

Business Organization

If you have a great idea for a product or a business and are eager to get started, do not let your enthusiasm be the reason you get off on the wrong foot. Take a while to consider how you will organize your business. The form of organization your business takes controls how income and deductions are reported to the government on a tax return. Sometimes you have a choice of the type of business organization; other times circumstances limit your choice. If you have not yet set up your business and do have a choice, this discussion will influence your decision on business organization. If you have already set up your business, you may want to consider changing to another form of organization. In this chapter you will learn about:

- Sole proprietorships (including independent contractors)
- Partnerships and limited liability companies
- S corporations and their shareholder-employees
- C corporations and their shareholder-employees
- Employees
- Factors in choosing your form of business organization
- Forms of business organization compared
- Changing your form of business

For a further discussion on worker classification, see IRS Publication 15-A, *Employer's Supplemental Tax Guide*.

Sole Proprietorships

If you go into business for yourself and do not have any partners, you are considered a *sole proprietor*. You may think that the term *proprietor* connotes a storekeeper. For purposes of tax treatment, proprietor means any unincorporated business owned entirely by one person. Thus, the category includes individuals in professional practice, such as doctors, lawyers, accountants, and architects. Those who are experts in an area, such as engineering, public relations, or computers, may set up their own consulting businesses and fall under the category of sole proprietor. The designation also applies to independent contractors.

There are no formalities required to become a sole proprietor; you simply conduct business. You may have to register your business with your city, town, or county government by filing a simple form stating that you are doing business as the "Quality Dry Cleaners" or some other business name. This is sometimes referred to as a DBA.

From a legal standpoint, as a sole proprietor, you are personally liable for any debts your business incurs. For example, if you borrow money and default on a loan, the lender can look not only to your business equipment and other business property but also to your personal stocks, bonds, and other property. Some states may give your house homestead protection; state or federal law may protect your pensions and even Individual Retirement Accounts (IRAs). Your only protection for your personal assets is adequate insurance against accidents for your business and other liabilities and paying your debts in full.

Independent Contractors

One type of sole proprietor is the *independent contractor*. To illustrate, suppose you used to work for Corporation X. You have retired, but X gives you a consulting contract under which you provide occasional services to X. In your retirement, you decide to provide consulting services not only to X, but to other customers as well. You are now a consultant. You are an independent contractor to each of the companies for which you provide services.

More precisely, an independent contractor is an individual who provides services to others outside an employment context. The providing of services becomes a business, an independent calling. In terms of claiming business deductions, classification as an independent contractor is generally more favorable than classification as an employee. (See "Tax Treatment of Income and Deductions in General," later in this chapter.) Therefore, many individuals whose employment status is not clear may wish to claim independent contractor status. Also, from the employer's perspective, hiring independent contrac-

tors is more favorable because the employer is not liable for employment taxes and need not provide employee benefits. Federal employment taxes include Social Security and Medicare taxes under the Federal Insurance Contribution Act (FICA) as well as unemployment taxes under the Federal Unemployment Tax Act (FUTA).

You should be aware that the Internal Revenue Service (IRS) aggressively tries to reclassify workers as employees in order to collect employment taxes from employers. The IRS agents are provided with a special audit manual designed to help the agents reclassify a worker as an employee if appropriate (view this manual at <www.irs.gov/pub/irs-utl/emporind.pdf>). The key to worker classification is control. In order to prove independent contractor status, you, as the worker, must show that you have the right to control the details and means by which your work is to be accomplished. You may also want to show that you have an economic stake in your work (that you stand to make a profit or loss depending on how your work turns out). It is helpful in this regard to supply your own tools and place of work, although working from your home, using your own computer, and even setting your own hours (flex time) are not conclusive factors that preclude an employee classification. Various behavioral, financial, and other factors can be brought to bear on the issue of whether you are under someone else's control. You can learn more about worker classification in IRS Publication 15-A, *Employer's Supplemental Tax Guide*.

There is a distinction that needs to be made between the classification of a worker for income tax purposes and the classification of a worker for employment tax purposes. By statute, certain employees are treated as independent contractors for employment taxes even though they continue to be treated as employees for income taxes. Other employees are treated as employees for employment taxes even though they are independent contractors for income taxes.

There are two categories of employees that are, by statute, treated as non-employees for purposes of federal employment taxes. These two categories are real estate salespersons and direct sellers of consumer goods. These employees are considered independent contractors (the ramifications of which are discussed later in this chapter). Such workers are deemed independent contractors if at least 90 percent of the employees' compensation is determined by their output. In other words, they are independent contractors if they are paid by commission and not a fixed salary. They must also perform their services under a written contract that specifies they will not be treated as employees for federal employment tax purposes.

Statutory Employees

Some individuals who consider themselves to be in business for themselves—reporting their income and expenses as sole proprietors—may still be treated as employees for purposes of employment taxes. As such, Social

Security and Medicare taxes are withheld from their compensation. These individuals include:

- Corporate officers
- Agent-drivers or commission-drivers engaged in the distribution of meat products, bakery products, produce, beverages other than milk, laundry, or dry-cleaning services
- Full-time life insurance salespersons
- Homeworkers who personally perform services according to specifications provided by the service recipient
- Traveling or city salespersons engaged on a full-time basis in the solicitation of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar businesses

Full-time life insurance salespersons, homeworkers, and traveling or city salespersons are exempt from FICA if they have made a substantial investment in the facilities used in connection with the performance of services.

One-Member Limited Liability Companies

Every state allows a single owner to form a limited liability company (LLC) under state law. From a legal standpoint, an LLC gives the owner protection from personal liability (only business assets are at risk from the claims of creditors) as explained later in this chapter. But from a tax standpoint, a one-member LLC is treated as a “disregarded entity” (the owner can elect to have the LLC taxed as a corporation, but there is probably no compelling reason to do so). If the owner is an individual (and not a corporation), all of the income and expenses of the LLC are reported on Schedule C of the owner’s Form 1040. In other words, for tax purposes, the LLC is treated just like a sole proprietorship.

