CHAPTER 1

Business Organization

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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. Consider how you will organize your business. The form of organization of your business 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, the discussion in this chapter may 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.

About 95% of all businesses in the United States are organized as sole proprietorships, partnerships, limited liability companies (LLCs), or S corporations, all of which are "pass-through" entities. This means that the owners, rather than the businesses, pay tax on business income. The way in which you set up your business impacts the effective tax rate you pay on your profits.

As you organize your business, consider which type of entity to use after factoring in taxes (federal and state) and other consequences. Also, as business activities and tax laws change, consider whether to change from your current form of business entity to a new one and what it means from a tax perspective, which is discussed later in this chapter. Finally, be sure to obtain your business's federal tax identification number or a new one when making certain entity changes (explained in Chapter 26).

Sole Proprietorships

If you go into business for yourself and do not have any partners (with the exception of a spouse, as explained shortly), you are considered a *sole proprietor*, and your business is called a *sole proprietorship*. You may think that the term *proprietor* connotes a storekeeper, but for purposes of tax treatment, proprietor means any unincorporated business owned entirely by one person. 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. Other terms used for sole proprietors include freelancers, solopreneurs, and consultants. And it includes "dependent contractors": self-employed individuals who provide all (or substantially all) of their services for one company (often someone laid off or retired from a corporate job who is then engaged to provide nonemployee services for the same corporation). Further, it includes those working in the gig economy through such online platforms as Uber, Lyft, HopSkipDrive, TaskRabbit, Takl, and Upwork (although some workers for these companies may be employees under state law or court decisions). And there's a growing number of social media influencers who conduct their activities as sole proprietors.

Sole proprietorships are the most common form of business. The IRS reports that more than one in five Form 1040 or 1040-SR contains a Schedule C (the form used by sole proprietorships). Most sideline businesses are run as sole proprietorships, and many start-ups commence in this business form.

There are no formalities required to become a sole proprietor; you simply conduct business. If the name of your business is something other than your own name, 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 a fictitious business name (FBN). This is sometimes referred to as a DBA, which stands for "doing business as."

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 personal-use 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 other personal assets is adequate insurance against accidents for your business and other liabilities, and paying your debts in full.

Simplicity is the advantage to this form of business. This form of business is commonly used for sideline ventures, as evidenced by the fact that half of all sole proprietors earn salaries and wages along with their business income. For 2023 (the most recent year for statistics), more than 31 million taxpayers filed returns as sole proprietors.

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. Similarly, if you work full-time or part-time in the gig economy, such as doing graphic design work through Fiverr, as a YouTube influencer, or as an Uber Eats food delivery driver, you, too, are an independent contractor.

More precisely, an independent contractor or freelancer is an individual who provides services to others outside an employment context. The provision 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.) That is why 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 doesn't have to provide employee benefits. (It costs about 30% more for a business to use an employee than an independent contractor after factoring in employment taxes explained in Chapter 30, workers' compensation and other insurance, and benefits.)

Income Taxes versus Employment Taxes

The Internal Revenue Service (IRS) aggressively tries to reclassify workers as employees in order to collect employment taxes from employers. And states do so as well to see that workers are covered by overtime rules, unemployment insurance, and workers' compensation. A discussion about worker classification is in Chapter 7.

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 2 categories of employees that are, by statute, treated as non-employees for purposes of federal employment taxes. These 2 categories are real estate salespersons and direct sellers of consumer goods. These employees are considered independent contractors. Such workers are deemed independent contractors if at least 90% 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 (FICA) 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. But they'll have to pay Social Security and Medicare taxes through self-employment tax on their net earnings.

Day Traders

Traders in securities may be viewed as being engaged in a trade or business in securities if they seek profit from daily market movements in the prices of securities (rather than from dividends, interest, and long-term appreciation) and these activities are substantial, continuous, and regular. Calling yourself a day trader does not make it so; your activities must speak for themselves.

Being a trader means you report your trading expenses on Schedule C, such as subscriptions to publications and online services used in this securities business. Investment interest can be reported on Schedule C (it is not subject to the net investment income limitation that otherwise applies to individuals).

Being a trader means income is reported in a unique way—income from trading is *not* reported on Schedule C. Gains and losses are reported on Schedule D unless you make a mark-to-market election. If so, then income and losses are reported on Form 4797. The mark-to-market election is explained in Chapter 2.

Gains and losses from trading activities are not subject to self-employment tax (with or without the mark-to-market election).

Spousal Joint Ventures

Usually when 2 or more people co-own a business, they are in partnership. But spouses who co-own a business, file jointly, and conduct a joint venture can opt *not* to be treated as a partnership, which requires filing a partnership return (Form 1065) and reporting 2 Schedule K-1s (as explained later in this chapter). Instead, these "couplepreneurs" each report their share of income on 2 Schedule Cs attached to the couple's Form 1040 or 1040-SR. To qualify for this election, each must materially participate in the business (neither can be a silent partner), and there can be no other co-owners. Making this election simplifies reporting while ensuring that each spouse receives credit for paying Social Security and Medicare taxes.

One-Member Limited Liability Companies

A single owner can 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). But from a tax standpoint, a single-member LLC is treated as a "disregarded entity." 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 or 1040-SR. In other words, for federal income tax purposes, the LLC is treated just like a sole proprietorship.

The owner may elect to have the LLC taxed as a corporation, but this is not typical. An election made to be taxed as a corporation can be followed by an S election, so that the owner can receive a salary and make tax payments through wage withholding rather than making estimated tax payments, as well as minimize Social Security and Medicare taxes.

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

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

Attach to Form 1040, 1040-SR, 1040-SS, 1040-NR, or 1041; partnerships must generally file Form 1065.
Go to *www.irs.gov/ScheduleC* for instructions and the latest information.

OMB No. 1545-0074

2026

Attachment Sequence No. **09**

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see instructions) | **B Enter code from instructions**

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN)** (see instr.)

E Business address. Number and street. If you have a post office box, see instructions. | Apt. no.

