BUSINESS ENTITIES & MORE

Kentucky
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Office of Income Taxation Communications & Training Branch

CT200 Business Entities & More

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BUSINESS ENTITIES
BASICS AND MORE

INTRODUCTION

Of all the choices made when starting a business, one of the most important is the type of legal organization selected for the entity. For most entities, the original structure remains intact for the life of the entity.

This decision can affect how much the business pays in taxes, the amount of paperwork required, how liability is assigned and even the ability to borrow money.

All businesses must file an annual return. It may be a tax return or an informational return. The form used depends on how the business is organized. Business formation is controlled by the law of the state where the business is organized.

The answer to the question "What structure makes the most sense?" depends on the individual circumstances of each business entity. Making an informed choice on how best to structure the entity will involve several factors, including:

- Taxation
- Recordkeeping
- Liability

The material in this manual will detail how businesses may be structured, filing requirements, forms used, and more. In addition, pros and cons of the various structures will be discussed.

Contents:

DISCLAIMER

The information in this manual is for educational and informational purposes only and does not constitute legal advice. Information is presented as an overall review that is subject to law changes and may not apply to all states. For accurate information on tax treatment of entities by specific states please reference appropriate state statutes.

In the event that any information in this manual is later determined to be in error, this manual cannot be used by taxpayers in supporting a specific position or issue before the Department of Revenue as it does not have the statutory or regulatory authority.

SOLE PROPRIETORSHIPS

Contents:

SOLE PROPRIETORSHIPS

A business with a single owner with no formal or separate form of business structure is known as a sole proprietorship. The vast majority of small businesses start out as sole proprietorships. These firms are owned by one person, usually the individual who has day-to-day responsibility for running the business. The owner has sole control and responsibility for the business.

A sole proprietorship typically has fewer legal restrictions than other entity types. In this situation the owner and the business are indistinguishable. In the eyes of the law and the public, the owner and the business are one and the same. Thus, the life of the business and owner are the same and the business cannot be transferred to others.

Sole proprietors own all the assets of the business and the profits generated by it. They also assume complete responsibility for any of its liabilities or debts.

The sole proprietor's responsibilities include:

- Furnishing capital
- Recordkeeping
- Obtaining state & local licenses & permits
- Personal liability
- Reporting income on personal income tax return

Sole proprietors can operate any kind of business. It must be a business, not an investment or hobby. It can be full-time or part-time work. This includes operating a:

- Shop or retail trade business
- Large company with employees
- Home based business
- One person consulting firm

Every sole proprietor is required to keep sufficient records to comply with federal and state tax requirements regarding business records.

Advantages of a Sole Proprietorship

- Easiest and least expensive form of ownership to organize.
- Sole proprietors are in complete control, and within the parameters of the law, may make decisions as they see fit.
- Sole proprietors receive all income generated by the business to keep or reinvest.
- Profits from the business flow-through directly to the owner's personal tax return.
- The business is easy to dissolve, if desired.

Disadvantages of a Sole Proprietorship

- Sole proprietors have unlimited liability and are legally responsible for all debts against the business. Their business and personal assets are at risk.
- May be at a disadvantage in raising funds and are often limited to using funds from personal savings or consumer loans.
- May have a hard time attracting high-caliber employees, or those that are motivated by the opportunity to own a part of the business.
- Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially deductible as an adjustment to income).

HOW TO FORM A SOLE PROPRIETORSHIP

To form a sole proprietorship:

1. Choose the type of business you wish to operate.
2. Pick a name for the business.
3. Obtain necessary licenses and permits.
4. Determine where the business will be located.
5. Set up a record keeping system.
6. Estimate financial needs and plan accordingly.
7. Purchase any supplies and equipment needed.
8. Open the doors for business.

NOTES

Business and income profits and losses are reported on your personal tax return.

A sole proprietorship can include your spouse.

Sole proprietors can set up retirement plans through a Keogh plan.

FILING REQUIREMENTS

Income from a sole proprietorship must be included on the taxpayer's individual income tax return. Generally, sole proprietors file Schedule C or C-EZ, Profit or Loss from Business, with their Form 1040. Sole proprietor farmers file Schedule F, Profit or Loss from Farming. Net business income or loss is combined with other income and deductions and taxed at individual rates on the taxpayer's personal tax return.

Sole proprietors must also pay self-employment tax on the net income reported on Schedule C or Schedule F. You may also be able to deduct one-half of SE tax on your 1040. Use Schedule SE, Self-Employment Tax, to compute this tax.

Sole proprietors do not have taxes withheld from their business income so you will generally need to make quarterly estimated tax payments in order to avoid penalties if your business income is above certain threshholds.

PRIMARY REQUIRED FORMS

Federal Tax Forms That a Sole Proprietorship May Need to File

- Form 1040: Individual Income Tax Return
- Schedule C: Profit or Loss from Business (or Schedule C-EZ)
- Schedule SE: Self-Employment Tax
- Form 1040-ES: Estimated Tax for Individuals
- Form 4562: Depreciation and Amortization
- Form 8829: Expenses for Business Use of your Home
- Employment Tax Forms

Kentucky Tax Forms That a Sole Proprietorship May Need to File

- Form 740: Individual Income Tax Return
- Form 740NP: Nonresident or Part-Year Resident Income Tax Return
- Form 740-ES: Estimated Tax Vouchers

DISSOLUTION

Sole proprietorships may end due to a variety of reasons. Sale of the business, illness or death of the owner, under-capitalization, lack of profitability or transformation into a different type of entity, such as a partnership, limited liability corporation or S-corporation are all valid reasons for ending a sole proprietorship.

Unlike a corporation that needs to be dissolved (this requires filing articles of dissolution with the secretary of state) or a limited liability company, which also needs to be dissolved, a sole proprietorship ends when you stop doing business.

C CORPORATIONS

Contents:

C CORPORATIONS

A corporation whose profits are taxed separate from its owners under Subchapter C of the Internal Revenue Code is known as a C corporation and commonly called a C corp. C corporations differ from an S corporation, in that an S corporation's profits are passed through to shareholders and taxed on their personal income tax return.

Most publicly-traded companies — and all major ones — fall under this classification. For United States tax purposes, C corporations are required to pay income taxes on their profits. One advantage to a C corporate structure is the fact that, unlike S corporations, there is no limit to the number of shareholders. A disadvantage is the fact that, because a C corporation is taxed itself and its individual shareholders are taxed on distributions and dividends, it is subject to double taxation.

Characteristics of a C Corporation

A C corporation:

- Is legally independent from its owners

A traditional Corporation (or a "C" corporation) is a business structure that is created as a separate, distinct legal entity from its owners (or "shareholders"). Once a corporation is formed, the corporation can have its own bank accounts, own property, conduct business, and even establish a line of credit, irrespective of the individual accounts or credit of the shareholders.

- Owners are not personally liable

The primary advantage to having a business formed as a corporation is the fact that the owners are not personally liable for the debts and legal liabilities incurred by the corporation. For example, if a corporation is sued for business reasons and loses, the owners will not be required to satisfy the debts of the corporation from their own personal assets. This safeguards assets and properties of the individual owners, and as such, is more attractive to potential investors.

- Has a more complex structure

Another important thing to know about the formation and maintenance of a corporation is that certain corporate formalities must be observed. These are things like a required annual meeting of the board of directors, the need to maintain the corporate "minutes," the separation of corporate and personal funds (no "co-mingling" of funds), and a necessity to maintain written agreements for all corporate transactions (including internal transactions such as internal loans, executive compensation agreements, etc.).

- Has a board of directors and shareholders

Once a corporation is established, the shareholders must name (via election) a board of directors that is responsible for the operation of the business, making business decisions, and managing all business-related affairs. The board appoints “officers” of the corporation to specific duties.

ADVANTAGES of a C CORPORATION

- Limited Liability for Shareholders

This limits the liability of the owners/investors to only the amount of their investment. The owners of a corporation are not personally liable for business debts, claims, or other liabilities.

- Certain Tax Benefits

Tax rate on certain tiers of corporate income is usually lower than the comparable tax rate on similar tiers of personal income. The owners can arrange salaries and bonuses in conjunction with retained corporate earnings to lower their overall tax rate.

- Ability to Raise Capital and Attract Investors

Investors are protected so they are more likely to invest in the corporation. Additionally, the corporation may choose to issue stock or stock options to employees.

- Tax Deductions

Even if a small business is quite profitable, a C corporation is entitled to so many deductions that it may be possible to greatly reduce business income. For example, the owner of a C corporation’s salary and those of employees are tax-deductible for the business.

- Fringe Benefits

While all business entities can provide fringe benefits to its owners and/or employees, the structure of a corporation allows for a greater range of benefits.

- Perpetual Existence

The existence of a corporation is considered perpetual, although it can be terminated voluntarily by its owners (shareholders). The board carries on the company, not the owner. That means that a corporation can last longer than an owner-based company such as an LLC.

Corporations have many other tax breaks and expenses they may use to offset taxable income, including:

- Rents
- Repairs and maintenance
- Bad debts
- Depreciation
- Profit-sharing and employee benefit plans, including insurance and pensions
- Charitable donations

DISADVANTAGES of a C CORPORATION

- Double Taxation Pitfall

A major disadvantage of the traditional corporation is double taxation. A traditional C corporation pays tax on all corporate (business) income, and then once a distribution is made to the shareholders, the individual shareholders pay income tax again on these distributions or dividends.

- Cost of Setup

It's may be costlier to start than a sole proprietorship or partnership.

- Extensive Record-keeping Requirements

Corporations typically require more ongoing paperwork than most other business entities in order to stay compliant with the law and maintain their corporate status. This includes holding and documenting annual meetings of shareholders and directors and keeping minutes of important corporate meetings. It can be difficult and labor intensive to maintain the necessary paperwork for a C corporation than other type entities.

Note: One way to avoid the double taxation dilemma is to establish the corporation as a “pass through” entity like a partnership wherein all corporate profits pass through to the individual shareholders and they are then responsible for the tax burden. A corporation that has made the election to be treated in this manner (by making the appropriate filings and meeting the requirements) is known as an “S corporation.”

HOW TO FORM A C CORPORATION

To form a C corporation, you will need to register your business name, file a certificate of incorporation or articles of incorporation and complete other necessary paperwork. You will also need to draft corporate bylaws and hold a board of director's meeting.

Steps to Forming a C Corporation

1. Choose an available business name that complies with your state's corporation rules.

2. Appoint the initial directors of your corporation.

3. File formal paperwork, usually called "Articles of Incorporation," and pay a filing fee (to the Secretary of State for Kentucky) that ranges from $40 to $800, depending on the state where you incorporate.

4. Create corporate "bylaws," which lay out the operating rules for your corporation.

5. Hold the first meeting of the board of directors.

6. Issue stock certificates to the initial owners (shareholders) of the corporation.

7. Obtain licenses and permits that may be required for your business.

8. Register with the Secretary of State.

FILING REQUIREMENTS

All domestic corporations must file an income tax return with the IRS and Kentucky whether or not they have taxable income unless they qualify for exempt status.

For federal purposes, the most common exempt corporations are those not for profit organizations exempt under IRC Section 501, which is discussed later in this material. A listing of exempt corporations for Kentucky may be found under KRS 141.040, as follows:

141.040 Corporation income tax -- Exemption -- Rate.

(1) Every corporation doing business in this state, except those corporations listed in paragraphs (a) to (i) of this subsection, shall pay for each taxable year a tax to be computed by the taxpayer on taxable net income or the alternative minimum calculation computed under this section at the rates specified in this section:

(a) Financial institutions, as defined in KRS 136.500, except bankers banks organized under KRS 286.3-135;

(b) Savings and loan associations organized under the laws of this state and under the laws of the United States and making loans to members only;

(c) Banks for cooperatives;

(d) Production credit associations;

(e) Insurance companies, including farmers or other mutual hail, cyclone, windstorm, or fire insurance companies, insurers, and reciprocal underwriters;

(f) Corporations or other entities exempt under Section 501 of the Internal Revenue Code;

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g) Religious, educational, charitable, or like corporations not organized or conducted for pecuniary profit;

(h) Corporations whose only owned or leased property located in this state is located at the premises of a printer with which it has contracted for printing, provided that:

1. The property consists of the final printed product, or copy from which the printed product is produced; and

2. The corporation has no individuals receiving compensation in this state as provided in KRS 141.120(8)(b); and

(i) For all taxable years except those beginning after December 31, 2004, and before January 1, 2007, S corporations.

