LEARN TO RELAX WHEN DEALING WITH TAXES—AND MAKE MORE MONEY

TAX STRATEGIES FOR THE SMALL BUSINESS OWNER

REDUCE YOUR TAXES AND FATTEN YOUR PROFITS

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Introduction

When I was just out of college, my father gave me Charles Adams's classic book on the history of taxes, *For Good and Evil: The Impact of Taxes on the Course of Civilization*.[1] Since then, I've been fascinated with taxes and am something of a tax nerd. As one of my clients said to me, "We're glad *someone* enjoys taxes."

That's not really accurate. I like working in tax, but I don't know anyone who truly enjoys paying taxes. I suspect we would all like to pay less. Meanwhile, many Americans are facing the specter of tax increases on the federal, state, and local levels.

That's where this book comes in. This is a commonsense, practical guide to taxes for the small business owner. The goal of the book to give small business owners an understanding of what he or she needs to think about regarding taxes—from when the business is formed to when it is sold.

The book is divided into four parts. "Before the Business Opens" focuses on the types of business entities (and how they are taxed), the taxes a small business owner faces, and the start-up phase and record-keeping requirements. "Day-to-Day Expenses" looks at deductions you can take and what's required to take them. The third part, "Payroll, Payroll Taxes, and Benefit Plans," looks at paying yourself and employees, payroll taxes you must pay, retirement plans, and medical expenses (with a focus on the new Affordable Care Act). The final part, "Other Items," reviews the documentation you generally need for taxes besides the federal income tax, what to do when a tax agency contacts you, and other topics (including electronic filing, foreign issues, using a tax professional, and selling your business).

I tell my clients that tax is a combination of common sense and arcane rules. I've tried to keep the minutiae of the rules, regulations, and laws to a minimum in this text. I hope this book will set you on the course of paying the least amount of tax you legally can.

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[1] Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization (2nd Edition)*, (Toronto: Madison Books, 2001).

PART

I

Before the Business Opens

There are several different types of business entities for a small business owner to choose among, including sole proprietorships, partnerships, corporations (both C and S), and limited liability companies. This is perhaps the most critical decision a business makes, and Part I begins by exploring this important area.

Chapter 2 looks at the types of taxes a small business owner must pay, the definitions of income and expenses, and cash versus accrual accounting. The last chapter in Part 1 covers the rules of the start-up phase: that part of the business before you receive any revenue. The final part of Chapter 3 examines the recordkeeping requirements of a small business in dealing with tax agencies.

CHAPTER

1

The Business Entity

The business of America is business.

—President Calvin Coolidge

You've been in business or you're just starting out. You've picked up this book because you're wondering how to deal with taxes. You might expect the book to start by looking at taxes; however, we won't look directly at them at all in this first chapter. That's because the most important decision a business owner can make is about the structure of the business.

You may have been told, "The best structure for a business is an LLC." Perhaps your buddy told you he has an S corporation, and it works great. If you choose your business entity based on someone else's business, you may be making a major mistake. *There is no one right business structure.* Like many things in tax (and business), the correct answer to "What is the best structure for a business?" is: "It depends."

Generally, all businesses calculate their income in the same manner: Figure out the gross income, subtract all ordinary and necessary business expenses, and whatever is left is profit. Of course, this is a simplification, but the general principle holds. Why, then, is the choice of business entity so important?

- *Different tax treatments.* Though *income* is generally calculated identically across business structures, the *tax* may not be.
- *Legal consequences.* Not only will different entities be treated differently under the law, but the treatment can vary state by state.

- *Your goals*. Depending on your goals, you may be able to only use one specific type of business entity.

In this chapter we take a look the different types of business entities, the requirements for each, their pros and cons, and how they are taxed. We discuss how you can change your type of entity and conclude with how you should choose your form of business entity.

The Sole Proprietor

If you alone conduct your business without forming a separate legal entity, you are a *sole proprietor*. This is the simplest form of business entity. Any business conducted by an individual that is not another form of business entity will be a sole proprietorship.

There is no such thing as wages or salary with a sole proprietorship. You are the business, so wages would just be moving money from your left hand to your right hand.

This is by far the simplest form of business entity. It's just you conducting a business. Of course, you must truly be conducting a business and not just trying to make a hobby into a business.

