A GUIDEBOOK TO UNDERSTANDING CORPORATIONS

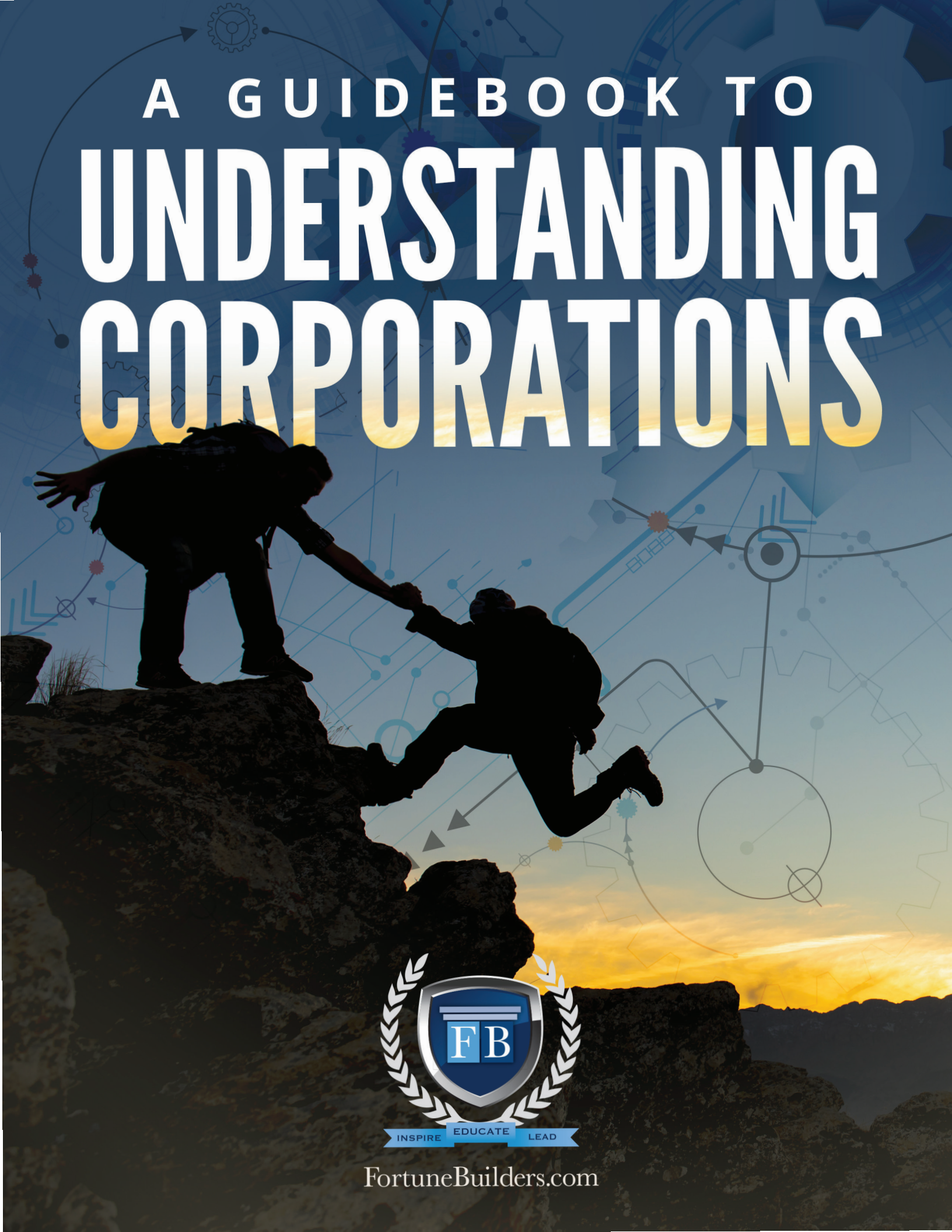

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Table of Contents

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3) Introduction

4) Choosing The Right Business Entity For Your Company

Sole Proprietorships

5) General Partnerships

6) Limited Partnerships

7) Limited Liability Companies (LLCs)

10) Which Corporation Are You?

Corporations

11) The Corporate Business Structure

12) Comparison of C Corporations & S Corporations

S Corporations

C Corporations

16) The Ever-Popular Corporation

17) Liability Protection

18) Asset Protection

19) Tax Savings

Impacting the Bottom Line

20) Saving on Taxes vs. Increasing Sales

Saving on Taxes vs. Cutting Costs

Raising Capital

21) Reducing Audit Risk

Living the Corporate Lifestyle

22) Building Business Credit

Estate Planning

23) Corporate Image

Business Plans for Business Success

24) Tax Deductions & Selected Business Expenses

26) Other Deductions Allowed for a Corporation, But Not an Individual

Real Estate Losses to Offset Active Corporate Income

Start-Up Business Deductions

27) Costs You Cannot Amortize.

Introduction

There are many benefits and advantages to starting, forming and running your own business. While admittedly, at times it can prove to be quite challenging, with the proper education, few businesses can offer you a platform to build lasting wealth quite like that of real estate investing – for many reasons:

- You can enjoy significant profits from the deals you close.
- You can make substantial passive, residual income from valuable rental properties.
- You can gain access to more credit from banks and private lenders.
- You can leave a lasting legacy to your loved ones.

Finally, you can take comfort in the knowledge, that even after all of the turmoil and volatility the real estate industry experienced in recent years, real estate investing is still one of the best business opportunities you can pursue. So the sooner you have your real estate investing business set up, the sooner you can begin your journey down the pathway toward financial freedom and a more secure future for you and your loved ones.

Choosing to start a real estate investing business is the easy part. Deciding how to go about setting your company up as a legal and legitimate business entity on the other hand, can be tricky. In fact, it's the one decision you will make during the life of your business that could literally change everything. That's why we've put together this free, informative handbook about understanding corporations. Our ultimate goal with this guide is to make sure that you have enough information at your fingertips to help you make an informed decision about how to form the entity that will become your company on paper for legal and tax purposes. Whether it's a one- or two-person business, or a corporation employing thousands, it's our hope that this guide will give you a comprehensive, basic understanding of how corporations work. Ultimately, our goal is to teach you how to set your company up to give you the best possible foundation for success – today, tomorrow and for years to come.

Choosing The Right Business Entity For Your Company

What follows are several examples that illustrate the different options you can choose from in setting up and establishing your company, along with some of the advantages and disadvantages of each of them. After reading this guide, you may want to seek additional advice from a lawyer or a business tax expert to help you decide which route is best for you.

Entity comparison Chart:

TYPE	LIABILITY PROTECTION	TAX SAVINGS
Sole Proprietorship	None	None
General Partnership	None	None
Limited Partnership	For Limited Partners Only	None
Limited Liability Company	Yes	Possible
Corporation	Yes	Yes

Sole Proprietorships

Let's say Mary decides to start a graphic design business and, because she is operating basically as a freelancer with no employees, she figures a sole proprietorship is the logical way to go. She gets a business license from the state and the appropriate local municipality, files a DBA (doing business as) certificate with the County Recorder's office, and is now established as a legitimate business. While this seems like the right thing to do based on Mary's situation and the fact that the sole proprietorship is the least expensive form of business to establish, other factors can make it the most expensive business structure in the long run.

There is no legal distinction between yourself and the sole proprietorship. Therefore, there is no distinction between business and personal assets, and sole proprietors risk everything they have in the business. If a judgment is awarded against the business, every personal asset of the owner can be used to satisfy the judgment.

Another drawback of the sole proprietorship is that it cannot survive without you, meaning the business dies along with you. If you, as a sole proprietor, want to pass the business to your heirs, there are a number of estate planning and taxation issues that must be overcome. Indeed, there are several basic estate planning considerations that are particular to sole proprietorship status.

Beyond that, you will likely find it difficult to raise capital as a sole proprietor. Your only option is a personal loan or investment, compared to the third-party investment options that are available to corporations through an issuance of stock.

Sole proprietorships are fairly easy to operate compared to corporations because there are no formalities to maintain, no meetings to hold, and no documents to draft and file. (Of course, even though there are no formation hoops to jump through to set up the sole proprietorship, its business activity must still fall within federal, state, and local guidelines.)

From a tax standpoint, as a sole proprietor, you do not have to file a separate business tax return. A Schedule C is attached to your 1040 and filed with the IRS. Taxes are paid based on whatever personal income tax rate applies to you.

Gains and losses from the business are simply combined with other personal taxable items.