City, town, or post office | State | ZIP code

F Accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) _____

G Did you "materially participate" in the operation of this business during 2026? If "No," see instructions for limit on losses . . ☐ **Yes** ☐ **No**

H If you started or acquired this business during 2026, check here . . . . . ☐

I Did you make any payments in 2026 that would require you to file Form(s) 1099? See instructions . . . . . ☐ **Yes** ☐ **No**

J If "Yes," did you or will you file required Form(s) 1099? . . . . . ☐ **Yes** ☐ **No**

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ☐	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42)	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 instructions)	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		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
				20	Rent or lease (see instructions):		
10	Commissions and fees	10		20a	Vehicles, machinery, and equipment	20a	
11	Contract labor (see instructions)	11		20b	Other business property	20b	
12	Depletion	12		21	Repairs and maintenance	21	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		22	Supplies (not included in Part III)	22	
				23	Taxes and licenses	23	
14	Employee benefit programs (other than on line 19)	14		24	Travel and meals:		
				24a	Travel	24a	
15	Insurance (other than health)	15		24b	Deductible meals (see instructions)	24b	
16	Interest (see instructions):			25	Utilities	25	
16a	Mortgage (paid to banks, etc.)	16a		26	Wages (less employment credits)	26	
16b	Vehicle loan	16b		27a	Energy efficient commercial buildings deduction (attach Form 7205)	27a	
16c	Other	16c		27b	Other expenses (from line 48)	27b	
17	Legal and professional services	17					

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27b	28	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method. See instructions. **Simplified method filers only:** Enter the total square footage of (a) your home: _____ and (b) the part of your home used for business: _____ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Schedule 1 (Form 1040)**, **line 3**, and on **Schedule SE**, **line 2**. (If you checked the box on line 1, see instructions.) Estates and trusts, enter on **Form 1041**, **line 3**. • If a loss, you **must** go to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity. See instructions. • If you checked box 32a, enter the loss on both **Schedule 1 (Form 1040)**, **line 3**, and on **Schedule SE**, **line 2**. (If you checked the box on line 1, see the line 31 instructions.) Estates and trusts, enter on **Form 1041**, **line 3**. • If you checked box 32b, you **must** attach **Form 6198**. Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

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FIGURE 1.1 Schedule C, Profit or Loss From Business

Schedule C (Form 1040) 2026 Page 2

Part III **Cost of Goods Sold** (see instructions)

33 Method(s) used to value closing inventory: **33a** ☐ Cost **33b** ☐ Lower of cost or market **33c** ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . . . ☐ **Yes** ☐ **No**

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4	42	

Part IV **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

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

44 Of the total number of miles you drove your vehicle during 2026, enter the number of miles you used your vehicle for:

44a Business _____ **44b** Commuting (see instructions) _____ **44c** Other _____

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

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

47a Do you have evidence to support your deduction? . . . . . ☐ **Yes** ☐ **No**

47b If "Yes," is the evidence written? . . . . . ☐ **Yes** ☐ **No**

Part V **Other Expenses.** List below business expenses not included on lines 8–27a, or line 30.

48	**Total other expenses.** Enter here and on line 27b	48

Schedule C (Form 1040) 2026

FIGURE 1.1 ***(Continued)***

amount (profit or loss after offsetting income with deductions) is then reported on Schedule 1 of Form 1040 or 1040-SR. Individuals engaged in farming activities report business income and deductions on Schedule F, *Profit or Loss from Farming*, the net amount of which is then reported on Schedule 1 of Form 1040 or 1040-SR. Individuals who are considered employees cannot use Schedule C to report their income and claim deductions. See page 29 for the tax treatment of income and deductions by employees.

In effect, a sole proprietor pays tax on business profits using tax rates for individuals; there is no separate tax rate for a sole proprietorship. The top rate for an individual is 37%, although the sole proprietor may be able to claim a 20% qualified business income deduction on his or her personal return to reduce the effective tax rate on profits (see Chapter 21).

Partnerships and Limited Liability Companies

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

There are 2 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 (LPs), 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. Some states allow LPs to become limited liability limited partnerships (LLLPs) to give general partners personal liability protection with respect to the debts of the partnership.

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. This means that 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). In legalese, this is called the right of contribution.

Partnerships may be informal agreements to share profits and losses of a business venture. More typically, 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 withdrawal, 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 may 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*. Every state 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 established by existing partnerships filing an LLP election with the state. A partner in an LLP has personal liability protection with respect to the firm's debts, but remains personally liable for his or her professional actions.

About half the states and the District of Columbia permit multiple LLCs to operate under a single LLC umbrella called a "series LLC" (each LLC is called a "cell"). A few other states don't allow the formation of a series LLC but permit one formed in another state to register and do business in the state. The rules are not uniform in all of these states. If you are in a state that does not have a law for series LLC, in most but not all states you can form the series in Delaware, for example, and then register to do business in your state. 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 long as each LLC maintains separate bank accounts and financial records.

Public Benefit LLCs (PBLLCs). Some states (e.g., Delaware, Kansas, Illinois, Maryland, Oregon, Pennsylvania, and Utah) allow Public Benefit LLCs (PBLLCs), which are limited liability companies obtaining the same opportunities that the state's benefit corporations enjoy. They produce a specific public benefit; profit can be an important purpose. They strongly resemble Benefit Corporations (discussed later in this chapter), but are taxed in the same way as regular LLCs. They are usually designated to the public as PBLLCs.

L3Cs. A variation on the LLC theme is a Low-Profit Limited Liability Company (L3C). It combines the desire for some profit with the goal of benefiting society (a charitable or educational purpose); there isn't a significant profit motive. L3Cs are more restrictive than PBLLCs. Currently, this hybrid entity is recognized in 9 states. L3Cs are taxed in the same way as regular LLCs. They are designated to the public as L3Cs.

Tax Treatment of Income and Deductions in General

Partnerships are *pass-through* entities. They are not separate taxpaying entities; instead, they pass income, deductions, gains, losses, and tax credits through to their owners. (Partnerships only become taxpayers if they are audited under the Bipartisan Budget Act regime explained in Chapter 34 and don't opt to push out tax resulting from the audit to partners.) Over 5.2 million partnership returns were filed in the government's 2025 fiscal year. Of these, nearly three-quarters were limited liability companies, representing the most prevalent type of entity filing a partnership return, more common than general partnerships or limited partnerships. The owners report these amounts on their individual returns. Owners may be able to claim a 20% qualified business income deduction on their personal returns to reduce the effective rate levied on business profits.

While the entity does not pay taxes (except to the extent of certain adjustments following an audit as explained in Chapter 34), 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 2 or more owners who do not elect to be taxed as a corporation. The entity also completes Schedule K-1 of Form 1065, see Figure 1.2, a copy of which is given to each owner to allocate the share of partnership/LLC amounts. Like W-2 forms used by the IRS to match employees' reporting of their compensation, the IRS employs computer matching of Schedules K-1 to ensure that owners are properly reporting their share of their business's income.

651123

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

2026

For calendar year 2026, or tax year beginning / / 2026 ending / /

Partner's Share of Income, Deductions, Credits, etc.

See separate instructions.

Part I 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 ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN _____ Name _____

I1 What type of entity is the partner? _____

I2 If the partner is a retirement plan (IRA/SEP/Keogh/etc.), check here . ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to:
☐ Sale or ☐ Exchange of partnership interest. See instructions.