Additional Filing Requirements

Once a corporation (foreign or domestic, business or nonprofit) is registered with the Secretary of State, it has a few continuing obligations. These include:

- File an annual report by June 30 of each year;
- Report any change in the corporation's registered agent or registered office on a Statement of Change of Registered Office or Registered Agent or Both as soon as those changes occur;
- Report any change in the principal office address to the Secretary of State on a Statement of Change of Principal Office Address

HOW is a C CORPORATION TAXED?

Unlike many other business entities in which the profits pass through to the owners' personal tax return (e.g. LLCs, S corporations, etc.), the C Corporation is a completely separate taxable entity. The C corporation pays federal taxes on the net profits (after all expenses, including salaries and bonuses) of the business. The after tax profits can be paid out to the owners (shareholders) in the form of dividends, or retained for reinvestment of the business.

PRIMARY REQUIRED FORMS

Federal Tax Forms Required for a C Corporation

- Form 1120: U.S. Corporation Income Tax Return, or Form 1120-a, U.S. Corporation Short-Form Income Tax Return, and
- All other appropriate related Federal Schedules

Kentucky Tax Forms Required for a C Corporation

- Form 720: Kentucky Corporation Income Tax and LLET Return
- Schedule LLET Limited Liability Entity Tax
- All other appropriate related Kentucky Schedules

DISSOLUTION

The first step in officially dissolving a corporation is the adoption of a corporate resolution to dissolve by the board of directors. A vote must be taken and the minutes of the meeting must be recorded and retained in the corporate records. Once the resolution has been approved by the board of directors, it must also be approved by a majority (in some cases two-thirds) of the corporation's shareholders.

Next, the corporation needs to file Articles of Dissolution with the Secretary of State. In some states this is done with a simple certificate while others require a more complex process. Once the state has approved the dissolution, the corporation's assets can be distributed to its shareholders.

FAILURE TO OFFICIALLY DISSOLVE

The consequences of not properly dissolving a corporation can be severe; therefore taking the necessary steps to officially dissolve should be followed. Aside from a lack of corporate closure, some of the consequences you may be forced to deal with include the following:

- *Tax Filings.* Until the corporation is formally dissolved for tax purposes*, it will continue to be required to file all relevant federal, state, and municipal tax reports. Failure to do so will result in the normal penalties and fees associated with a late filing.
- *Personal Liability.* Since the business is still considered a legally viable entity, its officers, directors, and shareholders may be personally liable for the corporation, even if it is no longer doing business.
- *Annual Reports.* Your corporation will need to file annual reports every year (and pay the penalties for neglecting to file them) until the corporation is dissolved.
- *Future Product Liability.* A corporation that has not been officially dissolved continues to risk future product liability from the products it sold while it was in operation.
- *Asset Allocation Delay.* Shareholders are not legally entitled to their share of the corporation's assets until it has been officially dissolved with the secretary of state.

** Administrative dissolution via the Kentucky Secretary of State does not exempt corporations from Kentucky tax filing requirements. Corporations must file formal Articles of Dissolution in order to properly terminate their requirement to file tax returns*

S CORPORATIONS

Contents:

S Corporations

A corporation is a legal and tax entity by itself. It is similar to a person in that it has its own assets and tax identification number, called a Federal Tax Identification Number (FEIN).

An S corporation is a corporation which is taxed under Subchapter S of the Internal Revenue Code. Unlike a C corporation, S corporations are pass-through business entities, meaning any profit or losses are passed through to the owners and reported on their personal tax returns.

If it meets the qualifications, a C corporation can elect to be taxed as an S corporation at any time. For purposes of dissolution, by default, corporations are considered C corporations unless they have elected S corporation status.

There are certain requirements a corporation must meet to be an S corporation. The general requirements are that there must be no more than 100 shareholders, the election to be an S corporation must be made timely, and there can only be one class of stock issued by the corporation.

Like other business entities, an S corporation needs to have a license to do business in locations in which it has offices. S corporations may use an assumed name, so for example, Roses Inc. may, in fact, operate as Derby Roses.

A corporation's assets or ownership is easily transferred through sale of the assets or sale of stock. The death of the shareholders or directors or officers of a corporation has no effect on the existence of the corporation. A corporation must be legally dissolved to terminate.

ADVANTAGES of an S CORPORATION

The primary advantage of forming a corporation is that it is a separate legal and tax entity from its owner(s). If you form a corporation, the corporation will grant you shares.

Shareholders are not liable for the debts or acts of the corporation as long as they abide by the corporate procedures required by law. The most a shareholder can lose is the amount invested for shares of the corporation. This means that if the corporation is sued and loses, they cannot take personal assets such as a home, personal cars and other personal assets.

Another advantage is that corporations are regarded as a more professional business-like structure. Venture capital and investors usually prefer to invest in corporations as they provide the most flexible and consistent procedures for business and investment.

If you are an S corporation, you are not subject to the double taxation which can occur when a corporation pays income tax and then shareholders pay tax on dividends as well. There are also other tax benefits.

Other advantages include:

- Corporate losses can be passed through to the shareholders and as the owner (and shareholder) you may be able to take the loss against income that appears on your personal return.

- You can have the protection of limited personal liability without having to pay corporate taxes.
- You can minimize self-employment tax and FICA tax. Profits, as a shareholder, are not taxed in this manner.
- It is easier to raise capital as a corporation than as a sole proprietorship or partnership.

DISADVANTAGES of an S CORPORATION:

Many of the disadvantages of an S corporation can be attributed to costs and regulations. The costs and effort of maintaining a corporation are higher than some other business forms due to legal requirements such as annual shareholder meetings, maintaining corporate minutes and other procedures which must be followed.

In addition, a corporation which has an office in a state other than the one it's incorporated in must register as a foreign corporation in that state. The cost of incorporation, maintaining an agent for service (a person to receive legal documents required by law), registering as a foreign corporation and upkeep of corporate procedure documents is higher than some other forms of business.

Other disadvantages include:

- Numerous regulations and requirements that must be upheld by an S corporation including a limit of no more than 100 shareholders.
- Like a C corporation, it can be costly to set up and follow formalities.
- Close scrutiny by the IRS of shareholder-employees, who must receive reasonable compensation (subject to employment taxes) before any non-wage distributions may be made to that shareholder-employee.

Other regulations imposed on S Corporations include:

- All shareholders must be U.S. citizens.
- Benefits such as health or accident insurance for employee shareholders (with at least 2 percent partnership) may not be deducted by the corporation.

ELIGIBILITY

What factors are required for a corporation to be eligible for S corporation status?

The corporation must:

- Be filed as a U.S. corporation.
- Maintain only one class of stock.
- Maintain a maximum of 100 shareholders.
- Be comprised SOLELY of shareholders who are individuals, estates or certain qualified trusts or certain tax exempt organizations. Partnerships and C Corporations are not eligible to hold stock in an S Corporation.
- Have only citizens or residents of

the United States as shareholders.

Failure to observe ANY of the above requirements could revoke S corporation status at any time.

STEPS TO FORMING AN S CORPORATION

In order to create an S corporation, the organizers of the business must take the following steps:

1. Draw up articles of incorporation, by-laws, and various resolutions,
2. Incorporate the business as a corporation in the state where the company will conduct the bulk of its business,
3. Verify that the corporation meets the eligibility criteria for being an S corporation, and
4. Notify the IRS of its intention to be taxed as an S corporation by filing IRS Form 2553 no later than the 15th day of the third month following its date of incorporation.
5. Follow appropriate requirements of Secretary of State.

Electing S Corporation Status

The election of S corporation status must be made by a qualified corporation, with the unanimous consent of the shareholders, on or before the 15th day of the 3rd month of its tax year in order for the election to be effective beginning with the year when made. If the election is made after the 15th day of the 3rd month of its tax year, the election will be effective the following year.

Corporations elect S Corporation status using IRS Form 2553. Each shareholder at the time the form is filed must sign the form.

Submitting Form 2553

IRS Form 2553, Election by a Small Business Corporation must be filed:

- Before the 16th day of the 3rd month of the corporation's tax year,
- Before the 15th day of the 2nd month of a tax year lasting 2-1/2 months or less,
- At any time during the tax year before the tax year the election is to take effect,
- At any time after these deadlines if the corporation follows special rules for making a late S corporation election.

TAX TREATMENT

S corporation profit or loss is passed through to shareholders and reported on the shareholders' tax returns. A Subchapter S corporation generally does not pay tax at the corporate level.

Exception: If the Subchapter S corporation was previously a C corporation, the Subchapter S corporation may be liable for tax on excess net passive income, LIFO reserve recapture, and net built-in gains.

Subchapter S Corporation Estimated Tax Requirements:

Shareholders are responsible for payment of estimated tax on their personal returns. The Subchapter S corporation must pay estimated tax payments if corporate level taxes apply.

FILING REQUIREMENTS

Subchapter S Corporation Filing Requirements:

Every corporation (except those exempted by law) must file, regardless of the amount of income or loss. It must file even if it stops conducting business. Filing ends when totally dissolved.

PRIMARY REQUIRED FORMS

For Federal Purposes:

Form 1120S: U.S. Income Tax Return for an S corporation
Form 1120S Schedule K-1: Shareholder's Share of Income, Credit, Deductions

For Kentucky Purposes:

Form 720S: Kentucky S Corporation and LLET Return
Schedule K-1: Shareholder's Share of Income, Credit, Deductions

DISSOLVING AN S CORPORATION

An S corporation is not as expensive or complicated to dissolve as a C corporation because gain on the distribution of assets is taxed once. (If an S corporation was formerly a C corporation or received assets from a C corporation, there may be double taxation.) To liquidate an S corporation, you must do the following:

- Follow any established by-laws
- Obtain shareholder approval to dissolve.
- File a statement of intent to dissolve with the Secretary of State.
- Pay taxes, debts, and creditors.
- Distribute assets of the corporation to shareholders.

LIMITED LIABILITY COMPANIES

Contents:

LIMITED LIABILITY COMPANY (LLC)

The LLC is a relatively new type of hybrid business structure that is now available in all states. It is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.

Often *incorrectly* called a "limited liability corporation" (instead of company), it is a hybrid business entity having certain characteristics of both a corporation and a partnership or sole proprietorship (depending on how many owners there are). The primary characteristic an LLC shares with a corporation is limited liability, and the primary characteristic it shares with a partnership is the availability of pass-through income taxation.

The owners are members, and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration.

LLC's must not have more than two of the four characteristics that define corporations: Limited liability to the extent of assets; continuity of life; centralization of management; and free transferability of ownership interests.

Multi-member LLCs are taxed as partnerships in most cases; corporation forms must be used if there are more than 2 of the 4 corporate characteristics. Single member LLCs are treated as sole proprietorships for federal purposes. State tax treatment can vary.

ADVANTAGES

- Default classification. An LLC with one member is disregarded as an entity separate from its single member. An LLC with multi-members is classified as a partnership.
- Check-the-box taxation. An LLC can elect to be taxed as a S corporation or C corporation, providing much flexibility.
- Limited liability, meaning that the owners of the LLC, called "members," are protected from some or all liability for acts and debts of the LLC depending on state shield laws.
- Much less administrative paperwork and record keeping than a corporation.
- Pass-through taxation (i.e., no double taxation), unless the LLC elects to be taxed as a C corporation.
- LLCs in some states can be set up with just one natural person involved.
- Membership interests of LLCs can be assigned, and the economic benefits of those interests can be separated and

assigned, providing the assignee with the economic benefits of distributions of profits/losses (like a partnership), without transferring the title to the membership interest.