Tax Treatment of Income and Deductions in General

Sole proprietors, including independent contractors and statutory employees, report their income and deductions on Schedule C, see *Profit or Loss From Business* (Figure 1.1). The net amount (profit or loss after offsetting income with deductions) is then reported as part of the income section on page one of your Form 1040. Such individuals may be able to use a simplified form for reporting business income and deductions: Schedule C-EZ, *Net Profit From Business* (see Figure 1.2). Individuals engaged in farming activities report business income and deductions on Schedule F, the net amount of which is then reported in the income section on page one of your Form 1040. Individuals who are considered employees cannot use Schedule C to report their income and claim deductions. See page 21 for the tax treatment of income and deductions by employees.

SCHEDULE C
(Form 1040)Department of the Treasury
Internal Revenue Service**Profit or Loss From Business**
(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

► Attach to Form 1040 or 1041. ► See instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2004Attachment
Sequence No. **09**

Name of proprietor

Social security number (SSN)

A Principal business or profession, including product or service (see page C-2 of the instructions)**B** Enter code from pages C-7, 8, & 9**C** Business name. If no separate business name, leave blank.**D** Employer ID number (EIN), if any**E** Business address (including suite or room no.) ►
City, town or post office, state, and ZIP code**F** Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►**G** Did you "materially participate" in the operation of this business during 2004? If "No," see page C-3 for limit on losses ☐ Yes ☐ No**H** If you started or acquired this business during 2004, check here ☐ ☐**Part I Income**

1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here. <input type="checkbox"/>	1	
2 Returns and allowances	2	
3 Subtract line 2 from line 1	3	
4 Cost of goods sold (from line 42 on page 2)	4	
5 Gross profit. Subtract line 4 from line 3.	5	
6 Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7 Gross income. Add lines 5 and 6	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8		19 Pension and profit-sharing plans	19	
9 Car and truck expenses (see page C-3)	9		20 Rent or lease (see page C-5):	20	
10 Commissions and fees	10		a Vehicles, machinery, and equipment	20a	
11 Contract labor (see page C-4)	11		b Other business property	20b	
12 Depletion	12		21 Repairs and maintenance	21	
13 Depreciation and section 179 expense deduction (not included in Part II) (see page C-4)	13		22 Supplies (not included in Part II)	22	
14 Employee benefit programs (other than on line 19)	14		23 Taxes and licenses	23	
15 Insurance (other than health)	15		24 Travel, meals, and entertainment:	24	
16 Interest:			a Travel	24a	
a Mortgage (paid to banks, etc.)	16a		b Meals and entertainment		
b Other	16b		c Enter nondeductible amount included on line 24b (see page C-5)		
17 Legal and professional services	17		d Subtract line 24c from line 24b	24d	
18 Office expense	18		25 Utilities	25	
26 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns	26		26 Wages (less employment credits)	26	
29 Tentative profit (loss). Subtract line 26 from line 7	29		27 Other expenses (from line 48 on page 2)	27	
30 Expenses for business use of your home. Attach Form 8829	30				
31 Net profit or (loss). Subtract line 30 from line 29.	31				
• If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.					
• If a loss, you must go to line 32.					
32 If you have a loss, check the box that describes your investment in this activity (see page C-6).					
• If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.					
• If you checked 32b, you must attach Form 8185.					
			32a <input type="checkbox"/> All investment is at risk.		
			32b <input type="checkbox"/> Some investment is not at risk.		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2004

FIGURE 1.1 Schedule C, Profit or Loss From Business

SCHEDULE C-EZ
(Form 1040)Department of the Treasury
Internal Revenue Service

Name of proprietor

Net Profit From Business

(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

► Attach to Form 1040 or 1041. ► See instructions on back.

OMB No. 1545-0074

2004Attachment
Sequence No. **09A**

Social security number (SSN)

Part I General Information**You May Use
Schedule C-EZ
Instead of
Schedule C
Only If You:**

- Had business expenses of \$5,000 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as a sole proprietor.

And You:

- Had no employee during the year.
- Are not required to file Form 4562, Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-4 to find out if you must file.
- Do not deduct expenses for business use of your home.
- Do not have prior year unallowed passive activity losses from this business.

A Principal business or profession, including product or service	B Enter code from pages C-7, 8, & 9 <div style="border: 1px solid black; width: 100px; height: 20px; margin: 0 auto;"></div>
C Business name. If no separate business name, leave blank.	D Employer ID number (EIN), if any
E Business address (including suite or room no.). Address not required if same as on Form 1040, page 1. City, town or post office, state, and ZIP code	

Part II Figure Your Net Profit

1 Gross receipts. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see Statutory Employees in the instructions for Schedule C, line 1, on page C-3 and check here <input type="checkbox"/>	1	
2 Total expenses (see instructions). If more than \$5,000, you must use Schedule C.	2	
3 Net profit. Subtract line 2 from line 1. If less than zero, you must use Schedule C. Enter on Form 1040, line 12, and also on Schedule SE, line 2. (Statutory employees do not report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.)	3	

Part III Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 2.

4 When did you place your vehicle in service for business purposes? (month, day, year) ► / /

5 Of the total number of miles you drove your vehicle during 2004, enter the number of miles you used your vehicle for:

a Business b Commuting c Other

6 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

7 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

8a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Cat. No. 14374D

Schedule C-EZ (Form 1040) 2004

FIGURE 1.2 Schedule C-EZ, Net Profit From Business

Partnerships and Limited Liability Companies

If you go into business with others, then you cannot be a sole proprietor. You are automatically in a *partnership* if you join together with one or more people to share the profits of the business and take no formal action. Owners of a partnership are called *partners*.

There are two types of partnerships: *general partnerships* and *limited partnerships*. In general partnerships, all of the partners are personally liable for the debts of the business. Creditors can go after the personal assets of any and all of the partners to satisfy partnership debts. In limited partnerships, only the general partners are personally liable for the debts of the business. Limited partners are liable only to the extent of their investments in the business plus their share of recourse debts and obligations to make future investments.

Example

If a partnership incurs debts of \$10,000 (none of which are recourse), a general partner is liable for the full \$10,000. A limited partner who initially contributed \$1,000 to the limited partnership is liable only to that extent. He or she can lose the \$1,000 investment, but creditors cannot go after personal assets.

General partners are jointly and severally liable for the business's debts. A creditor can go after any one partner for the full amount of the debt. That partner can seek to recoup a proportional share of the debt from other partner(s).