K1 Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

K2 Check this box if item K1 includes liability amounts from lower-tier partnerships ☐

K3 Check if any of the above liability is subject to guarantees or other payment obligations by the partner. See instructions . . . . . ☐

L Partner's Capital Account Analysis

Beginning capital account . . . $ _____
Capital contributed during the year . . $ _____
Current-year net income (loss) . . . $ _____
Other increase (decrease) (attach explanation) $ _____
Withdrawals and distributions . . . $ (_____)
Ending capital account . . . . $

M Did the partner contribute property with a built-in gain (loss)?
☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.

N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)
Beginning . . . . . $ _____
Ending . . . . . $

Part III Partner's Share of Current-Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	14	Self-employment earnings (loss)
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . . ☐
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses
6c	Dividend equivalents		
7	Royalties		
8	Net short-term capital gain (loss)	19	Distributions
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)	20	Other information
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)		
11	Other income (loss)		
12	Section 179 deduction	21	Foreign taxes paid or accrued
13	Other deductions		

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

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FIGURE 1.2 Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.

NOTE

K-1s (and K-3s where applicable) can be distributed to partners electronically if the partnership has the partners' consent. Obtain consent by sending instructions to partners on how to obtain, complete, and submit a consent form to the partnership.

Schedule K-3 is also furnished to partners if the partnership has certain foreign tax relevance (e.g., foreign-sourced income; foreign partners). But the schedule does not have to be furnished to partners if 4 conditions specified in the instructions are met. Because foreign matters are not covered in this book, this schedule is not discussed any further.

For federal income tax purposes, LLCs with more than one member are treated like partnerships unless the members elect to have the LLCs taxed as corporations. This election is made on IRS Form 8832, *Entity Classification Election*, and reflects what is referred to as check-the-box rules. See Figure 1.3. For purposes of our discussion throughout this book, it will be assumed that multi-member LLCs have not chosen corporate tax treatment and so are taxed the same way as partnerships.

As explained earlier, a single-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. Like multi-member LLCs, a single-member LLC may choose to be taxed as a corporation.

Under regulations proposed in 2010 and which have never been finalized, for federal tax purposes a series LLC is treated as an entity formed under local law, whether or not local law treats the series as a separate legal entity. The tax treatment of the series is then governed by the check-the-box rules.

There are 2 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 to employees (non-partners), 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 or 1040-SR. Figure 1.4 shows Part II of Schedule E on which a partner's or member's distributive share is reported.
- ***Separately stated items.*** These 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, such as capital gains and losses, Section 179 (first-year expensing) deductions, investment interest deductions, charitable contributions, and tax credits. 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 in 2026 are deductible only to the extent of 60% of adjusted gross income (AGI) after reduction for all other charitable donations and assuming the partner itemizes personal deductions, the partner's allocable share of the partnership's charitable contribution is subject to his or her individual adjusted gross income limit and the 0.5% of AGI floor.

Form **8832**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

► Information about Form 8832 and its instructions is at *www.irs.gov/form8832*.

OMB No. 1545-1516

Type or Print	Name of eligible entity making election	Employer identification number
	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. Follow the country's practice for entering the postal code.	

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I Election Information

1 **Type of election** (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ► _____
b Identifying number of owner ► _____

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ► _____
b Employer identification number ► _____

For Paperwork Reduction Act Notice, see instructions. Cat. No. 22598R Form **8832** (Rev. 12-2013)

FIGURE 1.3 **Form 8832, Entity Classification Election**

Form 8832 (Rev. 12-2013) Page 2

Part I Election Information (Continued)

6 Type 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.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶ _____

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . . ▶ _____

9 Name and title of contact person whom the IRS may call for more information

10 Contact 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 election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title

Form **8832** (Rev. 12-2013)

FIGURE 1.3 ***(Continued)***

Schedule E (Form 1040) 2026 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**

24	**Income.** Add positive amounts shown on line 21. **Do not** include any losses	24	
25	**Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 3 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 3	26	

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

Part II Income or Loss From Partnerships and S Corporations

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

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

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

	Passive income and loss		Nonpassive income and loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					
B					
C					
D					
29a Totals					
29b Totals					

30	Add columns (h) and (k) of line 29a	30	
31	Add columns (g), (i), and (j) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31	32	

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

	Passive income and loss		Nonpassive income and loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
34a Totals				
34b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Schedule E (Form 1040) 2026

FIGURE 1.4 Part II of Schedule E

Partners generally must report income on their personal returns consistent with what's reported on Schedule K-1 (and K-3 where applicable).

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. These limitations are explained in Chapter 4. In addition to income taxes, partners are subject to self-employment tax on their distributive share and guaranteed payments (see Chapter 30).

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 (and state income taxes where applicable).

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.

There are over 6.1 million S corporations, making these entities the most prevalent type of corporation. Over 72% of all corporations file a Form 1120-S, the return for S corporations. The vast majority of S corporations have only 1, 2, or 3 shareholders.

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.

Electing to be an S corporation. 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 15th day of the 3rd 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 had to file an election no later than March 16, 2026 (March 15 is a Sunday), to be effective for its 2026 tax year. If a corporation is formed on July 1, 2026, and wants an S election to be effective for its first tax year, the S election must be filed no later than October 15, 2026.

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. If you want the election to be effective now but missed the deadline, you may qualify for relief under Rev. Proc. 2013–30 (see the instructions to Form 2553 for making a late election).

To be eligible for an S election, the corporation must meet certain shareholder requirements. There can be no more than 100 shareholders. For this purpose, all family members (up to 6 generations) are treated as a single shareholder. Only certain types of trusts are permitted to be

shareholders. There can be no nonresident alien shareholders as direct shareholders; nonresidents can be indirect shareholders if they become beneficiaries of Electing Small Business Trusts (ESBTs). A complete discussion of ESBTs and their taxation is beyond the scope of this book. The corporation can have only one class of stock to be an S corporation.

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.

Once the election is made, it remains in effect until it is revoked or is terminated because the corporation fails to meet S corporation requirements (e.g., more than 100 shareholders own the stock, a nonresident alien becomes a direct shareholder, or the corporation creates a second class of stock). If an election is revoked, a new one cannot be made for 5 years unless the IRS agrees to it.

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. This means owners pay tax on their business profits using individual tax rates. They may be able to claim a 20% qualified business income deduction on their personal return (see Chapter 21).

The S corporation files a return with the IRS—Form 1120-S, *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 1120-S, 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 shown in Figure 1.5). S corporations with certain foreign interests and activities also file *Shareholder's Share of Income, Deductions, Credits, Etc.,—International*. The schedule does not have to be furnished to shareholders if 3 conditions specified in the instructions are met. Because foreign matters are not covered in this book, these schedules are not discussed any further.

Like partners, S corporation shareholders have a duty of consistency in reporting on their personal returns was what reported to them (and to the IRS).