DISADVANTAGES

- Although there is no statutory requirement for an operating agreement in most states, members who operate without one may run into problems.
- It may be more difficult to raise financial capital for an LLC as investors may be more comfortable investing funds in the better-understood corporate form.
- Many states, including Alabama, California, Kentucky, New York, Pennsylvania, Tennessee, and Texas, levy a tax on LLCs. In essence, this tax is the "fee" the LLC pays the state for privilege of doing business with the benefit of limited liability. The tax can be an amount based on revenue, an amount based on profits, or an amount based on the number of owners or the amount of capital employed in the state, or some combination of those factors, or simply a flat fee, depending on the law of the state involved.
- Some creditors will require members of up-and-starting LLCs to personally guarantee the LLC's loans, thus making the members personally liable for the debt of the LLC.
- The management structure of an LLC may be unfamiliar to many. Unlike corporations, they are not required to have a board of directors or officers.
- The LLC form of organization is relatively new, and as such, some states do not fully treat LLCs in the same manner as corporations for liability purposes, instead treating them more as a disregarded entity, meaning an individual operating a business as an LLC may in such a case be treated as operating it as a sole proprietorship, or a group operating as an LLC may be treated as a general partner, which defeats the purpose of establishing an LLC in the first place, to have limited liability.
- The principals of LLCs use many different titles—e.g., member, manager, managing member, managing director, chief executive officer, president, and partner. As such, it can be difficult to determine who actually has the authority to enter into a contract on the LLC's behalf.

Exceptions to Limited Liability

While LLC owners enjoy limited personal liability for many of their business transactions, this protection is not absolute. This drawback is not unique to LLCs, however -- the same exceptions apply to corporations. An LLC owner can be held personally liable if he or she:

- personally and directly injures someone
- personally guarantees a bank loan or a business debt on which the LLC defaults
- fails to deposit taxes withheld from employees' wages
- intentionally does something fraudulent, illegal, or reckless that causes harm to the company or to someone else, or
- treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

This last exception is the most important. If owners don't treat the LLC as a separate business, a court might decide that the LLC doesn't really exist and find that its owners are really doing business as individuals who are personally liable for their acts.

Member

LLC members are the owners of the LLC much as shareholders are the owners of a corporation or the partners of a partnership. Like shareholders, a member's liability to repay the LLC's obligations is limited to his or her capital contribution. Members may be natural persons, corporations, partnerships, or other LLCs.

Membership Interest

A member's ownership interest in an LLC is often called a membership interest. Membership interests are often divided into standardized units which, in turn, are often called shares or units. Unless otherwise provided for in the operating agreement, a member's right to receive distributions or exercise member rights over the LLC is proportionate to their membership interest. Membership interests and member rights are regulated by state law.

Manager

LLCs may be managed by their members in proportion to their membership interests. Many LLC operating agreements, however, provide for a manager or board of managers to oversee or run the day-to-day operations of the LLC. The managers are elected or appointed by members and may also be, if so provided in the operating agreement, removed by members. A member may also be a manager, often called the managing member.

HOW TO FORM A LIMITED LIABILITY COMPANY

Forming an LLC requires following a few simple steps. Here are the steps you need to take to make your LLC a legal reality.

1. Choose an available business name that complies with your state's LLC rules.
2. File formal paperwork, usually called articles of organization, and pay the filing fee (ranging from about $40 to $800, depending on state).
3. Create an LLC operating agreement, which sets out the rights and responsibilities of the LLC members.
4. Publish a notice of your intent to form an LLC (required in only a few states).
5. Obtain licenses and permits that may be required for your business
6. Set up a record keeping system

Articles of Organization

All LLCs must file evidence of their existence with the secretary of state (or some governmental office) of the state where they choose to be organized. The Articles of Organization serve this purpose.

Operating Agreement

The Operating Agreement of an LLC is the document most important to its success because it determines, defines, and apportions the rights of the members and the managers if any.

NOTE: State and federal laws may not agree so legal advice is critical.

TAXATION OF LLCs

The IRS treats single member LLCs, whose single member is an individual, estate or trust as sole proprietorships for tax purposes. This means that the LLC itself does not pay taxes and does not have to file a return with the IRS. Note that a single member can be an individual, estate, trust or general partnership.

Like sole proprietorships and partnerships, an LLC is not considered a separate entity from its owners for tax purposes. This means that the LLC does not generally pay any income taxes itself; instead, the LLC owners pay taxes on their allocated share of profits (or deduct their share of business losses) on their personal tax returns. However, some states, such as Kentucky which has a LLET tax, do impose additional tax on LLCs.

MULTI-MEMBER LLCs

The IRS treats multi-member LLCs as partnerships for tax purposes. Like one-member LLCs, multi-member LLCs do not pay taxes on business income; instead, the LLC owners each pay taxes on their share of the profits on their personal income tax returns (with Schedule E attached). Each LLC member's share of profits and losses, called a distributive share, should be set out in the LLC operating agreement.

Multi-member LLC owners can elect to have their LLC taxed like a corporation. This may reduce taxes for those LLC owners who need to retain a significant amount of profits in the company.

FILING REQUIREMENTS

SINGLE MEMBER LLCs

A single member LLC (SMLLC) is simply a limited liability company that has only one member. Under current IRS rules, unless the SMLLC elects to be treated as a corporation, it is disregarded for Federal income tax purposes.

That means if the only member is an individual, all of the income and expenses of a business operated as a single member limited liability company will be reported on a Schedule C attached to the individual's Form 1040. The sole owner of the LLC must report all profits (or losses) of the LLC on Schedule C and submit it with a federal 1040 tax return. As such, this becomes part of your federal adjusted gross income, which flows to the Kentucky return. Even if you leave profits in the company's bank account at the end of the year -- for instance, to cover future expenses or expand the business -- you must pay income tax on that money.

If the single member is a corporation or partnership, the SMLLC's income and expenses will be aggregated with the other income and expenses of the corporation or partnership and reported on that entity's tax return.

The principal disadvantage of a multiple member LLC is that it must file a partnership tax return and comply with the sometimes complex rules of partnership taxation. A SMLLC, on the other hand, is disregarded for Federal (and most state) tax purposes.

FORMS

File Form 1065 with the IRS. Even though a co-owned LLC does not pay its own income taxes, it must file Form 1065 with the IRS. This form, the same one that a partnership files, is an informational return that the IRS reviews to make sure that LLC members are reporting their income correctly. The LLC must also provide each LLC member with a Schedule K-1, which breaks down each member's share of the LLC's profits and losses. In turn, each LLC member reports this profit and loss information on his or her individual Form 1040, with Schedule E attached.

PRIMARY REQUIRED FORMS

Federal Tax Forms That a LLC May Need to File

Form 1040: Individual Income Tax Return
Schedule E: Supplemental Income and Loss
Form 1065: U.S. Return of Partnership Income
Form 1065 K-1: Partners' Share of Income, Deductions, Credits

Kentucky Tax Forms That a LLC May Need to File

Form 725: Kentucky Single Member LLC Individually Owned LLET return (a single member can be an individual, estate, trust or general partnership)
Form 765: Kentucky Partnership and LLET Return
Schedule LLET: Limited Liability Entity Tax
Schedule TCS: Tax Credit Summary

DISSOLVING A LLC

Depending on the reason that you wish to dissolve an LLC, you will need to first figure out how much each individual person's stake in the LLC is, and also to determine the assets of the LLC's. If you are the only person in your LLC, then there is a number of steps that you need to finish to completely dissolve your LLC.

Dissolving an LLC – Procedure

These steps do not need to be completed in any particular order, but they must all be completed in order to avoid any type of personal liability.

If you are having problems with other partners or members in your business, you are in for a much more involved process. Dissolving a LLC in this case often requires going to court, unless you can get the required approval to take this action. If you do, you will go through the steps to dissolve the LLC. If not, you will need to petition to your state court system and try to get a court order to dissolve the LLC.

The business owners of the company must approve the dissolution of the business. Corporations and LLCs are handled as such. With corporations, the shareholders must approve this action. With LLCs, the members must grant approval. To comply with the formalities of a corporation, the board of directors should draft and approve the resolution to dissolve the company. The shareholders should then vote on that resolution once approved by the directors. Both actions should be documented and placed in the corporate record book. Even though LLCs are not subject to the formalities, documenting the decision to dissolve the LLC and the member's approval is recommended.

STATE REQUIREMENTS

After the shareholders or members have voted to dissolve the LLC, the appropriate paperwork must be filed with the state. If the business has qualified to transact business in other states, the appropriate paperwork must also be filed in those states.

The process for filing the certificate of dissolution varies by state. Some states require the documents be filed before notifying creditors and resolving claims. Other states require the documents be filed after. Certain states require tax clearance for the company before the certificate of dissolution can be filed. In these cases, any back taxes owed by the corporation or LLC must first be paid.

Kentucky's Secretary of State web site includes forms for dissolving a LLC. The limited liability name on the articles of dissolution must read exactly as stated in the most recent articles filed. A fee of $40.00 is charged. Additional information may be found on the Secretary of State website.

PARTNERSHIPS AND GENERAL PARTNERSHIPS

Contents:

PARTNERSHIPS

A partnership is formed when two or more persons agree to carry on a business together. This agreement can be written or oral.

Partnerships are “flow-through” entities. Flow-through taxation means that the entity does not pay taxes on its income. Instead, the owners of the entity pay tax on their "distributive share" of the entity's taxable income, even if no funds are distributed by the partnership to the owners.

Federal tax law permits the owners of the entity to agree how the income of the entity will be allocated among them, but requires that this allocation be an accurate reflection of the economic reality of the business arrangement. The rules governing partnership taxation, for purposes of the U.S. Federal income tax, are codified as Subchapter K of Chapter 1 of the U.S. Internal Revenue Code (Title 26 of the United States Code).

There are two types of partnerships, general and limited, each of which are covered in this material. In addition, a limited liability company, composed of two or more people, is treated very similarly for tax purposes and liability issues.

The law governing general partnerships can be found in the Uniform Partnership Act. The U.P.A. is a model law that most states around the country have adopted with some variances - states often modify it or fail to update their laws as the U.P.A. is revised, so there is some variance among the states.

The laws contained in the U.P.A. are general guidelines for partnerships and are usually open to modification by the partners. The U.P.A. rules act as "default rules" that apply if the partners have not expressly contracted otherwise. Because the U.P.A. serves as only a fallback or default, businesspeople are left a great deal of flexibility to draft partnership agreements to address issues that are relevant to their business.

Although a partnership can be formed very informally and without legal aid, it is preferable to have your lawyer draw up an agreement reflecting your particular needs, if only to prevent future disagreements.

Like all other business entities, partnerships are a creation of state law. The majority of small business enterprises that include more than one entity are general partnerships.

GENERAL PARTNERSHIPS

You may choose to set up your business as a general partnership. If you do not choose a business form, under most state laws, a general partnership is the default partnership form. In other words, if you do not make a selection as to which type of partnership yours will be, the government will choose for you, and basically, a general partnership is the form the government will choose.

Essentially, there are no formalities that are required to be followed to form a general partnership. No written partnership agreement is specifically required. Oral partnership agreements may be enforceable, although, as discussed below, it is highly recommended that a written partnership agreement be prepared.

With a general partnership, absent a formal agreement, all partners are considered to be equal partners. This means that each partner owns equal interest in the partnership, is equally entitled to participate in operating and managing the business and is entitled to an equal share in the profits of the business. This also means that each partner will share equally in paying taxes on those profits.

Unless there is an agreement that specifies otherwise, disputes are settled by a majority vote of the partners and changes to the partnership agreement must be by unanimous vote of the partners. It is especially important to spell out in writing in a partnership agreement the terms in respect to managing the business and sharing in its profits.

While a general partnership can be the most simple partnership form, it does have some disadvantages. For example, under a general partnership, each of the partners is exposed to unlimited personal liability. This means that each partner is liable for the debts, obligations and losses of the partnership. Each partner is also liable for the actions of the other partners.

By law, if a general partner makes a decision associated with the partnership's business, the other general partners are bound by that decision. The remaining partners may also be held liable for the conduct of one of the partners committed in connection with the partnership's business, e.g., fraud or misappropriation of funds.

Such liability is "joint and several," which means, for example, that if there are five general partners, liability will not necessarily be apportioned five ways. For instance, if a judgment is entered against a general partnership made up of five partners, the creditor can go after the personal assets of all five partners in an attempt to satisfy the judgment. If only one of the general partners has personal assets, then it is possible that one hundred percent of the judgment may be satisfied from that partner's assets. He or she will not be able to argue that only one-fifth of the judgment should be satisfied from his or her assets.

