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to a Better Bottom Line**

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SMALL BUSINESS TAXES 2014

**Your Complete Guide
to a Better Bottom Line**

Barbara Weltman

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

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Preface

According to the National Federation of Independent Business (NFIB), 88% of small businesses use paid tax preparers to file their returns, and the percentage rises to 95% for businesses with 20 or more employees. So why do you need to read up on taxes? The answer is simple: You, not your accountant or other financial adviser and not software, 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 still a great time to be a small business. Not only is small business a 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 edition of the book has been revised to include all of the new rules taking effect for 2013 returns. Your business needs to use every tax-saving opportunity to survive and thrive at this time. The book 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. More than 1 in 5 small business owners (23%) said taxes are the single most important problem they faced, following sales and government regulations (NFIB Research Foundation). 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. However, the book takes a holistic approach to taxes, showing you where applicable the ramifications that tax decisions can have on your business activities and your bottom line. Statistics, resources, and other materials are provided to help you better run your business by making good tax decisions and implementing sound business practices.

It is important to stay alert to future tax changes. Uncertainty has been labeled an impediment to business growth. 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.

For a free supplement on tax developments affecting small businesses (available in February 2014), go to www.jklasser.com or www.barbaraweltman.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 minimize your taxes. 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 another form of business organization called a *limited liability company* (LLC). Limited liability companies with 2 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 to the extent possible 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, royalties, 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 and tax credits. It provides 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 2013 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, running a sideline business, running multiple businesses, and avoiding audits. It also highlights the most common mistakes that business owners make in their returns. 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 Appendix A, 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 crosscheck tax reporting and other financial information. Appendix B contains a checklist of tax-related corporate resolutions to help you keep your corporate minutes book up to date.

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 free online newsletter geared for small business owners and their professional advisers, and my Small Business Idea of the Day[®] (via email) at www.barbaraweltman.com. For more information on the tax implications of your small business and any developments on the Alerts throughout the book, visit www.jklasser.com. Here you will also find a supplement to this book in February 2014, updating information as it develops; the supplement is also posted on my site.

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

Barbara Weltman
September 2013

Introduction

Small businesses are vital to the U.S. economy. They employ half of the country's private sector workforce, and contribute more than half of the nation's gross national product. Historically, small businesses created 65% of all new jobs over the past 15 years.

For the 2010 tax year (the most recent year for statistics), there were 23 million sole proprietorships in the United States. Nearly 1 in 6 Form 1040 filers had a sole proprietorship that year. Another 7.1 million filers reported income from partnerships and S corporations. And the numbers of small businesses are growing. The IRS predicts that by 2015, 43 million individual returns will include business income.

Small businesses fall under the purview of the Internal Revenue Service's (IRS) Small Business and Self-Employed Division (SB/SE). This division services approximately 57 million tax filers, including 9 million small businesses (partnerships and corporations with assets of \$10 million or less) and more than 41 million of whom are full-time or partially self-employed. The SB/SE division accounts for about 40% of the total federal tax revenues collected. 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 DVD called *A Virtual Small Business Tax Workshop* is available free of charge at www.irs.gov. The SBA also provides tax information for start-ups at www.sba.gov.

There is also an IRS Tax Center devoted exclusively to small business and self-employed persons at www.irs.gov/Businesses/Small-Businesses-&Self-Employed. Here you will find special information for your industry—agriculture, automotive, child care, construction, entertainment, gaming, manufacturing, real estate, restaurants, retailers, veterinarians, 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 500 employees to 1,500 employees, depending on the industry or the SBA program (these new size standards are currently under review for certain business sectors). For tax purposes, however, the answer varies from rule to rule, as explained throughout the book. Sometimes it depends on your revenues, the number of employees, or total assets. 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

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 3 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 3 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 \$7 million (\$5 million for the first 3-year period)
DbK retirement plan (Chapter 16)	500 or fewer employees
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
Exemption from reporting health coverage on employees' W-2s	Fewer than 250 W-2s filed for the previous year
Employer mandate exemption from providing affordable health coverage*	More than 50 full-time employees
Employer wage differential credit for activated reservists (Chapter 7)	Fewer than 50 employees
First-year expensing election (Chapter 14)	Equipment purchases for 2013 of no more than \$2.5 million
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 for failure to file information return—cap (Appendix)	Average annual gross receipts of no more than \$5 million for a 3-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
Simple cafeteria plans (Chapter 7)	100 or fewer employees on business days during either of the 2 preceding years
Small employer health care credit (Chapter 19)	No more than 25 full-time equivalent employees
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 3-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 3-year period

*Small employer exemption from the health care mandate would have exempted businesses with fewer than 50 employees from providing minimum essential coverage starting in 2014; this mandate has been postponed.

liability companies (LLCs), and S corporations—require greater sensitivity to the timing of business income as these rates decline.