S corporations may become taxpayers if they have certain types of income. There are only 3 types of income that result in a tax on the S corporation. These 3 items cannot be reduced by any deductions:

1. *Built-in gains*. These are gains related to appreciation of assets held by a C corporation that converts to S status. If a corporation is formed and immediately elects S status, there will never be any built-in gains to worry about. The built-in gains tax ends once the S corporation has held the appreciated assets for more than 5 years.
2. *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% of gross receipts. Again, if a corporation is formed and immediately elects S status, or if a corporation that converted to S status does not have any earnings and profits at the time of conversion, then there will never be any tax from this source.

671124

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120-S) 2026

Department of the Treasury
Internal Revenue Service

For calendar year 2026, or tax year beginning / / 2026 ending / /

Shareholder's Share of Income, Deductions, Credits, etc.

See separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

D Corporation's total number of shares
Beginning of tax year . . . . . .
End of tax year . . . . . .

Part II Information About the Shareholder

E Shareholder's identifying number

F1 Shareholder's name, address, city, state, and ZIP code

F2 If the shareholder is a disregarded entity, a trust, an estate, or a nominee or similar person, enter the individual or entity responsible for reporting:
TIN _____ Name _____

F3 What type of entity is this shareholder? _____

G Current year allocation percentage . . . _____ %

H Shareholder's number of shares
Beginning of tax year . . . . . .
End of tax year . . . . . .

I Loans from shareholder
Beginning of tax year . . . . . $
End of tax year . . . . . $

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Schedule K-3 is attached if checked . . . . . ☐
6	Royalties	15	Alternative minimum tax (AMT) items
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)	16	Items affecting shareholder basis
10	Other income (loss)		
		17	Other information
11	Section 179 deduction		
12	Other deductions		

18 ☐ More than one activity for at-risk purposes*
19 ☐ More than one activity for passive activity purposes*

* See attached statement for additional information.

FIGURE 1.5 Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc.

3. *LIFO recapture*. When a C corporation using last-in, first-out (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 (other than momentarily), 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 does not have to 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). But 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.

According to IRS data for its 2025 fiscal year, there were more than 2.5 million C corporations, the vast majority of which were small or midsize companies (with assets of $10 million or less). Despite having a favorable 21% tax rate on corporations since 2018, the number of C corporations has been declining relative to the number of pass-through entities.

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. 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:

- 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). PSCs must also use a calendar year unless they make a special election to use a fiscal year.
- May use the cash method of accounting. Other C corporations cannot use the cash method and instead must use the accrual method unless they meet a gross receipts test (explained more fully in Chapter 2).

- Are subject to the passive loss limitation rules (explained in Chapter 4).
- May 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), other than taxable compensation and benefits, dividends, and certain other distributions. Figure 1.6 shows a sample copy of Form 1120.

C corporations have a flat corporate tax rate of 21%. A small business that operates as a C corporation and a multinational corporation pay the same tax rate on their profits.

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, the corporation cannot claim a deduction. This creates a 2-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 20% 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 20%. 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. 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.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2026 or tax year beginning _____, 2026, ending _____, 20___
Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123
2026

A Check if:
1a Consolidated return (attach Form 851) ☐
1b Life/nonlife consolidated return. ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

Name | **B Employer identification number**
Number and street. If a P.O. box, see instructions. | Room or suite no. | **C** Date incorporated
City or town | State or province | Country | ZIP or foreign code | **D** Total assets (see instructions) $

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

Income	1a	Gross receipts or sales	1a	
	1b	Returns and allowances	1b	
	1c	Balance. Subtract line 1b from line 1a	1c	
	2	Cost of goods sold (attach Form 1125-A)	2	
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Dividends and inclusions (Schedule C, line 23)	4	
	5	Interest	5	
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	
	9	Net gain or (loss) from Form 4797, Part II, line 19 (attach Form 4797)	9	
	10	Other income (see instructions—attach statement)	10	
	11	**Total income.** Add lines 3 through 10	11	
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E)	12	
	13	Salaries and wages (less employment credits)	13	
	14	Repairs and maintenance	14	
	15	Bad debts	15	
	16	Rents	16	
	17	Taxes and licenses	17	
	18	Interest (see instructions)	18	
	19	Charitable contributions	19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	20	
	21	Depletion	21	
	22	Advertising	22	
	23	Pension, profit-sharing, etc., plans	23	
	24	Employee benefit programs	24	
	25	Energy efficient commercial buildings deduction (attach Form 7205)	25	
	26	Other deductions (attach statement)	26	
	27	**Total deductions.** Add lines 12 through 26	27	
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11.	28	
	29a	Net operating loss deduction (see instructions)	29a	
	29b	Special deductions (Schedule C, line 24)	29b	
	29c	Add lines 29a and 29b	29c	
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions	30	
	31	Total tax (Schedule J, line 12)	31	
	32	First installment of section 1062 applicable net tax liability. Enter amount from Form 1062, line 15	32	
	33	Total payments, credits, and section 1062 applicable net tax liability from Schedule J, line 23	33	
	34	Estimated tax penalty. See instructions. Check if Form 2220 is attached ☐	34	
	35	**Amount owed.** If line 33 is smaller than the total of lines 31, 32, and 34, enter amount owed	35	
	36	**Overpayment.** If line 33 is larger than the total of lines 31, 32, and 34, enter amount overpaid	36	
	37	Enter amount from line 36 you want: **37a Credited to 2027 estimated tax** _____ **37b Refunded**	37b	
	37c	Routing number (9 digits) _____ **37d** Type: ☐ Checking ☐ Savings		
	37e	Account number (up to 17 digits) _____		

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 Use Only

Preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name | Firm's EIN
Firm's address | Phone no.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2026) Created 5/28/26

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

Form 1120 (2026) Page 2

Schedule C	Dividends, Inclusions, and Special Deductions (see instructions)	(a) Dividends and inclusions	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		50	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		65	
3	Dividends on certain debt-financed stock of domestic and foreign corporations		See instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		23.3	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		26.7	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		50	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		65	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Subtotal.** Add lines 1 through 8. See instructions for limitations		See instructions	
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Foreign-source portion of dividends received from a specified 10%-owned foreign corporation (excluding hybrid dividends) (see instructions)		100	
14	Dividends from foreign corporations not included on line 3, 6, 7, 8, 11, 12, or 13 (including any hybrid dividends)			
15	Reserved for future use			
16a	Subpart F inclusions derived from the sale by a controlled foreign corporation (CFC)/ foreign controlled foreign corporation (FCFC) of the stock of a lower-tier foreign corporation treated as a dividend (attach Form(s) 5471) (see instructions)		100	
16b	Subpart F inclusions derived from hybrid dividends of tiered corporations (attach Form(s) 5471) (see instructions)			
16c	Other inclusions from CFCs/FCFCs under subpart F not included on line 16a, 16b, or 17 (attach Form(s) 5471) (see instructions)			
17	Net CFC Tested Income (attach Form(s) 5471 and Form 8992)			
18	Gross-up for foreign taxes deemed paid			
19	IC-DISC and former DISC dividends not included on line 1, 2, or 3			
20	Other dividends			
21	Deduction for dividends paid on certain preferred stock of public utilities			
22	Section 250 deduction (attach Form 8993) (see instructions for limitations)			
23	**Total dividends and inclusions.** Add column (a), lines 9 through 20. Enter here and on page 1, line 4			
24	**Total special deductions.** Add column (c), lines 9 through 22. Enter here and on page 1, line 29b		24	