Hobby Loss Test

Most of us have hobbies—activities we pursue for enjoyment, not to make money. Many individuals attempt to turn their hobbies into businesses; after all, activities we pursue for enjoyment can make the best businesses. That said, to have a business for tax purposes, you *must* be trying to make money at it. The Internal Revenue Service (IRS) is naturally skeptical of a "business" that loses money year after year. A nine-factor test is used by the IRS and the courts to determine whether an activity is being conducted as a business or a hobby:[1]

1. The manner in which the taxpayer carried on the activity;
2. The expertise of the taxpayer or his or her advisers;
3. The time and effort expended by the taxpayer in carrying on the activity;
4. The expectation that the assets used in the activity may appreciate in value;

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[1] Treasury Regulation §1.183-2(b).

5. The success of the taxpayer in carrying on other similar or dissimilar activities;
6. The taxpayer's history of income or loss with respect to the activity;
7. The amount of occasional profits, if any, which are earned;
8. The financial status of the taxpayer; and
9. Elements of personal pleasure or recreation.

The effect of these rules for a business that's considered a hobby is that gross income is taxable but the expenses might not be deductible. Most of the time you do *not* want your business to be considered a hobby.

One of the most important ways of avoiding this is to *document all of your expenses*. My mother, a realtor, says that the cliché that real estate is location, location, and location is true. Similarly, the most important thing for a business owner is to document, document, and document.

Tip **Keep good records!** I cannot overemphasize this. You will see this point recurring throughout this book because it really is that important.

Let's look at a business that is a hobby. Say you've decided to buy a lot of cosmetics, and you decide to become a distributor for a multilevel marketing (MLM) company. By becoming a distributor for an MLM that markets cosmetics, you can make a little bit of money on the side. MLMs typically pay a residual to you for every product you order (and for product ordered by others you recruit to the company). However, in this example you do not have a profit motive: Your goal is solely to purchase cosmetics for your own use. This "business" would clearly be a hobby.

I deliberately chose an MLM for this example because they have a reputation for abuse with tax agencies. That does *not* mean that you should avoid MLMs as your choice when starting a business. On the contrary, many people have done quite well with businesses that are structured as MLMs. If you honestly conduct your business with the goal of making money, you will likely be considered to be running your business for the purpose of making a profit, not as a hobby.

Sole Proprietorship: The Advantages

The main reason for choosing a sole proprietorship is its ease. The moment you "hang up your shingle," you've formed a sole proprietorship. Other than a local business license[2] and/or a fictitious business statement,[3] there are usually no other requirements to form a sole proprietorship.[4] This makes it one of the easiest businesses to create.

From a tax perspective, a sole proprietorship reports its income and expenses on a Schedule C. This is part of your personal tax return, so no separate business entity tax return is required.

A sole proprietorship is usually one of the least expensive businesses to run from an organizational standpoint. Because there are few (if any) legal filings required, legal costs are usually limited. Because there's no separate tax return required, there can be a savings on tax preparation costs.

It's also easy to close a sole proprietorship: You simply stop working in that business and don't include the Schedule C on your tax return (though you may need to cancel your business license or fictitious business statement).

Sole Proprietorship: The Disadvantages

The ease of forming a sole proprietorship is also one of its negatives. A sole proprietorship is you conducting a business. You can be held personally liable for anything that is conducted by your business.

Indeed, protection from legal liability is one of the main reasons that people form business entities. I am not an attorney, and nothing written in this book is meant as legal advice. That said, it's safe to say that most individuals do not want to be exposed to potential liability issues.

Second, a sole proprietorship is, by definition, you conducting a business by yourself. With one exception,[5] there cannot be any other owners if you file as a sole proprietorship.

Finally, according to IRS statistics, a business that files a sole proprietorship has on average five to ten times the audit risk of a corporation or a partnership.[6]

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[2] Business licenses are generally issued by cities and counties, though some states (such as Nevada) also require them.

[3] A *fictitious business statement* is required when you conduct a business in anything other than your own name. In most jurisdictions, these statements are issued by counties.

[4] A business conducted out of a home may be subject to zoning and/or homeowners association restrictions. Consult an attorney familiar with your jurisdiction and legal issues to determine whether this is a concern.

