounting Periods

a. Different types of entities have different restrictions on the accounting period they may use. By way of example:

i. Absent a business purpose, "S" corporations, partnerships and limited liability companies generally must use a calendar year for tax reporting.

ii. "S" corporations, partnerships and limited liability companies may use a September, October, or November year end without permission and without a business purpose if a Section 444 election is used and the deposit requirements of Section 7519 are followed.

iii. Tiered structures generally require the subsidiary entity to conform its fiscal year to that of the parent entity if they are both flow throughs.

iv. Personal Service corporations generally must use a calendar year. However, if they agree to follow the payment rules of Section 280H, they may choose a September, October or November year end without permission and without a business purpose.

v. Trusts that are not entirely tax-exempt must use a calendar year.

3. Accounting Methods

a. There are two basic types of accounting methods:

i. Cash

ii. Accrual

b. Hybrid methods are available in limited circumstances

c. For the small business, the cash method usually allows for the most flexibility and tax planning opportunity.

d. Certain choices of entity impact the method of accounting that may be used. By way of example:

i. A "C" corporation that has over $5 million in gross receipts and is not a personal service corporation must use the accrual method of accounting. In contrast, an "S" corporation, partnership or limited liability company electing to be taxed as a partnership may use the cash method unless otherwise required to use the accrual method.

ii. An "S" corporation, partnership or limited liability company electing to be taxed as a partnership must use the accrual method if 35% of the losses of the company are allocated to passive owners.

iii. An accrual basis C corporation may accrue and deduct a salary payable to an owner who does not own more than 50% of the company as long as the salary is paid to the owner within 2 ½ months of the company's year end. An S corporation, partnership or limited liability company may not do the same for any owner (check this out).

4. Certain Specially Treated Items

a. Fringe benefits for Owners

i. fully deductible for "C" corporations

ii. not deductible for 2% owners of "S" corporations (Section 1372)

iii. not deductible for 10% owners of partnerships and limited liability companies electing to be taxed as partnerships (Section)

b. Health insurance premiums

i. fully deductible for owners of "C" corporations

ii. for self-employed individuals including most owners of S corporations, partnerships and members of limited liability companies electing to be taxed as partnerships, the deduction in 1999 is 45% of the premium. In 2000 and 2001, it is 50%. The deduction phases in to 100% by 2007 but this subject has been discussed for possible complete

phase-in immediately if the government goes back to trying to reduce tax in future legislation.

c. Cafeteria Plans

i. Shareholder/employees of "C" corporations may participate subject to rules that prohibit benefits to be too skewed in favor of the shareholder/employee.

ii. 2% shareholders in "S" corporations and 10% owners of partnerships and LLCs electing to be taxed as partnerships may not participate at all.

d. Qualified Plans

i. "C" corporation shareholder/participants may borrow up to $50,000 from the plan. The interest expense is not deductible.

ii. S corporation shareholder/participants and partnership and LLC owner/participants may not borrow money from the qualified plan at all.

5. Exit strategies

a. The choice of entity is often influenced by what will happen on sale of the business. Some of the considerations are as follows:

i. A sale of stock of a "C" corporation that is not a collapsible corporation under Section 341 will result in capital gain. If that gain is long-term, it is subject to a maximum 20% tax rate regardless of the type of property owned by the company or its holding period.

ii. A sale of the stock of an "S" corporation under new regulations in Section 1 (h) requires a "look-through" to the underlying assets of the company to determine what the character of the underlying capital gain is. This is to prevent the recharacterization of 28% and 25% capital gain into 20% capital gain. This rule applies to capital gain only.

iii. A sale of the units of a partnership or an LLC electing to be taxed as a partnership requires the same look-through for capital gain purposes under the regulations. In addition, Section 751 requires that gain attributable to "hot assets" (unrealized receivables and substantially appreciated inventory) be treated as ordinary income instead of capital gain.

iv. A sale of the assets of a "C" corporation generates gain or loss at the corporate level. If the sale proceeds are then distributed to the owner(s) in a liquidation, the proceeds are taxed again unless the owner is itself a "C" corporation. This results in a "double tax" that is usually to be avoided.

v. A sale of the assets of an "S" corporation that has always been an "S" corporation or that has been one for at least 10 years will generate only one tax. The gain generated at the corporate level will be taxed to the shareholder(s). This will step up their basis and the liquidation or other distribution of the proceeds will not generate further gain or tax.

