J.K. LASSER'S™

SMALL BUSINESS TAXES

Your Complete Guide to a Better Bottom Line

2006 Edition

Barbara Weltman

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SMALL BUSINESS TAXES

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This book is dedicated with love to my understanding husband, Malcolm Katt.

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Preface

According to the Internal Revenue Service (IRS), about 80 percent of small businesses use paid professionals to handle their tax returns. So why do you need to read up on taxes? The answer is simple: You, and not your accountant or other financial adviser, run the business, so you can't rely on someone else to make decisions critical to your activities. You need to be informed about tax-saving opportunities that continually arise so you can strategically plan to take advantage of them. Being knowledgeable about tax matters also saves you money; the more you know, the better able you are to ask your accountant key tax and financial questions that can advance your business, as well as to meet your tax responsibilities.

This is a great time to be a small business. Not only is small business the major force in our economy but it also is the benefactor of new tax rules that make it easier to write off expenses and minimize the taxes you owe. This is the eighth edition of this book, and it has been revised to include all of the new rules taking effect for 2005 returns. It also provides information about future changes scheduled to take effect in order to give you an overall view of business tax planning. Most importantly, it addresses the many tax questions I have received from readers as well as visitors to my web site, <www.barbaraweltman.com>.

This book focuses primarily on federal income taxes. But businesses may be required to pay and report many other taxes, including state income taxes, employment taxes, sales and use taxes, and excise taxes. Some information about these taxes is included in this book to alert you to your possible obligations so that you can then obtain further assistance if necessary.

It is important to stay alert to future changes. Pending or possible changes are noted in this book. Be sure to check on any final action before you complete your tax return or take any steps that could be affected by these changes. Changes can be found at my web site.

For a free update on tax developments affecting small businesses and a free download of the Supplement to this book (available February 1, 2006), go to <www.jklasser.com>.

How to Use This Book

The purpose of this book is to make you acutely aware of how your actions in business can affect your bottom line from a tax perspective. The way you organize your business, the accounting method you select, and the types of payments you make all have an impact on when you report income and the extent to which you can take deductions. This book is not designed to make you a tax expert. It is strongly suggested that you consult with a tax adviser before making certain important decisions that will affect your ability to claim tax deductions. I hope that the insight you gain from this book will allow you to ask your adviser key questions to benefit your business.

In Part 1, you will find topics of interest to all businesses. First, there is an overview of the various forms of business organization and an explanation of how these forms of organization affect reporting of income and claiming tax deductions. The most common forms of business organization include independent contractors, sole proprietors, and sole practitioners—individuals who work for themselves and do not have any partners. If self-employed individuals join with others to form a business, they become partners in a partnership. Sometimes businesses incorporate. A business can be incorporated with only one owner or with many owners. A corporation can be a regular corporation (*C corporation*), or it can be a small business corporation (*S corporation*). The difference between the C and S corporations is the way in which income of the business is taxed to the owner (which is explained in detail in Part 1). There is also a relatively new form of business organization called a *limited liability company* (LLC). Limited liability companies with two or more owners generally are taxed like partnerships even though their owners enjoy protection from personal liability. The important thing to note is that each form of business organization will affect what deductions can be claimed and where to claim them. Part 1 also explains tax years and accounting methods that businesses can select.

Part 1 contains another topic of general interest to all businesses. It covers important recordkeeping requirements and suggestions to help you audit-proof your return and protect your deductions and tax credits. In the course of business you may incur certain expenses, but unless you have specific proof of those expenses, you may not be able to claim a deduction or credit. Learn how to keep the necessary records to back up your write-offs in the event your return is questioned by the IRS.

Part 2 details how to report various types of income your business may receive. In addition to fees and sales receipts—the bread-and-butter of your business—you may receive other types of ordinary income such as interest income, dividends, and rents. You may have capital gain transactions as well as sales of business assets. But you may also have losses—from operations or the sale of assets. Special rules govern the tax treatment of these losses. The first part of each chapter discusses the types of income to report and special rules that affect them. Then scan the second part of each chapter, which explains where on the tax return to report the income or claim the loss.