[5] A married couple living in a community property state jointly conducting a business can file their business as a sole proprietorship. The income and expenses of the business would be split onto two Schedule C's. I discuss this in the note in the next section.

[6] 2011 Internal Revenue Service Data Book: October 1, 2010, to September 30, 2011, accessed at http://www.irs.gov/pub/irs=soi/11databk.pdf, page 22.

Why is this the case? The IRS has found that tax returns for sole proprietorships tend to have more errors than do corporate or partnership returns. The IRS is a collection agency; they go where the money is. They get more bang for their buck by examining sole proprietorships than investigating other business entities (except for the largest C corporations). Audits are covered in detail in Chapter 17.

Partnerships

A *partnership* is when two or more persons conduct a trade or business. Note that I did *not* say "two or more individuals"; a partner in a partnership can be a business entity, such as a corporation or an LLC (though this is rare). A business does not have to have a written agreement to be considered a partnership. Most states do not require partnerships to register with the state; however, partnerships have the same requirements as sole proprietorships in obtaining business licenses and fictitious business statements.

Partnerships file an *information return* (Form 1065) noting their income and expenses, but they generally do not pay income tax.[7] The income and expenses from a partnership flow through to the partners' own tax returns. Thus, a partnership is a *flow-through entity*. A partnership issues Schedule K-1's noting each partner's share of the income and expenses so that these items can be reported on each partner's personal tax returns.

As in sole proprietorships, individual owners in a partnership cannot be paid wages. Instead, owners take *draws* of money from the business. Note that a draw is *not* an expense; rather, it is the movement of earnings from the partnership to the partners.

Note The married couple exception in community property states. There is one business with two owners that can, if it wishes, file a Schedule C (sole proprietorship) rather than a partnership return: a business operated by a married couple in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin; Alaska and Puerto Rico allow for community property but it is not the default status). Such a business can file a partnership return (Form 1065) or two Schedule C's on their individual return (Form 1040). If the owners choose to file Schedule C's, the income and expenses would be split equally on the two Schedule C's. The pros and cons of this should be carefully considered before choosing a filing method. Be aware that community property law is *not* identical in each community property state.

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[7] A few jurisdictions, such as Illinois, do charge tax on partnerships. Illinois calls its tax the "Partnership Replacement Tax."

Partnerships: The Advantages

The positives of a partnership are similar to those of a sole proprietorship. If two individuals go into business together, they have formed a partnership. I recommend that a business partnership create a written partnership agreement; it will make things far easier if the partnership should dissolve.

First, a partnership is easy to form. Although you *should* have a written partnership agreement (ideally, reviewed by an attorney), you don't have to. Two individuals who go into business together absent some other form of business entity will have a partnership.

A partnership is usually easy to dissolve. The partners simply dissolve (close) the entity.

Partnerships have a low audit risk. In fiscal year 2011, only 0.4% of partnership returns were examined by the IRS.[8] Compare that to 3.6% of sole proprietorship returns with income of $200,000 to under $1 million and you can see why you might prefer a partnership return to a Schedule C.

Finally, a partnership is a flow-through entity. The partnership itself generally does not pay tax; rather, each partner pays tax based on his or her share of the income. Thus, a partner pays tax on the partnership income based on his or her marginal tax rate.

Partnerships: The Disadvantages

The ease of forming a partnership can also be a negative. When a partnership splits, it can be messy—especially if there was not a written partnership agreement.

There are other potential legal issues. A partnership does not give a business liability protection. Additionally, each partner can be held personally liable for another partner's actions.

A business entity that is similar to a partnership—a limited liability company (LLC)—gives liability protection while usually allowing for a partnership tax return. However, an LLC does require an operating agreement; the operating agreement should be prepared by an attorney. I discuss LLCs in more depth in the "LLCs" section of this chapter.

[8] 2011 Internal Revenue Service Data Book, page 22.