vi. A sale of the assets of an "S" corporation that was a "C" corporation within the previous ten years may generate a "double tax" on the sale of assets that were owned (including goodwill) at the time of the "S" election to the extent of the gain "built-in" at the effective date of the "S" election. The corporation pays tax on this gain which may be offset by net operating losses and credits that have carried over (if any) from the years when the corporation was a "C" corporation.

vii. A sale of the assets of a partnership or an LLC electing to be taxed as a partnership generates only one level of tax on gain that is flowed-through to the partner or LLC member. The character of the gain and the holding period will depend on the character and holding period to the partnership.

viii. A sale of stock of a "C" corporation or an "S" corporation may be treated as if the assets were sold if an election under Section 338 is made and both the buyer and the seller agree.

b. Tax free reorganizations – Sometimes the sale of a business takes the form of an exchange of ownership in the company for ownership of another company, often a public company.

i. "C" corporations and "S" corporations may engage in a tax free reorganization under the various forms allowed under Section 368 (a) (1).

ii. Partnerships and LLC's electing to be taxed as partnerships may not use the tax free reorganization provisions of the Code.

6. Problems that arise when substantially all of the business is sold but the company is not liquidated.

a. Personal Holding Companies

i. A "C" corporation that has more than 60% of its income generated being portfolio or if the income is passive rental income and more than 10% of the income is from portfolio sources, is a personal holding company. PHC status can cause double tax as if the income had been dividended out to the shareholders.

ii. Even where the company was not sold, if it is or becomes an incorporated pocketbook or if it is a company that receives the bulk of its income from rents and has significant interest and dividend income also, it will run into the PHC tax potential.

b. The Section 1375 tax

i. If an "S" corporation was a "C" corporation at any time in the past and has any "C" corporation retained earnings, and if the income of the company is at least 25% from passive sources including interest, dividends, capital gains, royalties and passive rentals, the company will be subject to a "double tax" on the excess passive income AND if this occurs for 3 straight years, the "S" election of the company will be revoked.

ii. There is a special provision that allows the "S" corporation to distribute out the retained earnings

and designate that the distributions are out of prior retained earnings before current and accumulated S corporation profits in order to fix the problem.

c. Installment sale disposition issues

i. A sale of the assets of a C or S corporation on the installment method will qualify (unless it is an accrual method taxpayer selling after December 17, 1999) for installment sale treatment.

ii. Ordinarily, a liquidation of the company during the period of the installment note will accelerate the recognition of gain on the sale and the gain to the shareholder.

iii. Under a special rule, if the company is a corporation and is liquidated within 12 months of sale, the installment reporting at the shareholder level will be preserved although the gain at the corporate level will be accelerated.

7. Operational Issues

a. Accumulated Earnings

i. A "C" corporation is subject to tax as if it had paid a dividend to its owners if the company accumulates too much, making it look like the company is a vehicle to shelter income by using the generally lower corporate tax rates.

ii. A regular "C" corporation may accumulate $250,000 without question. Any excess must be justified based on operational or capital needs. Accumulations to expand and to buy out shareholders under a buy/sell agreement are justifiable. Operational needs are determined generally using the *Bardahl* formula.

iii. A personal service corporation may accumulate only $150,000 before having to justify further accumulations.

b. Unreasonable Compensation

i. C corporations that pay owner/executives too much may find the excess compensation recharacterized as dividend if it is more than is justifiable.

ii. IRS may also attempt to recharacterize compensation as dividend if owners are paid in proportion to their stock ownership.

iii. This issue exists only for “C” corporations or possibly for some rare “S” corporations that have “C” corporation earnings and profits.

c. Payroll taxes

i. Compensation paid by a corporation to an owner/employee is subject to payroll taxes. This includes FICA on the first $76,200 of compensation in 2000 and medicare tax on all compensation, without a cap. Other payroll taxes apply to compensation including FUTA, SUTA and workers compensation.

ii. Self-employed individuals including proprietors, partners in operating partnerships and members of LLC’s that are operating companies, are subject to self-employment tax on all of the income allocable to them or paid to them as guaranteed payments. The self-employment tax is roughly the same as the FICA and medicare tax.

iii. S corporation income in excess of compensation paid to the owner-employees is not subject to payroll taxes except to the extent the amounts actually distributed to the owners during the year represent amounts paid in lieu of reasonable compensation.

e. Disproportionate distributions

i. Some companies desire to make disproportionate distributions to owners or are not able to adequately compensate owners for their efforts or use of capital unless amounts are paid out in ways that do not comport with their ownership percentages.

ii. Partnerships and LLC's electing to be taxed as partnerships may make distributions in just about any fashion as long as the distribution has substantial economic effect.

iii. "S" corporations are subject to strict two class of stock rules. Distributions must generally be pro-rata on a year by year basis or else a second class of stock will be deemed to be in place and the "S" election will be deemed to be revoked. In an "S" corporation, the only difference between the classes of stock that is allowed is voting rights. Any difference in distribution rights or rights on liquidation will be deemed a second class of stock. Stock options however will generally not cause a problem.