Partnerships can be informal agreements to share profits and losses of a business venture. More typically, however, they are organized with formal partnership agreements. These agreements detail how income, deductions, gains, losses, and credits are to be split (if there are any special allocations to be made) and what happens on the retirement, disability, bankruptcy, or death of a partner. A limited partnership must have a partnership agreement that complies with state law requirements.

Another form of organization that can be used by those joining together for business is a limited liability company (LLC). This type of business organization is formed under state law in which all owners are given limited liability. Owners of LLCs are called *members*. These companies are relatively new but have attracted great interest across the country. Every state now has LLC statutes to permit the formation of an LLC within its boundaries. Most states also permit limited liability partnerships (LLPs)—LLCs for accountants, attorneys, doctors, and other professionals—which are easily formed by existing partnerships filing an LLP election with the state. And Delaware now permits multiple LLCs to operate under a single LLC umbrella called a series LLC. The debts and liabilities of each

LLC remain separate from those of the other LLCs, something that is ideal for those owning several pieces of real estate—each can be owned by a separate LLC under the master LLC. At present, state law is evolving to determine the treatment of LLCs formed in one state but doing business in another.

As the name suggests, the creditors of LLCs can look only to the assets of the company to satisfy debts; creditors cannot go after members and hope to recover their personal assets. For federal income tax purposes, LLCs are treated like partnerships unless the members elect to have the LLCs taxed as corporations. Tax experts have yet to come up with any compelling reason for LLCs to choose corporate tax treatment, but if it is desired, the businesses just check the box on a special form (IRS Form 8832. See Figure 1.3). For purposes of our discussion throughout the book, it will be assumed that LLCs have not chosen corporate tax treatment and so are taxed the same way as partnerships. A one-member LLC is treated for tax purposes like a sole proprietor if it is owned by an individual who reports the company's income and expenses on his or her Schedule C.

Tax Treatment of Income and Deductions in General

Partnerships and LLCs are *pass-through* entities. They are not separate tax-paying entities; instead, they pass income, deductions, gains, losses, and tax credits through to their owners. The owners report these amounts on their individual returns. While the entity does not pay taxes, it must file an information return with IRS Form 1065, U.S. Return of Partnership Income, to report the total pass-through amounts. Even though the return is called a *partnership return*, it is the same return filed by LLCs with two or more owners. The entity also completes Schedule K-1 of Form 1065 (Figure 1.4), a copy of which is given to each owner. The K-1 tells the owner his or her allocable share of partnership/LLC amounts. Like W-2 forms used by the IRS to match employees' reporting of their compensation, the IRS now employs computer matching of Schedules K-1 to ensure that owners are properly reporting their share of their business's income.

There are two types of items that pass through to an owner: trade or business income or loss and separately stated items. A partner's or member's share is called the *distributive share*. Trade or business income or loss takes into account most ordinary deductions of the business—compensation, rent, taxes, interest, and so forth. Guaranteed payments to an owner are also taken into account when determining ordinary income or loss. From an owner's perspective, deductions net out against income from the business, and the owner's allocable share of the net amount is then reported on the owner's Schedule E. Figure 1.5 shows a sample portion of Schedule E on which a partner's or member's distributive share is reported.

Separately stated items are stand-alone items that pass through to owners apart from the net amount of trade or business income. These are items that are subject to limitations on an individual's tax return and must be segregated

Form 8832
(Rev. September 2002)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

OMB No. 1545-1516

Type or Print	Name of entity	EIN ▶	
	Number, street, and room or suite no. If a P.O. box, see instructions.		
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country.		

1 Type of election (see instructions):

- a ☐ Initial classification by a newly-formed entity.
- b ☐ Change in current classification.

2 Form of entity (see instructions):

- a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- b ☐ A domestic eligible entity electing to be classified as a partnership.
- c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- e ☐ A foreign eligible entity electing to be classified as a partnership.
- f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

3 Disregarded entity information (see instructions):

- a Name of owner ▶
- b Identifying number of owner ▶
- c Country of organization of entity electing to be disregarded (if foreign) ▶

4 Election is to be effective beginning (month, day, year) (see instructions) ▶ / /

5 Name and title of person whom the IRS may call for more information	6 That person's telephone number
	()

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this consent statement, and to the best of my (our) knowledge and belief, it is true, correct, and complete. If I am an officer, manager, or member signing for all members of the entity, I further declare that I am authorized to execute this consent statement on their behalf.

Signature(s)	Date	Title

FIGURE 1.3 Form 8832, Entity Classification Election

6511

**Schedule K-1
(Form 1065)****2004**Department of the Treasury
Internal Revenue ServiceTax year beginning _____, 2004
and ending _____, 20__**Partner's Share of Income, Deductions,
Credits, etc.**

▶ See back of form and separate instructions.

☐ Final K-1☐ Amended K-1

OMB No. 1545-0049

Part I **General Information About the Partnership**

A Partnership's employer identification number
B Partnership's name, address, city, state, and ZIP code
C IRS Center where partnership filed return
D <input type="checkbox"/> Check if this is a publicly traded partnership (PTP)
E <input type="checkbox"/> Tax shelter registration number, if any _____
F <input type="checkbox"/> Check if Form 8271 is attached

Part II **Information About the Partner**

G Partner's identifying number																
H Partner's name, address, city, state, and ZIP code																
I <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member																
J <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner																
K What type of entity is this partner? _____																
L Partner's share of profit, loss, and capital:																
<table border="1"> <thead> <tr> <th></th> <th>Beginning</th> <th>Ending</th> <th>%</th> </tr> </thead> <tbody> <tr> <td>Profit</td> <td>_____ %</td> <td>_____ %</td> <td>_____ %</td> </tr> <tr> <td>Loss</td> <td>_____ %</td> <td>_____ %</td> <td>_____ %</td> </tr> <tr> <td>Capital</td> <td>_____ %</td> <td>_____ %</td> <td>_____ %</td> </tr> </tbody> </table>		Beginning	Ending	%	Profit	_____ %	_____ %	_____ %	Loss	_____ %	_____ %	_____ %	Capital	_____ %	_____ %	_____ %
	Beginning	Ending	%													
Profit	_____ %	_____ %	_____ %													
Loss	_____ %	_____ %	_____ %													
Capital	_____ %	_____ %	_____ %													
M Partner's share of liabilities at year end:																
Nonrecourse \$ _____																
Qualified nonrecourse financing \$ _____																
Recourse \$ _____																
N Partner's capital account analysis:																
Beginning capital account \$ _____																
Capital contributed during the year \$ _____																
Current year increase (decrease) \$ _____																
Withdrawals & distributions \$ (_____)																
Ending capital account \$ _____																
<input type="checkbox"/> Tax basis <input type="checkbox"/> GAAP <input type="checkbox"/> Section 704(b) book																
<input type="checkbox"/> Other (explain) _____																