Because of this simplicity, accountants and attorneys often recommend the sole proprietorship structure. However, there are many issues to consider that these professionals often forget or ignore. The way the world works today, it would be foolish to just assume that you are immune to losing your assets and that your privacy won't be invaded. The United States is the most litigious country in the world. We live in a place where someone who chooses to visit your home, invited or not, can sue you if he or she trips on a buckled rug. We live in a society where if you spill a cup of coffee on yourself, you can get millions out of the company that sold you the coffee. Think about it. Do you really think you're safe?

With more than one million attorneys in the U.S. today looking to make a buck (that's 1 for every 227 people), business owners new and old must take precautions to protect their interests. Sole proprietorships are risky entities that could cost you and your family everything you own, especially when there is no other entity more scrutinized by the IRS.

Beyond this risk, you're also likely to miss out on some tax advantages. Sole proprietorships have historically been limited in their ability to participate in such things as federally qualified pension plans and medical reimbursement plans that are available to other business entities, and they may have trouble justifying full deductions for certain business expenses.

All-in-all, the sole proprietorship is certainly not an ideal long-term business solution. If you're currently a sole proprietor, you're gambling on wishful thinking that you will not incur any business liability – and you're also ignoring the many tax advantages available to you as a corporation.

Advantages	Disadvantages
Ease of Formation: A sole proprietorship only requires a business license and DBA (doing business as) certificate to be filed with the state and/ or local municipalities, and it's in business. **Pass-Through Tax Treatment:** The income, profits, losses, and expenses of the company flow directly through to the individual who reports the income and expenses on his/her personal tax return. This makes the sole proprietorship less complex because only one tax return is involved instead of two separate ones. However, the tax burden may be greater due to differing tax rated and treatments for individuals vs. corporations.	**Personal Liability:** The individual is responsible for all the debts and obligations of the business, as well as any judgements against it. Creditors can lien personal property even if it's not part of the business. **Lack of Continuity**: If you die or are sick, the business dies or languishes. **Lack of Investment Flexibility:** Sole proprietorships are usually financed through capital contributions of the individual or by debt as opposed to generating capital from third-party investors through the issuance of stock.

General Partnerships

Let's say that Rich decides that he could use some help in opening up a new business, "Widget World." He decides to call up his college buddy, Guy, who was always good with finances. After all, he was their fraternity's treasurer and bookkeeper. So Rich and Guy decide to form a general partnership.

This type of entity is formed when two or more people come together for the purposes of conducting a business. As Rich and Guy work to form their general partnership, they must agree on which duties each will take on and what percentage of ownership they will each hold. Typically, this is done with a general partnership agreement that should be put together with the help of a business lawyer.

Similar to sole proprietorships, general partnerships have many of the same advantages and disadvantages. Like sole

proprietorships, general partnerships are easy to form, but they are taxed according to the tax levels of each partner. Likewise, no liability protection is offered. Again, businesses should seriously consider the consequences of litigation without any shield to protect the owners' personal assets. Last but not least, a word of warning: Keeping in mind that 50 percent of marriages fail even with the extensive relationship building that occurs before the wedding, the odds of a successful and lasting business partnership are even less likely, given the lesser level of effort exerted in most cases. In fact, it's estimated that 90 percent of business partnerships fail – which is most likely not an outcome you're seeking for your business.

Advantages	Disadvantages
Ease of Formation: A general partnership is a voluntary association of two or more individuals or business entities who agree to work together for a common buinsess prupose. They share their profits and losses equally or ad otherwise stated in a partnership agreement. **Pass-Through Tax Treatment:** By forming a partnership, the profits and losses from the business are split and recorded on each partner's personal income tax return. Like the sole proprietorship, this may unify and simplify the process fo filing taxes but offers no separation between personal and business assets. The tax burden may also be greater due to differing tax rated and treatments for individuals vs. corporations.	**Personal Liability:** Rich and Guy are each personally responsible for all the debts and obligations of, as well as any judgments against, the business. If one partner makes a mistake, it may cost both partners dearly. **Lack of Continuity:** If one of the partners ceased to be a partner, whether by retirement or by death, the partnership is usually dissolved as a matter of law. **Lack of Investment Flexibility:** General partnerships are usually financed through capital contributions of partners or by debt.

Limited Partnerships

In this example, John and Sarah, coworkers at a government agency, decide to start their own business to consult with other firms on how to comply with the agency's requirements. Both have mentors who are successful entrepreneurs and who believe John and Sarah have found a unique market and have the right backgrounds to be very successful in their venture. As a result, both mentors want to invest in the company to help get it started even though they don't want to be personally liable for the business. Beyond that, neither really has the time or the industry knowledge to participate actively in the business. For their investment, the mentors are willing to share in the operating profits and losses of the company as limited partners. John and Sarah, with both financial and management interest in the company, will serve as the general partners.

Limited partnerships are composed of two types of participants: **general partners** and **limited partners**

General partners accept the responsibility for and take all the risks involved in managing and conducting the business. Limited partners, on the other hand, are investors who share some risk, depending on the amount invested, but who have no participation in the actual management of the entity. Limited partners simply enjoy the profits and share in the losses on the basis of what is stipulated in the partnership agreement. These provisions provide limited liability protection, but they do not allow any privacy for the parties involved.

Limited partnerships called family limited partnerships are often used for estate planning purposes. These vehicles allow individuals to control their assets, while still having the ability to pass ownership of those assets along to their heirs. Limited partners can substantially minimize their estate taxes. Estate planning requires careful preparation and often involves other entities as well. A few words to the wise: Be sure to consult knowledgeable tax planning experts before pursuing this option.

Advantages	Disadvantages
Pass-Through Tax Treatment: The income and losses of the business flow through to the partners' individual tax returns in accordance with their partnership shares, simplifying the income reporting process. However, the tax burden may also be greater due to differing tax rates and treatments for individuals vs. corporations. **Financial Flexibility:** A limited partnership can take on more limited partners to raise additional capital. **Discounting:** Family limited partnerships take adavantage of the discounting allowed by the IRS. Discounting occurs when the heirs of an estate, who hvae an interest as limited partners, take over the estate due to a death. The heirs can take the value of the limited partnership and discount the value by as much as one-third. This will lower any estate taxes due. **Charging Order:** If a person with an interest in a limited partnership is involved in a lawsuit for any reason and loses, the judge/jury may award damages to the other party. If this happens, the person will have to disclose their interest in the limited partnership. This can be assessed to satisfy the judgement by means of a judgment lien. However, most attorneys will not have their clients take this kind of lien because of the potential tax issues. The general partner controls the distibution of profits that comes out of the limited partnership. IF the general partner(s) see that a creditor has taken onwership of the interest of the limited partner, they can decide not to distibute profits yet still report a K-1 distibution to the IRS that states the creditor is still responsible for the tax obligation of the distibution, even though the profits were never distributed.	**Liability of the General Partner(s):** The general partner is fully liable for the obligations of the business. Many general partners will insulate themselves through incorporation. **Lack of Control for the Limited Partners:** The limited partners are legally precluded form participating in the management of the business. If limited partners do manage or excercise control, they can lose their linited liability protection and have personal exposure to the obligation of the business. **Lack of investment Flexibilty:** Limited partnerships are usually financed by capital contributions of the partners or by debt. Additional limited partners can also be brought in to raise money for the partnership, but this dilutes the existing partners' interest.

Limited Liability Companies (LLCs)

Harry and Ron are two forensic experts who specialize in complementary areas. As a result, they decide to write a book together. They want to be able to really focus on their work, with minimal energy directed to the 'operations' of their partnership, so they decide to form a limited liability company, or LLC, named R&H LLC. This structure will allow them to set out, in a legally binding agreement, all the arrangements (roles, responsibilities, contributions, profit distributions) at the start of the venture and offers them both asset and liability protection superior to a partnership arrangement. Their personal assets are protected against any business claims.