The IRS reported a “tax gap” (the spread between revenues that should be collected and what actually is collected) of \$450 billion a year and that \$122 billion of this can be traced to entrepreneurs who underreport or don’t report their income, or overstate their deductions. In order to close the tax gap, the IRS is stepping up its audit activities for self-employed individuals, and increased reporting to the IRS and other measures may be adopted.

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 Government Accountability Office (formerly the General Accounting Office) in January 2004 compiled statistics on deductions claimed by sole proprietors for 2001 (no data more current is available). 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% of sole proprietors with business gross receipts under \$25,000 claimed a deduction for advertising costs. This percentage rose to 65% when gross receipts exceeded \$100,000. You can view these old 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. “Ordinary” means common or accepted in business and “necessary” means appropriate and helpful in developing and maintaining a business.

Often the IRS and the courts reach different conclusions about whether an item meets this definition and is deductible, 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. However, 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 39.6% in 2013, then each \$100 deduction will save you \$39.60. Had you not claimed this deduction, you would have had to pay \$39.60 of tax on that \$100 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%. This means that the corporation is in the 35% tax bracket. Thus, each \$100 deduction claimed saves \$35 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/pub/irs-pdf/p1518.pdf).

You can obtain most federal tax forms online at www.irs.gov. Nonscannable forms, which cannot be downloaded from the IRS, can be ordered by calling toll free at 800-829-4933.

Organization

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. 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.

According to the Tax Foundation, more than 90% of all businesses 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. Nearly 50% of

the private sector workforce is employed by these pass-through entities. Taxes, however, are only one factor in deciding what type of entity to use for your business.

As you organize your business, consider which type of entity to use after factoring in taxes and other consequences. Also consider whether to change from your current form of business entity to a new one and what it means from a tax perspective. Finally, be sure to obtain your business' federal tax identity number (or a new one when making certain entity changes).

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 (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. For purposes of tax treatment, proprietor means any unincorporated business owned entirely by 1 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.

Sole proprietorships are the most common form of business. The IRS reports that 1 in 6 Form 1040s contains a Schedule C or C-EZ (the forms 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. 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 other than your own (a fictitious business name, or 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 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 over 70% 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. In 2011 (the most recent year for statistics), 22.9 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.

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. (It costs about 30% more for an employee than an independent contractor after factoring in employment taxes, insurance, and 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. A discussion about worker classification can be found 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 (the ramifications of which are discussed later in this chapter). 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 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.

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).

Husband-Wife Joint Ventures

Usually when 2 or more people co-own a business, they are in partnership. However, husbands and wives who 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 Schedule C of Form 1040. 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

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 single-member LLC is treated as a “disregarded entity.” (The owner can elect to have the LLC taxed as a corporation, but this is not typical. An election may be made to be taxed as a corporation, followed by an S election, so that the owner can easily make tax payments through wage withholding rather than making estimated tax payments, as well as minimize Social Security and Medicare taxes). 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 1 of your Form 1040. Such individuals may be able to use a simplified form for reporting business income and deductions: Schedule C-EZ, *Net Profit From Business* (see Figure 1.2). Individuals engaged in farming activities report business income and deductions on Schedule F, the net amount of which is then reported in the income section on page 1 of Form 1040. Individuals who are considered employees cannot use Schedule C to report their income and claim deductions. See page 28 for the tax treatment of income and deductions by employees.