A partnership has some characteristics of a separate legal entity. Often, a partnership can sue other parties in courts and convey or buy property. But partnerships retain one very large disadvantage of the sole proprietorship: partners are held personally liable for the obligations of the partnership.

As you can see, it is extremely important to actively select the appropriate business form for your partnership. If you do decide on a general partnership, it is crucial that you spell out the rights and responsibilities of the partners in order to avoid being subjected to the default general partnership rules.

ADVANTAGES OF A GENERAL PARTNERSHIP

- Two (or more) heads are better than one. When you have a team building and believing in the same business, you have a big advantage. Diversity in training, skills, experience, personalities and talents is a plus when it is managed in such a way that people complement each other.
- Ability to raise capital and pool resources. More partners equal more assets available to the business.
- Easy to form. Like sole proprietorships, partnership businesses can be formed easily without any compulsory legal formalities. A simple agreement or partnership deed, either oral or in writing, is sufficient to create a partnership.
- Enhanced decision making. The partners are the owners of the business. Each of them has equal right to participate in the management of the business. In case of any conflict, they can sit together to solve the problem. Since all partners participate in the decision-making process, there is less scope for reckless and hasty decisions.
- Flexibility. A partnership firm is a flexible organization. At any time, the partners can decide to change the size or nature of the business or area of its operation. Only the consent of all the partners is required.
- Risk sharing. In a general partnership all the partners "share" the business risks.
- Protection of interest of each partner. In a general partnership, every partner has an equal say in decision making and the management of the business.
- Specialization. Since all the partners are owners of the business, they can actively participate in every aspect of business as per their specialization, knowledge and experience.
- Maintenance. Partnerships are often cheaper and simpler to maintain than corporations. Partnerships do not have to record minutes detailing their actions like corporations. There are no directors,

officers, etc., just the partners.

DISADVANTAGES of a GENERAL PARTNERSHIP

- Unlimited liability. All the partners are liable for the debt of the firm. They can share the liability among themselves or any one can be asked to pay all the debts, even from his personal properties, depending on the arrangement made between the partners.

- Uncertain life. The partnership form has no legal existence separate from its partners. It comes to an end with death, insolvency, incapacity or the retirement of a partner. Further, any unsatisfied or discontented partner can also give notice at any time for the dissolution of the partnership.

- Possible discord. In a partnership firm every partner has an equal right to participate in the management. Also, every partner can voice his or her opinion or viewpoint before the management regarding any matter at any time. Because of this, there can be friction and discontent among the partners. Difference of opinion may lead to the end of the partnership and the business.

- Limited capital. Smaller partnerships may be limited on resources to raise capital.

- Transferring shares. If you are a partner in any firm, you cannot transfer your share or part of the company to outsiders, without the consent of other partners. This creates inconvenience for the partner who wants to leave the firm or sell part of his share to others.

FORMING A GENERAL PARTNERSHIP

Formation of a partnership can be a simple matter. Two people who have a “handshake agreement” may be partners under the law, even if they do not write anything down or say another word on the topic. This is not the best way to form a relationship where any more than nominal amounts of money are going to be involved.

Utilizing a lawyer to form a partnership can be more expensive than forming either a sole proprietorship or a corporation. The additional expense comes from the attorney-time necessary to craft a partnership agreement. Partnership agreements tend to be less standardized than other business entity agreements and thus need more attention.

However, it is well worth the expense to have the clarity that a well-drafted partnership agreement can bring to your partnership. A written agreement is also a plus with lenders and investors.

Forming partnerships haphazardly is very risky financially since, as previously noted, each partner is liable for the partnership liabilities and a partner's personal assets can be seized to pay such liabilities. Coupled with the fact that each partner has complete and total power to act on behalf of the partnership, the potential for risk should be addressed up-front.

Imagine, for example, your partner taking out a loan from a bank in the partnership's name, which he could legally do, and then he loses it all in a risky deal that was a "sure thing". Who is liable? The partnership, and that means *you* are liable. Such occurrences may be avoided through a properly executed partnership agreement.

KENTUCKY REQUIREMENTS

File formal paperwork with the Secretary of State called Statement of Partnership Authority. The current fee is $40.00. Complete any other necessary state and local licenses and permits.

THE PARTNERSHIP AGREEMENT

Although partnership agreements can be verbal; it is recommended that a written partnership agreement be prepared with the input of all partners and the advice of a knowledgeable tax attorney.

Some of the matters it should cover include:

- The nature of the business
- The role and authority of each partner
- Proportion of ownership of each partner
- Each partner's liability to contribute funds
- The manner of dissolution
- The distribution of assets on dissolution
- The resolution of disputes

SAMPLE PARTNERSHIP AGREEMENT

The following sample agreement is just one example illustrating the different aspects of a partnership that should be addressed. Actual agreement may vary greatly based on the particular partnership circumstances.

PARTNERSHIP AGREEMENT

THIS PARTNERSHIP AGREEMENT ("Agreement") made and effective this [*date*], by and between the following individuals, referred to in this Agreement as the "Partners": [*list names of partners*].

The Partners wish to set forth, in a written agreement, the terms and conditions by which they will associate themselves in the Partnership.

NOW, THEREFORE, in consideration of the promises contained in this Agreement, the Partners affirm in writing their association as a partnership in accordance with the following provisions:

1. Name and Place of Business.

The name of the partnership shall be called [*name of partnership*] (the "Partnership"). Its principal place of business shall be [*city and state of principal place of business*], until changed by agreement of the Partners, but the Partnership may own property and transact business in any and all other places as may from time to time be agreed upon by the Partners.

2. Purpose.

The purpose of the Partnership shall be to [*describe business purpose*]. The Partnership may also engage in any and every other kind or type of business, whether or not pertaining to the foregoing, upon which the Partners may at any time or from time to time agree.

3. Term.

The Partnership shall commence as of the date of this Agreement and shall continue until terminated as provided herein.

4. Capital Accounts.

A. The Partners shall make an initial investment of capital, contemporaneously with the execution of this Agreement, as follows:

Partners and Capital
[*list partners' names and amounts invested*]

In addition to each Partner's share of the profits and losses of the Partnership, as set forth in Section 5, each Partner is entitled to an interest in the assets of the Partnership.

B. The amount credited to the capital account of the Partners at any time shall be such amount as set forth in this Section 4 above, plus the Partner's share of the net profits of the Partnership and any additional capital contributions made by the Partner and minus the Partner's share of the losses of the Partnership and any distributions to or withdrawals made by the Partner. For all purposes of this Agreement, the Partnership net profits and each Partner's capital account shall be computed in accordance with generally accepted accounting principles, consistently applied, and each Partner's capital account, as reflected on the Partnership federal income tax return as of the end of any year, shall be deemed conclusively correct for all purposes, unless an objection in writing is made by any Partner and delivered to the accountant or accounting firm preparing the income tax return within one (1) year after the same has been filed with the Internal Revenue Service. If an objection is so filed, the validity of the objection shall be conclusively determined by an independent certified public accountant or accounting firm mutually acceptable to the Partners.

5. Profits and Losses.

Until modified by mutual consent of all the Partners, the profits and losses of the Partnership and all items of income, gain, loss, deduction, or credit shall be shared by the Partners in the following proportions:

Partner and Shares [*list partners' names and percent of profits or losses*]

6. Books and Records of Account.

The Partnership books and records shall be maintained at the principal office of the Partnership and each Partner shall have access to the books and records at all reasonable times.

7. Future Projects.

The Partners recognize that future projects for the Partnership depend upon many factors beyond present control, but the Partners wish to set forth in writing and to mutually acknowledge their joint understanding, intentions, and expectations that the relationship among the Partners will continue to flourish in future projects on similar terms and conditions as set forth in this Agreement, but there shall be no legal obligations among the Partners to so continue such relationship in connection with future projects.

8. Time and Salary.

Until and unless otherwise decided by unanimous agreement of the Partners, [*list time commitments*]. Each Partner shall nonetheless be expected to devote such time and attention to Partnership affairs as shall from time to time be determined by agreement of the Partners. No Partner shall be entitled to any salary or to any compensation for services rendered to the Partnership or to another Partner.

9. Transfer of Partnership Interests.

A. Restrictions on Transfer. None of the Partners shall sell, assign, transfer, mortgage, encumber, or otherwise dispose of the whole or part of that Partner's interest in the Partnership, and no purchaser or other transferee shall have any rights in the Partnership as an assignee or otherwise with respect to all or any part of that Partnership interest attempted to be sold, assigned, transferred, mortgaged, encumbered, or otherwise disposed of, unless and to the extent that the remaining Partner(s) have given consent to such sale, assignment, transfer, mortgage, or encumbrance, but only if the transferee forthwith assumes and agrees to be bound by the provisions of this Agreement and to become a Partner for all purposes hereof, in which event, such transferee shall become a substituted partner under this Agreement.

B. Transfer Does Not Dissolve Partnership.

No transfer of any interest in the

Partnership, whether or not permitted under this Agreement, shall dissolve the Partnership. No transfer, except as permitted under Subsection 9.A. above, shall entitle the transferee, during the continuance of the Partnership, to participate in the management of the business or affairs of the Partnership, to require any information or account of Partnership transactions, or to inspect the books of account of the Partnership; but it shall merely entitle the transferee to receive the profits to which the assigning Partner would otherwise be entitled and, in case of dissolution of the Partnership, to receive the interest of the assigning Partner and to require an account from the date only of the last account agreed to by the Partners.

10. Death, Incompetency, Withdrawal, or Bankruptcy.

Neither death, incompetency, withdrawal, nor bankruptcy of any of the Partners or of any successor in interest to any Partner shall operate to dissolve this Partnership, but this Partnership shall continue as set forth in Section 3, subject, however, to the following terms and conditions:

A. Death or Incompetency. In the event any Partner dies or is declared incompetent by a court of competent jurisdiction, the successors in interest of that Partner shall succeed to the partnership interest of that Partner and shall have the rights, duties, privileges, disabilities, and obligations with respect to this Partnership, the same as if the successors in interest were parties to this Agreement, including, but not limited to, the right of the successors to share in the profits or the burden to share in the losses of this Partnership, in the same manner and to the same extent as the deceased or incompetent Partner; the right of the successors in interest to continue in this Partnership and all such further rights and duties as are set forth in this Agreement with respect to the Partners, the same as if the words "or his or her successors in interest" followed each reference to a Partner; provided, however, that no successor in interest shall be obligated to devote any service to this Partnership and, provided further, that such successors in interest shall be treated as holding a passive, rather than active, ownership investment.

B. Payments Upon Retirement or Withdrawal of Partner.

(1) Amount of Payments. Upon the retirement or withdrawal of a Partner, that Partner or, in the case of death or incompetency, that Partner's legal representative shall be entitled to receive the amount of the Partner's capital account (as of the end of the fiscal year of the Partnership next preceding the day on which the retirement or withdrawal occurs) adjusted for the following:

(a) Any additional capital contributions made by the Partner and any distributions to or withdrawals made by the Partner during the period from the end of the preceding fiscal year to the day on which the retirement or withdrawal occurs;

(b) The Partner's share of profits and

losses of the Partnership from the end of the preceding fiscal year of the Partnership to the day on which the retirement or withdrawal occurs, determined in accordance with generally accepted accounting principles, consistently applied; and

(c) The difference between the Partner's share of the book value of all of the Partnership assets and the fair market value of all Partnership assets, as determined by a fair market value appraisal of all assets. Unless the retiring or withdrawing Partner and the Partnership can agree on one appraiser, three (3) appraisers shall be appointed--one by the Partnership, one by the retiring or withdrawing Partner, and one by the two appraisers thus appointed. All appraisers shall be appointed within fifteen (15) days of the date of retirement or withdrawal. The average of the three appraisals shall be binding on all Partners.

(2) Time of Payments. Subject to a different agreement among the Partners or successors thereto, the amount specified above shall be paid in cash, in full, but without interest, no later than twelve (12) months following the date of the retirement or withdrawal.

(3) Alternate Procedure. In lieu of purchasing the interest of the retiring or withdrawing Partner as provided in subparagraph (1) and (2) above, the remaining Partners may elect to dissolve, liquidate and terminate the Partnership. Such election shall be made, if at all, within thirty (30) days following receipt of the appraisal referred to above.