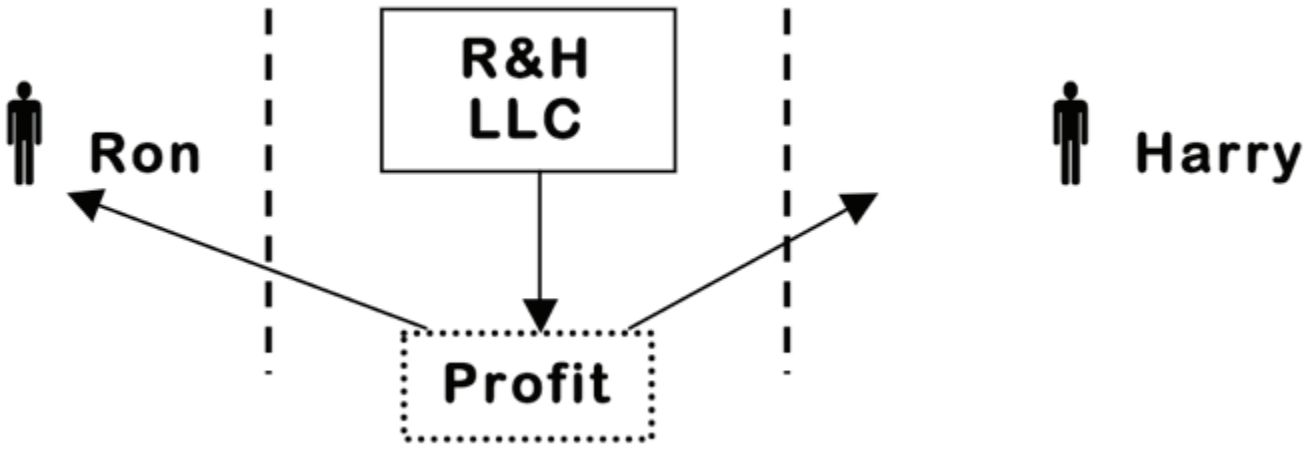
Limited liability companies have been around for many years in such countries as South America and Germany, but they first came to America in 1977 in Wyoming.

Evidence of LLC legislation in other states around the country did not take place until the IRS made a key ruling on the

taxation of this new structure. On September 19, 1998, the IRS issued Revenue Ruling 88-76, stating that LLCs would be taxed as partnerships even though none of the members (partners) or managers would be personally liable for any of the company's debt. This ruling encouraged other states beyond Wyoming to adopt this new vehicle as well. Today, most states have accepted LLCs into their domain as legitimate business structures.

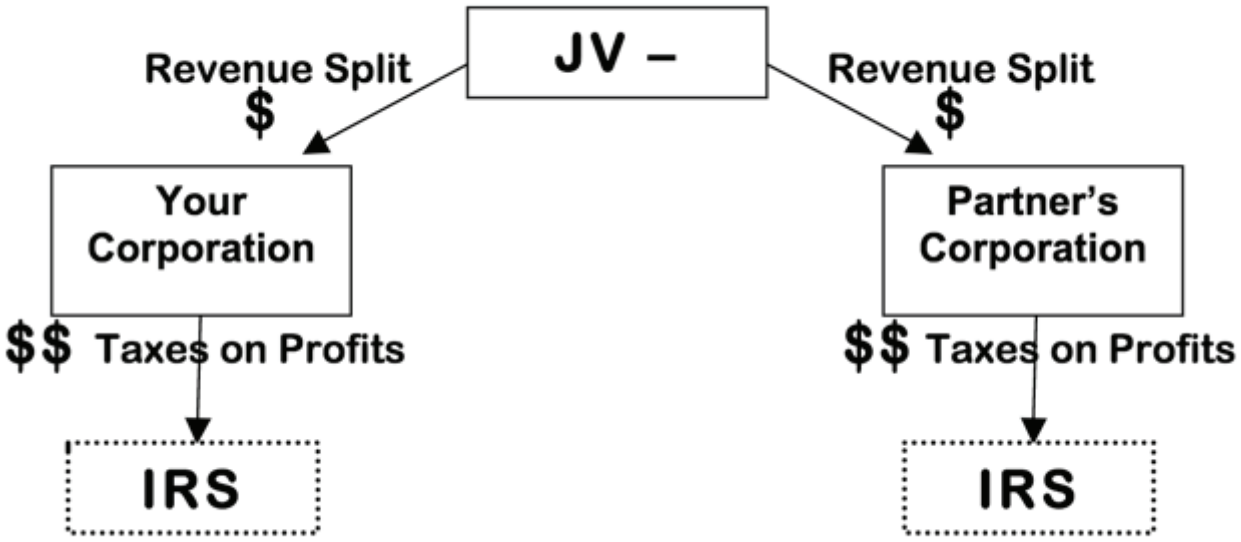
The LLC structure can be used to hold property and transact any type of business. For tax purposes, LLC structures are similar to sole proprietorships, general partnerships, limited partnerships, S corporations, and trusts. An LLC is a flow-through entity. It passes all of the LLC profits and losses directly to the members (i.e., owners) of the LLC. Individual members are therefore taxed at their own personal tax rates.

Nevada statutes only require one individual or legal entity to form an LLC. However, the IRS has the ability to tax the one-member LLC as either a corporation or a partnership. In most cases, the decision to structure as an LLC is driven by the desire to have profits treated as pass-through income for tax purposes, like a partnership. To ensure you are able to do so, you need to have two persons or legal entities as members/owners so the IRS cannot tax the business as a corporation. While it may seem that the need for a partner is a disadvantage because of control issues, there are alternative strategies to abate those concerns. Your 'partner' in the LLC could actually be a corporation you own or your trust. In essence, you can be your own partner.



LLCs can also be handy tools when exploring joint ventures. For example, let's say you are enjoying the benefits of controlling your own corporation and you now want to combine efforts with another individual by forming a joint venture. Using two corporations that you each control to form an LLC will allow the profits or losses from the joint venture to flow directly into your respective corporations. The taxable entity in this case would be the corporation. This is a simple way to bring two corporate entities together and keep an arm's length from the business at hand. LLC Terminology

Member Ownership: LLCs are owned by members, which are like shareholders in a corporation. Unlike S-corporations, which are limited to 75 shareholders, the LLC can have an unlimited amount of members. Some states even allow one member to own the LLC.



Membership Interest: A member's ownership interest in the LLC is referred to as a 'membership interest'. It's like stock in a corporation.

Articles of Organization: Articles of Organization are like a corporation's Articles of Incorporation or a partnership's Certificate of Limited Partnership; they are filed with the Secretary of State's office.

They usually include:
- The name of the LLC
- The principal place of business of the LLC.
- The date the LLC will be dissolved, if the business is not perpetual. (NOTE: Nevada allows for perpetual LLCs; most states do not.)
- The appointment of a resident agent for service of process.

Some states also require you to list whether the LLC is managed by members (i.e., owners) or by managers. (In Nevada, you must list either the manager's name or two members' names).

Generally, the members, who vote in proportion to their ownership interest, manage LLCs. If the LLC is to be managed by one or more managers, the Articles of Organization should include a provision to that effect.

Operating Agreement: The operating agreement establishes the rules for the operations of the LLC business. It is similar to a corporation's bylaws or a partnership agreement. The operating agreement can control such things as profit and loss and how management powers are divided up among members or managers. An operating agreement is critical because things always go more smoothly when the rules for potential 'issues' (such as distribution of profits) are put in writing before the LLC gets started. Unless specifically stated in the original agreement itself, the operating agreement can only be amended with the written consent of all members.

Manager: All members of an LLC can manage the business. Management can also be delegated to fewer than all members or to a single manager. A manager can be an individual, a partnership, a corporation, or, in some states such as Nevada, even another LLC. Managers may appoint officers but are not required to do so. The Articles of Organization would specify the scope of the manager's authority, if any.

Default Provision: If the members do not specify their business relationship with each other in the operating agreement, the rules of the state in which the LLC was formed apply by default. Provisions imposed on the members are known as 'default provisions'. In some states, the statutes include default provisions that members deem so important, they do not allow them to be changed even by agreement. These are known as "bulletproof provisions" and "bulletproof acts."

Advantages	Disadvantages
Pass-Through Tax Treatment: If the LLC is taxed as a partnership, the income and losses of the business flow throuhg to the partners' individual tax returns in accordance with their partnership shares, simplifying the income reporting process. (You lose this benefit if your LLC is taxed as a corporation.) **Charging Order:** If a person with interest in an LLC is involved in a lawsuit for any reason and loses, the judge/jury may award damages to the other party. However, most attorneys will not have their clients accept a lien on distributions because of the potential tax issues. If a creditor takes ownership of a member's interest in the LLC, the members can decide not to distibute profits yet still report a K-1 distribtuion to the IRS that states the creditor is responisble for the tax obligation of the distribution, event though the profits were never distributed.	**Loss of Pass-Through Tax Treatment:** As mentioned earlier, a one-member LLC may be taxed as a corporation by the IRS, or you may elect to be taxed that way if it works to your advantage. In this case, you must file a separate tax return instead of reporting income on your individual return. (You still benefit from pass-through tax treatment if your LLC is taxed as a partnership.) **Federal Security Limitations:** The LLC is only available to privately owned companies. If a company were to go public, it would have to be a C corporation. With merger laws, it would be relatively easy to convert an LLC to a C corporation. **State Tax Treatment:** Some states impose an income or franchise tax on LLC's.