**SCHEDULE C
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

**Profit or Loss From Business
(Sole Proprietorship)**

► For information on Schedule C and its instructions, go to www.irs.gov/schedulec.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2013
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 (including suite or room no.) ► City, town or post office, state, and ZIP code			
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►			
G Did you "materially participate" in the operation of this business during 2013? If "No," see instructions for limit on losses		Yes <input type="checkbox"/> No <input type="checkbox"/>	
H If you started or acquired this business during 2013, check here		Yes <input type="checkbox"/> No <input type="checkbox"/>	
I Did you make any payments in 2013 that would require you to file Form(s) 1099? (see instructions)		Yes <input type="checkbox"/> No <input type="checkbox"/>	
J If "Yes," did you or will you file required Forms 1099?		Yes <input type="checkbox"/> No <input type="checkbox"/>	

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	<input type="checkbox"/>	1	
2	Returns and allowances		2	
3	Subtract line 2 from line 1		3	
4	Cost of goods sold (from line 42)		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	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9	Pension and profit-sharing plans	19	
10	Commissions and fees	10	20 Rent or lease (see instructions):		
11	Contract labor (see instructions)	11	a Vehicles, machinery, and equipment	20a	
12	Depreciation	12	b Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	21 Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14	22 Supplies (not included in Part III)	22	
15	Insurance (other than health)	15	23 Taxes and licenses	23	
16	Interest:		24 Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a	a Travel	24a	
b	Other	16b	b Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17	25 Utilities	25	
			26 Wages (less employment credits)	26	
			27a Other expenses (from line 48)	27a	
			b Reserved for future use	27b	
28	Total expenses before expenses for business use of home. Add lines 8 through 27a			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 Form 1040, line 12 (or Form 1040NR, line 13) 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 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) 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 32b, you must attach Form 6198 . Your loss may be limited.			32a	<input type="checkbox"/> All investment is at risk.
				32b	<input type="checkbox"/> Some investment is not at risk.

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2013

FIGURE 1.1 Schedule C, Profit or Loss From Business

Part III Cost of Goods Sold (see instructions)

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

Table with 3 columns: Description, Line Number, and Amount. Rows include: 35 Inventory at beginning of year, 36 Purchases less cost of items withdrawn for personal use, 37 Cost of labor, 38 Materials and supplies, 39 Other costs, 40 Add lines 35 through 39, 41 Inventory at end of year, 42 Cost of goods sold.

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 2013, enter the number of miles you used your vehicle for:

a Business b Commuting (see instructions) c 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

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.

Table with 3 columns: Description, Line Number, and Amount. Row 48: Total other expenses.

FIGURE 1.1 (Continued)

**SCHEDULE C-EZ
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)
Name of proprietor

Net Profit From Business
(Sole Proprietorship)

► Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B.
► Attach to Form 1040, 1040NR, or 1041. ► See instructions on page 2.

OMB No. 1545-0074

2013
Attachment
Sequence No. **09A**

Social security number (SSN)

Part I General Information

**You May Use
Schedule C-EZ
Instead of
Schedule C
Only If You:**

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

And You:

- 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, 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.

<p>A Principal business or profession, including product or service</p>	<p>B Enter business code (see page 2)</p>
<p>C Business name. If no separate business name, leave blank.</p>	<p>D Enter your EIN (see page 2)</p>
<p>E Business address (including suite or room no.). Address not required if same as on page 1 of your tax return.</p> <p>City, town or post office, state, and ZIP code</p>	
<p>F Did you make any payments in 2013 that would require you to file Form(s) 1099? (see the Schedule C instructions) <input type="checkbox"/> Yes <input type="checkbox"/> No</p>	
<p>G If "Yes," did you or will you file required Forms 1099? <input type="checkbox"/> Yes <input type="checkbox"/> No</p>	

Part II Figure Your Net Profit

<p>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 <i>Statutory Employees</i> in the instructions for Schedule C, line 1, and check here <input type="checkbox"/></p>	1	
<p>2 Total expenses (see page 2). If more than \$5,000, you must use Schedule C</p>	2	
<p>3 Net profit. Subtract line 2 from line 1. If less than zero, you must use Schedule C. Enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 and Schedule SE, line 2 (see instructions). (Statutory employees, do not report this amount on Schedule SE, line 2.) Estates and trusts, enter on Form 1041, line 3</p>	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 2013, enter the number of miles you used your vehicle for:

a Business	b Commuting (see page 2)	c Other
------------------	--------------------------------	---------------
- 6** Was your vehicle available for personal use during off-duty hours? Yes No
- 7** Do you (or your spouse) have another vehicle available for personal use? Yes No
- 8a** Do you have evidence to support your deduction? Yes No
- b** If "Yes," is the evidence written? Yes No

FIGURE 1.2 Schedule C-EZ, Net Profit From Business

Partnerships and Limited Liability Companies

If you go into business with others, then you cannot be a sole proprietor (with the exception of a husband-wife 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 and 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. 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, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Utah, Texas, and Wisconsin (to a limited extent) permit 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.

