

2022

# National Income Tax Workbook

CHAPTER 5: BUSINESS ENTITY TAX  
ISSUES



# Chapter Issues

P 175

1. Limited Liability Companies Seeking Tax-Exempt Status
2. I.R.C. §501(c)(4) Tax Exemption
3. Form 7203 & S Corporation Shareholder Basis

# Learning Objectives

P 175

- Know the requirements for an LLC to qualify for tax-exempt status
- Understand which organizations are eligible for I.R.C §501(c)(4) tax-exempt status and the filing requirements
- Understand who must, and how to complete Form 7203
- Know how to reconstruct an S corporation shareholder's basis in his/her shares

# Form 7203 & S Corp Shareholder Basis

ISSUE 3 (PAGE 189)

# Overview

P 189

- New for tax/fiscal year ending 2021
- Reports stock & debt basis
- IRS compliance campaign S corp. loss limitations

# Filing Requirements

P 189

**FIGURE 5.5**  
**Schedule E (Form 1040) Basis Reporting**

Schedule E (Form 1040) 2021

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II** **Income or Loss From Partnerships and S Corporations** — **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . . ☐ **Yes** ☐ **No**

<b>28</b>	(a) Name	(b) Enter <b>P</b> for partnership; <b>S</b> for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

# Filing Requirements

P 190

1. A deduction for a share of an aggregate loss from the S corp.  
(including an aggregate loss not allowed from a prior year due to a basis limitation)
2. A nondividend distribution from the S corporation
3. A disposition of stock in an S corp. (regardless of whether gain is recognized)
4. A loan repayment from an S corp.

# Practitioner Note

P 190

- Most distributions are nondividend
- Dividend – only if C Corp. history



# Completing Form 7203

P 192

- Part I – Shareholder Stock Basis
- Part II – Shareholder Debt Basis
- Part III – Shareholder Allowable Loss and Deduction Items

Multiple Forms 7203 may be required

# Cross-Reference

P 194

- *2017 National Income Tax Workbook*
- Other loss limitations
- At-risk & passive activity

# Debt Basis

P 200

- *2020 National Income Tax Workbook* – guarantees don't create debt basis

Adjustments to debt basis when losses exceed stock basis:

- In the year of the loss, after stock basis is reduced to zero, reduce debt basis
- In a subsequent year when the corporation reports income, the shareholder restore debt basis before increasing stock basis

# Reconstructing Basis

P 202

- Determine initial basis
- Then adjustments

# Figure 5.12 Initial Basis Rules

P 203

Acquisition	Basis Calculation	Citation
Incorporation	Basis of contributed property	I.R.C. § 358
Purchase	Cost	I.R.C. § 1012
Inherited	FMV on date of death or alternative valuation date	I.R.C. § 1014
Gift after 1976	Donor's basis adjusted by gift tax paid	I.R.C. § 1015
Compensation	FMV on date included in income	Treas. Reg. § 1.83-4

# Basis Adjustments

P 203

- Adjusted annually
- Increase income items
- Decrease loss, deductions, & distributions
- Ordering rules
  - Income items, tax-exempt income, separately stated
  - Distributions (nondividend)
  - Nondeductible, noncapital expenses
  - Loss items & deductions

# Practitioner Note

P 203

## Reconstructing Basis

- Review taxpayer's Schedule K-1s
- Review corporate balance sheet
- Schedule M-2

# LLCs Seeking Tax-Exempt Status

## ISSUE 1



## Why Would We Consider a Non-Profit LLC?

- **High-risk programs** – Running programs that, while they are part of the core mission, entail greater risk of liability, such as wilderness outings or at-risk youth programs.
- **High-risk assets** – Investing in real estate with environmental risks or expensive transportation or other equipment