Which Corporation Are You?

The most dynamic and flexible business entity is the corporation. Offering tremendous advantages that generally outweigh all other business structures, the corporation is the most commonly used structure in business today. In the next chapter, you will see the many benefits that exist with incorporating. This chapter will compare various types of corporations.

Corporation

Black's Law Dictionary defines a corporation as:
"An artificial person or legal entity created, by or under the authority of, the laws of a state or nation, composed, in some rare instances, of a single person and his successors, being incumbents of a particular office, but ordinarily consisting of an association of numerous individuals, who subsist as a body politic under a special denomination, which is regarded in law as having a personality and existence distinct from that of its several members, and which is by the same authority, vested with the capacity of continuous succession, irrespective of changes in its membership, either in perpetuity or for limited term of years, and of acting as a unit or single individual in matters relating to the common purpose of the association, within the scope of the powers and authorities conferred upon such bodies by law. A franchise possessed by one or more individuals, who subsist as a body politic, under a special denomination, and are vested by the policy of the law with the capacity of perpetual succession, and of acting in several respects, however numerous the associations may be, as a single individual."

The commonly understood definition of a corporation is:

"A business that is granted a charter recognizing it as a separate legal entity having its own rights, privileges, and liabilities distinct from those of its owners."

The Corporate Business Structure

Although a corporation is separate and distinct from its stockholders, directors and officers, it is a separate entity that can act only through its members, officers, or agents and cannot have knowledge or belief of any subject independent of the knowledge or belief of its people. A stockholder (owner or partial owner) is a holder of shares of stock in the corporation and is not generally in legal danger for the acts of the corporation (unless they are fraudulent and damaging or corporate formalities are not maintained). A stockholder is not the employer of those working for the corporation nor is he the owner of a corporate property.

This separation is an important benefit. Consider the many sizable and newsworthy lawsuits in the last few years in which negligence or other major liabilities have been charged against a corporation. From the Firestone tire failures to the breast implant and tobacco debacles, the news has been peppered with instances of high-dollar settlements to consumers affected by the products in question. In all of these cases, only the corporation itself was held liable; the individual stockholders were protected as separate from the corporate entity.

A corporation is also a citizen in the state where it was created and does not cease to be a citizen of its state of domicile by engaging in business or acquiring property in another state. Since a corporation is solely a creature of state law, its powers are derived from the constitution and laws of the state in which it is incorporated. As an artificial person, a corporation is considered to have its domicile in the state where it is incorporated and the place where it has a statutory presence. When the corporation functions in a different state, the site of its designated resident or registered agent is sometimes called its "statutory domicile."

Once brought to life, this artificial entity has most of the rights and privileges that a person has. A corporation can own and operate businesses, hire employees, buy and sell goods and services, make contracts, rent office space, have checking and savings accounts, maintain retirement plans for employees, can file lawsuits and can be sued.

The existence of the corporation is not affected by the death or bankruptcy of a shareholder, officer or director. It has a continuous existence, as long as it complies with the statutory requirements of the state where it is incorporated.

Although the corporation is a legal "person" with rights of its own, a corporation cannot walk, talk, think, or act for itself. It cannot market its products, nor can it perform any of the physical tasks required to operate a business. You and those hired to work within the structure of the corporation do all of this.

The important point to remember is that when you own a corporation, the corporation exists as a separate entity or person. You can live anywhere you choose, in any state or country, but it is the corporation that conforms to the requirements of the state in which it resides. You will soon find out that Nevada is the state with the greatest benefits for protecting you and your corporation.

Comparison of C Corporations & S Corporations

Corporations vary in their structure and organization. A corporation is not just a corporation. You will need to select from various types. The two typical corporations that most CPAs or attorneys will recommend are S and C corporations. In considering the differences between S and C corporations, one should keep in mind that every state has different laws for corporations. Here we talk about the basic differences that apply no matter where in the U.S. you form the corporation.

S Corporation

- Allows for limited liability of the owners/officers/directors.
- Typically runs on a calendar year.
- Requires full disclosure of corporate owners.
- Profits pass through to the individual tax return 1040. No tax brackets separate from the personal tax brackets apply.
- All profits are taxed on the owner's tax return even if not distributed.
- State taxes will apply for individuals who are located in a state with an individual state income tax.
- (NOTE: Nevada has no state income tax of any kind.)

C Corporation

- Allows for limited liability of the owners/officers/directors.
- Allows an unlimited number of stockholders.
- Runs on a fiscal or calendar year, which may be designated by the Board of Directors.
- Profits can be kept as retained earnings.
- Profits are taxed at corporate rates on an 1120 tax return, separate from the individual return.
- (NOTE: Nevada has no state corporate income tax of any kind.)

There are several other differences between the two types of corporations, which we will demonstrate by describing the S corporation in detail.

S Corporations

There are certain qualifications that the corporation must meet in order to elect S corporation status. To become classified as an S corporation with the IRS, you will need to file Form 2533, and your corporation must meet all of the following requirements.

1. It must be a domestic corporation formed in the U.S.A.
2. It may have no more than 75 shareholders.
3. It may only have individuals, estates or certain trusts as shareholders.
4. It may not have non-resident alien shareholders.
5. It may only have one class of stock.
6. It must be a small business corporation. (Financial institutions, such as banks, insurance companies, or building and loan associations cannot take advantage of an S corporation election.)
7. It must conform to state statutory restrictions, which limit the transfer of shares/ownership of the company.

An S corporation operates on a December 31st calendar-year-end basis. However, as with most rules, there are exceptions. The corporation can make a Section 444 election, which generally allows for a tax year ending September 30, October 31, or November 30, but estimated tax payments must be made that offset any advantage a shareholder might gain by having an offsetting fiscal year.

Considerations When Electing an S Corporation

- When losses flow through the corporation, those losses can be used to offset active income from either spouse. (Active income includes income derived directly from business activity.)
- If the S corporation earns active profits, the profits can be offset by losses from other businesses and/or operating expenses from a sole proprietorship.
- There is no double taxation.
- There are no penalties for excessive accumulated earnings for S corporations.
- The S corporation shareholder/employee may now deduct 100 percent of the cost of medical insurance as an adjustment to income.
- The S corporation must report premiums paid for health insurance and group term life insurance as taxable income if the shareholder owns more than two percent of the stock. However, the shareholder can still take the 100 percent deduction noted previously to help offset this.

Who Should Use S Corporation Status

- Companies expecting start-up losses during the initial years of operation.
- Companies with no intent of going public in the future.
- Companies that do not expect to issue multiple classes of stock.
- Companies that might be subject to the Alternative Minimum Tax.

C Corporations

C corporations have different tax rates than individuals. In many instances, C corporations will pay less in tax than an individual. C corporations have no limitations on shareholders. Shareholders can live anywhere in the world and can be any type of entity. C corporations will give you the most flexibility and are recommended in most instances.

The only thing you will have to be concerned with when using a C corporation is double taxation. S corporations allow the profits and losses of a corporation to flow directly through to the owners/stockholders of the corporation. All of this takes place without taxation at the corporate level, thereby eliminating the potential for double taxation. Double taxation of a C corporation occurs when the corporation has its profits taxed initially, and then the dividends paid out to shareholders are taxed again on the personal level.

Eliminating or deferring profits through proper financial management can easily remedy this problem.

Double taxation typically only occurs with large corporations who have several stockholders that need the profits distributed to them at the year-end of the corporation. The owner of a corporation can decide at the end of the year what to do with the profits. They can distribute them to the owners in the form of a dividend (not recommended), pay

bonuses (wages) which are tax-deductible to the corporation, keep retained earnings or have a retirement plan that profits are distributed to on a tax-deferred basis.