Part III **Partner's Share of Ordinary Business Income, Loss, Capital Gains, and Other Items**

1 Ordinary business income (loss)	15 Credits & credit recapture
2 Net rental real estate income (loss)	
3 Other net rental income (loss)	16 Foreign transactions
4 Guaranteed payments	
5 Interest income	
6a Ordinary dividends	
6b Qualified dividends	
7 Royalties	
8 Net short-term capital gain (loss)	
9a Net long-term capital gain (loss)	17 Alternative minimum tax (AMT) items
9b Collectibles (28%) gain (loss)	
9c Unrecaptured section 1250 gain	
10 Net section 1231 gain (loss)	18 Tax-exempt income and nondeductible expenses
11 Other income (loss)	
12 Section 179 deduction	19 Distributions
13 Other deductions	20 Other information
14 Self-employment earnings (loss)	

*See attached statement for additional information.

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For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1065.

Cat. No. 11394R

Schedule K-1 (Form 1065) 2004

FIGURE 1.4 Schedule K-1, Partner's Share of Income, Credits, Deductions, etc.

Schedule E (Form 1040) 2004

Attachment Sequence No. 13

Page 2

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

Your social security number

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

Part II

Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which any amount is not at risk, you must check column (e) on line 28 and attach Form 6198. See page E-1.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses?

☐ Yes ☐ No

If you answered "Yes," see page E-5 before completing this section.

	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A					
B					
C					
D					

Passive Income and Loss		Nonpassive Income and Loss		
(f) Passive loss allowed (attach Form 5582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1
A				
B				
C				
D				
29a Totals				
b Totals				
30 Add columns (g) and (j) of line 29a			30	
31 Add columns (f), (h), and (i) of line 29b			31 ()	
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below.			32	

FIGURE 1.5 Schedule E, Part II, Income or Loss From Partnerships and S Corporations

from the net amount of trade or business income. They are reported along with similar items on the owner's own tax return.

Example

A charitable contribution deduction made by a partnership passes through separately as a charitable contribution. The partner adds the amount of the pass-through charitable contribution to his or her other charitable contributions. Since an individual's cash contributions are deductible only to the extent of 50 percent of adjusted gross income, the partner's allocable share of the partnership's charitable contribution is subject to his or her individual adjusted gross income limit.

Other items that pass through separately to owners include capital gains and losses, Section 179 expense deductions, investment interest deductions, and tax credits.

When a partnership or LLC has substantial expenses that exceed its operating income, a loss is passed through to the owner. A number of different rules operate to limit a loss deduction. The owner may not be able to claim the entire

loss. The loss is limited by the owner's *basis*, or the amount of cash and property contributed to the partnership, in the interest in the partnership.

Example

You contributed \$2,000 to the AB Partnership. In 2004 the partnership had sizable expenses and only a small amount of revenue. Your allocable share of partnership loss is \$3,000. You may deduct only \$2,000 in 2004, which is the amount of your basis in your partnership interest. You may deduct that additional \$1,000 of loss when you have additional basis to offset it.

There may be additional limits on your write-offs from partnerships and LLCs. If you are a passive investor—a silent partner—in these businesses, your loss deduction is further limited by the passive activity loss rules. In general, these rules limit a current deduction for losses from passive activities to the extent of income from passive activities. Additionally, losses are limited by the individual's economic risk in the business. This limit is called the *at-risk rule*. The passive activity loss and at-risk rules are discussed in Chapter 4. For a further discussion of the passive activity loss rules, see IRS Publication 925, *Passive Activity and At-Risk Rules*.

S Corporations and Their Shareholder-Employees

S corporations are like regular corporations (called *C corporations*) for business law purposes. They are separate entities in the eyes of the law and exist independently from their owners. For example, if an owner dies, the S corporation's existence continues. S corporations are formed under state law in the same way as other corporations. The only difference between S corporations and other corporations is their tax treatment for federal income tax purposes.

For the most part, S corporations are treated as pass-through entities for federal income tax purposes. This means that, as with partnerships and LLCs, the income and loss pass through to owners, and their allocable share is reported by S corporation shareholders on their individual income tax returns. The tax treatment of S corporations is discussed more fully later in this chapter.

Note

State laws vary on the tax treatment of S corporations for state income tax purposes. Be sure to check the laws of any state in which you do business.

S corporation status is not automatic. A corporation must elect S status in a timely manner. This election is made on Form 2553, Election by Small Business Corporations to Tax Corporate Income Directly to Shareholders. It must be filed with the IRS no later than the fifteenth day of the third month of the corporation's tax year.

Example

A corporation (on a calendar year) that has been in existence for a number of years wants to elect S status. It has to file an election no later than March 15, 2005 to be effective for its 2004 tax year. If a corporation is formed on August 1, 2004, and wants an S election to be effective for its first tax year, the S election must be filed no later than November 15, 2004.

If an S election is filed after the deadline, it is automatically effective for the following year. A corporation can simply decide to make a prospective election by filing at any time during the year prior to that for which the election is to be effective.

Example

A corporation (on a calendar year) that has been in existence for a number of years wants to elect S status for its 2005 tax year. It can file an election at any time during 2004.

An election cannot be made before the corporation is formed. The board of directors of the corporation must agree to the election and should indicate this assent in the minutes of a board of directors meeting.

Remember, if state law also allows S status, a separate election may have to be filed with the state. Check with all state law requirements.

