

## ***West Suburban Business Solutions, Inc.***

The goal of West Suburban Companies is to establish a full-service financial network to meet the aspects of the financial needs of individuals and business owners. West Suburban Companies constantly refines its services at reasonable prices. Together, the managers and administrable of West Suburban Companies stand ready to provide personalized services to support our clients in reaching their financial goals.

West Suburban Companies continuously looks for ways to expand its services to adjust to our clients' changing needs. We now offer fully computerized accounting and tax service for bot small and large businesses, as well as individual tax planning and preparation. We are dedicated to helping clients reach their financial goals through financial planning. A wide ran of investment and/or risk products are offered to suit each individual investment situation.

As West Suburban Companies develops, each new enhancement is focused on increasing our ability to fully service our customers' financial needs. To learn more about our new services or upcoming events, please visit our website at **www.WSCFinancial.com** or call Stephen A. Vranek at 630.368.6390 ext. 105 or email [svranek@wscfinancial.com](mailto:svranek@wscfinancial.com).

### ***Services Available***

- ❖ Virtual Controller
- ❖ Virtual CFO
- ❖ Business Consulting
- ❖ Tax Strategy and Planning
- ❖ QuickBooks Seminars
- ❖ Networking and Educational Events
- ❖ Entity Analysis
- ❖ Web Site Development
- ❖ Web Based:
  - Bookkeeping
  - Accounting and Tax

Sincerely,

*Stephen A. Vranek*

Accounting and Tax Specialist

West Suburban Business Solutions, Inc.

## ***A Business of Your Own Is Still the Best Tax Shelter Around***

One of the most important decisions to make is what legal form your business should take. Each form of doing business has its own tax consequences. The most common forms of business to select from are: sole proprietorship, partnership, Limited Liability Company, and corporation.

### ***Sole Proprietorship***

***An unincorporated business with only one owner***

#### **Tax Advantages**

- ✓ Losses incurred in starting up the business are deductible on the owner's personal tax return. These losses can be used to reduce the owner's taxable income from other sources.
- ✓ There is no double taxation. Income of a regular corporation is taxed twice—first, the business pays corporate income tax on its profits, and then the shareholders pay personal income taxes on the dividends they receive. The income of a sole proprietorship is taxed only once, to the owner on his personal income tax return.
- ✓ Income is taxed at individual income tax rates which are lower than corporate rates (c-corporation).

#### **Tax Disadvantage**

- ✓ Income tax cannot be deferred by retaining profits in the business. The income is taxed to the owner, whether or not s/he takes the money out of the business.

#### **Major Drawback**

- ✓ The owner of the business has unlimited personal liability for the debts, obligations, and lawsuits of the business.

### ***Partnership***

***Operates like a sole proprietorship, however, it has more than one owner***

#### **Tax Advantages**

- ✓ The partnership agreement determines each partner's share of income, loss, deductions and credits. These items are passed through to the partners to be reflected on their personal returns.
- ✓ Income is taxed at the individual partner's rate.
- ✓ There is no double taxation, since the partnership pays no taxes.
- ✓ Partners can deduct losses to the extent they are personally liable for partnership obligations (basis).
- ✓ The allocation percentages to partners of profit and loss can be changed easily from one year to the next as circumstances dictate (dependent on the partnership agreement).

## ***Partnership (cont.)***

### **Major Drawbacks**

- ✓ Each general partner is fully liable for all the debts and obligations of the partnership.
- ✓ Profits are taxed even though they're not distributed to the partners.

### ***Limited Liability Company (LLC)***

*Operates like a partnership for tax purposes and enjoys the advantages of a corporation for liability purposes*

### **Additional Advantages over a Partnership**

- ✓ Has the same legal protection as a corporation against personal liability for debts, obligations and lawsuits of the business.
- ✓ Permits a single-member partnership in some states (not Illinois).

### **Disadvantage**

- ✓ Annual fees and initial legal fees are more costly than a partnership or corporation.

## ***Regular "C" Corporations***

### **Tax Disadvantage**

- ✓ These businesses have their own tax structure. The profits are separately taxed. That is, they're taxed twice, once at the corporate level, and again when dividends are distributed to stockholders.