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. More than 21 million partners file over 3.5 million partnership returns each year. Of these, 62.2% are 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. 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 2 or more owners who do not elect to be taxed as a corporation (following). The entity also completes Schedule K-1 of Form 1065 (Figure 1.3), 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 employs computer matching of Schedules K-1 to ensure that owners

NOTE

K-1s 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.

ers are properly reporting their share of their business’s income.

For federal income tax purposes, LLCs are treated like partnerships unless the members elect to have the LLCs taxed as corporations. This is done on IRS Form 8832, *Entity Classification Election*. See Figure 1.4. 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 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. Under proposed regulations, for federal tax purposes a series LLC

651113

OMB No. 1545-0099

**Schedule K-1
(Form 1065)**

Department of the Treasury
Internal Revenue Service

2013

For calendar year 2013, or tax
year beginning _____, 2013
ending _____, 20_____

Final K-1 Amended K-1

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

▶ See back of form and separate instructions.

Part I Information About the Partnership		Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items																	
A	Partnership's employer identification number	1	Ordinary business income (loss)																
B	Partnership's name, address, city, state, and ZIP code	2	Net rental real estate income (loss)																
C	IRS Center where partnership filed return	3	Other net rental income (loss)																
D	<input type="checkbox"/> Check if this is a publicly traded partnership (PTP)	4	Guaranteed payments																
Part II Information About the Partner		5	Interest income																
E	Partner's identifying number	6a	Ordinary dividends																
F	Partner's name, address, city, state, and ZIP code	6b	Qualified dividends																
G	<input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member	7	Royalties																
H	<input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner	8	Net short-term capital gain (loss)																
I1	What type of entity is this partner? _____	9a	Net long-term capital gain (loss)																
I2	If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here <input type="checkbox"/>	9b	Collectibles (28%) gain (loss)																
J	Partner's share of profit, loss, and capital (see instructions):	9c	Unrecaptured section 1250 gain																
	<table border="1" style="width:100%; border-collapse: collapse;"> <thead> <tr> <th colspan="2" style="text-align: left;">Beginning</th> <th colspan="2" style="text-align: left;">Ending</th> </tr> </thead> <tbody> <tr> <td>Profit</td> <td style="text-align: right;">%</td> <td></td> <td style="text-align: right;">%</td> </tr> <tr> <td>Loss</td> <td style="text-align: right;">%</td> <td></td> <td style="text-align: right;">%</td> </tr> <tr> <td>Capital</td> <td style="text-align: right;">%</td> <td></td> <td style="text-align: right;">%</td> </tr> </tbody> </table>	Beginning		Ending		Profit	%		%	Loss	%		%	Capital	%		%	10	Net section 1231 gain (loss)
Beginning		Ending																	
Profit	%		%																
Loss	%		%																
Capital	%		%																
K	Partner's share of liabilities at year end:	11	Other income (loss)																
	Nonrecourse \$ _____																		
	Qualified nonrecourse financing . . . \$ _____																		
	Recourse \$ _____																		
L	Partner's capital account analysis:	12	Section 179 deduction																
	Beginning capital account . . . \$ _____	13	Other deductions																
	Capital contributed during the year \$ _____																		
	Current year increase (decrease) . . \$ _____	14	Self-employment earnings (loss)																
	Withdrawals & distributions . . . \$ (_____)																		
	Ending capital account \$ _____																		
	<input type="checkbox"/> Tax basis <input type="checkbox"/> GAAP <input type="checkbox"/> Section 704(b) book																		
	<input type="checkbox"/> Other (explain)																		
M	Did the partner contribute property with a built-in gain or loss?	*See attached statement for additional information.																	
	<input type="checkbox"/> Yes <input type="checkbox"/> No	For IRS Use Only																	
	If "Yes," attach statement (see instructions)																		

FIGURE 1.3 Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.

Form 8832 (Rev. December 2013) Department of the Treasury Internal Revenue Service	<h3 style="margin: 0;">Entity Classification Election</h3> <p style="font-size: small; margin: 0;">▶ Information about Form 8832 and its instructions is at www.irs.gov/form8832.</p>	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: <input type="checkbox"/> Address change <input type="checkbox"/> Late classification relief sought under Revenue Procedure 2009-41 <input type="checkbox"/> 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 ▶

FIGURE 1.4 Form 8832, Entity Classification Election