Schedule J	Tax Computation and Payment (see instructions)		
1a	Income tax (see instructions)	1a	
1b	Tax from Form 1120-L (see instructions)	1b	
1c	Section 1291 tax from Form 8621	1c	
1d	Tax adjustment from Form 8978	1d	
1e	Additional tax under section 197(f)	1e	
1f	Base erosion minimum tax from Form 8991	1f	
1g	Amount from Form 4255, Part I, line 3, column (q)	1g	
1z	Other chapter 1 tax	1z	
2	Total income tax. Add lines 1a through 1z	2	

Form **1120** (2026)

FIGURE 1.6 ***(Continued)***

Form 1120 (2026) Page 3

Schedule J **Tax Computation and Payment** (see instructions) *(continued from page 2)*

3	Corporate alternative minimum tax from Form 4626, Part II, line 13 (attach Form 4626)	3	
4	Add lines 2 and 3	4	
5a	Foreign tax credit (attach Form 1118)	5a	
5b	Credit from Form 8834 (see instructions)	5b	
5c	General business credit (see instructions—attach Form 3800)	5c	
5d	Credit for prior-year minimum tax (attach Form 8827)	5d	
5e	Bond credits from Form 8912	5e	
5f	Adjustment from Form 8978	5f	
6	**Total credits.** Add lines 5a through 5f	6	
7	Subtract line 6 from line 4	7	
8	Personal holding company tax (attach Schedule PH (Form 1120))	8	
9a	Amount from Form 4255, Part I, line 3, column (r)	9a	
9b	Recapture of low-income housing credit (attach Form 8611)	9b	
9c	Completed long-term contract look-back interest due (attach Form 8697)	9c	
9d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d	
9e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e	
9f	Interest/tax due under section 453A(c)	9f	
9g	Interest/tax due under section 453(l)	9g	
9z	Other (see instructions—attach statement)	9z	
10	**Total.** Add lines 9a through 9z	10	
11a	Total tax before deferred taxes. Add lines 7, 8, and 10	11a	
11b	Deferred tax on the corporation's share of undistributed earnings of a qualified electing fund	11b	
11c	Deferred LIFO recapture tax (section 1363(d))	11c	
12	Total tax. Subtract the sum of lines 11b and 11c from 11a. Enter here and on page 1, line 31	12	
13	Preceding year's overpayment credited to the current year	13	
14	Current year's estimated tax payments	14	
15	Current year's refund applied for on Form 4466	15	( )
16	Reserved for future use	16	
17	Tax deposited with Form 7004	17	
18	Withholding (see instructions)	18	
19	**Total payments.** Combine lines 13 through 18	19	
20a	Credit from Form 2439	20a	
20b	Credit from Form 4136	20b	
20c	Credit for tax withheld under chapter 3 or 4 from Form 1042-S, Form 8805, or Form 8288 (attach the form)	20c	
20z	Other refundable credits (attach statement—see instructions)	20z	
21	**Total credits.** Add lines 20a through 20z	21	
22a	Elective payment election amount from Form 3800	22a	
22b	Section 1062 applicable net tax liability. Enter amount from Form 1062, line 14	22b	
23	**Total payments, credits, and section 1062 net tax liability.** Add lines 19, 21, 22a, and 22b. Enter here and on page 1, line 33	23	

Form **1120** (2026)

FIGURE 1.6 ***(Continued)***

Form 1120 (2026) Page **4**

Schedule K **Other Information** (see instructions)

		Yes	No
1	Check accounting method: **1a** ☐ Cash **1b** ☐ Accrual **1c** ☐ Other (specify) _____		
2	See the instructions and enter the:		
2a	Business activity code no. _____		
2b	Business activity _____		
2c	Product or service _____		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? . . . . . If "Yes," enter name and EIN of the parent corporation.	☐	☐
4	At the end of the tax year:		
4a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)	☐	☐
4b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G) .	☐	☐
5	At the end of the tax year, did the corporation:		
5a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851**, Affiliations Schedule? For rules of constructive ownership, see instructions . . . . . If "Yes," complete (i) through (iv) below.	☐	☐

(i) Name of corporation	**(ii)** EIN (if any)	**(iii)** Country of incorporation	**(iv)** Percentage owned in voting stock

		Yes	No
5b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions . . . . . If "Yes," complete (i) through (iv) below.	☐	☐

(i) Name of entity	**(ii)** EIN (if any)	**(iii)** Country of organization	**(iv)** Maximum percentage owned in profit, loss, or capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? See sections 301 and 316 . . . . . If "Yes," file **Form 5452**, Corporate Report of Nondividend Distributions. See the instructions for Form 5452. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.	☐	☐
7	At any time during this tax year, did one foreign person own, directly or indirectly, at least 25% of the total voting power of all classes of the corporation's stock entitled to vote or at least 25% of the total value of all classes of the corporation's stock? . For rules of attribution, see section 318. If "Yes," enter:	☐	☐
7a	Percentage owned **7a** _____ % and **7b** Owner's country code **7b** _____		
7c	The corporation may have to file **Form 5472**, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached . **7c** _____		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . . **8** ☐ If checked, the corporation may have to file **Form 8281**, Information Return for Publicly Offered Original Issue Discount Instruments.		