Part 3 focuses on specific deductions. It will provide you with guidance on the various types of deductions you can use to reduce your business income. Each type of deduction is explained in detail. Related tax credits are also explained in each deduction chapter. In the first part of each chapter, you will learn what the deduction is all about and any dollar limits or other special requirements that may apply. As with the income chapters, the second part of each deduction chapter explains where on the tax return you can claim the write-off. The answer depends on your form of business organization. You simply look for your form of business organization to learn where on the return to claim the deduction. The portion of the appropriate tax form or schedule is highlighted in certain instances. For your convenience, key tax forms for claiming these deductions have been included. While the forms and schedules are designed for the 2005 returns, they serve as an example for future years. Also, in Chapter 22, Miscellaneous Business Deductions, you will find checklists that serve as handy reference guides on all business deductions. The checklists are organized according to your status: self-employed, employee, or small corporation. You will also find a checklist of deductions that have not been allowed.

Part 4 contains planning ideas for your business. You will learn about strategies for deferring income, boosting deductions, starting up or winding down a business, and avoiding audits. It also highlights the most common mistakes that business owners make in their returns when claiming deductions. This information will help you avoid making the same mistakes and losing out on tax-saving opportunities. You will also find helpful information about electronic filing of business tax forms and how to use the Internet for tax assistance and planning purposes. And you will find information about other taxes on your business, including state income taxes, employment taxes, sales and use taxes, and excise taxes.

In the Appendix, you will see a listing of information returns you may be required to file with the IRS or other government agencies in conjunction with your tax obligations. These returns enable the federal government to cross-check tax reporting and other financial information.

Several forms and excerpts from forms have been included throughout the book to illustrate reporting rules. These forms are not to be used to file your return. (In many cases, the appropriate forms were not available when this book was published, and older or draft versions of the forms were included.) You can obtain the forms you need from the IRS's web site at <www.irs.gov> or where otherwise indicated.

Another way to stay abreast of tax and other small business developments that can affect your business throughout the year is by subscribing to *Barbara Weltman's Big Ideas for Small Business*®, a newsletter geared for small business owners and their professional advisers at <www.barbaraweltman.com>.

I would like to thank Sidney Kess, Esq. and CPA, for his valuable suggestions in the preparation of the original tax deduction book; Donna LeValley, Esq., for reviewing the new materials; and Elliott Eiss, Esq., for his expertise and constant assistance with this and other projects.

Barbara Weltman
September 2005

Introduction

Small businesses are big news today. They employ 51 percent of the country's private sector workforce, produce 51 percent of private sector output, and now contribute more than half of the nation's gross national product. Small businesses create 75 percent of all new jobs.

Small businesses fall under the purview of the Internal Revenue Service's (IRS) Small Business and Self-Employed Division (SB/SE). This division handles businesses with assets under $10 million and services approximately 45 million tax filers, more than 33 million of whom are full-time or partially self-employed. The SB/SE division accounts for about 40 percent of the total federal tax revenues collected. Headquartered in New Carrolton, MD, the SB/SE has service centers in Brookhaven, New York; Cincinnati, Ohio; Memphis, Tennessee; Ogden, Utah; and Philadelphia, Pennsylvania. The goal of this IRS division is customer assistance to help small businesses comply with the tax laws.

Toward this end, the Small Business Administration (SBA) has teamed up with the IRS to provide small business owners with help on tax issues. A special CD-ROM called *Small Business Resource Guide 2005: What You Need to Know About Taxes and Other Products,* is available free of charge through the IRS web site <www.irs.gov> and IRS tax experts now participate in SBA Business Information Centers where tax forms and publications are also available.

There is also an IRS web site devoted exclusively to small business and self-employed persons <www.irs.gov/business/small/index.htm>. Here you will find special information for your industry—agriculture, automotive, child care, construction, entertainment, gaming, gas retailers, manufacturing, real estate, restaurants, and even tax professionals are already covered, and additional industries are set to follow. You can see the hot tax issues for your industry, find special audit guides that explain what the IRS looks for in your industry when examining returns, and links to other tax information.