11. Procedure on Dissolution of Partnership.

Except as provided in Section 10.B.(3) above, this Partnership may be dissolved only by a unanimous agreement of the Partners. Upon dissolution, the Partners shall proceed with reasonable promptness to liquidate the Partnership business and assets and wind-up its business by selling all of the Partnership assets, paying all Partnership liabilities, and by distributing the balance, if any, to the Partners in accordance with their capital accounts, as computed after reflecting all losses or gains from such liquidation in accordance with each Partner's share of the net profits and losses as determined under Section 5.

12. Title to Partnership Property.

If for purposes of confidentiality, title to Partnership property is taken in the name of a nominee or of any individual Partner, the assets shall be considered to be owned by the Partnership and all beneficial interests shall accrue to the Partners in the percentages set forth in this Agreement.

13. Leases.

All leases of Partnership assets shall be in writing and on forms approved by all the Partners.

14. Controlling Law.

This Agreement and the rights of the Partners under this Agreement shall be governed by the laws of the State of [*state of governing law*].

15. Notices.

Any written notice required by this Agreement shall be sufficient if sent to the Partner or other party to be served by registered or certified mail, return receipt requested, addressed to the Partner or other party at the last known home or office address, in which event the date of the notice shall be the date of deposit in the United States mails, postage prepaid.

16. General.

This Agreement contains the entire agreement of the Partners with respect to the Partnership and may be amended only by the written agreement executed and delivered by all of the Partners.

17. Binding Upon Heirs.

This Agreement shall bind each of the Partners and shall inure to the benefit of (subject to the Sections 9 and 10) and be binding upon their respective heirs, executors, administrators, devisees, legatees, successors and assigns.

IN WITNESS WHEREOF, the Partners have executed this Agreement the date first above written.

Management and Control

The law is fairly quiet about management of a partnership, saying only that in the absence of an agreement to the contrary, all co-owners of the partnership have an equal right to manage the affairs of the partnership regardless of the actual ownership percentage. This means that a partner owning 90% of a partnership cannot overrule his two partners who own 5% each.

Problems with management authority can be avoided by addressing this issue within the partnership agreement. Not surprisingly, this is often done when partnerships are formed, and management authority is commonly given to the partner who will be most active in partnership affairs.

Due to the law's lack of guidance on management, there is a great deal of flexibility in structuring a partnership's management. Thus, management parameters should be put into written form through utilizing a competent attorney with partnership knowledge.

One of the traditional reasons people preferred the partnership structure is that there was this flexibility of management, as compared with the rigidity of the corporation. The development of a hybrid entity, the Limited Liability Company, has created another type of entity to consider when structuring a business.

Fiduciary Relationship

Partners in a partnership are bound together in a peculiar legal relationship: fiduciaries. While the law may forgive a person's transgressions against other legal relationships like marriage, brotherhood, and parent/child, the law actually cares about fiduciary duties, and will not look kindly on those partners who do not honor the fiduciary relationship.

As a fiduciary of your partners, you will owe them your complete loyalty, honesty and fairness in all business dealings with one another. Once you enter the partnership, you cannot open a competing business, deprive the partnership of your time or skill, misappropriate partnership property (including intellectual property like computer programs), or take money out of the partnership without proper procedures being followed.

There is a positive side to the fiduciary relationship. The law recognizes that people want to choose people with whom they will share this type of relationship, so there are rules concerning the inclusion of new partners. No person can become a member of the partnership without the consent of all the partners.

To illustrate, if one of your partners sells his partnership interest to another person who is not a partner, that new person is NOT a partner with all the rights and obligations that the law grants and imposes, at least not until you agree to have the new person as your partner. Note, however, that the new person *would* have a right to get the profits or losses that their ownership interest entitles them to (e.g., a 50% interest entitles them to 50% of the profits).

TAXING A GENERAL PARTNERSHIP

A partnership does not file an income tax return, although it does file an information return. A partnership is a tax reporting entity, not a taxpaying entity. The total income of the partnership is determined and each partner's share of the income is shown on a Schedule K-1.

Each partner is taxed on his or her share of the profits. This is reflected on the partner's individual income tax return. Partners in a partnership pay income tax on their business activities and other income at the applicable personal tax rate for the year.

PRIMARY REQUIRED FORMS

Federal Forms That a General Partnership May Need to File

- Form 1065: U.S. Return of Partnership Income
- Form 1065 K-1: Partner's Share of Income, Credits, Deductions
- Additional employee & miscellaneous forms

Kentucky Forms That a General Partnership May Need to File

- Form 765-GP General Partnership Income Return
- Form 765-K-1 Partner's Share of Income, Credits, Deductions
- Schedule A Apportionment and Allocation
- Additional employee forms

DISSOLUTION

Partnerships, unlike corporations, do not have perpetual existence. Partnerships generally end upon the occurrence of the following events: the death, retirement, withdrawal, expulsion, incapacity, or bankruptcy of a partner; court ordered dissolution of the partnership; or the expiration of any date set as the termination date in the partnership agreement.

A well-crafted partnership agreement should include the proper procedure for dissolving the partnership. Some issues addressed in the agreement may include:

- Public and governmental notice as required by law
- Payment of liabilities
- Return of capital investments as originally invested by the partners
- Distribution of remaining assets and profits among partners

LIMITED PARTNERSHIPS

Contents:

LIMITED PARTNERSHIPS

A special type of partnership is the limited partnership. This type of partnership is found in almost all of the fifty states. Each state has specific statutes regulating limited partnerships. Although it is based on the structure of the general partnership, the limited partnership has some very significant differences.

A limited partnership is a business entity comprised of two or more partners who operate or manage a business together. In every limited partnership (LP), there are two types of partners-general partners and limited partners.

General partners control the company's day-to-day operations and take on the legal debts and obligations of the business. In other words, they run the business. Because they are responsible for any debts or lawsuits incurred by the company, general partners often form corporations or LLCs to protect themselves from liability. To further reduce exposure to personal liability, a limited partnership may be formed with a corporation or corporations as the general partner(s). Under this scenario, the corporation(s) would bear the responsibilities and liabilities of the general partner and the individual shareholders would under most circumstances be afforded protection from personal liability.

As previously mentioned, the limited partnership must have at least one general partner who is personally liable for the debts of the partnership debt. The general partner controls the limited partnership with the same scope of powers as a general partner would have in a standard general partnership.

The general partner also owes the limited partnership at least the same level of fiduciary loyalty that a general partner in a general partnership owes, perhaps more. Limited partners in a limited partnership, however, generally do not owe fiduciary duties to one another.

Limited partners contribute capital to the partnership but do not participate in the daily operations of the company. The limited partners are essentially financial backers. Their interest in the partnership is financial only. They put up the capital to operate the business of the partnership and share in the profits of the partnership. Their liability is limited to the amount of their contribution of capital to the partnership.

Limited partners do have the right, as investors, to access and review the records of the partnership. However, in order for the limited partnership form of business to be legally effective, it is crucial that the limited partners stay out of the day-to-day operations of the business and the decision-making process. As an added benefit, they are also shielded from company debts and other liabilities. Limited partnerships are a great choice for individuals who lack the time or expertise to run a business but would like to invest and share in the profits.

In recent years, the limited partnership or LP has become an increasingly popular choice for businesses-especially those involved in real estate or other investment ventures. The main reason is that unlike general partnerships, limited partnerships (as the name suggests) have the ability to limit both the liability risk and the business involvement of certain partners known as "limited partners." This feature is particularly useful for attracting investment partners who'd like to participate in the profits of the business but not necessarily its risks or daily operations.

The limited liability partnership is attractive to entrepreneurs because they can retain control of the business by acting as the general partner, while still being able to offer limited partner investors the tax benefits of a tax flow-through entity. However, because Limited Liability Companies now offer the same benefits without requiring a general partner, limited partnerships may be declining in popularity.

ADVANTAGES OF A LIMITED PARTNERSHIP

- The primary advantage of a limited liability partnership over a general partnership is that each partner is potentially liable for only the amount of money put into the partnership. *
- Easier to attract investors since the only liability for limited partners is the capital they invest in the business.
- Allows general partners to focus their efforts on running the business.
- This arrangement allows for general partners to use their expertise, make key decisions, and manage the business.
- Limited partners can leave the business or be replaced, without the need for the limited partnership to be dissolved.
- Limited liability partnerships also offer an advantage over the corporate form by allowing partners to directly own and manage business, rather than having to go through a multi-step corporate ownership process as corporations necessarily involve both shareholders and a corporate board.

* It is important to know that the limited partner's protection against personal liability can be lost in cases where a limited partner is found to participate in the control of the business beyond the limited role allowed to limited partners. What is the boundary of the limited role allowed to limited partners? How much participation is too much? This is one of those questions that can only be answered based on the facts on a case-by-case basis.

DISADVANTAGES OF A LIMITED PARTNERSHIP

- General partners assume personal liability unless the partners form an LLC, corporation or other company with limited liability protection.
- There are more filings, formalities, and state requirements with limited partnerships.

FORMATION

To form a limited partnership, there are strict and rigid statutory rules which must be followed, otherwise the attempt to form the limited partnership fails and a general partnership usually results instead.

Formation and maintenance costs are still higher than those of corporations for the same reasons that the general partnership costs are higher.

KENTUCKY REQUIREMENTS

A certificate must be filed with the Kentucky Secretary of State. This form is identified by the title " Certificate of Limited Partnership". The filing certificate contains pertinent information about the partnership.

Taxing Limited Partnerships

For tax purposes, a limited partnership typically works like a general partnership. Profits are "passed through" to the partners who report the income on their personal tax returns. The total income of the partnership is determined and each partner's share of the income is shown on a Schedule K-1.

Each partner is then taxed on his or her share of the profits. This is reflected on the partner's individual income tax return. Partners in a partnership pay income tax on their business activities and other income at the applicable personal tax rate for the year.

PRIMARY REQUIRED FORMS

Federal Forms That a Limited Partnership May Need to File

- Form 1065: U.S. Return of Partnership Income
- Form 1065 K-1: Partner's Share of Income, Credits, Deductions
- Additional employee & miscellaneous forms

Kentucky Forms That a Limited Partnership May Need to File

- Form 765 Partnership Income Return
- Form 765-K-1 Partner's Share of Income, Credits, Deductions
- Schedule A Apportionment and Allocation
- Additional employee forms

Dissolution of a Limited Partnership

Dissolution of a business partnership can be caused by conflicts or irreparable differences between one or more of the partners. Additionally, an unsuccessful partnership may influence a partner's decision to leave along with a host of other possible reasons such as health, other commitments, passing away, loss of interest, dispute etc.

The death, retirement, withdrawal, or bankruptcy of a limited partner does not end the existence of the limited partnership, but instead only requires an amendment to the limited partnership's agreement. The limited partnership interest may be transferred to another person without the consent of the other limited or general partners. But the limited partner will still lack some rights unless there is approval by the other partners. The death, retirement, withdrawal, or bankruptcy of the general partner will dissolve the partnership.

Most partnership laws within the United States require certain actions to be taken before a partnership is considered ended. Since partnerships are not incredibly formal types of businesses, the amount of paperwork that needs to be filed can be minimal if the ending of the partnership, and its terms are agreed upon by the partners. The required actions may include:

- Proper public and governmental notice as required by law

- Pay all creditors what they are owed
- Return Capital investments as originally invested by the partners
- Distribute remaining assets and profits among partners
- Completing required Secretary of State form

LIMITED LIABILITY PARTNERSHIPS

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LIMITED LIABILITY PARTNERSHIPS

A limited liability partnership (LLP) resembles a general partnership, but with the added liability protections of a corporation or limited liability company. An LLP is a partnership in which some or all partners (depending on the jurisdiction) have limited liability. It therefore exhibits elements of both partnerships and corporations.

In an LLP, one partner is not responsible or liable for another partner's misconduct or negligence. This is an important difference from that of a limited partnership. In most jurisdictions, including Kentucky, LLPs must have at least one general partner with unlimited liability.

In general, this business form is available only to those professions that are precluded by statute from forming as a limited liability company, e.g., attorneys, accountants or architects. These professionals often prefer LLPs to general partnerships, corporations, or LLCs because they don't want to be personally liable for another partner's problems -- particularly those involving malpractice claims.