Form **1120** (2026)

FIGURE 1.6 ***(Continued)***

Form 1120 (2026) Page 5

Schedule K **Other Information** *(continued from page 4)*

			Yes	No
9	Enter the amount of tax-exempt interest received or accrued during this tax year	9		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer)	10		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here (see instructions) 11 ☐			
	If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.			
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction reported on page 1, line 29a)	12		
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		☐	☐
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during this tax year	13		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement? See instructions		☐	☐
	If "Yes," complete and attach Schedule UTP.			
15a	Did the corporation make any payments that would require it to file Form(s) 1099?		☐	☐
15b	If "Yes," did or will the corporation file required Form(s) 1099?		☐	☐
16	During this tax year, did the corporation have an 80%-or-more change in ownership, including a change due to redemption of its own stock?		☐	☐
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		☐	☐
18	Did this corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		☐	☐
19	During this corporation's tax year, did the corporation make any payments that would require it to file Forms 1042 and 1042-S under chapter 3 (sections 1441 through 1464) or chapter 4 (sections 1471 through 1474) of the Code?		☐	☐
20	Is the corporation operating on a cooperative basis?		☐	☐
21a	During this tax year, did the corporation pay or accrue any interest or royalty for which the deduction is not allowed under section 267A? See instructions		☐	☐
21b	If "Yes," enter the total amount of the disallowed deductions	21b		
22	Does this corporation have gross receipts of at least $500 million in any of the 3 preceding tax years? (See sections 59A(e)(2) and (3).)		☐	☐
	If "Yes," complete and attach Form 8991.			
23	Did the corporation have an election under section 163(j) for any real property trade or business or any farming business in effect during this tax year? See instructions		☐	☐
24	Does the corporation satisfy one or more of the following? If "Yes," complete and attach Form 8990. See instructions		☐	☐
	• The corporation owns a pass-through entity with current- or prior-year carryover excess business interest expense.			
	• The corporation's aggregate average annual gross receipts (determined under section 448(c)) for the 3 tax years preceding the current tax year are more than $32 million and the corporation has business interest expense.			
	• The corporation is a tax shelter and the corporation has business interest expense.			
25a	Does the corporation intend to self-certify as a Qualified Opportunity Fund?		☐	☐
25b	If "Yes," complete and attach Form 8996. Enter the amount (if any) from Form 8996, line 24	25b		
26a	Since December 22, 2017, did a foreign corporation directly or indirectly acquire substantially all of the properties held directly or indirectly by the corporation, and was the ownership percentage (by vote or value) for purposes of section 7874 greater than 50% (for example, the shareholders held more than 50% of the stock of the foreign corporation)? If "Yes," list the ownership percentage by vote and by value. See instructions		☐	☐
	26b By vote _____ % **26c** By value _____ %			
27	At any time during this tax year, did the corporation (a) receive a digital asset (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? See instructions		☐	☐
28	Is the corporation a member of a controlled group?		☐	☐
	If "Yes," attach Schedule O (Form 1120). See instructions.			

Form **1120** (2026)

FIGURE 1.6 ***(Continued)***

Form 1120 (2026) Page **6**

Schedule K **Other Information** *(continued from page 5)*

		Yes	No
29	Corporate alternative minimum tax:		
29a	Was the corporation an applicable corporation under section 59(k)(1) in any prior tax year?	☐	☐
	If "Yes," go to question 29b. If "No," skip to question 29c.		
29b	Is the corporation an applicable corporation under section 59(k)(1) in the current tax year because the corporation was an applicable corporation in the prior tax year?	☐	☐
	If "Yes," complete and attach Form 4626. If "No," continue to question 29c.		
29c	Does the corporation meet the requirements of the safe harbor method as provided under section 59(k)(3)(A) for the current tax year? See instructions	☐	☐
	If "No," complete and attach Form 4626. If "Yes," the corporation is not required to file Form 4626.		
30	Is the corporation required to file Form 7208 relating to the excise tax on repurchase of corporate stock (see instructions):		
30a	Under the rules for stock repurchased by a covered corporation (or stock acquired by its specified affiliate)?	☐	☐
30b	Under the applicable foreign corporation rules?	☐	☐
30c	Under the covered surrogate foreign corporation rules?	☐	☐
	If "Yes" to either question 30a, 30b, or 30c, complete Form 7208, Excise Tax on Repurchase of Corporate Stock. See the Instructions for Form 7208.		
31	Is this a consolidated return with gross receipts or sales of $1 billion or more and a subchapter K basis adjustment, as described in the instructions, of $10 million or more?	☐	☐
	If "Yes," attach a statement. See instructions.		
32	Reserved for future use		

Form **1120** (2026)

FIGURE 1.6 ***(Continued)***

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Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
	Assets	**(a)**	**(b)**	**(c)**	**(d)**
1	Cash				
2a	Trade notes and accounts receivable				
2b	Less allowance for bad debts	( )		( )	
3	Inventories				
4	U.S. Government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets				
10b	Less accumulated depreciation	( )		( )	
11a	Depletable assets				
11b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
13b	Less accumulated amortization	( )		( )	
14	Other assets (attach statement)				
15	Total assets				
	Liabilities and Shareholders' Equity				
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock: **a** Preferred stock				
	b Common stock				
23	Additional paid-in capital				
24	Retained earnings—appropriated (attach statement)				
25	Retained earnings—unappropriated				
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		( )		( )
28	Total liabilities and shareholders' equity				

Form **1120** (2026)

FIGURE 1.6 ***(Continued)***

Form 1120 (2026) Page 8

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: The corporation may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest	
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):				
			8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		8a	Depreciation	
5a	Depreciation		8b	Charitable contributions	
5b	Charitable contributions				
5c	Travel and entertainment				
			9	Add lines 7 and 8	
6	Add lines 1 through 5		10	Income (page 1, line 28)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Schedule L, Line 25)

1	Balance at beginning of year		5	Distributions: **5a** Cash	
2	Net income (loss) per books			**5b** Stock	
3	Other increases (itemize):			**5c** Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	
4	Add lines 1, 2, and 3		8	Balance at end of year (line 4 less line 7)	

Form **1120** (2026)

FIGURE 1.6 *(Continued)*

Benefit Corporations

As of March 2026, more than 3 dozen states and the District of Columbia permit benefit corporations in their jurisdictions, and others are considering it. Benefit corporations are for for-profit companies committed to having a positive impact on employees, the environment, the community, and society; officers and directors must consider these stakeholders in their business decisions. Companies incorporate as benefit corporations, which protects officers and directors from certain investor lawsuits and tells the public that they're committed to societal benefit programs. Benefits corporations focus on the 3 P's: people, planet, and profits. The key attributes of a benefit corporation are:

- Public benefit programs conducted to create a material impact on society and the environment.
- Transparency and reporting to provide an annual review of its conduct. When no audit is required, performance is measured against a third-party standard to assess their creation of a general public benefit.
- Benefit enforcement to entitle shareholders to sue in order to hold the corporation accountable for its public purpose.

Benefit corporations do not have any special tax treatment. They may be an S corporation or a C corporation, with the tax treatment that follows these entities. There are state filing fees for becoming a benefit corporation.

Instead of "inc," "corp," or "ltd," a benefit corporation uses the designation PBC (public benefit corporation). They can be public or privately held; there's no asset or revenue limits or requirements. A well-known PBC is Kickstarter (www.kickstarter.com/blog/kickstarter-is-now-a-benefit-corporation) and others include Coursera, Eileen Fisher, and Patagonia.