## Why Would We Consider a Non-Profit LLC?

- **Partner with other nonprofits** – When working with other nonprofits, an LLC can ensure that your organization is not harmed by other members' actions and legal status. Otherwise, tax exempt status could be at risk.
- **Collaborate with for-profit companies** – The LLC itself can either be tax exempt (if all member organizations are nonprofits) or taxable (if members include both nonprofit and for-profit entities)

Notice 2021-56, 2021-45 I.R.B. 716

P 176

- Standards for LLC determination letter for recognition under §501
- Organizational test
- State law may prohibit qualifying

# Background

P 176

- Corporation includes associations
- Organized and operated for charitable or exempt purposes
- NOT for the benefit of any private shareholder or individual

# Entity Classification

P 176

- Treas. Reg. 301.7701-1,2 & 3 – check the box
- Default:
  - Disregarded entity – single-member LLC
  - Partnership – multimember LLC
- Form 8832 – Entity Classification Election

# Treas. Reg. §301.7701-3(c)(1)(v)(A)

- Deemed election to be classified as an association if:
  - Determined to be exempt OR
  - Claims to be exempt
- Effective 1<sup>st</sup> day exemption is claimed or determined to have applied
- Withdrawn, rejected, or revoked
  - Form 8832 required to change classification

# Organizational Test

P 176

- Organized exclusively for charitable or exempt purposes
- Articles of Organization limited purpose
  - Cannot authorize more than insubstantial non-exempt purposes

# Assets upon Dissolution

PP 176-177

- Not organized exclusively for exempt purpose, unless assets dedicated to exempt purpose
- Articles or state law require distribution:
  - For one or more exempt purposes
  - Federal, state, or local government, for public purpose OR
  - By a court to another organization w/ same general purpose for which the dissolved organization was organized
- CANNOT be distributed to MEMBERS OR SHAREHOLDERS



# Notice 2021-56 LLC Requirements

P 177

1. Articles & Operating Agreement
  - ✓ Limited to nonprofit members
  - ✓ Stated nonprofit purpose
  - ✓ Distribution of Assets to nonprofit entity upon dissolution
2. Representation that enforceable provisions

## Articles & Operating Agreement Requirements (Cont.) P. 177

### Need a contingency plan

- ✓ Suspension of member rights if ceases to be 501(c)(3) or governmental unit

# State Law & Notice 2021-56

P 177

- If statement of purpose prohibited in Articles, include in Operating Agreement
  - NO inconsistent provisions

# Practitioner Note

P 178

- Business purpose requirement in some states
- Notice 2021-56 – LLC can represent charitable purposes are allowed
- Commentary requested – whether LLCs in those states can be formed exclusively for §501(c)(3)

# Nonexempt Members

P 178

- State law may grant members economic rights contrary to
- Assets dedicated to exempt purpose
- No private inurement
- Can disclaim or transfer to qualify?

# § 501(c)(4) Tax Exemption

ISSUE 2

# Overview

P 179

501(c)(4) organizations:

- Civic leagues
- Organizations exclusively to promote social welfare
- Local employee associations
- Net earnings devoted exclusively to charitable, educational, or recreational purposes

# Social Welfare Organizations

P 179

- Operates exclusively for promotion of social welfare if primarily promotes common good and general welfare
- A catchall for presumptively beneficial nonprofit organizations that don't qualify under (c)(3)



# Business Activities

P 181

- Finance social welfare programs
- Primary activity promotion of social welfare

# Practitioner Note

P 181

- Police & Firefighter Relief Organizations
- Do not qualify if:
  - Payments to members
  - Death benefits to family
- Qualify if:
  - Provides retirement benefits
  - Funded from government sources
  - Serve a sufficient public interest

# Local Associations of Employees

P 181

1. Local character
2. Membership limited to employees of a designated person or persons in a particular locality
3. Net earnings devoted exclusively to charitable, educational, or recreational purposes

# Local Associations of Employees

PP 181-182

1. Local – particular community, place, or district
2. Retirement and/or death benefits – disqualified
3. Cooperative buying service - disqualified
4. Rev. Rul. 66-180, recreational association qualified