8. Flexibility – when choosing an entity, sometimes the best one is one that is easy to change. Here are some general rules:

a. It is usually tax free to incorporate a proprietorship, partnership or limited liability company electing to be taxed as a partnership. This is true unless :

i. There are liabilities in excess of the basis of the assets being contributed to the company.

ii. The corporation would be deemed an investment company and the contributor is diversifying his holdings.

b. It is usually tax free to make an "S" election over a "C" corporation but you must work around the Section 1374 built-in gains issues and the Section 1375 passive income tax issues. In addition, if LIFO inventories are used, the LIFO reserve must be picked up in income in the last year as a "C" corporation.

c. It is usually a taxable event to merge a C or S corporation into a partnership or LLC.

d. It is usually tax free to drop assets into a subsidiary from any entity to another entity but an S corporation may not be owned by a corporation, partnership or LLC. An S corporation may be owned by another S corporation if it

owns 100% and an election to be a Qualified Subchapter S Subsidiary (Qsub) is made.

9. Estate Planning Issues

a. Different types of entities have different attributes for transfer tax purposes.

b. Some transfer techniques work better with some types of entities than others.

c. Some types of entities have different attributes than others when it comes to valuation.

d. Examples:

i. Family limited partnerships – may not own stock of an S corporation but may own stock of a C corporation or the units of another partnership or LLC.

ii. GRATs and similar techniques – often work better if the asset used to fund the trust is a flow through entity such as an S corporation, LLC or partnership rather than a C corporation.

iii. C corporations can achieve a valuation discount for the corporate level tax inherent in the assets under recent cases of *Eisenberg* and *Davis.* Whether an S corporation may also obtain a discount for the Built-in gains tax is still up in the air.

iv. C corporations may have preferred stock or other classes that differ as to liquidation and dividend preferences. S corporations may not. Partnerships and LLCs may achieve similar results with preferred interests.

II. FORMATION, OPERATION AND LIQUIDATION OF DIFFERENT ENTITIES

A. C Corporations

1. Formation

a. Incorporation

i. Ordinarily tax free if assets are transferred to the corporation by shareholders who after the transfer "control" the corporation. Control is defined as ownership of stock totaling at least 80% of the outstanding stock of the corporation.

a. Exceptions:

1) If assets transferred in have liabilities in excess of basis (sec. 357)

2) If the assets transferred in to the corporation would create an investment company in which there would be diversification - sec. 351(e).

ii. Basis of the assets transferred in to the corporation is equal to the basis the assets have in the hands of the transferor shareholder.

iii. Basis of the stock to the shareholders is equal to the basis of the assets transferred in.

iv. A statement is required to be attached to the tax returns of the shareholder and the corporation when assets are transferred in to a corporation subject to the tax free incorporation provisions of sec. 351.

b. Filings with the state of Ohio

i. File Articles of Incorporation with the state of Ohio.

ii. State of Ohio issues Ohio Charter Number

iii. File a 90 day Personal Property Tax return within 90 days of beginning operations.

iv. File Ohio Franchise Tax return on or before January 31 of the next year unless extended.

v. File full year Personal Property Tax return on or before April 30 unless extended or unless property is owned in more than one county in which case the return is due June 15.

vi. File city income tax return if located in a taxing city, on a date which is either 3 ½ months or 4 months after the fiscal year ends depending on the city.