Tax Treatment of Income and Deductions in General

For the most part, S corporations, like partnerships and LLCs, are pass-through entities. They are generally not separate taxpaying entities. Instead, they pass through to their shareholders' income, deductions, gains, losses, and tax credits. The shareholders report these amounts on their individual returns. The S corporation files a return with the IRS—Form 1120S, U.S. Income Tax Return for an S Corporation—to report the total pass-through amounts. The S corporation also completes Schedule K-1 of Form 1120S, a copy of which is given to each shareholder. The K-1 tells the shareholder his or her allocable

share of S corporation amounts. The K-1 for S corporation shareholders is similar to the K-1 for partners and LLC members.

Unlike partnerships and LLCs, however, S corporations may become taxpayers if they have certain types of income. There are only three types of income that result in a tax on the S corporation. These three items cannot be reduced by any deductions:

- **Built-in gains.** These are gains related to appreciation of assets held by a C corporation that converts to S status. Thus, if a corporation is formed and immediately elects S status, there will never be any built-in gains to worry about.
- **Passive investment income.** This is income of a corporation that has earnings and profits from a time when it was a C corporation. A tax on the S corporation results only when this passive investment income exceeds 25 percent of gross receipts. Again, if a corporation is formed and immediately elects S status, or if a corporation that converted to S status did not have any earnings and profits at the time of conversion, then there will never be any tax from this source.
- **LIFO recapture.** When a C corporation uses last-in, first-out or LIFO to report inventory converts to S status, there may be recapture income that is taken into account partly on the C corporation's final return, but also on the S corporation's return. Again, if a corporation is formed and immediately elects S status, there will not be any recapture income on which the S corporation must pay tax.

To sum up, if a corporation is formed and immediately elects S status, the corporation will always be solely a pass-through entity and there will never be any tax at the corporate level. If the S corporation was, at one time, a C corporation, there may be some tax at the corporate level.

C Corporations and Their Shareholder-Employees

A *C corporation* is an entity separate and apart from its owners; it has its own legal existence. Though formed under state law, it need not be formed in the state in which the business operates. Many corporations, for example, are formed in Delaware or Nevada because the laws in these states favor the corporation, as opposed to the investors (shareholders). However, state law for the state in which the business operates may still require the corporation to make some formal notification of doing business in the state. The corporation may also be subject to tax on income generated in that state.

For federal tax purposes, a C corporation is a separate taxpaying entity. It files its own return (Form 1120, U.S. Corporation Income Tax Return) to report its income or losses (or Form 1120-A, U.S. Corporation Short-Form In-

come Tax Return, for corporations with gross receipts under \$500,000). Shareholders do not report their share of the corporation's income. The tax treatment of C corporations is explained more fully later in this chapter.

Personal Service Corporations

Professionals who incorporate their practices are a special type of C corporation called **personal service corporations (PSCs)**.

Personal service corporation (PSC) A C corporation that performs personal services in the fields of health, law, accounting, engineering, architecture, actuarial science, performing arts, or consulting and meets certain ownership and service tests.

Personal service corporations are subject to special rules in the tax law. Some of these rules are beneficial; others are not. Personal service corporations:

- Cannot use graduated corporate tax rates; they are subject to a flat tax rate of 35 percent.
- Are generally required to use the same tax year as that of their owners. Typically, individuals report their income on a calendar year basis (explained more fully in Chapter 2), so their PSCs must also use a calendar year. However, there is a special election that can be made to use a fiscal year.
- Can use the cash method of accounting. Other C corporations cannot use the cash method and instead must use the accrual method (explained more fully in Chapter 2).
- Are subject to the passive loss limitation rules (explained in Chapter 4).
- Can have their income and deductions reallocated by the IRS between the corporation and the shareholders if it more correctly reflects the economics of the situation.
- Have a smaller exemption from the accumulated earnings penalty than other C corporations. This penalty imposes an additional tax on corporations that accumulate their income above and beyond the reasonable needs of the business instead of distributing income to shareholders.

Tax Treatment of Income and Deductions in General

The C corporation reports its own income and claims its own deductions on Form 1120, U.S. Corporation Income Tax Return. Shareholders in C corporations do not have to report any income of the corporation (and cannot claim any deductions of the corporation). Figure 1.6 shows a sample copy of page one of Form 1120.

Distributions from the C corporation to its shareholders are personal items

Form 1120

Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2004 or tax year beginning 2004, ending 2004
See separate instructions.

OMB No. 1545-0123

Check if:

1 Consolidated return (attach Form 985) ☐

2 Personal holding co. (attach Sch. PH) ☐

3 Personal service corp. (see instructions) ☐

4 Schedule M-3 required (attach Sch. M-3) ☐

Use IRS label. Otherwise, print or type.

Name

Number, street, and room or suite no. If a P.O. box, see page 7 of instructions.

City or town, state, and ZIP code

B Employer identification number

C Date incorporated

D Total assets (see page 8 of instructions)

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income

1a Gross receipts or sales

b Less returns and allowances

c Bal

1c

2 Cost of goods sold (Schedule A, line 8)

3 Gross profit. Subtract line 2 from line 1c

4 Dividends (Schedule C, line 19)

5 Interest

6 Gross rents

7 Gross royalties

8 Capital gain net income (attach Schedule D (Form 1120))

9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)

10 Other income (see page 9 of instructions—attach schedule)

11 Total income. Add lines 3 through 10

Deductions (See instructions for limitations on deductions.)

12 Compensation of officers (Schedule E, line 4)

13 Salaries and wages (less employment credits)

14 Repairs and maintenance

15 Bad debts

16 Rents

17 Taxes and licenses

18 Interest

19 Charitable contributions (see page 11 of instructions for 10% limitation)

20 Depreciation (attach Form 4562)

21 Less depreciation claimed on Schedule A and elsewhere on return

22 Depletion

23 Advertising

24 Pension, profit-sharing, etc., plans

25 Employee benefit programs

26 Other deductions (attach schedule)

27 Total deductions. Add lines 12 through 26

28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11

29 Less: a Net operating loss deduction (see page 13 of instructions)

b Special deductions (Schedule C, line 20)

29c

Tax and Payments

30 Taxable income. Subtract line 29c from line 28

31 Total tax (Schedule J, line 11)

32 Payments: a 2003 overpayment credited to 2004

b 2004 estimated tax payments

c Less 2004 refund applied for on Form 4466

e Tax deposited with Form 7004

f Credit for tax paid on undistributed capital gains (attach Form 2439)

g Credit for Federal tax on fuels (attach Form 4136). See instructions.