An LLP protects each partner from debts against the partnership arising from professional malpractice lawsuits against another partner. A partner who loses a malpractice suit for his own mistakes, however, doesn't escape liability.

Unlike corporate shareholders, partners in an LLP have the right to manage the business directly. As opposed to that, corporate shareholders have to elect a board of directors under the laws of various state charters. The board organizes itself (also under the laws of the various state charters) and hires corporate officers who then have as "corporate" individuals the legal responsibility to manage the corporation in the corporation's best interest. An LLP also contains a different level of tax liability than a corporation.

Any partner without the other may bind the LLP. Money and property contributed to the LLP becomes owned by the partnership unless otherwise stated and the contributor is not entitled to its return except as stated in the partnership agreements.

A large number of states only extend liability protection against negligence claims. This means that a partner can be personally liable for other claims, such as contract claims. Profits from the limited liability partnership are distributed evenly among the partners. This is for tax purposes, as the partnership is not taxed separately.

Unless otherwise provided in the partnership agreement, no one can become a member of the partnership without the consent of all partners. However, a partner may assign his share of the profits and losses and right to receive distributions.

ADVANTANGES OF A LIMITED LIABILITY PARTNERSHIP

- Easy to establish
- LLPs allow for pass-through taxation
- Separate legal entity
- All partners are not held personally responsible for the

debts and liabilities of the business
- Partners have more flexibility in structuring the management with less formal requirements and annual paperwork
- Easier conversion from a general partnership to an LLP than to a LLC or corporation

DISADVANTAGES OF A LIMITED LIABILITY PARTNERSHIP

- LLP may be limited in raising funds.
- Any act of the partner without the other may bind the LLP.
- Under some cases, liability may extend to personal assets of partners.
- No separation of management from owners

FORMING A LIMITED LIABILITY PARTNERSHIP

Creating and forming a limited liability partnership is done at the state level. Each state has its own rules, but in general you must pay a fee and file papers with the state, usually a "Certificate of Limited Partnership" or "Certificate of Limited Liability Partnership." This document is similar to the articles of incorporation filed by a corporation and includes information about the general and limited partners.

Some states require proof that the partnership has enough assets to cover any claims and has obtained adequate liability insurance. In all states, the limited liability partnership must file a registration fee and include the phrase *Registered Limited Liability Partnership* or *LLP* in their business title.

Kentucky Requirements

A certificate must be filed with the Kentucky Secretary of State. This form is identified by the title " Certificate of Limited Partnership". The filing certificate contains pertinent information about the partnership and an area to mark "Limited Liability Partnership".

Taxing a Limited Liability Partnership

With a few exceptions, unless an LLP elects to be taxed as a corporation, its income is not taxed to the LLP but is instead "passed-through" to the partners and taxed to them at their individual tax rates in the same manner as the income of a general partnership is taxed.

Taxwise, a limited partnership's profits and losses are allocated to limited partners according to the terms of the partnership agreement. In the absence of any special allocations, limited partners are allocated profits and losses according to the relative value of their capital contributions. Typically, the business pays the general partner a management fee that is netted against partnership income, so limited partners receive only a share after the general partner has been fully compensated for services on behalf of the business, where applicable.

An LLP can be organized to combine several of the best features of the other forms of business organization. An LLP provides its partners with limited personal liability for the obligations of the business.

In most cases, treatment of an LLP as a partnership for tax purposes will be the desired result. When an LLP is treated for tax purposes as a partnership it is called a "pass-through" entity. This is because the income or loss of the LLP's business is not taxed to the LLP but is instead allocated among the partners (either in proportion to their ownership interest in the LLP or in other proportions agreed to by them) and then combined with the partners' other income and taxed to them separately on their individual income tax returns.

On the other hand, if an LLP elects to be treated as a corporation for tax purposes, and not as an S corporation, the income of the LLP is subject to what is sometimes called the corporate "double-tax." The income is taxed once directly to the LLP and then taxed again to the partners as part of their individual income when they receive distributions from the profits of the LLP.

In the absence of an election to the contrary, multi-member limited liability companies (LLCs), limited liability partnerships (LLPs) and certain multi-member trusts are treated as partnerships for United States federal income tax purposes. Certain non-U.S. entities may also be eligible for treatment as partnerships. Individual states of the United States do not universally accord "flow-through" taxation to partnerships, and some distinguish among different kinds of entities that are treated the same under federal tax principles (e.g. Texas taxes LLCs as corporations, while according flow-through treatment to partnerships). Local jurisdictions may also impose their own taxes on entities taxed as partnerships at the federal level (e.g., New York City unincorporated business tax).

PRIMARY REQUIRED FORMS

Federal Forms That a Limited Partnership May Need to File

- Form 1065: U.S. Return of Partnership Income
- Form 1065 K-1: Partner's Share of Income, Credits, Deductions
- Additional employee & miscellaneous forms

Kentucky Forms That a Limited Partnership May Need to File

- Form 765 Partnership Income Return
- Form 765-K-1 Partner's Share of Income, Credits, Deductions
- Schedule A Apportionment and Allocation
- Additional employee forms

Dissolving a Limited Liability Partnership

Ending Limited Liability Partnerships works the same as ending other type partnerships. Partnerships generally end upon the occurrence of the following events: the death, retirement, withdrawal, expulsion, incapacity, or bankruptcy of a partner; court ordered dissolution of the partnership; or the expiration of any date set as the termination date in the partnership agreement.

A well-crafted partnership agreement should include the proper procedure for dissolving the partnership. In general, follow the same steps as discussed previously for other type partnerships.

Once the business is dissolved, file a statement of dissolution, which lets third parties know that neither partner has any rights to enter into binding transactions unless it’s to end the business. It is usually assumed that all third parties know of the dissolution after ninety days of filing the statement of dissolution.

QUALIFIED INVESTMENT PARTNERSHIPS

QUALIFIED INVESTMENT PARTNERSHIPS

In 2002, another type of partnership was established via KRS 141.206 called a Qualified Investment Partnership. These entities are exempt from Kentucky tax and are for nonresident individuals.

KRS 141.206 states, in part:

KRS 141.206 (12) (a) Nonresident individuals shall not be taxable on investment income distributed by a qualified investment partnership. For purposes of this subsection, a "qualified investment partnership" means a pass-through entity that, during the taxable year, holds only investments that produce income that would not be taxable to a nonresident individual if held or owned individually.
(b) A qualified investment partnership shall be subject to all other provisions relating to a pass-through entity under this section and shall not be subject to the tax imposed under KRS 141.040 or 141.0401.

Income distributed from a qualified investment partnership to a *nonresident* partner is not subject to Kentucky tax. “Qualified investment partnership” is defined to mean a partnership formed to hold only investments that produce income that would not be taxable to the nonresident individual if held or owned individually.

NON PROFIT ORGANIZATIONS

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NON PROFIT CORPORATIONS

A non-profit organization, often characterized as a 501 (C) organization, is a group organized for purposes other than generating profit and in which no part of the organization's income is distributed to its members, directors, or officers. Non-profit corporations are often termed "non-stock corporations." They can take the form of a corporation, an individual enterprise (for example, individual charitable contributions), unincorporated association, partnership, foundation, etc.

Non-profit organizations must be designated as nonprofit when created and may only pursue purposes permitted by statutes for non-profit organizations. Non-profit organizations include churches, public schools, public charities, public clinics and hospitals, political organizations, legal aid societies, volunteer services organizations, labor unions, professional associations, research institutes, museums, and some governmental agencies.

A nonprofit organization does not simply refer to an organization that cannot generate a profit, it means that it can only earn a profit at the entity level and may not be passed on to its board of directors, officers or members. Any profit realized must be used for a charitable or public purpose. A nonprofit entity may legally and ethically run a trade or business that generates a profit or hold investments, however, the profit must be used exclusively for attaining the organizations goals. A nonprofit entity is generally exempt from taxation, with certain exceptions.

501 (C) ORGANIZATIONS

501(c) is a provision of the United States Internal Revenue Code (26 U.S.C. § 501(c)), listing 26 types of non-profit organizations exempt from some federal income taxes. Sections 503 through 505 list the requirements for attaining such exemptions. Many states reference Section 501(c) for definitions of organizations exempt from state taxation as well.

501 (c)(3) organizations are the most common and include many familiar type organizations such as religious, educational, charitable, scientific, literary, those that foster national or international amateur sports competitions, prevention of cruelty to children or animals, etc.

A comprehensive list of 501 (c) organizations may be found at the end of this section.

ADVANTAGES of NON PROFIT ORGANIZATIONS

Tax exemption is one of the principal benefits for non-profit organizations. Tax exemption enables the organization to operate without federal (and perhaps state) income tax. This benefit often enhances the organization's ability to accumulate income and assets and can therefore be more productive over the long-term.

A second primary benefit to a tax-exempt entity is that charitable contributions to a 501(c)(3) organization are tax-deductible. If an organization has obtained IRC Section 501(c)(3) tax exempt status, an individual or company's charitable contributions to this entity are tax-deductible.

DISADVANTAGES of NON PROFIT ORGANIZATIONS

The cost of a non-profit organization is one of its principal disadvantage. Because a non-profit is a legal entity, the use of an attorney or accountant is necessary as the rules and regulations are complex. While tax exemption is one of the advantages of qualified non-profits, the fee of incorporation and application for exemption is a disadvantage. These costs are not the same for every entity. With the corporate form of non-profit organizations, filing with the state is required. The cost of annual reporting requirements is also a disadvantage.

In creating non-profits, personal control is limited. In some cases the organization's directors are the only people allowed to elect officers and to determine corporate policies. Non-profits are subject to federal and state laws and regulations along with its own articles of incorporation and bylaws, which again limits personal control over the non-profit entity.

Because a non-profit organization is dedicated to charity or the public, its finances are also open to inspection by the public. The public may obtain copies of the non-profit organization's expense and salary reports as well as state and federal filings.

In addition, certain detailed documents including financial records, articles of incorporation, bylaws and annual reports, as required by the state in which it is incorporated, must be prepared in a specific manner and filed by certain deadlines.

FORMING A NON PROFIT ORGANIZATION

Forming a nonprofit corporation is much like creating a regular corporation, except that nonprofits have to take additional steps, such as applying for tax-exempt status with the IRS and their state tax division. They must also choose an available business name that meets the requirements of state law.

This is the basic process:

1. File formal paperwork, usually called articles of incorporation.
2. Apply for federal and state tax exemptions.
3. Create corporate bylaws, which set out the operating rules for the nonprofit corporation.
4. Appoint the initial directors. (In some states you must choose your initial directors before you file your articles, because you must list their names in the document.)
5. Hold the first meeting of the board of directors.
6. Obtain a federal employer identification number (EIN).
7. Obtain other licenses and permits that may be required for your corporation.
8. Filing required documents on the state level.

Completing those steps involve several processes. Some of them are discussed below.

First establish the purpose of the organization. In practical terms this works like a mission statement. As a non-profit organization, you exist to accomplish your mission, which should be crafted based upon your purpose, services and values.

Form a Board of Directors. Forming a board requires careful thought and extensive recruitment efforts. Each state has regulations that determine the minimum size of the board, typically three, but the optimum number of people who sit on the board should be determined by the needs of the organization.

File Articles of Incorporation. Articles of Incorporation are official statements of creation of an organization filed with the appropriate state agency. They are important to protect both board and staff from legal liabilities incurred by the organization, making the corporation the holder of debts and liabilities, not the individuals and officers who work for the organization. The specific requirements governing how to incorporate are determined by each state.

Draft bylaws. Bylaws are simply the "rules" of how the organization operates. Although bylaws are not required to file for 501(c)(3) status, they will help you in governing your organization. Bylaws should be drafted with the help of an attorney and approved by the board.

Develop a budget. Creating a budget is often one of the most challenging tasks when creating a nonprofit organization. A budget is the expression, in financial terms, of the plan of operation designed to achieve the objectives of an organization.

Develop a record-keeping system. Legally, you must save all Board documents including minutes and financial statements. It is necessary to preserve your important corporate documents, including board meeting minutes, bylaws, Articles of Incorporation, financial reports, and other official records.