### **Ways to Avoid the Double Tax**

- ✓ Retain earnings in the corporation and pay little or nothing in dividends.
  - Trap** - The IRS imposes a penalty on unreasonable accumulation of earnings, those in excess of \$250,000. To avoid the penalty, the company must show valid business reasons to retain and accumulate earnings.
  - Solution #1** - The money is needed for expansion, for working capital, or to repay borrowings.
  - Solution #2** - Officer-stockholders can pay high salaries and bonuses to themselves, thus reducing taxable profits.
  - Trap on Solution #2** - The IRS will challenge, as a non-deductible dividend, salaries that are not reasonable in relation to the work performed and in line with what other companies pay officers in similar positions.

### **Legal Advantage**

- ✓ Offers legal protection against personal liability for debts, obligations, and lawsuits of the business.

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## ***Regular "C" Corporations (cont.)***

### **Tax Reasons for Very Small Businesses To Incorporate**

- ✓ C-Corporation shareholder/employees are allowed deductible health and accident insurance plans and medical reimbursement plans.
- ✓ To take advantage of lower federal corporate tax rates on the first \$50,000 of income. How corporate income is taxed federally:

<b>Income</b>	<b>Tax Rate</b>
\$0 - \$50,000	15%
\$50,000 - \$75,000	25%
\$75,000 - \$100,000	34%
\$100,000 - \$335,000	39%
\$335,000 - \$10,000,000	34%
\$10,000,000 - \$15,000,000	35%
\$15,000,000 - \$18,333,333	38%
Over \$18,333,333	35%

### ***Subchapter S-Corporation***

***A business that elects to operate under subchapter S  
of the Internal Revenue Service Tax Code***

### **Tax Advantages**

- ✓ No double taxation. Income is taxed only once, directly to the corporation's shareholders on their personal income tax returns.
- ✓ Income is taxed at lower individual income tax rates.
- ✓ The penalty tax that regular corporations pay on accumulated earnings in excess of \$250,000 (\$150,000 for professional corporations) is avoided. S-corporation income is taxed to the stockholders even if it is not distributed.
- ✓ The double tax that regular corporations pay when assets are liquidated is avoided. When a regular corporation liquidates, the corporation pays tax on the gain, and the shareholders pay tax on the part of the gain that is passed through to them. This double taxation is eliminated with S-corporation status since there is no tax at the corporate level.

### **Legal Advantage**

- ✓ Offers legal protection against personal liability for debts, obligations, and lawsuits of the business.

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## ***Subchapter S-Corporation*** (cont.)

### **Major Drawbacks**

- ✓ The deduction for losses is limited to the amount of money a shareholder invested in or loaned to the company (basis).
- ✓ Money accumulated in an S-corporation is taxed to shareholders, whether they receive it or not.
- ✓ There are eligibility requirements to become an S-corporation. For example, an S-corporation cannot have more than 75 shareholders and cannot have a foreign shareholder. In addition, corporations and partnerships cannot be shareholders.
- ✓ The cost of key fringe benefits for shareholders who are also employees are not deductible by the corporation. This includes accident, health, and group-term life insurance.

### **When to Elect Subchapter S-Corporation Status**

- ✓ All of the following requirements are satisfied.
- ✓ An election can be made by filing **Form 2553** either:
  - At any time through the 15th day of the third month of the tax year if filed during the tax year that the election is to take effect
  - At any time during the tax year preceding the tax year that the election is to take effect
  - During the first 75 days of the new corporation

### **Requirements for Electing Subchapter S-Corporation Status**

A corporation must meet the requirements of Code Section 136 to be eligible to make an S corporation election:

- ✓ The corporation must be a domestic corporation.
- ✓ The corporation may have no more than 75 shareholders.
- ✓ Corporations and partnerships may not be shareholders.
- ✓ The shareholders must be U. S. citizens or resident individuals, estates, or electing small business trusts.
- ✓ All beneficiaries of the small business trust must be individuals or estates eligible to be Subchapter S shareholders.
- ✓ A grantor trust is allowed to hold Subchapter S stock for two years from date of death.
- ✓ A trust that becomes a Subchapter S shareholder due to a will can hold the stock for two years from date of the stock transfer into the trust.
- ✓ Beginning in 1998, tax-exempt organizations may become Subchapter S shareholders.
- ✓ The corporation may not have more than one class of stock. Differences in voting rights in one class of common stock do not violate the one-class-of-stock rule, but care must be taken in issuing debt, since debt can be potentially treated as a second class of stock. However, commercial lender loans can no longer be treated as a second class of stock.
- ✓ Banks, insurance companies, possessions corporations, and past and present domestic international sales corporations are ineligible. However, domestic building and loan associations, mutual savings banks and cooperative mutual banks are eligible.