33 Estimated tax penalty (see page 14 of instructions). Check if Form 2220 is attached

34 Tax due. If line 32h is smaller than the total of lines 31 and 33, enter amount owed

35 Overpayment. If line 32h is larger than the total of lines 31 and 33, enter amount overpaid

36 Enter amount of line 35 you want: Credited to 2005 estimated tax Refunded

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer

Date

Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature

Preparer's name (or yours if self-employed), address, and ZIP code

Check if self-employed ☐

Preparer's SSN or PTIN

EIN

Phone no. ()

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Est. No. 11450Q Form 1120 (2004)

FIGURE 1.6 Form 1120, U.S. Corporation Income Tax Return

for the shareholders. For example, if a shareholder works for his or her C corporation and receives a salary, the corporation deducts that salary against corporate income. The shareholder reports the salary as income on his or her individual income tax return. If the corporation distributes a dividend to the shareholder, again, the shareholder reports the dividend as income on his or her individual income tax return. In the case of dividends, however, the corporation cannot claim a deduction. This, then, creates a two-tier tax system, commonly referred to as *double taxation*. First, earnings are taxed at the corporate level. Then, when they are distributed to shareholders as dividends, they are taxed again, this time at the shareholder level. There has been sentiment in Congress over the years to eliminate the double taxation, but as of yet no legislation has been introduced to accomplish this end.

Other Tax Issues for C Corporations

In view of the favorable corporate rate tax structure (compared with the individual tax rates), certain tax penalties prevent businesses from using this form of business organization to optimum advantage.

- **Personal holding company penalty.** Corporations that function as a shareholder investment portfolio rather than as an operating company may fall subject to the personal holding corporation (PHC) penalty tax of the highest personal income tax rate—15 percent in 2004—on certain undistributed corporate income. The tax rules strictly define a PHC according to stock ownership and adjusted gross income. The penalty may be avoided by *not* triggering the definition of PHC or by paying out certain dividends.
- **Accumulated earnings tax.** Corporations may seek to keep money in corporate accounts rather than distribute it as dividends to shareholders with the view that an eventual sale of the business will enable shareholders to extract those funds at capital gain rates. Unfortunately, the tax law imposes a penalty on excess accumulations at the highest personal income tax rate—15 percent in 2004. Excess accumulations are those above an exemption amount (\$250,000 for most businesses, but only \$150,000 for PSCs) *plus* amounts for the reasonable needs of the business. Thus, for example, amounts retained to finance planned construction costs, to pay for a possible legal liability, or to buy out a retiring owner are reasonable needs not subject to penalty regardless of amount.

Employees

If you do not own any interest in a business but are employed by one, you may still have to account for business expenses. Your salary or other compensation

is reported as wages in the income section as seen on page one of your Form 1040. Your deductions (with a few exceptions), however, can be claimed only as miscellaneous itemized deductions on Schedule A. These deductions are subject to two limitations. First, the total is deductible only if it exceeds 2 percent of adjusted gross income. Second, high-income taxpayers have an overall reduction of itemized deductions when adjusted gross income exceeds a threshold amount.

Under the 2-percent rule, only the portion of total miscellaneous deductions in excess of 2 percent of adjusted gross income is deductible on Schedule A. *Adjusted gross income* is the tax term for your total income subject to tax (gross income) minus business expenses (other than employee business expenses), capital losses, and certain other expenses that are deductible even if you do not claim itemized deductions, such as qualifying IRA contributions or alimony. You arrive at your adjusted gross income by completing the Income and Adjusted Gross Income sections on page one of Form 1040.

Example

You have business travel expenses that your employer does not pay for and other miscellaneous expenses (such as tax preparation fees) totaling \$2,000. Your adjusted gross income is \$80,000. The amount up to the 2-percent floor, or \$1,600 (2 percent of \$80,000), is disallowed. Only \$400 of the \$2,000 expenses is deductible on Schedule A.

The second deduction limitation applies to higher-income taxpayers whose adjusted gross income exceeds a threshold amount that is adjusted annually for inflation. For example, for 2004 returns the limitation applies to taxpayers with adjusted gross income over \$142,700, or over \$71,350 if married and filing separately. If the limitation applies, itemized deductions other than medical expenses, investment interest, casualty or theft losses, and gambling losses are generally reduced by 3 percent of the excess of adjusted gross income over the annual threshold (\$142,700 or \$71,350). A worksheet included in the IRS instruction booklet is used to calculate the reduction.

For the Future

The overall limit on itemized deductions for high-income taxpayers that can affect the actual business write-offs for employees is set to be phased out starting in 2006. It will be fully phased out by 2010.

If you fall into a special category of employees called *statutory employees*, you can deduct your business expenses on Schedule C instead of Schedule A. Statutory employees were discussed earlier in this chapter.

Factors in Choosing Your Form of Business Organization

Throughout this chapter, the differences of how income and deductions are reported have been explained, but these differences are not the only reasons for choosing a form of business organization. When you are deciding on which form of business organization to choose, many factors come into play.

Personal Liability

If your business owes money to another party, are your personal assets—home, car, investment—at risk? The answer depends on your form of business organization. You have personal liability—your personal assets are at risk—if you are a sole proprietor or a general partner in a partnership. In all other cases, you do not have personal liability. Thus, for example, if you are a shareholder in an S corporation, you do not have personal liability for the debts of your corporation.

Of course, you can protect yourself against personal liability for some types of occurrences by having adequate insurance coverage. For example, if you are a sole proprietor who runs a store, be sure that you have adequate liability coverage in the event someone is injured on your premises and sues you.

Even if your form of business organization provides personal liability protection, you can become personally liable if you agree to it in a contract. For example, some banks may not be willing to lend money to a small corporation unless you, as a principal shareholder, agree to guarantee the corporation's debt. In this case, you are personally liable to the extent of the loan to the corporation. If the corporation does not or cannot repay the loan, then the bank can look to you, and your personal assets, for repayment.