2. Operation

a. The corporation is a separate tax paying entity which files a federal Form 1120 to pay its tax.

i. If it is a personal holding company, it attaches a form 1120 PH

ii. If it is a foreign corporation, it files a form 1120F

iii. If it is a foreign sales corporation, it files a 1120FSC

iv. If it is a member of a consolidated group of controlled entities (parent and subsidiaries), it files a consolidated tax return for federal tax purposes but may file separately in each state and city it is located in.

v. Other entities have special filings.

b. The corporation computes its taxable income like any other business. Taxable income is taxed in tax brackets ranging from 15% to 35%. Average tax on the first $100,000 of income is 22%.

c. The Alternative Minimum Tax applies to C corporations that have average gross receipts that exceed $5 million.

d. C Corporations with average gross receipts in excess of $5 million must use the accrual method of accounting unless it is a personal service corporation.

e. The corporation may select any fiscal year it desires without penalty or encumbrance except if it is a personal service corporation in which case fiscal years are required to be a calendar year unless a September, October or November year is selected and the 280H rules on payment of items to shareholders are followed.

f. Unreasonable accumulations of earnings may be taxed as if a dividend was paid.

g. Unreasonably high salary to shareholder/employees may be recharacterized as dividends instead of salary.

h. Life insurance proceeds may cause alternative minimum tax if the corporation is subject to the AMT.

3. Distributions

a. Dividends are taxed as ordinary income to the extent of current or accumulated earnings and profits, are return of capital thereafter and are capital gain thereafter.

b. Distributions that are not dividends result in capital gain to the shareholder if they meet the redemption rules of section 302 or are in complete liquidation of the company.

c. In family situations, it may be difficult to obtain capital gain treatment since family aggregation can be troublesome in determining if the shareholder has given up meaningful ownership interest.

4. Sale or other dispositions

a. Sale of the stock results in capital gain except if a collapsible corporation.

b. Sale of assets can result in a double tax. Once at the corporate level and once again at the shareholder level.

c. Assets or stock of a C corporation can be exchanged tax free for stock of another company including a public company (other than a mutual fund or other investment company).

d. A sale of stock can be treated as a sale of the assets under Section 338. An election must be made and the company is charged with the two levels of tax but certain other taxes and hassles are avoided such as sales tax on sale of assets or the hassles of retitling many assets that have titles that evidence ownership.

B. S Corporations

1. Formation

a. All of the same rules as for C corporations apply with the addition of the following:

   i. All of the shareholders of the corporation must affirmatively elect to have the corporation be treated as an S corporation.

   ii. The election must be made before the beginning of the year to which it is to apply or within 2 ½ months of the beginning of the year if it is to apply retroactively.

   iii. The first year election is to be made within 2 ½ months of the date the corporation first had assets, shareholders or began doing business, whichever came first.

b. The S election stays in force until any of the following occur:

   i. At least 50% of the shareholders affirmatively elect to revoke the election.

   ii. An ineligible shareholder acquires shares

   iii. The company has C corporation earnings and profits and passive income in excess of 25% of gross receipts for 3 straight years.

c. The following are ineligible shareholders:

   i. Non-resident alien individuals

   ii. Any trust that is not either a grantor trust, a qualified subchapter S trust (QSST), an electing small business trust (ESBT) or a voting trust

   iii. Any other non-individual except:

      a) another Sub S corporation if it owns 100% of the subsidiary S corporation and an election to be a Qualified subchapter S subsidiary (Qsub), is made OR if the owner is a disregarded entity such as a one-person LLC.

d. Accounting period selected at date of S election

i. New S corporations are required to select a calendar year for their tax reporting period except:

a) If a business purpose is established for a different year end. The one business purpose sanctioned by IRS is where at least 25% of the gross receipts of the company fall in the same two month period each year and the company establishes this for a three year period and applies to the IRS for recognition of this business purpose. There may be others such as government regulatory requirements but IRS has not announced any.

b) A September, October or November year may be selected if an election is made under Sec. 444 to pay a deposit as required in Sec. 280H which is made with IRS, is an asset of the company and is held by IRS without interest until the company liquidates or the fiscal year is changed to one that defers less income.

ii. The election of a fiscal year under sec. 444 is done when the original form 2553 is filed by attaching a form 8716 showing the year end. Although it is possible to get a fiscal year under sec. 444 without doing this, IRS is hard to deal with when you don't do it this way.

iii. A later switch from a fiscal year to a calendar year or to a year that provides less deferral is always automatically allowed. A switch from a year with less deferral to one that provides more deferral is not allowed unless a business purpose is shown to IRS.

e. Two Classes of Stock

i. An S corporation may not have more than one class of stock that has differences as to liquidation proceeds or as to distributions. The only difference allowed between types of stock is voting rights. An

S corporation may have voting and non-voting stock.