As a small business owner, you work, try to grow your business, and hope to make a profit. What you can keep from that profit depends in part on the income tax you pay. The income tax applies to your net income rather than to your gross income or gross receipts. You are not taxed on all the income you bring in by way of sales, fees, commissions, or other payments. Instead, you are essentially taxed on what you keep after paying off the expenses of providing the services or making the sales that are the crux of your business. Deductions for these expenses operate to fix the amount of income that will be subject to tax. So deductions, in effect, help to determine the tax you pay and the profits you keep. And tax credits, the number of which has been expanded in recent years, can offset your tax to reduce the amount you ultimately pay.

Special Rules for Small Businesses

Sometimes it pays to be small. The tax laws contain a number of special rules exclusively for small businesses. But what is a small business? The Small Business Administration (SBA) usually defines small business by the number of employees—size standards range from 50 employees to 1,500 employees, depending on the industry or the SBA program (these new size standards are currently under review). For tax purposes, however, the answer varies from rule to rule, as explained throughout the book. Sometimes it depends on your revenues and sometimes on the number of employees. In Table I.1 are various definitions from the Internal Revenue Code on what constitutes a small business.

Reporting Income

While taxes are figured on your bottom line—your income less certain expenses—you still must report your income on your tax return. Generally all of the income your business receives is taxable unless there is a specific tax rule that allows you to exclude the income permanently or defer it to a future time.

When you report income depends on your method of accounting. *How* and *where* you report income depends on the nature of the income and your type of business organization. Over the next several years, the declining tax rates for owners of pass-through entities—sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations—requires greater sensitivity to the timing of business income as these rates decline.

TABLE I.1 Examples of Tax Definitions of Small Business

Tax Rule	Definition
Accrual method exception for small inventory-based businesses (Chapter 2)	Average annual gross receipts of no more than $10 million in the three prior years (or number of years in business if less)
Bad debts deducted on the nonaccrual-experience method (Chapter 11)	Average annual gross receipts for the three prior years of no more than $5 million
Corporate alternative minimum tax (AMT) exemption for small C corporations (Chapter 22)	Average annual gross receipts of no more than $1 million for a three-year period
Disabled access credit (Chapter 10)	Gross receipts of no more than $1 million in the preceding year or no more than 30 full-time employees
Electronic deposits of federal employment taxes (Chapter 7)	Aggregate tax liability exceeding $200,000 in the year before the prior year
First-year expensing election (Chapter 14)	Equipment purchases for 2005 of no more than $525,000
Independent contractor versus employee determination—shifting burden of proof to IRS (Chapter 7)	Net worth of business does not exceed $7 million
Late filing penalty cap (Appendix)	Average annual gross receipts of no more than $5 million for a three-year period
Reasonable compensation—shifting the burden of proof to the IRS (Chapter 7)	Net worth of business not in excess of $7 million
Retirement plan start-up credit (Chapter 16)	No more than 100 employees with compensation over $5,000 in the preceding year
Savings Incentive Match Plans for Employees (SIMPLE) plans (Chapter 16)	Self-employed or businesses with 100 or fewer employees who received at least $5,000 in compensation in the preceding year
Small business stock—deferral or exclusion of gain on sale (Chapter 5)	Gross assets of no more than $50 million when the stock is issued and immediately after
UNICAP small reseller exception (Chapter 2)	Average annual gross receipts of no more than $10 million for a three-year period
UNICAP simplified dollar value last-in, first-out (LIFO) method (Chapter 2)	Average annual gross receipts of no more than $5 million for a three-year period

Claiming Deductions

You pay tax only on your profits, not on what you take in (gross receipts). In order to arrive at your profits, you are allowed to subtract certain expenses from your income. These expenses are called "deductions."

The law says what you can and cannot deduct (see below). Within this framework, the nature and amount of the deductions you have often vary with the size of your business, the industry you are in, where you are based in the country, and other factors. The most common deductions for businesses include car and truck expenses, utilities, supplies, legal and professional services, insurance, depreciation, taxes, meals and entertainment, advertising, repairs, travel, rent for business property and equipment, and in some cases, a home office.

Are your deductions typical? The General Accounting Office has compiled statistics on deductions claimed by sole proprietors for 2001. These numbers show the dollars spent on various types of deductions, the percentage of sole proprietors who claimed the deductions, and what percentage of total deductions each expense represented. For example, 25 percent of sole proprietors with business gross receipts under $25,000 claimed a deduction for advertising costs. This percentage rose to 65 percent when gross receipts exceeded $100,000. You can view these statistics at <www.gao.gov/new.items/d04304.pdf>.