B corporations. Do not confuse benefit corporations with B corporations. B corporations are corporations certified by B Lab, a non-profit organization, to show they meet standards for social and environmental performance, accountability, and transparency. The "b" stands for benefits. This certification can be used by a corporation in any state, whether or not it incorporated as a benefit corporation. The cost for B certification ranges from $500 to $50,000, depending on the business's revenue. An example of a B corporation is Hootsuite.

Social enterprises. There are also "social enterprises," which are for-profit (or non-profit) businesses using any legal structure that has a business model addressing unmet basic needs in society. More information about these businesses can be found from the Social Enterprise Alliance at https://socialenterprise.us/.

Public benefit LLCs, which are similar to benefit corporations, are discussed earlier in this chapter.

Employees

Whether or not you own any interest in a business, if you are employed by one, you still have income and business expenses. Your salary or other compensation is reported as wages on page 1 of your Form 1040 or 1040-SR.

Generally, your business expenses are not deductible. Employees cannot deduct your unreimbursed employee business expenses, other than what is noted throughout the book.

Example

You are the owner-employee of an S corporation. You drive your personal car on company business. You cannot take any deduction for this business driving on your personal return. (There is a better way to handle this expense, as explained in Chapter 9.)

Factors in Choosing Your Form of Business Organization

Throughout this chapter, the differences of how income and deductions are reported have been explained for different entities, but these tax 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, tax, financial, and many other factors come into play, including:

- Personal liability
- Access to capital
- Lack of profitability
- Fringe benefits
- Nature and number of owners
- Tax rates
- Social Security and Medicare taxes
- Restrictions on accounting periods and account methods
- Owner's payment of company expenses
- Multistate operations
- Audit chances
- Filing deadlines and extensions
- Exit strategy

Each of these factors is discussed below.

Personal Liability

If your business owes money to another party, are your personal assets—home, car, investments—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. So, if you are a shareholder in an S or C corporation or a member of an LLC, you do not have personal liability for the debts of your business.

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. SBA loans usually require the personal guarantee of any owner

with a 20% or more ownership interest in the business. 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 100% 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 U.S. Treasury. This liability is explained in Chapter 30.

Access to Capital

Most small businesses start up by using an owner's personal resources or by turning to family and friends. Some businesses need outside capital—equity and/or debt—to get started properly. A C corporation may make it easier to raise money, especially now. For example, access to equity crowdfunding, which allows businesses to raise small amounts from numerous investors, is effectively limited to C corporations (S corporations cannot have more than 100 investors; partnerships and LLCs would have difficulty in divvying up ownership among an ever-changing number of owners). Equity crowdfunding for accredited investors (net worth more than $1 million, excluding a principal residence, or income in each of the past 2 years exceeding $200,000 if single or $300,000 with a spouse) obviously works best for C corporations. There is no dollar limit on investments by accredited investors.

For non-accredited investors (those who do not qualify as accredited investors because they don't have annual income in each of the past 2 years of $200,000, or $300,000 with a spouse or a net worth of $1 million), equity crowdfunding investments are capped, the percentage of which depends on annual income. The SEC lists the 12-month investment limit at https://www.sec.gov/oiea/investor-alerts-bulletins/ib-crowdfunding/.

Lack of Profitability

All businesses hope to make money. But many sustain losses, especially in the start-up years and during tough economic times. 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. When losses are anticipated, for example, in the start-up phase, a pass-through entity generally is a preferable form of business organization. Once the business becomes profitable, the tables turn. In that situation, C corporations can offer more tax opportunities, such as a lower tax rate and fringe benefits for owners working in the business.

Companies that suffer severe losses may be forced into bankruptcy. The bankruptcy rules for corporations (C or S) are very different from the rules for other entities (see Chapter 26).

Fringe Benefits

The tax law gives employees of corporations the opportunity to enjoy special fringe benefits on a tax-free basis. They can receive within limits employer-provided group term life insurance, health insurance coverage, dependent care assistance, education assistance, adoption assistance, and more. 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% of the stock in their corporations (and are not considered employees) are 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, but only corporations make it possible to give ownership opportunities to employees. Corporations—both C and S—can offer employee stock ownership plans (ESOPs) in which employees receive ownership interests through a plan that is much like a qualified retirement plan (see Chapter 16). Certain C corporations can offer employees an income tax exclusion opportunity for stock they buy or receive as compensation. Owners holding qualified small business stock (Chapter 5) can exclude some or all of their gain on the sale of this stock. C corporations may offer incentive stock option (ISO) plans and nonqualified stock option (NSO) plans (see Chapter 7). The tax law does not bar S corporations from offering stock option plans, but because of the 100-shareholder limit (discussed earlier in this chapter), it becomes difficult to do so.

Nature and Number of Owners

With whom you go into business affects your choice of business organization. For example, foreign individuals—nonresident aliens—are not permitted to own S corporation stock directly (resident aliens are permitted to own S corporation stock). But a nonresident alien may be a potential current income beneficiary of an electing small business trust (ESBT). 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, a corporation (either C or S), or LLC. If you have more than one owner, you can set up the business in just about any way you choose, other than a sole proprietorship. S corporations cannot have more than 100 shareholders, but this number provides great leeway for small businesses.

Multiple corporations. 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 rules for multiple corporations are explained in Chapter 28. 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

If a business is highly profitable, tax rates may become a consideration in entity choice. C corporations pay a flat 21% rate on their profits. Owners of pass-through entities may pay up to a 37% tax rate on their share of profits. While there is a 20% qualified business income (QBI) deduction for owners of pass-through entities designed to lower the effective tax rate on business profits, there are various limitations that may restrict or bar the use of this write-off. For example, an accountant or attorney with taxable income in 2026 over $553,500 on a joint return or $276,750 if single cannot claim this deduction. The 20% QBI deduction is explained in Chapter 21.

But remember, even though the C corporation has a lower tax rate, there is a 2-tier tax structure with which to contend if earnings are paid out to you as dividends—tax at the corporate level and again at the shareholder level. While the so-called double taxation for C corporations is lessened by having a lower tax rate on dividends for individuals, there is still some double tax because dividends remain nondeductible at the corporate level. The rate on qualified dividends for most taxpayers is 15% (it may be zero or 20%, depending upon taxable income).

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 zero, 15%, or 20%, depending on taxable income.

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 corporations pay Social Security and Medicare taxes based on salary and taxable benefits, and the corporations pay a like amount. 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 may 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 usually don't earn any Social Security credits, while corporate owners can have salary paid to them on which Social Security credits can be generated.