Develop an accounting system. If your board does not include someone with a financial or accounting background, it is best to work with an accountant familiar with non-profit organizations. Nonprofits are accountable to the public, their funders, and, in some instances, government granting bodies, and it is vital to establish a system of controls (checks and balances) when establishing the organization's accounting practices.

File for 501(c)(3) status. To apply for recognition of tax-exempt, public charity status, obtain Form 1023 (application) and Publication 557 (detailed instructions) from the IRS.

Apply for a federal employer identification number. Regardless of whether or not you have employees, nonprofits are required to obtain a federal Employer Identification Number (EIN) — also referred to as the federal ID number. Available from the IRS, this number is used to identify the organization when tax documents are filed much like an individual's Social Security number.

File for state and local tax exemption. In accordance with state, county, and municipal law, you may apply for exemption from income, sales, and property taxes.

Fulfill charitable solicitation law requirements. If your organization's plans include fundraising, be aware that many states and few local jurisdictions regulate organizations that solicit funds within that state, county, or city. Usually compliance involves obtaining a permit or license and then filing an annual report and financial statement.

Apply for a nonprofit mailing permit. The federal government provides further subsidies for nonprofits with reduced postage rates on bulk mailings. While first-class postage rates for nonprofits remain the same as those for the for-profit sector, second- and third-class rates are substantially less when nonprofits mail to a large number of members or constituencies.

REQUIRED FILINGS FOR KENTUCKY PURPOSES

Kentucky requires non profit organization to file a copy of form 990-T with the Attorney General's office. In addition, Kentucky requires an annual report to be filed with the Secretary of State.

It is merely an update of company information, including members, managers, partners, and officers. It requires no disclosure of financial information. It does require businesses to inform the state on the names and addresses of officers, and of the address of the entity that is doing business in Kentucky.

DISSOLVING A NON PROFIT ORGANIZATION

Many organizations do not realize that there is a formal process for dissolving a nonprofit organization. If you are considering dissolution or have made the decision to dissolve, it is important to follow the proper procedures.

Procedures involved include the following:

1) Adopt a resolution. The organization's board must adopt a resolution that the corporation be dissolved.

2) Create a plan for distributing any assets and paying any liabilities.

3) Approve Dissolution plan. Once the resolution of dissolution has been adopted and the plan of distribution created, it must be submitted for approval to the organization's members or directors.

4) File dissolution with Kentucky Secretary of State.

Please note: Filing this form with the Office of the Secretary of State does not ensure the dissolution of the business entity is complete. Additionally, being administratively dissolved by the Secretary of State does not exempt the entity from any filing requirements with the Kentucky Department of Revenue.

5) After dissolution, the organization must notify the IRS that it has dissolved and will no longer be filing annual returns. The organization may utilize Form 966, Corporate Dissolution or Liquidation or a detailed letter of explanation.

6) Finally, the dissolved corporation must continue its corporate existence for the purpose of winding up its affairs by: (1) collecting its assets; (2) selling or transferring assets not provided for in the plan of distribution; (3) paying all debts and liabilities; and (4) doing all other acts incident to liquidation of its affairs.

501 (C) ORGANIZATIONS

According to IRS Publication 557, in the *Organization Reference Chart* section, the following is an exact list of 501(c) organization types and their corresponding descriptions.

- 501(c)(1) — Corporations Organized Under Act of Congress (including Federal Credit Unions)
- 501(c)(2) — Title Holding Corporation for Exempt Organization
- 501(c)(3) — Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations
- 501(c)(4) — Civic Leagues, Social Welfare Organizations, and Local Associations of Employees
- 501(c)(5) — Labor, Agricultural, and Horticultural Organizations
- 501(c)(6) — Business Leagues, Chambers of Commerce, Real Estate Boards, etc.
- 501(c)(7) — Social and Recreational Clubs
- 501(c)(8) — Fraternal Beneficiary Societies and Associations
- 501(c)(9) — Voluntary Employees Beneficiary Associations
- 501(c)(10) — Domestic Fraternal Societies and Associations
- 501(c)(11) — Teachers' Retirement Fund Associations
- 501(c)(12) — Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, etc.
- 501(c)(13) — Cemetery Companies
- 501(c)(14) — State-Chartered Credit Unions, Mutual Reserve Funds
- 501(c)(15) — Mutual Insurance Companies or Associations
- 501(c)(16) — Cooperative Organizations to Finance Crop Operations
- 501(c)(17) — Supplemental Unemployment Benefit Trusts
- 501(c)(18) — Employee Funded Pension Trust (created before June 25, 1959)
- 501(c)(19) — Post or Organization of Past or Present Members of the Armed Forces
- 501(c)(21) — Black lung Benefit Trusts
- 501(c)(22) — Withdrawal Liability Payment Fund
- 501(c)(23) — Veterans Organization (created before 1880)
- 501(c)(25) — Title Holding Corporations or Trusts with Multiple Parents
- 501(c)(26) — State-Sponsored Organization Providing Health Coverage for High-Risk Individuals

- 501(c)(27) — State-Sponsored Workers' Compensation Reinsurance Organization
- 501(c)(28) — National Railroad Retirement Investment Trust

REAL ESTATE INVESTMENT TRUSTS

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REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts, known as REITs, are entities that invest in different kinds of real estate or real estate related assets, including shopping centers, office buildings, hotels, and mortgages secured by real estate. The U.S. Master Tax Guide describes REITs as any corporation, trust or association that acts as an investment agent specializing in real estate and real estate mortgages.

There are basically three types of REITS:

- Equity REITS, the most common type of REIT, invest in or own real estate and make money for investors from the rents they collect;
- Mortgage REITS lend money to owners and developers or invest in financial instruments secured by mortgages on real estate; and
- Hybrid REITS are a combination of equity and mortgage REITS.

Congress created REITs in the U.S. in 1960 as a way to make investment in large-scale, income-producing real estate accessible to all investors in the same way they typically invest otherwise – through the purchase and sale of liquid securities. Prior to the creation of listed real estate equities, access to the investment returns of commercial real estate equity as a core asset was available only to institutions and wealthy individuals having the financial wherewithal to undertake direct real estate investment.

The Internal Revenue Code lists the conditions a company must meet to qualify as a REIT. For example, the company must pay 90% of its taxable income, in the form of dividends, to shareholders every year. It must also invest at least 75% of its total assets in real estate and generate 75% or more of its gross income from investments in or mortgages on real property.

Individuals can invest in REITs either by purchasing their shares directly on an open exchange or by investing in a mutual fund that specializes in public real estate. Among other things, REITs invest in shopping malls, office buildings, apartments, warehouses and hotels.

ADVANTAGES OF REITs

Diversified investments. REITs include tangible assets, such as land and buildings, and often sign their tenants to long-term lease contracts. Because of this, REITs tend to be some of the most stable companies on the market.

Professional management. REITs allow the investor the opportunity to have properties managed by a professional real estate team that knows the industry, understands the business and can take advantage of opportunities thanks to its ability to raise funds from the capital markets.

REITs can significantly limit personal risk. How? If an investor wanted to acquire real estate, it is likely he will take on debt by borrowing money from friends, family, or a bank. Often, he will be required to personally guarantee the funds. Purchasing a REIT, on the other hand, can be done with only a few hundred dollars as share prices are often as low, if not lower, than equities.

DISADVANTAGES OF REITs

Because they can only reinvest up to 10% of their annual profits back into their core business lines each year, most REITs tend to grow at a slower rate than the average stock on Wall Street.

Dividend payments are not guaranteed and the real estate market is prone to cyclical downturns.

Since they already enjoy a unique tax-advantaged status versus other firms (more specifically, they are allowed to deduct the dividends they pay out from their taxable income), from an investor's perspective, roughly 2/3 of all dividends paid by REITs do not qualify for the new lower 15% tax rate. By contrast, the vast majority dividends paid by non-REITs are taxed at this new low rate.

TAXATION OF REITs

REITs may escape corporation taxation because, unlike ordinary corporations, they are entitled to claim a deduction for dividends paid to shareholders against their ordinary income and capital gains. An entity qualifies as a REIT if it makes an election to be treated as such by filing a tax return on Form 1120-REIT and meets certain requirements as to ownership and organization, source of income, investment of assets, and distribution of income to shareholders.

More information on REITs may be found in the U.S. Master Tax Guide in Section 2326 through Section 2340.

DISREGARDED ENTITIES

Contents:

DISREGARDED ENTITIES

When choosing to form a business entity, being formed as a disregarded entity is not an option. That is because the term "disregarded" refers to the tax treatment rather than the legal form of the entity. A disregarded entity is a business entity that is disregarded as an entity separate from its business owner for federal tax purposes.

Businesses are organized under state statutes, and no state recognizes a "disregarded entity" as a business type. Most businesses, when they are set up, choose to be organized as separate entities from their owners for liability reasons; if the business is sued, in most instances the owner (and assets) cannot be brought into the suit.

A disregarded entity is not considered separate from its owner. This allows the business to be taxed on the business owner's income tax return.

The most common disregarded entity is a single-member limited liability company (LLC), owned by an individual, which is taxed as a sole proprietorship, unless it elects to be taxed as a corporation under the "check-the-box" rules. (TR 301.7701-3)

Under the entity default classification system, single-member entities (e.g., limited liability companies ("LLCs")) are disregarded for federal tax purposes. The assets, liabilities and operations of the single-member LLC are treated as assets, liabilities and operations of its owner.

A single owner eligible entity can elect, via the check-the-box rules, to be taxed as a corporation. At that point, there is also an option to elect S-corporation status.

When forming a business entity, your entity options are:

- Sole proprietorship
- Single-member limited liability company
- Multi-member limited liability company (partnership)
- General Partnership
- C-Corporation
- S-Corporation

The following information discusses these various entities, how they are treated for tax purposes, and if they qualify to be treated as disregarded entities.

Sole proprietorship - in which you and the business are the same entity. The sole proprietor is taxed on Schedule C, but there is no separate business entity to provide liability protection for you if the business can't pay its bills or gets sued.

A sole proprietorship is NOT a disregarded entity.

Single-member Limited Liability Company (LLC) - a separate entity for liability purposes, registered with the secretary of state, and the LLC activity of individuals is reported on Schedule C.

A single-member LLC IS a disregarded entity.

Multiple-member LLCs – an entity that registers with the secretary of state and has liability protection, but is treated as a partnership.

Multiple-member LLCs are NOT disregarded entities.

Partnership - as noted above, is not a disregarded entity, including general partnerships, limited partnerships or limited liability partnerships.

Corporation - a separate legal entity from the owners, providing liability protection, and pays taxes on Form 1120, so a corporation is NOT a disregarded entity.

Subchapter S corporation - an entity that has elected to be taxed as an S corporation, may be a corporation or other entity that has elected corporation status under the check-the-box rules and elected to be taxed as an S corporation. A qualified subchapter S subsidiary (QSSS or QSub) is treated as a disregarded entity.

So for purposes of tax treatment, your choices for disregarded entity are single-member LLCs or Sub-chapter S corporations making an election to be taxed as such.