Retained earnings can be used for future growth of the company, additional investments in equipment, buying another company, advertising expenses, etc. When the corporation has retained earnings, these profits are taxed at the corporate level, left in the corporation and not distributed to the owners. If the corporation's owner or officers need the money for personal expenses, they can be paid a wage in the form of a year-end bonus or set up a retirement plan to expense as much from the corporation as possible. The IRS says that it is the responsibility of taxpayers to lower their tax liability. They also say that a corporation can deduct any general related business expense, so lower tax liability can be achieved by using good money management.

Private vs. Public Corporations

A public entity is registered with the SEC (Securities Exchange Commission) and has stock available for purchase on one of the major stock exchanges, e.g., IBM, AT&T, etc. A private corporation is one in which the ownership of the company is not available for sale on any public market.

Closely Held Corporation

A family or close group usually owns a closely held corporation and shares cannot be sold outside the family or group. A corporation is a closely held corporation if, at any time during the last half of the tax year, more than 50 percent of the value of its outstanding stock is owned directly or indirectly by five or fewer individuals.

For the passive activity rules, a corporation is closely held if all of the following apply:

1. It is not an S corporation.
2. It is not a personal service corporation.
3. At any time during the last half of the tax year, more than 50 percent of the value of its outstanding stock is directly or indirectly owned by five or fewer individuals. "Individual" includes certain trusts and private foundations.

To figure out if more than 50 percent of the value of the stock is owned by five or fewer individuals, you will want to consult a tax professional.

Domestic Corporation

A domestic corporation is a corporate entity operated in the state in which it was formed (for example, a corporation that is formed in Nevada and operates its primary business in Nevada).

Foreign Corporation

A foreign corporation is a company that is doing business in a state other than the one in which it was formed (for example, a corporation that is formed in Nevada, but is operating its business in California).

Alien Corporation

An alien corporation is a corporation formed in a country other than where it is doing business (for example, a corporation that is formed in the United States, but operating its business in Canada).

Personal Service Corporation

A "Personal Service Corporation' is one label you definitely want to avoid. A 35-percent flat tax is assessed on all personal service corporation profits. Personal service corporations are generally owned and operated by lawyers, accountants, and consultants. There are two aspects considered in determining whether a corporation qualifies for this status. The first is functional; the second relates to ownership.

A corporation is a personal service corporation if it meets all of the following requirements:

1. It is not an S corporation.
2. Its principal activity during the "testing period" is the performance of personal services. The testing period for any tax year is the previous tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:
    a. The last day of its tax year, or
    b. The last day of the calendar year in which its tax year begins.
3. Its employee-owners substantially perform the services in (2). This requirement is met if more than 20 percent of the corporation's compensation cost for its activities of performing personal services during the testing period is for personal services performed by employee-owners.
4. Its employee-owners own more than 10 percent of the fair market value of its outstanding stock on the last day of the testing period. Personal services are those in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and performing arts.

A person is an employee-owner of a personal service corporation if both of the following apply:

1. He or she is an employee of the corporation or performs personal services for or on behalf of the corporation on any day of the testing period.
2. He or she owns any stock in the corporation at any time during the testing period.

Companies that are not classified as personal service corporations sell products, e.g., a law book (instead of consulting with others on the law), give seminars or do something else that is more tangible. The other way companies escape this classification is by giving up partial ownership of the corporation.

Professional Corporation

A professional corporation is a subcategory of the personal service corporation and is formed by one or more people to offer any type of personal service for which they must be licensed or otherwise legally authorized to render the professional services. Generally speaking, the professional corporation can only offer one specific type of professional service and is not allowed to conduct any other business. However, some exceptions may be allowed in a specific state, for example, offering any combination of services between the fields of medicine, homeopathy and osteopathy.

Personal Holding Corporation

The Internal Revenue Service designates any corporation with over 60 percent passive income, for which five or fewer people own more than 50 percent of the stock at any time during the last half of the tax year, as a "personal holding company." To determine whether a corporation is a personal holding company under the stock ownership principle, the rules consider stock owned by a corporation, partnership, or estate to be owned proportionately by its shareholders,

partners, or beneficiaries.

Having your corporation classified as a personal holding company is not desirable because these entities are taxed the same as a regular corporation plus charged a surtax of 15 percent on any undistributed personal holding company income. Distributions of personal holding company income to shareholders are taxed as dividends on the shareholders' personal income tax returns.

Personal holding company income includes the following:

1. Taxable income from estates and trusts
2. Dividends, interest, royalties, and annuities, including royalties from mineral, oil, gas, and copyrights
3. Rent adjusted for the use of or the right to use corporate property, with certain exceptions

Holding Corporation

A holding corporation is different than a personal holding company. The holding corporation status is when one corporation controls other corporations, usually called subsidiaries. A corporation maintains control of a subsidiary when it owns at least 80 percent of its stock. The IRS will allow (or may request) a holding corporation to combine their income and expenses and file a consolidated tax return that includes all subsidiaries. Banks will also accept a consolidated financial statement when applying for credit lines.

The Ever-Popular Corporation

Why Incorporate?

Many people think that, because their business consists only of a single person or their family, rather than a traditional business, incorporating is not for them. Nothing could be further from the truth. In fact, incorporating can offer your business, whatever its make-up, many financial and other advantages! A corporation is a legal entity created separately from those who own and operate it. As a separate entity, the corporation's debts and taxes are separate from its owners (shareholders), thereby offering the greatest personal liability protection of all business structures.

Every business owner needs to protect his or her personal and business assets from litigation. Hundreds of millions of dollars are awarded to employees of U.S. businesses each year in employment-related cases. In 1999, a jury rendered the largest award ever against a U.S. company in a consumer case – over $5 billion dollars – payable to the victims of a car crash.

In addition to liability protection, the corporation offers tremendous estate planning advantages because it continues to exist even after the death of a shareholder. Incorporating also offers attractive tax advantages, prestige, the road to better financing and the ability to raise cash. Corporations can be used to own real estate, automobiles, yachts, or aircraft, while also providing health and life insurance, retirement benefits and expense accounts.

Individual vs. Corporation

One of the major reasons individuals incorporate is the fact that, as individuals, we earn money, pay taxes, and buy things, but a corporation earns money, buys things, and then pays taxes. What would you rather do, pay for things with pre-tax or after-tax dollars?

The following illustration shows how one individual, who has $60,000 per year in revenue, can save almost $7,000 in taxes just by incorporating. The power of being able to determine what you pay for yourself and what stays in the corporation for future expenses of the company is what draws millions of people to incorporating rather than running their businesses as sole proprietorships or partnerships. The illustration does not take into account several areas that would make the illustration even more compelling, such as retirement accounts, fringe benefits and state income taxes.

Independent Contractor John Doe

Revenues $60,000
Expenses . . . . . .
$10,000
Gross Profit . . . .
$50,000
Taxable Income $38,375
Income Tax $6,404
Self-Employ. Tax $7,650
Total Taxes Paid $14,054

Corporate Plan John Doe, Inc.

Revenues $60,000
Expenses $10,000
Salaries Paid . . . . . .$21,530 (includes FICA)
Gross Profit $28,470
Corporate Tax . . . .$ 4,270
Net Profit..... . . . . $24,200
John's Income $20,000
John's Taxable Income. ..$12,200
John's Income Tax. . .. .$ 1,480
John's FICA. . . . .$ 1,530
Total Taxes Paid . . . . . .$ 7,280

Liability Protection

While most small businesses know that incorporating can shield personal assets in the event of a frivolous lawsuit, many are lulled into complacency by an it-won't-happen-to-me attitude. This thinking has resulted in tremendous losses to many unprepared business owners. It's not hard to see why, given these statistics:

- Over 15 million civil lawsuits are filed each year in the U.S. Almost 20 percent of all lawyers in the world practice in the U.S.
- The U.S. has one lawyer for every 227 residents compared to, for example, Japan where there is only one lawyer for every 8,412 residents.
- Chances of being involved in a lawsuit are estimated at one in four in the next two years.

In such a litigious society, incorporating to protect yourself makes great sense. No other structure gives you and your business the liability protection offered by a corporation. Nearly every state has adopted statutes that limit the liability of corporate representatives, including officers, directors and shareholders. Corporations can be sued, file bankruptcy, or be involved in other unfortunate activities and, in most cases, the personal assets of the owners are protected.

Unlike a sole proprietorship or even a partnership, a corporation can accumulate debt without ever making its officers, directors or stockholders responsible for the repayment of that debt. If a corporation gets itself into a lawsuit, the outcome of that lawsuit can affect the corporation directly, but the participants generally cannot be held responsible except if corporate formalities have not been maintained or in the case of fraudulent activity.