What Is the Legal Authority for Claiming Deductions?

Deductions are a legal way to reduce the amount of your business income subject to tax. But there is no constitutional right to tax deductions. Instead, deductions are a matter of legislative grace; if Congress chooses to allow a particular deduction, so be it. Therefore, deductions are carefully spelled out in the Internal Revenue Code (the Code).

The language of the Code in many instances is rather general. It may describe a category of deductions without getting into specifics. For example, the Code contains a general deduction for all *ordinary and necessary* business expenses, without explaining what constitutes these expenses. Over the years, the IRS and the courts have worked to flesh out what business expenses are ordinary and necessary. Often the IRS and the courts reach different conclusions, leaving the taxpayer in a somewhat difficult position. If the taxpayer uses a more favorable court position to claim a deduction, the IRS may very well attack the deduction in the event that the return is examined. This puts the taxpayer in the position of having to incur legal expenses to bring the matter to court. On the other hand, if the taxpayer simply follows the IRS approach, a good opportunity to reduce business income by means of a deduction will have been missed. Throughout this book, whenever unresolved questions remain about a particular deduction, both sides have been explained. The choice is up to you and your tax adviser.

Sometimes the Code is very specific about a deduction, such as an employer's right to deduct employment taxes. Still, even where the Code is specific and there is less need for clarification, disputes about applicability or terminology may still arise. Again, the IRS and the courts may differ on the proper conclusion. It will remain for you and your tax adviser to review the different authorities for the positions stated and to reach your own conclusions based on the strength of the different positions and the amount of tax savings at stake.

A word about authorities for the deductions discussed in this book: There are a number of sources for these write-offs in addition to the Internal Revenue Code. These sources include court decisions from the U.S. Tax Court, the U.S. district courts and courts of appeal, the U.S. Court of Federal Claims, and the U.S. Supreme Court. There are also regulations issued by the Treasury Department to explain sections of the Internal Revenue Code. The IRS issues a number of pronouncements, including Revenue Rulings, Revenue Procedures, Notices, Announcements, and News Releases. The department also issues private letter rulings, determination letters, field service advice, and technical advice memoranda. While these private types of pronouncements cannot be cited as authority by a taxpayer other than the one for whom the pronouncement was made, they are important nonetheless. They serve as an indication of IRS thinking on a particular topic, and it is often the case that private letter rulings on topics of general interest later get restated in revenue rulings.

What Is a Tax Deduction Worth to You?

The answer depends on your tax bracket. The tax bracket is dependent on the way you organize your business. If you are self-employed and in the top tax bracket of 35 percent in 2005, then each dollar of deduction will save you 35 cents. Had you not claimed this deduction, you would have had to pay 35 cents of tax on that dollar of income that was offset by the deduction. If you have a personal service corporation, a special type of corporation for most professionals, the corporation pays tax at a flat rate of 35 percent. This means that the corporation is in the 35-percent tax bracket. Thus, each deduction claimed saves 35 cents of tax on the corporation's income. Deductions are even more valuable if your business is in a state that imposes income tax. The impact of state income tax and special rules for state income taxes are not discussed in this book. However, you should explore the tax rules in your state and ascertain their impact on your business income.

When Do You Claim Deductions?

Like the timing of income, the timing of deductions—when to claim them—is determined by your tax year and method of accounting. Your form of business organization affects your choice of tax year and your accounting method.

Even when expenses are deductible, there may be limits on the timing of those deductions. Most common expenses are currently deductible in full. However, some expenses must be capitalized or amortized, or you must choose between current deductibility and capitalization. Capitalization generally means that expenses can be written off ratably as amortized expenses or depreciated over a period of time. Amortized expenses include, for example, fees to incorporate a business and expenses to organize a new business. Certain capitalized costs may not be deductible at all, but are treated as an additional cost of an asset (*basis*).

Credits versus Deductions

Not all write-offs of business expenses are treated as deductions. Some can be claimed as tax credits. A tax credit is worth more than a deduction since it reduces your taxes dollar for dollar. Like deductions, tax credits are available only to the extent that Congress allows. In a couple of instances, you have a choice between treating certain expenses as a deduction or a credit. In most cases, however, tax credits can be claimed for certain expenses for which no tax deduction is provided. Business-related tax credits, as well as personal credits related to working or running a business, are included in this book.