Corporations

Corporations are separate legal entities that have their own rights, privileges, and liabilities distinct from those of their owners. Most corporations are creatures of state laws. A corporation has its own life; it has rights and responsibilities just like you and me. Most corporations issue stock, have a board of directors, and have limited liability. In general, a stockholder will not be liable for the actions of a corporation *assuming the corporation is properly run.* If you own the stock of a publicly traded entity, it's probably a corporation.[9]

For tax purposes, all corporations start as *C corporations.* The other type of corporation is an *S corporation.* A C corporation files a *tax election* to become an S corporation. From a legal perspective, generally all corporations have the same legal rights as any other corporation in that state (irrespective of their C or S status).

One of the major advantages of a corporation is the separation of legal liability. A properly structured corporation has its own legal liability. This doesn't mean that owners and officers of a corporation cannot be sued, nor does it mean there aren't circumstances in which they can be held liable for a corporation's actions—these circumstances definitely exist. That said, *generally* a corporation is treated separately from the owners of the corporation.

There are disadvantages to corporations, too. Because a corporation is a separate legal entity, it files its own tax return. The corporation will need to have annual stockholders and board of directors meetings. You have to document and keep the minutes of these meetings. There will be filings with the agency in your state that handles corporations. This involves additional work (though your attorney may be willing, for a fee, to handle the additional work).

Though C and S corporations start the same, there are significant differences in these entities. C corporations are thought to be the province of large entities, but they can be right for some small businesses. On the other hand, many small businesses choose to become S corporations.

C Corporations

As noted earlier, all corporations start as C corporations. If you own the stock of a public corporation, you own the stock of a C corporation. Though most small business owners rarely think of using a C corporation form for their business, it could be the right choice for you. Although there are some disadvantages of a C corporation, there are several advantages. These include

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[9] There are a few publicly traded partnerships.

a low tax rate on the first $75,000 of income, advantages for health insurance and other fringe benefits, ability to use a *fiscal year* (a business year that ends other than on December 31), and some other tax benefits. There are some significant disadvantages, too: double taxation, high tax rates on income above $75,000, and certain other negative quirks.

C Corporations: The Advantages

Low Tax Rate on First $75,000 of Income. A C corporation, unlike a partnership or an S corporation, pays its own taxes; it files a Form 1120 each year. C corporations have a deserved reputation for high tax rates; income above $75,000 a year is taxed at a *minimum* rate of 34% for federal income tax. However, the marginal tax rate for a C corporation on its first $50,000 of income is just 15%; the next $25,000 is taxed at just 25%.[10] If a business is expected to remain small (or marginally profitable) a C corporation could be a wise choice.

Health Insurance and Fringe Benefits. C corporations are among the most flexible structures for a business entity. Besides the ability to have multiple classes of stock, there are some tax rules that benefit C corporation owners. Under §105(b) of the Tax Code, a self-insured medical reimbursement plan is allowed. This can cover owners' medical expenses that are not reimbursed by medical insurance, and it may allow for coverage of some over-the-counter medications.[11] If most of the employees of the corporation are owners, this can be a significant advantage.

Use of a Fiscal Year. Most business entities are required to use a calendar year; that is, the business year ends on December 31.[12] A C corporation can use a fiscal year—a business year that ends at the end of a month other than December (for instance, a fiscal year might run June 1 to May 31).

This gives the owner some ability to control when he or she receives salary and when expenses are taken. Also, tax professionals love businesses that have a fiscal year: Their tax returns will be due outside of the busy season.

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[10] These figures based on 2012 tax rates.

[11] Everything related to medical care, medical insurance, and reimbursements therein is subject to change based on the Affordable Care Act. While the Act was recently held to be constitutionally valid by the Supreme Court, challenges to specific provisions are certain. Additionally, many Republicans vow to repeal the measure at their first opportunity. Thus, anything written concerning health insurance and medical expenses *while accurate as of the date of writing* could be inaccurate as you read this book.

[12] Other business entities can make a §444 election to use a fiscal year; however, this is rarely of value to the business.

Other Tax Advantages. There are some other tax advantages of a C corporation. Under Tax Code §1202, if the stock of the business qualifies as "small business stock,"[13] then 50% of the gain from sale of shares can be excluded from income and the other 50% is taxed at 28% (an effective 14% tax rate). Some states recognize this exclusion, and this can cut state capital gains taxes in half. Under §1244, a deduction of $50,000 ($100,000 if married filing jointly) is available as an ordinary loss if the corporation fails. This potentially allows the owners to plan for the failure in a year when this can offset other income the owners have. Finally, if you plan on taking your business "public" (selling stock to the general public), you must be a C corporation.