There is another instance in which corporate or LLC status will not provide you with personal protection. Even if you have a corporation or LLC, you can be personally liable for failing to withhold and deposit payroll taxes, which are called trust fund taxes (employees' income tax withholding and their share of FICA taxes, which are held in trust for them) to the IRS. This liability is explained in Chapter 25.

Profitability

All businesses hope to make money. But many sustain losses, especially in the start-up years. The way in which a business is organized affects how losses are treated.

Pass-through entities allow owners to deduct their share of the company's losses on their personal returns (subject to limits discussed in Chapter 4). If a business is set up as a C corporation, only the corporation can deduct losses.

Thus, when losses are anticipated, for example in the start-up phase, a pass-through entity generally is a preferable form of business organization. However, once the business becomes profitable, the tables turn. In that situation, C corporations can offer more tax opportunities, such as fringe benefits.

Fringe Benefits

The tax law gives employees of corporations the opportunity to enjoy special fringe benefits on a tax-free basis. They can receive employer-provided group term life insurance up to \$50,000, health insurance coverage, dependent care assistance up to \$5,000, education assistance up to \$5,250, adoption assistance, and more. They can also be covered by medical reimbursement plans. This same opportunity is not extended to sole proprietors. Remember that sole proprietors are not employees, so they cannot get the benefits given only to employees. Similarly, partners, LLC members, and even S corporation shareholders who own more than 2 percent of the stock in their corporations are not considered employees and thus not eligible for fringe benefits.

If the business can afford to provide these benefits, the form of business becomes important. All forms of business can offer tax-favored retirement plans.

Nature and Number of Owners

With whom you go into business affects your choice of business organization. For example, if you have any foreign investors, you cannot use an S corporation, because foreign individuals are not permitted to own S corporation stock directly. An S corporation also cannot be used if investors are partnerships or corporations. In other words, in order to use an S corporation, all shareholders must be individuals who are not nonresident aliens (there are exceptions for estates, certain trusts, and certain exempt organizations).

The number of owners also presents limits on your choice of business organization. If you are the only owner, then your choices are limited to a sole proprietorship or a corporation (either C or S). Most states allow one-member LLCs. If you have more than one owner, you can set up the business in just about any way you choose. S corporations cannot have more than 75 shareholders, but this number provides great leeway for small businesses.

If you have a business already formed as a C corporation and want to start another corporation, you must take into consideration the impact of special tax rules for multiple corporations. These rules apply regardless of the size of the business, the number of employees you have, and the profit the businesses make. Multiple corporations are corporations under common control, meaning they are essentially owned by the same parties. The tax law limits the number of tax breaks in the case of multiple corporations. Instead of each corporation enjoying a full tax benefit, the benefit must be shared among all of the corporations in the group. For example, the tax brackets for corporations are graduated. In the case of certain multiple corporations, however, the benefit of the

graduated rates must be shared. In effect, each corporation pays a slightly higher tax because it is part of a group of multiple corporations. If you want to avoid restrictions on multiple corporations, you may want to look to LLCs or some other form of business organization.

Tax Rates

Both individuals and C corporations (other than PSCs) can enjoy graduated income tax rates. The top tax rate paid by sole proprietors and owners of other pass-through businesses is 35 percent for 2004. The top corporate tax rate imposed on C corporations is also 35 percent. Personal service corporations are subject to a flat tax rate of 35 percent. But remember, even though the C corporation has a lower top tax rate, there is a two-tier tax structure with which to contend if earnings are paid out to you—tax at the corporate level and again at the shareholder level.

Legislative Alert

Congress is considering a measure to lower the top corporate tax rate to 32 percent.

While the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) has eased for now the so-called double taxation for C corporations by lowering the tax rate on dividends, there is still some double tax because dividends remain nondeductible at the corporate level. The rate on dividends is 15 percent (5 percent for shareholders in the 10 percent and 15 percent tax brackets; zero for these taxpayers in 2008).

The tax rates on capital gains also differ between C corporations and other taxpayers. This is because capital gains of C corporations are not subject to special tax rates (they are taxed the same as ordinary business income), while owners of other types of businesses may pay tax on the business's capital gains at no more than 15 percent (or 5 percent if they are in the 10 percent or 15 percent tax brackets). Of course, tax rates alone should not be the determining factor in selecting your form of business organization.

Social Security and Medicare Taxes

Owners of businesses organized any way other than as a corporation (C or S) are not employees of their businesses. As such, they are personally responsible for paying Social Security and Medicare taxes (called *self-employment taxes* for owners of unincorporated businesses). This tax is made up of the employer and employee shares of Social Security and Medicare taxes. The deduction for one-half of self-employment taxes is explained in Chapter 13.

However, owners of corporations have these taxes applied only against salary actually paid to them. Owners of unincorporated businesses pay self-employment

tax on net earnings from self-employment. This essentially means profits, whether they are distributed to the owners or reinvested in the business. The result: Owners of unincorporated businesses can wind up paying higher Social Security and Medicare taxes than comparable owners who work for their corporations. On the other hand, in unprofitable businesses, owners of unincorporated businesses may not be able to earn any Social Security credits, while corporate owners can have salary paid to them on which Social Security credits can be generated.

Restrictions on Accounting Periods and Accounting Methods

As you will see in Chapter 2, the tax law limits the use of fiscal years and the cash method of accounting for certain types of business organizations. For example, partnerships and S corporations in general are required to use a calendar year to report income.

Also, C corporations generally are required to use the accrual method of accounting to report income. There are exceptions to both of these rules. However, as you can see, accounting periods and accounting methods are important considerations in choosing your form of business organization.

Multistate Operations

Each state has its own way of taxing businesses subject to its jurisdiction. The way in which a business is organized for federal income tax purposes may not necessarily control for state income tax purposes. For example, some states do not recognize S corporation elections and tax such entities as regular corporations.

A company must file a return in each state in which it does business and pay income tax on the portion of its profits earned in that state. Income tax liability is based on having a *nexus*, or connection, to a state. This is not always an easy matter to settle. Where there is a physical presence—for example, a company maintains an office—then there is a clear nexus. But when a company merely makes sales to customers within a state or offers goods for sale from a web site, there is generally no nexus.