2. Operation

a. Except where the sec. 1374 or 1375 taxes apply, the S corporation is not a federal tax paying entity. It files a form 1120S with the federal government and the income of the corporation flows through to the shareholders pro-rata based on relative shareholdings. The income is shown on a form 1120S k-1 in the name of each shareholder who shows the income on his/her personal income tax return.

i. The character of the income to the shareholder is the same as it was to the corporation.

ii. If a shareholder disposes of all of his or her stock during a year or if a 20% change in ownership occurs, income could at the election of the affected shareholders, be allocated as if the books were actually closed on the date of the dispositions(s). See secs. 1368 and 1377.

iii. Certain items are separately stated, such as charitable contributions, depreciation, interest expense and capital gains. These items are flowed through to the shareholder and appear on the shareholder's personal return on the schedules it would have appeared on if the amounts had been paid or received by the shareholder directly.

b. Losses, basis and distributions

i. A shareholders basis in the stock of an S corporation includes what he paid for the stock, plus income reported on his k-1, plus tax exempt income, minus distributions taken with respect to stock, minus losses reported on his k-1.

ii. If the stock is inherited, the starting point for basis is the fair market value of the stock inherited. Whatever went before that makes no difference. Adjustments for income, losses and distributions thereafter are added to or subtracted from that amount.

ii. Basis may not go below zero. If losses or distributions exceed basis, the basis of any loans made by the shareholder to the company are reduced until it reaches zero.

iii. Losses in excess of basis are held in abeyance until there is sufficient basis or income to absorb it. Distributions in excess of basis create capital gain to the shareholder. There may be dividend income also depending on the AAA account at the corporate level.

iv. Zero basis loans that are later repaid give rise to income to the shareholder.

c. Accumulated Adjustments Account

i. In addition to outside basis of the company tracked by each shareholder, the company keeps track of its accumulated adjustments account and an other adjustments account.

ii. The AAA generally tracks the income of the company since it became an S corporation that has not been distributed. It will generally be equivalent to the aggregate bases of the shareholders outside of the company if the company was always an S corporation and no shareholder has died or sold to another person.

iii. Distributions in the ordinary course of business from the corporation are treated as coming first out of the AAA account which is previously taxed income that is not taxed again. This is true even if the income was previously taxed to a different shareholder. After AAA is exhausted, if there are earnings and profits from C corporation years, those amounts are treated as dividends. After that, amounts are treated as coming out of other adjustments such as tax exempt income and then as return of basis (discussed above). If any excess amounts are distributed, they are treated as capital gain.

iv. Distributions must be prorata within a limited period of time or else they may constitute a second class of stock which could destroy the S election.

v. A corporation may elect to treat a distribution as coming out of C corporation earnings and profits first before AAA if it desires. This might be done to avoid the sec. 1375 tax.

d. Unreasonably high compensation and accumulated earnings in an S corporation are not usually issues to be concerned about. Unreasonably low salaries may be attacked by IRS as a way to avoid payroll taxes. IRS will attempt to recharacterize income distributed as salary instead of distributions with respect to stock out of AAA as the taxpayer may desire. See Rev. Rul. 74-44, *Radtke* and *Spicer.*

e. Corporate alternative minimum tax does not apply to an S corporation although tax preferences generated at the corporate level may be passed through to the shareholder and may cause alternative minimum tax at the shareholder level.

f. Ohio does not tax an S corporation if it has been an S corporation for the entire year. Form FT 1120S is filed by June 30 showing the shareholders. Non-Ohio S shareholders are subject to tax in Ohio on allocable Ohio income. The shareholders may file individual returns or if there are more than one non-Ohio shareholders, a composite tax return may be filed by the corporation.

g. An S corporation generally pays city income tax to the city in which it is located or does business. Some cities may attempt to tax S income in the city of residence of the shareholder also but have not had much success.

h. S corporations are subject to the same personal property tax rules as C corporations and all other entities.

3. Sale or other dispositions

a. Sale of the stock of an S corporation generally results in capital gain except if the collapsible corporation rules apply.

b. If the corporation holds depreciable real estate or collectibles, a sale of the stock is treated as if a prorata portion of the underlying real estate or collectibles were sold for purposes of determining the maximum tax rate on certain kinds of capital gain.

c. On death of a shareholder, the stock generally steps up in basis to the fair market value of the stock at date of death except that if the property in the corporation would constitute income in respect of a decedent if held by the shareholder at death, it will to that extent prevent a step up in the basis of the stock in the hands of the estate.

d. S corporations may avail themselves of all of the tax free reorganization provisions that C corporations may. Section 338 is also available to treat a stock sale as an asset sale.

e. Generally, a sale of assets of the corporation results in only one level of tax except to the extent the section 1374 or 1375 taxes may apply.