C Corporations: The Disadvantages

There is no perfect business entity type, and C corporations definitely have their tax disadvantages. These include the ability to move money to the owners, double taxation, and generally high tax rates.

Moving Money to the Owners. There are generally only two methods available to move money to owners of C corporations: salaries and dividends. Using wages means that you pay payroll taxes; dividends will cause double taxation (see the next paragraph). Although other methods can be devised, the movement of money from the business to the owners is always an issue with a C corporations.

Double Taxation. Taxes are bad enough the first time around. They're even worse when you have to take after-tax money (with regard to the business) to send to yourself (the owner) and then pay taxes on that! But that's what a dividend is: An after-tax distribution of funds from the business that's then taxed again on your personal return. Additionally, assets of the business can end up being double-taxed when the business is sold or dissolves.

High Tax Rates. Although C corporations have relatively low income tax rates on income of $75,000 or less, that's not the case when income rises above that. The *minimum* tax rate on income above $75,000 is 34%.

Is a C Corporation Right for You?

A C corporation can be the right business structure for a small business. That said, if you choose this structure, make sure you are fully aware of all of the advantages and disadvantages.

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[13] Among the requirements: The stock must be held for at least five years, at least 80% of the assets of the entity must be used in a trade or business, and the business cannot be a personal service provider.

S Corporations

Most corporations elect to become S corporations. The "S" refers to the Subchapter S of Chapter 1 of the Internal Revenue Code (the Tax Code). There are some technical rules for S corporations that you *must* follow. First, all shareholders must be either US citizens or resident aliens. There can be a maximum of only 100 shareholders (spouses are automatically treated as a single shareholder; other family members can be treated as a single shareholder if any family member elects such treatment). Shareholders generally must be people, though some trusts, estates, and tax-exempt corporations qualify as shareholders.

A corporation elects S corporation status by filing Form 2553 with the IRS. This form must be filed by the fifteenth day of the third month of the tax year for which the election is to be effective. Although there is a procedure available to make a late S election, it is far easier to do it correctly the first time. Note that some states (such as New Jersey and New York) require a *separate* election to be made for state tax purposes.

Caution What happens if your S corporation suddenly doesn't qualify? Suppose a shareholder of your S corporation gives a share of the corporation to a nonresident alien. You will suddenly have made a "deemed election" to lose your S corporation status and will become a C corporation. If you choose to be an S corporation, make sure your stock cannot go where it would disqualify you from being an S corporation.

S Corporations: The Advantages

A C corporation pays its own taxes. Although an S corporation does have to file a tax return (Form 1120S is used for federal taxes), it *generally does not pay any tax.*[14] Instead, S corporations are flow-through entities: The profits and losses flow through to the owners' tax returns.

While S corporation officers must take a "reasonable salary," distributions can be made that are not subject to payroll taxes. This eliminates the double taxation issue of dividends that impacts C corporations.

[14] The most common exception is if the business converted from a C corporation and is subject to the Built-In Gains Tax. See the discussion on converting business types later in this chapter. Additionally, California taxes S corporations at 1.5%, and New York City does *not* recognize S corporations for their business tax (S corporations are treated the same as C corporations).

S Corporations: The Disadvantages

S corporations are corporations, a formal business entity. That means that you must have your annual shareholders and board of directors meetings (and keep minutes of those meetings). There are some other tax issues that negatively impact S corporations.

Required Salary. As mentioned, any corporate officer of an S corporation must be paid a reasonable salary. This has become a point of emphasis with the IRS in examinations (audits) of S corporations and their owners. What is reasonable can be debated, but clearly a salary of $0 for a profitable entity is *not* reasonable. A rule of thumb is that you should take as salary that is at least half the net income of the business, or the current FICA wage base,[15] whichever is less. This is discussed in depth in Chapter 12.

Health Insurance. Although health insurance premiums are deductible for the self-employed, S corporation owners[16] *cannot* take full advantage of this deduction. The rules are not straightforward and are the result of how Congress has made the Tax Code overly complex.