Assuming that a company does consult multistate business, then its form of organization becomes important. Most such businesses are C corporations because only one corporate income tax return needs be filed in each state that they do business. Doing business as a pass-through entity means that each owner would have to file a tax return in each state the company does business.

Audit Chances

Each year the IRS publishes statistics on the number and type of audits it conducts. The rates for 2003, the most recent year for which statistics are available, show a slight increase in audit activity for most types of business returns.

The chances of being audited vary with the type of business organization, the amount of income generated by the business, and the geographic location

TABLE 1.1 Percentage of Returns Audited

	2002	2003
Sole proprietors (Schedule C) (based on gross receipts)		
Under \$25,000	2.67%	3.00%
\$25,000 to under \$100,000	1.18	1.33
\$100,000 and over	1.45	1.47
Farming (Schedule F) (based on gross receipts)		
Under \$100,000	0.47	0.57
\$100,000 and over	0.72	0.78
Partnerships	0.26	0.35
S corporations	0.39	0.30
C corporations (based on assets)		
Under \$10 million	0.63	0.58

of the business. While the chance of an audit is not a significant reason for choosing one form of business organization over another, it is helpful to keep these statistics in mind.

Table 1.1 sheds some light on your chances of being audited, based on the most recently available statistics.

Filing Deadlines and Extensions

How your business is organized dictates when its tax return must be filed, the form to use, and the additional time that can be obtained for filing the return. Table 1.2 lists the filing deadlines for calendar-year businesses, the available automatic extensions, and the forms to use in filing the return or requesting a filing extension.

Tax Treatment on Termination

The tax treatment on the termination of a business is another factor to consider. While the choice of entity is made when the business starts out, you can-

TABLE 1.2 Filing Deadlines, Extensions, and Forms

Type of Entity	Return Due Date	Income Tax Return	Automatic Filing Extension	Form to Request Filing Extension
Sole proprietorship	April 15	Schedule C of Form 1040	August 15	Form 4868
Partnership/LLC	April 15	Form 1065	July 15	Form 8736
S corporation	March 15	Form 1120S	September 15	Form 7004
C corporation	March 15	Form 1120	September 15	Form 7004

not ignore the tax consequences that this choice will have when the business terminates. The liquidation of a C corporation produces a double tax—at the entity and owner levels. The liquidation of an S corporation produces a double tax *only* if there is a built-in gains tax issue—created by having appreciated assets in the business when an S election is made. However, the built-in gains tax problem disappears 10 years after the S election so termination after that time does not result in a double tax.

If the termination of the business results in a loss, different tax rules come into play. Losses from partnerships and LLCs are treated as capital losses (explained in Chapter 5). A shareholder's losses from the termination of a C or S corporation may qualify as a Section 1244 loss—treated as an ordinary loss within limits (explained in Chapter 5).

Forms of Business Organization Compared

So far, you have learned about the various forms of business organization. Which form is right for your business? The answer is really a judgment call based on all the factors previously discussed. You can, of course, use different forms of business organization for your different business activities. For example, you may have a C corporation and personally own the building in which it operates—directly or through an LLC. Or you may be in partnership for your professional activities, while running a sideline business as an S corporation.

Table 1.3 summarizes two important considerations: how the type of business organization is formed and what effect the form of business organization has on where income and deductions are reported.

Changing Your Form of Business

Suppose you have a business that you have been running as a sole proprietorship. Now you want to make a change. Your new choice of business organization is dictated by the reason for the change. If you are taking in a partner, you would consider these alternatives: partnership, LLC, S corporation, or C corporation. If you are not taking in a partner, but want to obtain limited personal liability, you would consider an LLC (if your state permits a one-person LLC), an S corporation, or a C corporation. If you are looking to take advantage of certain fringe benefits, such as medical reimbursement plans, you would consider only a C corporation.

Whatever your reason, changing from a sole proprietorship to another type of business organization generally does not entail tax costs on making the changeover. You can set up a partnership or corporation, transfer your business assets to it, obtain an ownership interest in the new entity, and do all this

TABLE 1.3 Comparison of Forms of Business Organization

Type of Business	How It Is Formed	Where Income and Deductions Are Reported
Sole proprietorship	No special requirements	On owner's Schedule C or C-EZ (Schedule F for farming)
Partnership	No special requirements	Some items taken into account in figuring (but generally have trade or business income directly on partnership agreement) Form 1065 (allocable amount claimed on partner's Schedule E); separately stated items passed through to partners and claimed in various places on partner's tax return
Limited special partnership	Some items taken into account in figuring partnership under state law	Trade or business income directly on Form 1065 (allocable amount claimed on partner's Schedule E); separately stated items passed through to partners and claimed in various places on partner's tax return
Limited liability company	Organized as such under state law	Some items taken into account in figuring trade or business income directly on Form 1065 (allocable amount claimed on member's Schedule E); separately stated items passed through to members and claimed in various places on member's tax return
Limited liability partnership	Organized as such under state law	Some items taken into account in figuring trade or business income directly on Form 1065 (allocable amount claimed on member's Schedule E); separately stated items passed through to members and claimed in various places on member's tax return
S corporation	Formed as corporation under state law; tax status elected by filing with IRS	Some items taken into account in figuring trade or business income directly on Form 1120S (allocable amount claimed on shareholder's Schedule E); separately stated items passed through to shareholders and claimed in various places on shareholder's tax return
C corporation	Formed under state law	Claimed by corporation in figuring its trade or business income on Form 1120 or 1120-A
Employee	No ownership interest	Income reported as wages; deductions as itemized deductions on Schedule A (certain expenses first figured on Form 2106)
Independent contractor	No ownership interest in a business	Claimed on individual's Schedule C

on a tax-free basis. You may, however, have some tax consequences if you transfer your business liabilities to the new entity.

But what if you now have a corporation or partnership and want to change your form of business organization? This change may not be so simple. Suppose you have an S corporation or a C corporation. If you liquidate the corporation to change to another form of business organization, you may have to report gain on the liquidation. In fact, gains may have to be reported both by the business and by you as owner.

Before changing your form of business organization it is important to review your particular situation with a tax professional. In making any change in business, consider the legal and accounting costs involved.