ENTITY COMPARISONS

COMPARISON OF FEDERAL ATTRIBUTES

	Sole Proprietorship	Partnership	"S" Corporation	"C" Corporation
Net operating income	Taxed directly to owner on 1040	Passed through to partners 1040 via form K-1 whether or not distributed	Passed through to shareholders 1040 via form K-1 whether or not distributed	Double tax-once on C Corp., again when paid to shareholder as dividends
Net operating loss	Reduces AGI - Can be carried back 2 years and then forward 20	Passed through to partners 1040 via form K-1 Losses cannot exceed partners basis in Co.	Passed through to shareholders 1040 via form K-1 – Losses cannot exceed partners basis in Corporation	Deductible only against income - Losses can be carried back 2 years and forward 20
Capital gains	Taxed to owner	Passed through to partners 1040 via formK-1	Passed through to shareholders 1040 via form K-1	Gains taxed at regular Corporation rate
Capital losses	Offset against capital gains + $3K per year	Passed through to partners 1040 via form K-1	Passed through to shareholders 1040 via form K-1	Deductible only against Corporation capital gains
Donations to charities	Itemized deduction on 1040	Passed through to partners 1040 via form K-1	Passed through to shareholders 1040 via form K-1	Limited to 10% of Corporation income (adjusted)

	Sole Proprietorship	Partnership	"S" Corporation	"C" Corporation
Dividends received	Taxed to owner on 1040	Passed through to partners 1040 via form K-1	Passed through to shareholders 1040 via form K-1	Can deduct from income 70% of dividends received
Fringe benefits	Partially deductible	Not eligible to receive benefits	Greater than 2% owners cannot receive benefits	No restrictions
Retirement plans	Various	Various	Profit sharing or defined contribution plan - no loans	Profit sharing or defined contribution plan - loans allowed
Sale of ownership	Capital gain	May be part CG and part ordinary income	Capital gain	Capital gain
Liquidation	N/A	N/A	Capital gain or loss to shareholder	Double taxation- First at Corporation level, then for shareholder
Alternative minimum tax	26% to 28% ATM	Partnership not subject - preference items passed through	S Corp. not subject - preference items passed through	ATM of 20% at Corporation level
Payroll tax	15.3% SE tax - 50% deductible on page 1 of 1040	Partnership income taxed as SE income on 1040	Undistributed income is not subject to payroll taxes	Corporation and each employee pay 7.65% of FICA wages
Items affecting the partners' and shareholders' basis in business	N/A	**1.** income and gains increase - losses decrease **2.** capital increases - distributions decrease **3.** partners share of liabilities increase basis	**1.** income and gains increase - losses decrease **2.** capital increases - distributions decrease **3.** loans put into the Co. increase basis - share of liabilities do not	N/A

	Sole Proprietorship	Partnership	"S" Corporation	"C" Corporation
Cash vs. Accrual	Can use either	Can use either unless inventory is a factor	Can use either unless inventory is a factor	Cannot use cash if receipts are $5 million or more or if inventory is a factor
Splitting of income	N/A	Allocated according to partnership agreement	Allocated according to shares owned	N/A
Tax year	Calendar year	Must use same year as partners	Calendar year, generally	Calendar or fiscal year
Accumulated earnings tax	N/A	N/A	N/A - unless S had previously been a C Corporation	Unreasonable earnings above $250K ($150K for PSC) are hit with 39.6% special tax
Excessive compensation	N/A	N/A	N/A	If deemed excessive - becomes non-deductible dividend
Disallowed personal expenses	Individual tax rate	Partner pays individual tax rate	Shareholder pays individual tax rate	Double taxation - first at Co. level then at shareholder level
Personal Holding Co.	N/A	N/A	N/A	Subject to 39.6% tax rate
		Other Considerations		
Ease and cost of formation	No special actions	No special actions - just written partnership agreement	Initial legal costs of $500 to $1,000 or $400 to $600 if you do it yourself	Same as S Corporation
Period of existence	Discretion of owner	Termination if partners agree or on partners death or retirement	Continues until dissolution - not affected by sale of shares	Same as S Corporation with no restriction on eligibility of shareholders

	Sole Proprietorship	Partnership	"S" Corporation	"C" Corporation
Continuing costs	Minimal	Annual Federal and State partnership returns	Annual Federal and State Corporation returns & annual state filing fee & minimum tax	Annual Federal and State Corporation returns & annual state filing fee & minimum tax
Owners' exposure to business debts	Liable for all debts of business	General partners liable for all debts of business	Shareholders liable only for capital contributions and debts that are personally guaranteed	Shareholders liable only for capital contributions and debts that are personally guaranteed
Effect on entity upon withdrawal of taxpayer	None	Dissolution of partnership	After stock is disposed of, Corporation continues	After stock is disposed of, Corporation continues
Transfer of ownership	N/A	New partner requires consent of other partners	Easy to do - just transfer stock to new owner	Easy to do - just transfer stock to new owner
Limitation of ownership	N/A	No limit on number of partners	Limited to 100 eligible shareholders	No limit on number and eligibility of shareholders

KENTUCKY SECRETARY OF STATE

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KENTUCKY SECRETARY OF STATE

The Secretary of State directs the Department of State of the Commonwealth of Kentucky pursuant to KRS 14.025. The department is organized into two divisions: The Division of Corporations and The Division of Administration.

DIVISION OF CORPORATIONS

The Division of Corporations is divided into three departments: Business Filings, Business Records, and the Uniform Commercial Code (UCC) Branch. Business Filings is responsible for administering the incorporation of businesses, both domestic and foreign, profit and nonprofit, including the administration of documents of merger, dissolution, name changes, and certain stock matters. This office is entrusted with filing, maintaining, and preserving certain historically significant documents and public records of the Commonwealth. These records include organizational documents for more than 100,000 corporations doing business in Kentucky and trademarks and service marks.

In addition, the Secretary of State represents the Commonwealth as agent for service of process in cases involving foreign corporations, as well as service of summons and petitions in actions against non-resident motorists.

Business Records is responsible for issuing certificates of existence, authorization, and certified copies of the original document that is on file with the Secretary of State. The UCC Branch was created after legislation was passed during the 2000 General Assembly which adopted Revised Article 9 of the Uniform Commercial Code.

DIVISION OF ADMINISTRATION

The Division of Administration is responsible for fiscal and personnel matters, public documents, legal affairs, and special projects and commissions.

ANNUAL REPORT REQUIREMENTS

All corporations (profit, non-profit & professional service), limited liability companies (profit, non-profit & professional service), limited partnerships (filed under 2006 Act), limited liability limited partnerships (filed under the 2006 Act), and business trusts that are registered with the state, are required to file an annual report by June 30 of each year.

Failure to file the annual report will result in the company being listed in bad standing with this office and could lead to administrative dissolution or revocation of authority to transact business in Kentucky.

BUSINESS FILINGS

There are a variety of business filings that are administered by the Secretary of State. The following list represents many that are utilized by business entities. Visit their web site for additional information.

Domestic Corporation

Certificate of Existence
Certificate of Existence (long form)
Certificate of Voluntary Dissolution
Certificate of Administrative Dissolution

Certificate of Registered Agent
Certificate of No Record

Foreign Corporation

Certificate of Authorization
Certificate of Authorization (long form)
Certificate of Withdrawal
Certificate of Revocation of
Certificate of Authority
Certificate of Registered Agent
Certificate of No Record

Domestic Limited Liability Company

Certificate of Existence
Certificate of Existence (long form)
Certificate of Dissolution
Certificate of Administrative Dissolution
Certificate of Registered Agent
Certificate of No Record

Foreign Limited Liability Company

Certificate of Authorization
Certificate of Authorization (long form)
Certificate of Withdrawal
Certificate of Revocation of
Certificate of Authority
Certificate of Registered Agent
Certificate of No Record

Domestic Limited Partnerships

Certificate of Formation
Certificate of Registered Agent
Certificate of No Record

Registered Limited Liability Partnerships

Certificate of Registration (domestic)
Certificate of Registration (foreign)
Certificate of No Record

Business Trusts

Certificate of Business Trust
Certificate of Registered Agent (foreign business trust)

Domestic Corporations Forms

Articles of Incorporation Business Corporation

Articles of Incorporation Nonprofit Corporation

Articles of Incorporation Professional Service Corporation

Foreign Corporations Forms

Application for Certificate of Authority Foreign Corporation

Application for Amended Certificate of Authority Foreign Corporation

Application for Certificate of Withdrawal Foreign Corporation

Application for Registration or Renewal of Corporate Name Foreign Corporation

Other Forms

Application for Reservation or Renewal of Reserved Name (ARN)

Notice of Transfer of Reserved Name

Notice of Cancellation of Reserved Name

Statement of Change of Registered Office, Registered Agent, or Both

Statement of Change of Principal Office Address

Statement of Consent of Registered Agent

Statement of Resignation of Registered Agent

Domestic Limited Liability Companies Forms

Articles of Organization

Articles of Organization Professional Limited Liability Company

Articles of Organization - Non-profit LLC

Foreign Limited Liability Company Forms

Application for Certificate of Authority (Foreign LLC)

Application for Amended Certificate of Authority (Foreign LLC)

Application for Certificate of Withdrawal

Application for Registration or Renewal of Limited Liability Company Name

Other Forms

Application for Reservation or Renewal of Reserved Name

Notice of Cancellation of Reserved Name Statement of Consent of Registered Agent

Statement of Resignation of Registered Agent

Statement of Change of Registered Office, Registered Agent, or Both

Statement of Change of Principal Office Address

Partnerships

Statement of Partnership Authority

Statement of Denial

Statement of Dissociation

Statement of Dissolution

Statement of Merger

Limited Partnerships

Certificate of Limited Partnership

Certificate of Dissolution with Respect to a Domestic Limited Partnership

Application for Reservation or Renewal of Reserved Name

Notice of the Transfer of a Name Reserved for Use By a Domestic or a Foreign Limited Partnership

Cancellation of Certificate of Limited Partnership

Statement of Consent of Registered Agent

Change of Registered Agent or Change of the Address of the Registered Office, or Both

Registered Agent's Statement of Change of Registered Office for Each Affected Limited Partnership

Statement of Change of the Mailing Address of the Principal Office

Notice of Cancellation of Reserved Name

Foreign Limited Partnerships

Application for Certificate of Authority as a Foreign Limited Partnership

Application for Amended Certificate of Authority

Application for Certificate of Withdrawal

Application for Reservation or Renewal of Reserved Name

Notice of the Transfer of a Name Reserved for Use By a Domestic or a Foreign Limited Partnership

Statement of Consent of Registered Agent

Statement of Change of Registered Agent or Change of the Address of the Registered Office, or Both

Registered Agent's Statement of Change of Registered Office for Each Affected Limited Partnership

Statement of Change of the Mailing Address of the Principal Office

Application for Registered Name

Application for Renewal of Registered Name

Limited Liability Partnerships

Statement of Qualification

Amendment to a Statement of Qualification

Statement of Foreign Qualification

Statement of Change of Registered Agent or Change of the Address of the Registered Office, or Both

Registered Agent's Statement of Change of Registered Office for Each Affected Limited Partnership

Change of the Mailing Address of the Chief Executive Office

Statement of Resignation of Registered Agent

Statement of Registration or Renewal of Limited Liability Partnership

Application for Certificate of Withdrawal

Application for Reservation or Renewal of Reserved Name

Notice of the Transfer of a Name Reserved for Use By a Domestic or a Foreign Limited Partnership

Application for Registered Name

Application for Renewal of Registered Name

Assumed Names

Certificate of Assumed Name

Amended Certificate of Assumed Name

Certificate of Withdrawal of Assumed Name

Renewal Certificate of Assumed Name

Dissolutions

Articles of Dissolution of a Non-profit Corporation

Articles of Dissolution of a Profit or Non-profit Limited Liability Company (LLD)

Articles of Dissolution of a Profit Corporation *This form is to be used for dissolution by Incorporators or Initial Directors. New Form

Articles of Dissolution of a Profit Corporation *This form is to be used for dissolution by the Board of Directors or Shareholders. New Form

STATUTES, REGULATIONS AND REFERENCES

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STATUTES, REGULATIONS & REFERENCES

STATUTES

KRS 141.010: Definitions for Chapter

KRS 141.020: Levy of income tax on individuals

KRS 141.040: Corporation income tax – Exemption – Rate

KRS 141.0401: Limited Liability Tax – Exemption - Rate

KRS 141.206: Filing of Returns by pass-through entities

KRS 141.130: Liability for tax on discontinuation of business

REGULATIONS

103 KAR 15:020: Election to pay tax on share of corporation

103 KAR 16: 370: Corporation income tax treatment of foreign sales corporations and domestic international sales corporations

REFERENCES

CCH Editorial Staff Publication. 2009 U.S. Master Tax Guide. Chicago: CCH.

Anosike, Benji O. How to Form Your Own Profit or Non-Profit Corporation. Rev. ed. Newark: Do-It-Yourself Legal Publishers

Warner, Ralph and Clifford, Denis. Form a Partnership, The Complete Legal Guide. 8th ed. Berkeley: Delta Printing Solutions, Inc.

WEB SITES

www.irs.gov

www.revenue.ky.gov

www.sos.ky.gov

www.cpa-services.com

www.lectlaw.com

www.limitedliabilitycompanycenter.com