The deduction is taken *not* on the S corporation tax return; rather, it's taken on the owner's tax return (Form 1040). To take the deduction, you must include the premiums as part of your taxable income (wages) in Box 1 of your W-2. However, these "wages" are *not* included for FICA or Medicare tax. You then can take the deduction on your Form 1040. The premiums must be paid for by the employee, but can be reimbursed by the corporation.

Documentation of Loan Basis. Loans add basis to an S corporation. (I look at the reasons you want basis in Chapter 18.) Let's say you personally lend money to your S corporation. Make sure you document the loan (have a written loan agreement), the loan repays with interest,[17] and that the terms of the loan are followed. The Tax Court has disallowed loans that are not documented with signed agreements.

LLCs

One of the newest forms of business entity is the *limited liability company* (LLC). An LLC is a more informal entity than a corporation. For example, no

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[15] The FICA (Federal Insurance Contributions Act, or Social Security payroll tax) wage base for 2012 is $110,100.

[16] Defined as someone who owns at least 2% of the stock of an S corporation.

[17] Each month, the IRS publishes the minimum required loan rates, or Applicable Federal Rates (AFRs). These are published as Revenue Rulings and can be downloaded from the IRS website at http://www.irs.gov/app/piclist/list/federalRates.html.

annual meeting of owners or officers is required. A properly formed LLC offers liability protection (similar to corporations).

The key for an LLC is its operating agreement. Though it's relatively easy to change a corporation's bylaws, it is more difficult to change an LLC's operating agreement. This means that if you form an LLC, you should carefully consider having your operating agreement professionally prepared (by an attorney).

The tax treatment for an LLC depends on its number of owners. The owners of an LLC are considered to be its *members*. A single-member LLC is generally a *disregarded entity* for tax purposes. Because the entity is ignored on the tax return, a single-member LLC files a Schedule C (just like a sole proprietorship).

LLCs with more than one member are generally considered partnerships for tax filing and will file a Partnership Return of Income (Form 1065). That makes multiple-member LLCs flow-through entities (like partnerships and S corporations).

However, LLCs can elect a different tax status. An LLC can elect to be taxed as a C corporation or an S corporation. This gives this business structure tremendous flexibility.

LLCs, like corporations, are creatures of state law. Corporate law is similar in most states, but the laws dealing with LLCs vary considerably. For example, many professionals cannot form LLCs in California. You should consult with a local attorney familiar with business formations to make sure that your LLC is legal in your local jurisdiction.

Be aware that state tax treatment of LLCs is *not* identical. Although most states will consider a single-member LLC a disregarded entity (and, thus, there is no separate tax filing), California does not. All LLCs in California must pay an $800 a year minimum franchise tax. California also has a gross receipts tax on LLCs.

The tax advantages and disadvantages of LLCs depend on how they are taxed. A disregarded LLC will have the same issues as a sole proprietorship (see "Sole Proprietorships: The Disadvantages" section); a multiple-member LLC will have the same issues as a partnership (see "Partnerships: The Disadvantages"). LLCs electing C corporation status or S corporation status will have the same issues as those entities (see the respective "Disadvantages" sections). The one special advantage that LLCs will have over sole proprietorships and partnerships is that they offer liability protection, whereas sole proprietorships and partnerships do not.

It's easy to see why LLCs have become very popular. This structure combines liability protection with the ease of a sole proprietorship and a partnership.

Other Business Entities

The types of entities noted here are the most common, but the limited liability partnership and the professional service corporation are also options.

Limited Liability Partnership

The *limited liability partnership* (LLP) is a hybrid entity between a partnership and an LLC. It offers the liability protection of an LLC with the tax filing of a partnership. Generally, only individuals in professions who cannot form LLCs will consider an LLP. These are usually professionals who are prohibited by state laws or other rules from forming LLCs.

Professional Service Corporation

A *professional service corporation* (PSC) is a special kind of C corporation. Under the Tax Code, professionals such as accountants, architects, or attorneys who form C corporations are considered to have formed a PSC. PSCs are taxed at a flat rate of 35%. Thus, a PSC loses one of the tax advantages of a C corporation (the relatively low tax rate on income of less than $75,000).