Corporations are used in the business world today primarily for liability protection. Corporations came into existence to limit the direct responsibility of the participants for the faults or debts of a business. An individual can invest money in a corporation, and that investor's potential loss will be limited to the amount of money invested and no more.

Because of the obvious advantages of limiting the amount of personal liability that one takes on by operating through a corporation, many strategies have been developed to protect the assets of businesses that have potential lawsuit risk. In addition, other strategies have been developed to protect the assets of individuals because of our litigation-crazy society.

Asset Protection

It doesn't take a catastrophic lawsuit to wipe out everything you own. There are many common business events that can equally affect small businesses, leaving the owner's personal assets fully exposed. For example:

1. One or more of your largest customers could stop paying their bills or file for bankruptcy.
2. New technologies, competition, legislation or market conditions could render your product or service obsolete or significantly reduce the demand.
3. You could suddenly become incapacitated and unable to manage the operations of the business. Could you satisfy all your business obligations without tapping into personal reserves or losing personal assets? Existing assets (bank accounts, homes, cars, etc.) are not the only targets for creditors. Unrealized assets, such as future earnings, inheritances, and insurance settlements, are also at risk in the event of an unfavorable judgment.

Tax Savings

The myriad of tax benefits that can be achieved by utilizing a corporation outweigh those available through the use of any other business structure. For example, corporations are entitled by law to many deductions not available to individuals. Many of the tax benefits available to a corporation can greatly benefit corporate owners. Even without considering these differences, you can see that at income levels up to $100,000, all else being equal, the corporation would pay less federal income tax. This does not include the impact of self- employment taxes paid as a sole proprietor or of any state income taxes that may apply.

Taxable Income	Single Individual's Federal Tax (Sole Proprietorship)	Corporation's Federal Tax
$49,000	$9,060	$7,350
$74,000	$15,466	$13,500
$100,000	$22,746	$22,250
$150,000	$37,071	$41,750
$300,000	$86,571	$100,250

*No exemption deduction accounted for individuals.

If we add in the estimated self-employment tax (which is basically the Social Security payment for the self- employed) to the above scenario, the picture looks even brighter as a corporation in comparison with a sole proprietorship. Corporations pay only on the actual salary you would draw as an employee instead of on the entire taxable income of the business. Plus, the corporation would pay only half of the Social Security amount; the other half would be taken from your paycheck as an employee. If you take a salary that is less than the entire taxable income of the corporation, you will pay less (between the corporation and your individual Social Security taxes) than you would as a sole proprietor paying on the entire income. Let's say that you draw a $25,000 salary per year out of the corporation (which you can do because your travel, vehicle and many other expenses are paid by the corporation because they are legitimately used in your business).

Taxable Income	Total Federal Tax Paid as Single Individual (Sole Proprietor), including Self-Employment Tax	Total Federal Tax Paid as Corporation, including Soc. Sec. paid by both the corp. & you, the employee, on your $25K salary
$49,000	$9,060 + $9,410 = $18,470	$7,350 + $3,825 = $11,175
$74,000	$15,466 + $13,311 = $28,777	$13,750 + $3,825 = $17,575
$100,000	$22,746 + $13,311 = $36,057	$22,250 + $3,825 = $26,075
$150,000	$37,071 + $13,311 = $50,382	$41,750 + $3,825 = $45,575
$300,000	$86,571 + $13,311 = $99,882	$100,250 + $3,825 = $104,075

This chart demonstrates the strong advantage utilizing a corporation for your business can deliver, considering taxes alone. It is only at high levels of income that corporations pay more in taxes. However, the asset and liability protection benefits available through a corporation will be much more valuable as your income increases and will offset the fairly minor difference in taxes (approximately 4 percent in this example).
It's the responsibility of individual taxpayers to structure their business affairs in such a manner as to minimize their tax liability. While tax evasion is a serious crime, legal tax reduction is the right of every business owner.

Impacting the Bottom Line

Which delivers more dollars – increasing sales, reducing costs, or cutting taxes? It may surprise you to learn that, from a pure cash-in-your-pocket point of view, a tax dollar saved is much more valuable to you than an added sales dollar or a cost-savings dollar.

A tax dollar saved is a full dollar retained in the business. The federal and state governments take a tax bite out of every other business dollar, whether it's a dollar that was retained by reducing costs or a dollar that was brought in by increasing company sales. If you still aren't convinced of the critical importance of paying close and constant attention to possible tax savings, here's proof:

Saving on Taxes vs. Increasing Sales

Let's say XYZ, Inc., operating at a 10-percent pre-tax profit margin (pre-tax profits divided by sales) and in an overall 35 percent tax bracket (federal and state), did some comprehensive tax planning with its advisers and saved $10,000 in taxes. The tax savings are equivalent to the profit on $153,846 in additional sales, computed as follows:

_____Tax Savings_____= Sales Equivalent (100% - % Tax Rate) times % Profit Margin
_____$10,000_____ = $153,846 (100% - 35%) times 10%

This shows that the $10,000 of tax savings brought XYZ, Inc. the after-tax profit equivalent of almost $154,000 in additional sales. Each $1,000 of tax savings was equivalent to $15,400 in increased sales. So what's the easier way to increase profits – reducing your tax burden or increasing your sales?

Saving on Taxes vs. Cutting Costs

Assuming an overall tax of 35 percent on your company's taxable income, here is the impact of saving $1,000 in taxes compared with saving $1,000 in costs for various levels of pre-tax profit margin:

Pre-tax Profit Margin	Sales Equivalent to Saving $1,000 in Taxes	Sales Equivalent to Saving $1,000 in Costs
20%	$7,692	$5,000
15%	$10,256	$6,667
10%	$15,385	$10,000
8%	$19,231	$12,500
4%	$38,462	$25,000

As shown above, if you have a 10-percent profit margin, you would need to sell $10,000 more to generate the same benefit as saving $1,000 in costs. That's good, however, when you look at the impact taxes have, you find you would need to sell $15,385 more to generate the same benefit as saving $1,000 in taxes. This is a difference of $5,385 just for spending time on tax-saving strategies rather than on cost-cutting measures.

Raising Capital

For the person looking to raise capital for a business or project, the corporate structure is superior to all others. Corporations allow investors an opportunity to participate in the profitability and growth of a business without having to participate in its day-to-day activities. Through the sale of stock to investors, a corporation is able to raise capital at all phases of its life cycle. This process can be kept simple by limiting the number of investors. If a corporation is planning to raise large amounts of capital, however, or wishes to solicit more than twenty-five potential investors, the rules and regulations are quite stringent. When you decide that you want to raise capital for your corporation, be sure to consult with an experienced securities attorney.

Reducing Audit Risk

The minute you incorporate, your audit risk may be dramatically reduced. The IRS puts more emphasis on sole proprietorships than on small corporations when it comes to audits. The IRS audits 1.6 percent of all sole proprietors and only .34 percent of corporations with assets of less than $1 million.

The IRS sees an individual operating as a sole proprietor or those operating as general partners to be less sophisticated than businesses operating as corporations. The IRS also assumes that, because they are operating one of these two ways, they are more likely to make mistakes on their return. According to IRS insiders, operating your business as a corporation means you have a higher sophistication level and are less likely to misrepresent items on your taxes. In general, corporations, or at least smaller ones, are also less lucrative to audit because they are allowed more deductions and are taxed at a lower rate (in most cases) than sole proprietorships and partnerships.

This is not to say that corporations in general are not targets for the IRS, even if that's true for small closely held corporations. Corporations targeted by the IRS are those with assets over $250,000 or revenue over $3 million. These large corporations are seen as a big money-making opportunity for the IRS. If a corporation with $25 million in profit is off on their taxes by just a small percentage, there is a large tax collection that could still be made. The IRS will spend time with those companies they feel they will get the most from. Successful corporations often keep attorneys and CPAs on staff to combat the likelihood of an IRS audit.

Understanding Possible Tax Benefits

As an officer or owner of a corporation, there may be certain business deductions that you may have overlooked.Why use after-tax dollars to purchase automobiles, travel, computers, office equipment, education, and certain utilities if these expenses are incurred in the operation of your business -- when you may be able to use pre-tax dollars through your corporation.