The additional Medicare surtaxes on earned income and net investment income (NII) are yet another factor to consider. The 0.9% surtax on earned income applies to taxable compensation (e.g., wages, bonuses, commissions, and taxable fringe benefits) of shareholders in S or C corporations; it also applies to net earnings from self-employment for sole proprietors, partners, and limited liability company members. The 3.8% NII tax applies to business income passed through from an entity in which the owner does not materially participate (i.e., one in which the owner is effectively a silent investor).

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.

Owner's Payment of Company Expenses

In small businesses it is common practice for owners to pay certain business expenses out of their own pockets—either as a matter of convenience or because the company is short of cash. The type of entity dictates where owners can deduct these payments.

A partner who is not reimbursed for paying partnership expenses can deduct his or her payments of these expenses as an above-the-line deduction (on a separate line on Schedule E of the partner's Form 1040 or 1040-SR, which should be marked as "UPE"), as long as the partnership agreement requires the partner to pay specified expenses personally and includes language that no reimbursement will be made.

A shareholder in a corporation (S or C) is an employee, so that unreimbursed expenses paid on behalf of the corporation cannot be deducted. Shareholders can avoid this deduction problem by having the corporation adopt an accountable plan to reimburse their out-of-pocket business expenses. An accountable plan allows the corporation to deduct the expenses, while the shareholders do not report income from the reimbursement (see Chapter 8).

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 jurisdictions 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 if there is a state income tax. 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 website, there is generally no nexus. A growing number of states are liberalizing the definition of nexus in order to get more businesses to pay state taxes so they can increase revenue; some states are moving toward "a significant economic presence," meaning taking advantage of a state's economy to produce income, as a basis for taxation. Another thorny problem is having remote workers and whether this creates nexus for state income tax purposes.

Assuming that a company does conduct multistate business, then its form of organization becomes important. Most multistate businesses are C corporations because only one corporate income tax return needs to be filed in each state where they do business. Doing business as a pass-through entity means that each owner has to file a tax return in each state the company does business. More on multistate operations is in Chapter 28.

Audit Chances

IRS audit rates for all types of businesses have been very low in recent years. The IRS has been targeting certain types of businesses, such as large partnerships, but this doesn't mean small businesses can assume they won't be audited.

As a general rule, 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. Audit statistics for the government's 2025 fiscal year are in the 2025 IRS Data Book.

Many tax experts agree that your location can impact your audit chances. Some IRS offices are better staffed than others. There have been no recent statistics identifying these high-audit locations.

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. Pass-throughs (partnerships and S corporations) reporting on a calendar year must file by March 15; they can obtain a 6-month filing extension. Calendar year C corporations don't have to file until April 15 (the same deadline for individuals, including Schedule C filers); they, too, have an extended due date of October 15. The September 15 extended due date gives S corporations, limited liability companies, and partnerships time to provide a Schedule K-1 to owners so they can file their personal returns by their extended due date of October 15. The filing deadlines and extensions may be longer for owners and businesses within federally declared disaster areas (see disaster relief at https://www.irs.gov/newsroom/tax-relief-in-disaster-situations).

Table 1.1 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. Note that these

TABLE 1.1 Filing Deadlines, Extensions, and Forms for 2026 Returns

Type of Entity	Return Due Date	Income Tax Return	Automatic Filing Extension	Form to Request Filing Extension
Sole proprietorship	April 15, 2027	Schedule C of Form 1040 or 1040-SR	October 15, 2027	Form 4868
Partnership/LLC	March 15, 2027	Form 1065	September 15, 2027	Form 7004
S corporation	March 15, 2027	Form 1120-S	September 15, 2027	Form 7004
C corporation	April 15, 2027	Form 1120	October 15, 2027	Form 7004

dates are extended to the next business day when a deadline falls on a Saturday, Sunday, or legal holiday.

Beneficial Ownership Information Reporting

The Treasury had created Beneficial Ownership Information (BOI) reporting under the Corporate Transparency Act. This reporting applied to entities created under state law, such as limited liability companies and corporations, and became effective on January 1, 2024. But reporting for domestic entities was suspended due to court action, and under a final rule issued August 11, 2026, there is no BOI reporting for domestic small businesses. What's more, the Treasury said it would delete data of such businesses that already filed. But if you are a *foreign* entity authorized under state law to do business in the U.S., you must do BOI reporting. FinCEN has reporting information at https://www.fincen.gov/boi.

Exit Strategy

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, is sold, or goes public. The liquidation of a C corporation usually 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. The built-in gains tax problem disappears a certain number of years after the S election, so termination after that time does not result in a double tax.

If you plan to sell the business sometime in the future, again your choice of entity may have an impact on the tax consequences of the sale. The sale of a sole proprietorship is viewed as a sale of the underlying assets of the business; some may produce ordinary income while others trigger capital gains. In contrast, the sale of qualified small business stock, which is stock in a C corporation, may result in tax-free treatment under certain conditions. Sales of business interests are discussed in Chapter 5.

Another exit strategy is using an Employee Stock Ownership Plan (ESOP) to have a trust—a ready marketplace for privately held stock—acquire the owner's stock; the employees who participate in the ESOP effectively become owners. Obviously, because ESOPs are based on stock, only C and S corporations can use them. ESOPs are discussed in greater detail in Chapter 32.

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).

If the business goes bankrupt, the entity type influences the type of bankruptcy filing to be used and whether the owners can escape personal liability for the debts of the business. Bankruptcy is discussed in Chapter 26.

Forms of Business Organization Compared

So far, you have read 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 1.2 summarizes 2 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 certain medical reimbursement plans, you would consider only a C corporation.

If you project that the tax rate on your business profits would be greatly reduced by becoming a C corporation, then you'd need to revoke an S election by filing a statement of revocation with the IRS or incorporate an unincorporated business. Keep in mind that if you revoke an S election, a new one cannot be made for 5 years.

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 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 gains on the liquidation. In fact, gains may have to be reported both by the business and by you as owner.

Partnerships can become corporations and elect S corporation status for their first taxable year without having any intervening short taxable year as a C corporation if corporate formation is made under a state law formless conversion statute or under the check-the-box regulations mentioned earlier in this chapter.

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 and the long-term goals of your business.

TABLE 1.2 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 (Schedule F for farming)
Partnership	No special requirements	Some items taken into account in figuring trade or business income directly on Form 1065 (allocable amount claimed on partner's Schedule E); separately stated items are 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 (one member)	Organized under state law	On owner's Schedule C (unless the member elects to be treated as a corporation and makes an election to be taxed as an S corporation
Limited liability company (2 or more members)	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 1120-S (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
Employee	No ownership interest	Income reported as wages; no deduction for unreimbursed employee business expenses
Independent contractor	No special requirements	Claimed on individual's Schedule C