PSCs are generally used only by professionals who must have a C corporation because of benefits such as health insurance or retirement planning or are forced into this entity because of legal reasons. Most PSCs try to zero out their income each year: Usually it is less expensive to pay the owners' wages (and the associated taxes) than to pay the 35% income tax rate (plus state income tax).

Moving from One Entity Type to Another

Sometimes you form a business entity and you want or need to change it. In some cases, you can move from one kind of entity to another.

You can almost always move from a sole proprietorship to any other form of business entity. The sole proprietorship is not a separate entity, so if you move from one to, say, an S corporation, it would be like forming the S corporation from scratch. Note that for tax reporting purposes, you would use the date the new entity formed as the date you stopped reporting income on a Schedule C and began reporting it as an S corporation.

Similarly, you can almost always move from a partnership to any other form of business entity (you would become a sole proprietorship if there were only one partner remaining in the business). A partnership is a group of individuals acting as a business. Again, you would be forming a new business.

You can move from being an S corporation to a C corporation or vice versa. (Note that if you become an S corporation you must legally qualify as an S corporation; see "S Corporations" section for the requirements.) However, there can be tax consequences to doing so.

If you convert a C corporation to an S corporation, there are three major taxes that might be faced. First, there is the Built-in Gains Tax on any assets that have appreciated (above what they are shown on the books for) that are disposed of within ten years of the S corporation election. Second, any C corporation that used *LIFO inventory* must pay a tax on the benefits under LIFO.[18] (This tax can be paid over four years.) Third, S corporations that have converted from C corporations must pay a tax if their *passive investment income* (i.e., dividends, interest, rents, and capital gains) exceeds 25% of their gross receipts *and* they have accumulated earnings and profits from the time they were a C corporation. One additional factor is that any net operating losses from the time a business was a C corporation do *not* carry forward to the S corporation.

It is much easier to move from an S corporation to a C corporation. Sometimes this will be forced on you if you no longer meet the S corporation qualifications. Note that if you convert from an S corporation to a C corporation you cannot convert back to an S corporation for five years (unless the IRS approves the reconversion, something that almost never happens).

Although you can convert from being a corporation (both an S and a C) to any other form of entity (such as an LLC), there will be significant tax consequences. The corporation will dissolve for federal tax purposes; thus, the owners of the corporation may have a large capital gains tax to pay.

Finally, it's rare to convert an LLC to another form of entity because the LLC can elect to be taxed like a C corporation or an S corporation. An already existing LLC files Form 8832 to be taxed as a C corporation or Form 2553 to be taxed as an S corporation. Note that these forms have date deadlines if the entity wishes to be taxed as a corporation for the entire year.

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[18] LIFO stands for Last In, First Out. Under this method of inventory, items purchased most recently are considered sold first rather than the oldest items. LIFO is discussed in detail in Chapter 5.

In all cases where you are considering converting your business entity, make sure you discuss your options with a tax professional and an attorney so that you understand all the rules and consequences prior to making the conversion.

Which Entity Is Right for You?

There is no one right entity for every kind of business. You have to weigh the tax issues, legal issues, and your goals to determine which form you should choose.

First, determine your goals. Let's say you've started a high-tech business that you want to take public in a few years; you would likely want to be a C corporation. Perhaps you are an architect in California, just starting out in your own business. In most states an LLC would be a good choice of entity, but you can't choose that in California. You might decide to form an S corporation. The decision will always be different depending on *your* situation.

Once you've set your goals, you should discuss them with a tax professional and an attorney familiar with business entity formation in your jurisdiction. They should be able to help you decide which kind of entity is right for your situation.

Tip Do not form a business entity before discussing it with a tax professional and an attorney.

Table 1-1 lists the different kinds of business entities and their strengths and weaknesses.

Table 1-1. Business Entity Types and Their Strengths and Weaknesses

	Sole Prop.	Partnership	S Corp.	C Corp.	LLC
Easy to form?	Yes	Yes	More difficult	More difficult	More difficult
Liability protection	No	No	Yes	Yes	Yes
Flow-through entity?	No*[a]	Yes	Yes	No	If taxed as partnership
Reasonable salary required?	No salary	No salary for partners	Yes	No	If taxed as S corp