chapter 1

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.

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. 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*, 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 contractors 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).

The Internal Revenue Service (IRS) aggressively tries to reclassify workers as employees in order to collect employment taxes from employers. 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. 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*.

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 nonemployees 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, 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. 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. 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.

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*. 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.

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 IRS Form 8832, Entity Classification Election. 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.

Tax Treatment of Income and Deductions in General

Partnerships and LLCs are *pass-through* entities. They are not separate taxpaying 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. The entity also completes Schedule K-1 of Form 1065, 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 of Form 1040.

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

Examples of separately stated items include capital gains and losses, Section 179 expense deductions, investment interest deductions, charitable contributions, 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. Limitations on losses are discussed in Chapter 4

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.

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.

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 and result only if the corporation had been a C corporation for some time before the S election: built-in gains, passive investment income, and LIFO recapture (explained in Chapter 4).

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 Income Tax Return, for corporations with gross receipts under $500,000). Shareholders do not report their share of the corporation's income.

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 are subject to a flat tax rate of 35 percent and certain other restrictions.

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).

Distributions from the C corporation to its shareholders are personal items 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.

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.

- **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.

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 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.

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.

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.

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.

Fringe Benefits

The tax law gives employees of corporations the opportunity to enjoy special fringe benefits on a tax-free basis. This same opportunity is not extended to sole proprietors, partners, LLC members, and even S corporation shareholders who own more than 2 percent of the stock in their corporations.

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, S corporations restrict the number of shareholders and who those shareholders can be.

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.

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.

While the so-called double taxation for C corporations is eased by the cut 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.

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.

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.

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.

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. 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 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.

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 1.1 lists the filing deadlines for calendar-year

TABLE 1.1 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

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 cannot 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

Which form of business organization 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.

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, 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 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.