The tax code is structured so that companies can deduct ordinary and necessary business expenses. Why not use this to your benefit? Sports arenas rely on corporations to pay for the VIP boxes to watch their sporting events. As the owner of a corporation, you might benefit from taking your clients and employees to these events and doing it all with pre-tax dollars. Or why not join the country club with a corporate membership and golf every day with clients? (Before deciding to take any business expense deductions, you should always consult with a professional tax advisor or preparer to discuss and consider the applicability and limitation of deductions for your corporation).

Many other expenses may also be paid by a corporation, including educational expenses, legal and accounting fees, insurance, moving expenses, seminars, books, meals, entertainment, and much more. With these 'perks', you will find that you may not need to be paid as much salary which may lower your personal tax liability in the process. Isn't it time to start understanding the possible tax benefits of a corporation today?

Building Business Credit

Just as an individual can apply for credit, so can a corporation. A new corporation seeking credit is similar to a young adult applying for credit for the first time. It may take some persistence in obtaining the credit lines wanted, but it can be achieved.

The process of building business credit involves several factors, including:

1. Establishing a D&B rating based on company financials. Obtaining a DUNS number. Determining any areas vendors will consider high-risk
2. Working with existing vendors to report to D&B and Experian
3. Identifying a list of companies that offer products and services on credit, who will also report their payment experiences to D&B and Experian to help build your business credit profile
4. Developing a PAYDEX of 75 or an Intelliscore of 70 or better, based on payment history with trade references
5. Applying for three to five retail business credit cards

It helps to know what factors matter to those evaluating your business credit. The following criteria are used by lenders and vendors to determine credit approval, limits and interest rates:

1. On-time bill payment history (payment experiences), D&B rating, D&B PAYDEX score, and public records information
2. Years in business, business tax returns, type of business, number of employees, location of business, business plan, trade references, banking references, accounts receivable aging reports, owner/officer credit scores
3. Loan package - A formal presentation of everything above to present to the lender
4. Credit reports - The credit reports lenders look at vary from lender to lender and vary based on the amount of funding they have available at any given time
5. Revenue, profits and business image

Estate Planning

One of the most practical uses of a corporation is in providing for a convenient transfer of wealth and assets to one's heirs. The corporation allows assets (that would, by their very nature, otherwise be difficult to split evenly) to be divided and controlled in precise increments.

Your corporation can be a helpful intermediary for disposing of property. Under this plan, you would transfer selected assets to your newly organized corporation in exchange for its shares of stock. You can then bequeath or transfer the desired amount of shares to your designated beneficiaries. These shares may be distributed either all at once or over a period of years, to take advantage of the annual gift tax exclusions.

The advantages are:

• Property held in the corporation may be safer from creditors than if owned by the donor or recipient of donations.
• The donor gains considerable flexibility in selecting the number of beneficiaries, as well as the division of ownership each will receive.
• The donor can immediately give beneficiaries shares of stock in the corporation that holds the assets, eliminating the need to sell the assets in order to divide them up.

Corporate Image

Image is everything in business today. The words "Inc.," "Incorporated" and "Corporation" command respect and promote a professional image. Individuals and businesses visualize incorporated companies on a higher level than sole proprietorships or partnerships. Major lending sources and credit card companies look more favorably upon corporations. Beyond the prestige aspect, projecting the corporate identity allows the owners and their personal assets to remain private and separated from the day-to-day operations of the business.

Other Benefits

The benefits talked about so far are the primary reasons that many individuals and businesses decide to incorporate. There are also many secondary reasons that just may make all the difference for you. Some of those reasons are:

1. Control and management of a corporation is very structured and clearly understood.
2. Losses by smaller corporations can be deducted personally.
3. Real estate can be controlled within a corporation for the ultimate in asset protection.
4. Corporations never die - they have a potentially perpetual existence.
5. A corporation can provide you with free health care.
6. Ownership can be easily transferred between generations.
7. Corporate pension plans can allow you to put a lot of tax-deferred money away for retirement.

The list goes on and on!

Business Plans for Business Success

If you have a business, you need a business plan. As you create it, going through the process of writing it ensures that you thoroughly think through what you plan to do and why, giving your strategies the greatest chance for success. On an ongoing basis, your business plan is what will keep you going in the right direction and give you a yardstick by which you can measure your progress. It quantifies and helps you measure the work that will be involved and functions as the roadmap to get you where you want to go. And, if you are looking to go after any outside funding from either banks or investors, you'll need to show them a business plan to demonstrate that your plan is well thought out and holds considerable potential for success.

A business plan goes into detail about the following areas:

1. Mission, vision and objectives of the venture
2. The Company (its legal description, history and current situation/location)
3. Products and services (offered and planned)
4. External environment (the industry status, the economy, legal/regulatory)
5. Overall market (including analysis of the competition, size, growth, demographics, etc.)
6. Target market (the specific segment or segments your firm is or plans on pursuing)
7. Analysis of strengths, weaknesses, opportunities and threats/risks
8. Sales and marketing strategy (including promotion, pricing, distribution, Internet, and forecasts)
9. Management team and advisors (one of the most critical areas for influencing funding)
10. Operational plan (including equipment, labor/personnel, and production/service process)
Implementation plan
11. Financials and exit/payback strategy (to show how investors/lenders will get their return)

According to the U.S. Small Business Administration (SBA), "All capital sources will want to see your plan for the start-up and growth of your business. If you don't have a business plan, make writing one your first priority." SCORE (Service Corps of Retired Executives), one of the leaders in small business assistance, advises that a thorough understanding of market and competitive factors is "essential to convince lenders that you have a valid business idea and realistic plans for business success."

Tax Deductions & Selected Business Expenses

In managing an active corporation, it's important to be familiar with all of the aspects of how a corporation works. Part of that management responsibility involves being familiar with business expenses. Understanding which expenses are deductible and which are not is important. By familiarizing yourself with all legal business expenses, you may be able to dramatically reduce your corporate taxes. Some of the special provisions for corporate tax deductions and selected business expenses are detailed further below.

Car Mileage. 54 cents per mile is the current rate that a business can reimburse an individual for using a personal vehicle for business purposes. This is not considered income to the individual. (NOTE: An alternative to this is to buy or lease a car to the corporation. With both purchased and leased business vehicles, one may be able to deduct the related expenses by standard mileage or actual expenses over a number of years).

Automobile Lease Program. This is for expenses related to vehicles leased by the corporation.

Meals and Lodging. Generally you can deduct the costs of these as long as the expense is an ordinary and necessary business expense. Regular business meals are now only 50 percent deductible.

Education Expenses. A business can fully deduct educational expenses for employees as long as the education is job-related.

Employee Health Insurance. Health insurance is not taxable to your business for FICA or FUTA tax purposes. You can also deduct the cost of providing benefits, provided that you meet all the requirements.

Employee Dental Insurance. Businesses can deduct dental insurance premiums for employees.

State Income Tax. If a corporation has to pay state income tax, this is a deductible item. However, if the business is a Nevada corporation, there is no state income tax.

Childcare. You can pay up to $5,000 annually for an employee's childcare without considering it income to the employee. (This is not an option for those individuals that are contractors of a corporation).

Below-Market Loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is treated as having received both:

1. A loan in exchange for a note that requires payment of interest at the applicable federal rate
2. An additional payment

Whether you treat the additional payment as a gift, dividend, contribution to capital, payment of compensation, or other payment will depend on the substance of the transaction.

Capital Losses. A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. It can, however, carry the loss to other tax years and deduct it from capital gains that occur in those years.

First, you will want to carry any net capital loss back three years and deduct it from any total net capital gain that occurred in that year. If you do not deduct the full loss in the third year back, you move the remainder forward one year to the second year back and then any remainder beyond that forward to last year (one year back). If any loss remains, you can then carry it forward to future tax years, one year at a time, for up to five years. When you carry a net capital loss to another tax year, you simply treat it as a short-term loss. It does not retain its original identity as long-term or short-term.

For examply, lets say that in 1999, a calendar-year corporation has a net short-term capital gain of $3,000 and a net long- term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. It treats this $6,000 as a short-term loss when carried back or forward.

The corporation carries the $6,000 short-term loss back three years to 1996. In 1996, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. It subtracts the $6,000 1999 short-term loss first from the 1996 net short-term gain. This results in a net capital gain for 1996 of $7,000, consisting of a net short-term capital gain of $2,000 ($8,000 - $6,000) and a net long-term capital gain of $5,000.

S Corporation Status. A corporation may not carry a capital loss from or to a year in which it was an S corporation.