### ***Subchapter S-Corporation*** (cont.)

- ✓ A corporation generally must meet the eligibility requirements listed above both on the date of its election and on each day of each taxable year for which the election is effective.
- ✓ All shareholders must consent to the election.

### ***Analysis of an S-Corporation***

#### **Advantages**

- ✓ An S-Corporation avoids double taxation on distributions. Only shareholders pay federal tax on income of an S-Corporation, not the corporation. (State laws vary)
- ✓ The individual federal income tax rate is lower than the corporate federal income tax rate.
- ✓ The S-Corporation may be able to retain more after-tax earnings to invest in current operations, expansion, or debt retirement than a C-Corporation.
- ✓ Undistributed earnings increase shareholder basis in stock, thereby reducing the gain on a subsequent sale or liquidation.
- ✓ An S corporation does not have accumulated earnings tax problems because all income is taxed currently to the shareholders.
- ✓ Reduced estimated tax requirements may create a cash-flow benefit/savings in the year of conversion to S-Corporation status. S-Corporations do not have to make estimated tax payments. Shareholders' estimated tax payments are based on prior year's actual liability.
- ✓ An S-Corporation may solve unreasonable compensation issues for shareholder-employees.
- ✓ An S corporation cannot have personal holding company problems (although passive earnings may cause problems for former C-Corporations).
- ✓ An S-Corporation is not subject to corporate alternative minimum tax.
- ✓ There may be state income tax savings from an S-Corporation election, depending on the state tax situation of the individual shareholders.

#### **Disadvantages**

- ✓ S-Corporations are not allowed to have 80%-owned subsidiaries. Consideration must be given to liquidating subsidiaries and reorganizing any foreign operations.
- ✓ S-Corporations are limited to one class of stock. However, a difference in voting rights in one class of common stock does not violate one-class-of-stock rule.
- ✓ Fiscal year ends are prohibited unless a valid business reason is established (e.g., natural business cycle) or a Section 444 election is made (required payments).
- ✓ Any built-in gain that exists on the effective date of an S-Corporation election made after December 31, 1986, may be taxed upon disposition of any asset within 10 years after the effective date of the S-Corporation election by a former C corporation. Certain transitional rules apply.

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### *Analysis of an S-Corporation (cont.)*

- ✓ Fringe benefits to a 2% shareholder are nondeductible. The fringe benefit definition does not include qualified pension and profit-sharing plans (i.e., contributions to these plans on behalf of shareholder - employees remain deductible).
- ✓ While regular corporations receive a 70% or 80% dividends-received deduction, dividends on non-controlled corporation stock in an S-Corporation flow through to the individual taxpayers as fully taxable dividend income.
- ✓ An S-Corporation with C-Corporation earnings and profits will owe corporate level tax if no more than 25% of total gross receipts are from passive income sources (e.g., dividends, interest, royalties, and certain rents). If such a corporation fails this greater-than-25% test for three consecutive taxable years, its corporation election will be terminated.
- ✓ Shareholders must individually recognize any tax preference items.
- ✓ Shareholders may be required to file tax returns and pay tax in states other than their states of residence. Accordingly, their state tax liability may increase.
- ✓ The S-Corporation cannot use C-Corporation net operating losses and credit carryovers that are unused at the time of the S-Corporation election.

#### **Requirements for Electing S-Corporation Status**

A corporation must meet the requirements of Code Section 136 to be eligible to make an S-Corporation election:

- ✓ The corporation must be a domestic corporation.
- ✓ The corporation may have no more than 35 shareholders.
- ✓ The shareholders must be U.S. citizens or resident individuals, estates, or certain trusts. Corporation and partnerships may not be shareholders.
- ✓ The corporation may not have more than one class of stock. Differences in voting rights in one class of common stock do not violate the one-class-of-stock rule, but care should be taken in issuing debt because debt could sometimes be treated as a second class of stock.
- ✓ The corporation may not have a subsidiary, other than one that is and always has been inactive, that it directly owns 80% or more by vote and value.
- ✓ Banks, insurance companies, possessions corporations, and past and present domestic international sales corporations are ineligible.
- ✓ A corporation generally must meet the eligibility requirements listed above both on the date of its election and on each day of each taxable year for which the election is effective.
- ✓ All shareholders must consent to the election.

#### **When to Elect S-Corporation Status**

- ✓ All of the above requirements are satisfied
- ✓ An election can be made by filing Form 2553 either:
  - At any time before the sixteenth day of the third month the tax year, if filed during the tax year the election is to take effect
  - At any time during the tax year preceding the tax year that the election is to take effect