C. Limited Liability Companies (LLCs)

1. Formation

a. Come into existence upon filing the Articles of Organization with the state.

b. No operating agreement is necessary although when there is more than one owner, an operating agreement is usually advisable.

c. If no operating agreement is present, the statute governs the running of the company. It will be a member managed company as opposed to a manager managed company.

d. An operating agreement can modify almost any provision of the statute, making the statute controlling only where no operating agreement is used or when the agreement does not cover the situation.

e. LLCs are typically taxed as partnerships by choice. If no elections are made, it is assumed under the Check the Box regulations that partnership taxation applies. In some states (i.e. Kentucky), it may be advantageous from a state tax standpoint to be an LLC taxed as a corporation. One

person LLC's are disregarded entities for federal tax purposes.

f. As a partnership for tax purposes, the following rules apply on formation:

   i. The transfer of cash or property to the company on formation or later is generally tax free and unlike a corporation, there is no need for the transferor(s) to have at least 80% control after the transfer.

   ii. The transfer to the partnership would not be tax free if there are liabilities in excess of basis and the partner is relieved of the liability or if the transfer results in the company being an investment company and the transferor is able to diversify his investment - Sec. 721(b).

g. Service partners may have compensation income if they receive a capital interest in the company in exchange for services. These are often structured as profits interests in order to get around. See *Sol Diamond* and *Campbell.*

h. Members are generally shielded from personal liability except in certain cases in professional service companies.

i. Selection of fiscal years and accounting methods follow closely the rules for S corporations above. If one of the members is a C corporation with gross receipts in excess of $5 million, the LLC may be required to report income on the accrual method.

j. The company does not pay tax at the federal or state level in Ohio. City tax is paid by the company in the city in which it is located or does business.

2. Operation

   a. The company files federal form 1065 to report income etc.

   b. The company does not pay federal or state tax

   c. The company income is flowed through to members on form 1065 k-1. The income has the same character in the hands of the the owner as it did at the company level. Certain items flow through separately and are reported on

the appropriate lines of the tax return of the owner as if he had incurred the item himself.

d. The Alternative Minimum Tax does not apply to a partnership although items that are passed through to the owners may cause personal AMT.

e. In addition to having C corporation owners, if the LLC allocates losses to 35% passive owners, it is considered a "tax shelter" and must use the accrual method of accounting.

f. No restrictions on who or what may own an interest.

g. Foreign owners may be subject to withholding at the company level on distributions. The amount is creditable for foreign tax credit purposes.

h. FICA/Self-employment tax issues are confusing because an LLC is so much like a limited partnership in many ways. Generally, if the owner is active the owner will owe self-employment tax.

3. Distributions

a. Distributions of cash and marketable securities reduce the owner's basis in the LLC interest until gone. All amounts received in excess of that is capital gain (some of which may be sec. 751 hot assets which generate ordinary income).

b. Distributions of other property take a carry-over basis equal to the LLC member's basis in the interest he owns in the LLC.

c. Anti-abuse rules in sec. 707 and 737 attempt to prevent the use of the LLC or partnership form to make disguised sales or to assign income to lower bracket taxpayers.

d. Unlike the S corporation, there is no entity level previously taxed income or basis account. The owner's basis is the cost (or fair market value if inherited), plus amounts contributed, less amounts distributed, plus income recognized less expenses paid.

e. Unlike S corporations, distributions may be made disproportionately and with preferences to one owner over another. There can be any number of classes of ownership.

4. Sale or Other Disposition

a. Sale of a LLC interest results in capital gain except to the extent the company has "hot assets" allocable to the interest. These are unrealized receivables and substantially appreciated inventory and generate ordinary income.

b. Sale of assets and sale of interests usually have the same result. There is only one level of tax on sale of an interest or assets of the company.

c. The company may not be exchanged in a tax-free reorganization like a corporation may.

d. Section 754 allows a basis adjustment in the underlying property of the company if an interest is sold or inherited. Company must make an election and it applies to all such transactions thereafter unless IRS grants permission to terminate the 754 election.

e. There is flexibility in determining the tax consequences to a retiring partner.

D. Partnerships

1. The rules for LLC's apply equally to partnerships from a tax standpoint.

2. Formation with the state follows a similar pattern as LLC's

3. Partnerships must be formed by more than one person or entity and must have a business purpose.

4. Limited partners are not subject to self-employment tax on their distributive share.