Tax Responsibilities

As a small business owner, your obligations taxwise are broad. Not only do you have to pay income taxes and file income tax returns, but you also must manage payroll taxes if you have any employees. You may also have to collect and report on state and local sales taxes. Finally, you may have to notify the IRS of certain activities on information returns.

It is very helpful to keep an eye on the tax calendar so you will not miss out on any payment or filing deadlines, which can result in interest and penalties. You might want to view and print out or order at no cost from the IRS its Publication 1518, *Small Business Tax Calendar* (go to <www.irs.gov/businesses/small/article/0,,id=101169,00.html>).

You can obtain most federal tax forms online at <www.irs.gov>.

PART 1

Organization

CHAPTER 1

Business Organization

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

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

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

Sole Proprietorships

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

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

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

Simplicity is the advantage to this form of business. It is the reason why 72.7 percent of all U.S. firms operate as sole proprietorships. 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.

Independent Contractors

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

More precisely, an independent contractor is an individual who provides services to others outside an employment context. The providing of services becomes a business, an independent calling. In terms of claiming business deductions, classification as an independent contractor is generally more favorable than classification as an employee. (See "Tax Treatment of Income and Deductions in General," later in this chapter.) Therefore, many individuals whose employment status is not clear may wish to claim independent contractor status. Also, from the employer's perspective, hiring independent contractors is more favorable because the employer is not liable for employment taxes and need not provide employee benefits. Federal employment taxes include Social Security and Medicare taxes under the Federal Insurance Contribution Act (FICA) as well as unemployment taxes under the Federal Unemployment Tax Act (FUTA).

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

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

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

Statutory Employees

Some individuals who consider themselves to be in business for themselves—reporting their income and expenses as sole proprietors—may still be treated as employees for purposes of employment taxes. As such, Social Security and Medicare taxes are withheld from their compensation. These individuals include:

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

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

One-Member Limited Liability Companies

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

Tax Treatment of Income and Deductions in General

Sole proprietors, including independent contractors and statutory employees, report their income and deductions on Schedule C, see *Profit or Loss From Business* (Figure 1.1). The net amount (profit or loss after offsetting income with deductions) is then reported as part of the income section on page one of your Form 1040. Such individuals may be able to use a simplified form for reporting business income and deductions: Schedule C-EZ, *Net Profit From Business* (see Figure 1.2). Individuals engaged in farming activities report business income and deductions on Schedule F, the net amount of which is then reported in the

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

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

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

OMB No. 1545-0074

2005

Attachment Sequence No. **09**

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

A Principal business or profession, including product or service (see page C-2 of the instructions) | **B Enter code from pages C-7, 8, & 9** ►

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

E Business address (including suite or room no.) ►
City, town or post office, state, and ZIP code

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

G Did you "materially participate" in the operation of this business during 2005? If "No," see page C-3 for limit on losses ☐ **Yes** ☐ **No**

H If you started or acquired this business during 2005, check here . . . . . ► ☐

Part I Income

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

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

8	Advertising . . .	**8**		**18**	Office expense . . .	**18**	
9	Car and truck expenses (see page C-3) . . .	**9**		**19**	Pension and profit-sharing plans	**19**	
10	Commissions and fees . .	**10**		**20**	Rent or lease (see page C-5):		
11	Contract labor (see page C-4)	**11**		**a**	Vehicles, machinery, and equipment .	**20a**	
12	Depletion . . .	**12**		**b**	Other business property . . .	**20b**	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4) . . .	**13**		**21**	Repairs and maintenance . .	**21**	
				22	Supplies (not included in Part III) .	**22**	
				23	Taxes and licenses . . .	**23**	
				24	Travel, meals, and entertainment:		
				a	Travel . . .	**24a**	
14	Employee benefit programs (other than on line 19) .	**14**		**b**	Deductible meals and entertainment (see page C-5)	**24b**	
15	Insurance (other than health) .	**15**		**25**	Utilities . . .	**25**	
16	Interest:			**26**	Wages (less employment credits) .	**26**	
a	Mortgage (paid to banks, etc.) .	**16a**		**27**	Other expenses (from line 48 on page 2) . . .	**27**	
b	Other . . .	**16b**					
17	Legal and professional services . . .	**17**					

