

Income Taxation

The Proprietorship

If you decided to set your business up as a proprietorship, the reporting of business income less business expenses becomes part of your personal income tax return. You will need to complete form 1040 Schedule C. For a copy of the form and instructions go to www.irs.gov. Click on Forms and Pubs, then List of current forms. Enter 1040 (Schedule C). In a proprietorship you are not on a payroll. If you have other employees, you need to set them up as employees with tax deductions but not yourself. You remove money from the proprietorship for personal needs by taking a draw check. Using our prior example that you have the government as at least a one-third partner, then for every \$300 you draw you need to send the government \$100. For the proprietor this is sent in every quarter with a form 1040-ES transmittal. For a copy of the form and instructions go to www.irs.gov. Click on Forms and Pubs, then List of current forms. Enter 1040-ES. You will have a similar procedure for your state. The 1040-ES is due April 15, June 15, September 15, and January 15. On the personal return you not only have to pay income tax but also self-employment tax (Social Security/Medicare). This is reported by attaching form 1040-SE to your return. You report the amounts paid with the 1040-ES form on page 2 of form 1040 under

estimated taxes. For a copy of the forms and instructions go to www.irs.gov. Click on Forms and Pubs, then List of current forms. Enter 1040 (Schedule SE) and then 1040.

The Partnership

If you decided to set up your business as a partnership, the reporting of business income less business expense is done on a partnership income tax form. You will need to complete form 1065. Partners are normally not set up as employees. The partnership income is allocated to the partners and each partner receives a K-1 form telling them what to report on their personal tax return form 1040 schedule E. For a copy of the form and instructions go to www.irs.gov. Click on Forms and Pubs, then List of current forms. Enter 1065 and then 1065 (Schedule K-1) and then 1040 (Schedule E). Partner income is subject to both income tax and self-employment tax. They make estimated quarterly payments using form 1040-ES. Similar state returns are required.

The Limited Liability Company

A single member LLC is considered a proprietorship and, accordingly, follows the proprietorship rules above. An LLC with more than one member is considered a partnership and, accordingly, follows the partnership rules above. In addition, an LLC may make an election to be taxed as a corporation

The C-Corporation

If you elected to set up your business as a standard corporation, the reporting of business income less business expense is done on a corporation income tax return. You will need to complete form 1120. For a copy of the form and instructions go to www.irs.gov. Click on Forms and Pubs, then List of current forms. Enter 1120. The owners would be on a salary and receive a W2. The tax on profits of the corporation are paid by the corporation and are not reportable on the personal tax return. Similar state filings are required. After tax income is retained by the corporation. Any dividend distributions are not deductible to the corporation but are taxable on the personal return. Any distributions closing the corporation are not deductible to the corporation but are taxable on the personal return.

The S-Corporation

If you decided to setup your business as an S-Corporation, you filed for an S-election on form 2553. The reporting of business income less expense is done on an S-Corporation income tax return. You will need to complete form 1120S. For a copy of the forms and instructions go to www.irs.gov. Click on Forms and Pubs, then List of current forms. Enter 2553 and then 1120S. Since a corporation is considered a separate entity from the owners, you receive your compensation in the form of a deductible salary. The corporation will give you a W2 form to report your salary on your personal return form 1040. The election to be an S-Corporation was made so that the profits of the corporation would be taxed at personal tax rates instead of corporate tax rates. Accordingly, just like partners, the stockholders in an S- Corp receive a K-1 to report their pro rata share of the S-Corp income on 1040 schedule E. They make estimated quarterly tax payments on this income using form 1040-ES.

Similar state forms are required. Assuming the stockholder salary is reasonable, the taxable K-1 amount is subject to income tax but not to self-employment tax.

Corporation Versus Individual Tax Rate

The more income you make personally, the higher your income tax rate on form 1040. As your business adds to your personal income, the lowest corporation rates may provide less total tax. Many individuals will start with an LLC and as their profit rises change to a corporate structure. You need to monitor this possibility at least annually.

For more resources visit www.rjclark.com.