Rules For Carryover And Carry-Back. When carrying a capital loss from one year to another, the following rules apply.
1. When figuring this year's net capital loss, you cannot use any capital loss carried from another year. In other words, you may carry capital losses only to years that would otherwise have a total net capital gain.
2. If you carry capital losses from two or more years to the same year, deduct the loss from the earliest year first. When you fully deduct that loss, deduct the loss from the next earliest year, and so on.
3. You cannot use a capital loss carried from another year to produce or increase a net operating loss in the year to which you carry it.

When you carry back a capital loss to an earlier tax year, you will need to refigure your tax for that year. If your corrected tax is less than you originally owed, you may apply for a refund.

Charitable Contributions. A corporation can claim a limited deduction for any charitable contributions made in cash or other property. The contribution is deductible if made to or for the use of a qualified organization. You cannot take a deduction if any of the net earnings of the organization receiving contributions benefit any private shareholder or individual.

You can ask any organization whether it is a qualified organization, and most will be able to tell you, or you can check IRS Publication 78, Cumulative List of Organizations, which lists most qualified organizations. You can often find Publication 78 in your local library's reference section.

A corporation cannot deduct more than 10 percent of its taxable income as charitable contributions for any tax year. Taxable income for this purpose is calculated without the charitable contribution deduction.

Other Deductions Allowed for a Corporation, But Not an Individual

Half of FICA at 7.65 percent. Self-employed individuals can deduct half of their self- employment taxes – roughly 7.65 percent – on Form 1040.

The 70 percent Dividend Exclusion Rule. Allows a corporation to deduct 70 percent of any dividends it earns from unrelated domestic corporations.

Meals & lodging provided for the convenience of the employer. Travel, lodging and meals associated with the director, officer and shareholder meetings.

Group insurance, which is fully deductible for owners if they are also employees. Self-employed individuals can deduct 100 percent of their health insurance expenses on Form 1040.

All ordinary business expenses for traders of commodities or stocks. Employee achievement awards up to $400 value. Catered meals. Fringe benefits for the officers, directors and shareholders.

Real Estate Losses to Offset Active Corporate Income

These losses are always classified as "passive losses" for tax purposes. This greatly limits your ability to deduct them because passive losses can only be used to offset passive income. Passive income is the income you earn from rental real estate or other passive activities. Without passive income, your losses become suspended losses you can't deduct until you have sufficient passive income in a future year or sell the property to an unrelated party. You may not be able to deduct such losses for years. In short, your rental losses will be useless without offsetting passive income.

Start-Up Business Deductions

When you go into business, treat all costs you incur to get your business started as capital expenses. Capital expenses are part of your basis in the business. Generally, you recover costs for particular assets through depreciation deductions. However, you generally cannot recover other costs until you sell the business or otherwise go out of business.

You can choose to amortize certain costs for setting up your business. The costs must qualify as one of the following:
1. A business start-up cost
2. An organizational cost

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit or for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or business.

A start-up cost is amortizable if it meets both of the following tests:
- It is a cost you could deduct if you paid or incurred it to operate an existing active trade or business (in the same field).
- It is a cost you pay or incur before the day your active trade or business begins.

Start-up costs can include costs for the following items:
1. A survey of potential markets
2. An analysis of available facilities, labor, supplies, etc.
3. Advertisements for the opening of the business, salaries and wages for employees who are being trained and their instructors
4. Travel and other necessary costs for securing prospective distributors, suppliers or customers
5. Salaries and fees for executives, consultants or other professional services

Start-up costs do not include deductible interest, taxes, or research and experimental costs.

Amortizable start-up costs for purchasing an active trade or business include only costs incurred in the course of a general search for or preliminary investigation of the business. Investigative costs are the costs that help you decide whether to purchase the business and which business to purchase. Costs you incur in the attempt to purchase a specific business are capital expenses, and you cannot amortize them.

If you completely dispose of your business before the end of the amortization period, you can deduct any remaining deferred start-up costs. However, you can only deduct these deferred start-up costs to the extent they qualify as a loss from a business.

You can amortize an organizational cost only if it meets all of the following tests:

1. It is for the creation of the corporation.
2. It is chargeable to a capital account.
3. You could amortize the cost over the life of the corporation, if the corporation had a fixed life.

You must have incurred the cost before the end of the first tax year in which the corporation was in business. A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

The following are examples of organizational costs:
1. The cost of temporary directors
2. The cost of organizational meetings
3. State incorporation fees
4. Accounting services for setting up the corporation
5. The cost of legal services (such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings)

Costs You Cannot Amortize

The following costs are not organizational costs and must be capitalized:

1. Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs
2. Costs associated with the transfer of assets to the corporation

How to amortize. You deduct start-up and organizational costs in equal amounts over a period of 60 months or more. You can choose a period for start-up costs that is different from the period you choose for organizational costs, as long as both are 60 months or more. Once you choose an amortization period, you cannot change it.
To figure your deduction, you simply divide your total start-up or organizational costs by the months in the amortization period. The result is the amount you can deduct each month. The amortization period starts with the month you begin business operations.

Shareholder costs. Only your corporation can choose to amortize its start-up or organizational costs. A shareholder cannot make this choice. You, as a shareholder, cannot amortize any costs you incur in setting up your corporation. The corporation can amortize these costs.
Depending on whether the corporation is using the cash or accrual accounting method, the tax deduction will be treated differently. Please consult a tax professional for more information on how this deduction is handled.

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Glossary of Terms

Alter Ego: 'Other Self', a person or legal entity (such as a corporation) who is legally the same as, and interchangeable with, another (e.g., the principal).

Articles Of Incorporation: A formal document that creates a corporation; a charter.

Board Of Directors: A group, elected by shareholders to oversee the management of the corporation.

Bylaws: Rules adopted by an organization chiefly for the government of its members and the regulation of its affairs.
Charter: A formal document that creates a corporation; Articles of Incorporation.

C Corporation: A corporation that pays tax on its own income under the general rules of Subchapter C of the Internal Revenue Code.

Capital Stock: The outstanding shares of a joint-stock company considered as an aggregate.

Closely Held Company: A company whose shares are held mostly by a small group of investors, management, founders, and/or family members.

Corporation: A body formed and authorized by law to act as a single person, although constituted by one or more persons, and legally endowed with various rights and duties, including the capacity of succession.

Director: A person elected by the shareholders to oversee the management of a corporation.

Double Taxation: Taxation by the federal government of corporate earnings once at the corporate level and again at the shareholder level upon distribution of dividends.

Encumbrance: A burden on either title to property or on the property itself (e.g., a mortgage, a lien).
Foreign Corporation: A corporation carrying on business in any state other than the state of its creation; in all such states, it is 'foreign'.

Fraudulent Conveyance: A contractual misrepresentation of the nature, quality, or existence of transferred assets. Also, a term denoting potential risk for sellers and lenders.

General Partnership: A partnership in which there are no limited partners, and each partner has managerial power and untitled liability for partnership debts.

Judgment-Proof: Having few, if any, assets that can be reached by a judgment creditor; thus, persons against whom money judgments are of no practical effect.

Limited Liability: Liability (as a stockholder) limited by statute or treaty.

Par Value Stock: Stock for which a specified dollar amount is indicated on the share certificate; the par value must be set out in the charter.

Partnership: The association of two or more persons who have expressly or implicitly agreed to carry on, as co-owners, a business for profit.

Passive Income: Income to certain taxpayers (including S corporation shareholders) that is subject to the passive activity loss (PAL) rules because the taxpayer does not materially participate in the business activity producing the income. This generally includes receipts from royalties, rents, dividends, interest, annuities, and the sale and exchange of stock and securities.

Pierce the Corporate Veil: To disregard the corporate entity and thus hold the shareholders liable for corporate actions; this is possible under circumstances involving fraud and, in many states, if corporate formalities are not maintained.

Professional Corporation: A corporation created by a professional or professionals in order to gain corporate tax advantages for traditional partnership or proprietary activities.
Resident Agent: A person or other entity authorized to receive service of process and other official papers for a corporation.

S Corporation: A corporation that is eligible and elects to be taxed under Subchapter S of the Internal Revenue Code. Basically, shareholders pay tax on the corporation's income by reporting their pro-rated shares of pass-through items on their own individual income tax returns.

Shareholder: An owner of a share of a corporation through the ownership of its stock.

Sole Proprietorship: The simplest form of business in which a sole owner and his or her business are not legally distinct entities; the owner is personally liable for business debts.

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