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns . . ►	**28**	
29	Tentative profit (loss). Subtract line 28 from line 7 . . .	**29**	
30	Expenses for business use of your home. Attach **Form 8829** . . .	**30**	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go to line 32.	**31**	
32	If you have a loss, check the box that describes your investment in this activity (see page C-6). • If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	**32a** ☐ All investment is at risk. **32b** ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 2005**

FIGURE 1.1 **Schedule C, Profit or Loss From Business**

Schedule C (Form 1040) 2005 Page 2

Part III **Cost of Goods Sold** (see page C-6)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ 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 page 1, 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 on page C-4 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 2005, enter the number of miles you used your vehicle for:

a Business ________ b Commuting (see instructions) ________ c Other ________

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

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

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

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

Part V **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

48	**Total other expenses.** Enter here and on page 1, line 27	48	

Printed on recycled paper **Schedule C (Form 1040) 2005**

FIGURE 1.1 *(Continued)*

SCHEDULE C-EZ (Form 1040)

Department of the Treasury
Internal Revenue Service

Net Profit From Business

(Sole Proprietorship)

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

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

OMB No. 1545-0074

2005

Attachment Sequence No. **09A**

Name of proprietor

Social security number (SSN)

Part I **General Information**

You May Use Schedule C-EZ Instead of Schedule C Only If You:		**And You:**	
	• Had business expenses of $5,000 or less. • Use the cash method of accounting. • Did not have an inventory at any time during the year. • Did not have a net loss from your business. • Had only one business as either a sole proprietor or statutory employee.		• Had no employees during the year. • Are not required to file **Form 4562,** Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-4 to find out if you must file. • Do not deduct expenses for business use of your home. • Do not have prior year unallowed passive activity losses from this business.

A Principal business or profession, including product or service

B Enter code from pages C-7, 8, & 9 ►

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN), if any

E Business address (including suite or room no.). Address not required if same as on Form 1040, page 1.

City, town or post office, state, and ZIP code

Part II **Figure Your Net Profit**

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

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

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

5 Of the total number of miles you drove your vehicle during 2005, enter the number of miles you used your vehicle for:

a Business ______ b Commuting (see instructions) ______ c Other ______

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

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

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

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

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 14374D **Schedule C-EZ (Form 1040) 2005**

FIGURE 1.2 **Schedule C-EZ, Net Profit From Business**

income section on page one of your Form 1040. Individuals who are considered employees cannot use Schedule C to report their income and claim deductions. See page 21 for the tax treatment of income and deductions by employees.

Partnerships and Limited Liability Companies

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

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

Example

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

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

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

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

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

Tax Treatment of Income and Deductions in General

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

There are two types of items that pass through to an owner: trade or business income or loss and separately stated items. A partner's or member's share is called the *distributive share*. Trade or business income or loss takes into account most ordinary deductions of the business—compensation, rent, taxes, interest, and so forth. Guaranteed payments to an owner are also taken into account when determining ordinary income or loss. From an owner's perspective, deductions net out against income from the business, and the owner's allocable share of the net amount is then reported on the owner's Schedule E of Form 1040. Figure 1.5 shows a sample portion of Schedule E on which a partner's or member's distributive share is reported.

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

Entity Classification Election

OMB No. 1545-1516

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

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

a ☐ Initial classification by a newly-formed entity.

b ☐ Change in current classification.

2 **Form of entity** (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.

b ☐ A domestic eligible entity electing to be classified as a partnership.

c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.

d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.

e ☐ A foreign eligible entity electing to be classified as a partnership.

f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

3 **Disregarded entity information** (see instructions):
a Name of owner ▶ ....
b Identifying number of owner ▶ ....
c Country of organization of entity electing to be disregarded (if foreign) ▶ ....

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

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

6 That person's telephone number
( )

Consent Statement and Signature(s) (see instructions)

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

Signature(s)	Date	Title

For Paperwork Reduction Act Notice, see page 4. Cat. No. 22598R Form **8832** (Rev. 9-2002)

FIGURE 1.3 Form 8832, Entity Classification Election