# Lobbying & Political Campaigns

P 182

- Can engage in lobbying if related to exempt purpose
- Can engage in political campaigns if not primary
  - I.R.C. §527 – may be subject to tax on political expenditures
- Practitioner Note
  - 501(c)(3) – limited lobbying
  - 501(c)(4) – unlimited lobbying for exempt purpose

# Private Inurement (benefit)

P 182

- No benefit to private shareholder or individual
- Excessive compensation
- Rent exceeds FMV
- Substantial reimbursement of personal expenses
- Sale of property less than FMV

# Excess Benefit Transactions

P 183

- I.R.C. §4958 – disqualified person
- Subject to excise tax

# Disqualified Person (Cont).

P 183

- Voting members of the governing body
- Presidents, CEOs, or COOs
- Treasurers and CFOs
- Person with a material financial interest in a provider-sponsored organization



# Deductibility of Contributions

P 183

- Not eligible for charitable contribution deduction
- I.R.C. §162 dues or contributions may be ordinary/necessary business expense
  - Not for lobbying or political

# Forming a 501(c)(4) Organization

P 183

1. Define the purpose and mission of the organization
2. Name the organization
3. Assemble the governing board
4. Form a nonprofit state entity
5. Obtain an EIN
6. Submit Form 8976 (Notice of Intent to Operate)
7. Submit Form 1024-A (Application for Recognition) recommended but not required

## Form 8976 – Notice of Intent to Operate P 184

- File within 60 days of formation
- IRS will acknowledge receipt, NOT a determination
- Transitional rules

## Form 8976 – efile

- E-File – <https://services.irs.gov/datamart/login.do>
- Required information
- \$ 50 Fee

# IRS Responses

PP 184-185

**FIGURE 5.1**  
**Response to Registration**

New IRS Online Registration System Account  
Created

RegistrationServices@irs.gov

Thank you for registering for an online account. Your temporary password is provided below. Please note that your online password is case sensitive and will expire in 24 hours. When you log on to your account, use your user ID and copy and paste the temporary password below under "Returning User." You will then be prompted to change your password.

**FIGURE 5.2**  
**Acknowledgment of Acceptance**

Notice Accepted

RegistrationServices@irs.gov

You have a new message in your IRS Online Registration System account mailbox. To view the message, log into your account and enter your User ID and Password under "Returning Users." Once you are logged in, select "View My Messages" from the Main Menu. If you do not remember your User ID or Password, select "Forgot User ID" or "Forgot Password" from the login screen.

# Penalties

P 185

- Organization
  - \$20 per day
  - \$5,000 max
- Reasonable cause penalty relief
- Responsible Person
  - Officer
  - Director
  - Trustee
  - Employee
  - Member
  - Individual responsible for submitting Form 8976

# Form 1024-A

P 185

- Application for Recognition of Exemption Under §501(c)(A)
- Filed separately from Form 8976
- E-File
- \$600 User Fee
- Practitioner Note – recommend filing
- File within 27 months of formation for retroactive status

# IRS Processing

P 187

- 90 days from submission
- April 2022 processing applications submitted prior to August 4, 2021
- Checking the status:
  - [www.irs.gov/charities-non-profits/charitable-organizations/wheres-my-application-for-tax-exempt-status](https://www.irs.gov/charities-non-profits/charitable-organizations/wheres-my-application-for-tax-exempt-status)
  - Call 877.829.5500



# Form 990 Series

P 188

- Even if no 1024-A or not yet granted
- First return - include proof of 501(c)(4) status
- Form 990-N, Form 990-EZ, or Form 990 based on gross receipts and assets
- Planning Pointer – organizations may choose to file Form 990 b/c provides greater transparency and bylaws may require it
- Due 15<sup>th</sup> day of 5<sup>th</sup> month following close of fiscal/calendar year