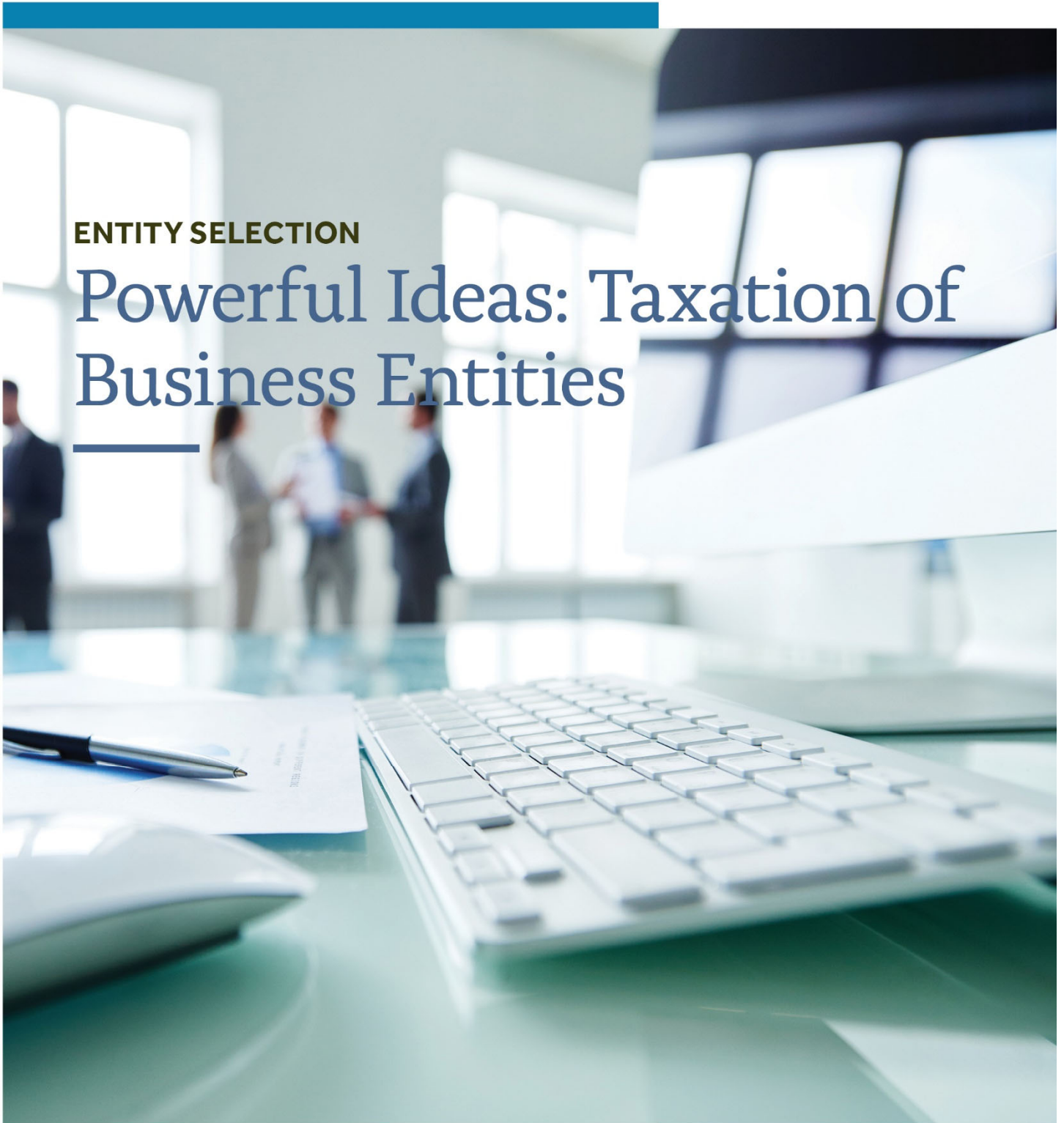


ENTITY SELECTION

Powerful Ideas: Taxation of Business Entities



Taxation of Business Entities

Taxation of Business Entities – In General

There are two primary factors in determining the tax impacts of entities on their owners. The first is what state level entity is chosen and the second is how the owners choose to have that entity taxed for federal income tax purposes.

All states have a variety of entities that can be used for operating a business or owning assets. The owners choose the entity type and file the appropriate paperwork with the state. The two primary entities used are corporations and limited liability companies (LLCs). Both entities provide limited liability for their owners. However, the use of a corporation generally limits its owners to being taxed as either a C corporation (called such because the rules of Subchapter C of the Internal Revenue Code (IRC) govern these entities), or an S corporation (called such because the rules of Subchapter S of the IRC govern these entities). On the other hand, LLCs were created to provide greater flexibility, and may be taxed as C corporations, S corporations, partnerships, and sole proprietorships.

While the state level entity choice can limit how the entity is taxed, the use of the entity does not definitively determine how it is taxed. Rather, the owners of the entity (corporation or LLC) can elect how the entity is taxed for federal (and state) income tax purposes, subject to the rules above. For example, an entity taxed as a C corporation is treated separately for tax purposes and reports its income and pays taxes on Form 1120, US Corporation Income. Whereas a single-member LLC is an LLC with only one member and can be taxed as a sole proprietorship, which will be disregarded for tax purposes, and all business income will be reported on the owner's individual tax return (Form 1040).

What Are the Differences in Taxation Between the Various Entities?

The major difference between C corporations and pass-through entities such as S corporations and partnerships is that C corporations are subject to double taxation while pass-through entities generally are not. Double taxation results because the C corporation pays income tax on the income it reports, and the shareholders pay a second level of income tax when they receive dividends from the corporation. In contrast, the owners of interests in S corporations or partnerships receive Schedule K-1 from the entity and report their share of the income on their personal tax returns.

The table below summarizes the taxation of the most common business entities.

| Taxation of Income and Transfers of Cash or Property from Various Business Entities | | | |
|---|--|---|---|
| | C Corporation | S Corporation | Partnership/LLC* |
| Income Taxation in General | <ul style="list-style-type: none">• Corporation pays income tax if it has taxable income.• Compensation paid is deductible, if reasonable.• Net operating losses are deductible up to 80% of income in subsequent years and may be carried forward indefinitely. | <ul style="list-style-type: none">• S Corporations do not pay income tax. All earnings and losses are passed through to the shareholders.• Flow through amounts are reported to shareholder on Schedule K-1; income taxable to shareholder but not subject to FICA.• Compensation paid to an employee is subject to FICA. | <ul style="list-style-type: none">• Partnerships do not pay income tax. All earnings and losses are passed through to the partners.• Partners pay self-employment tax on their share of partnership income, assuming they are active in the partnership. |

Taxation of Income and Transfers of Cash or Property from Various Business Entities

| | C Corporation | S Corporation | Partnership/LLC* |
|--|---|--|---|
| Cash Distributions | <ul style="list-style-type: none"> Dividends are taxable at rates of 15% and 20% (depending on the shareholder's taxable income) to shareholder to the extent of earnings and profits (E&P). Dividends are not deductible. | <ul style="list-style-type: none"> Distributions from accumulated adjustments account (if former C corporation) are not taxable but reduce shareholder's basis. Distributions from E&P (if former C corporation) do not reduce basis but are taxable to shareholder. Distributions in excess of basis are subject to capital gain. | <ul style="list-style-type: none"> Return of basis is not taxed to partner, but his/her basis is reduced by distribution. Distributions that exceed partner's basis are subject to capital gain. |
| Distributions of Appreciated Property** - Business Taxation | <ul style="list-style-type: none"> Gain (FMV - basis) is taxable to the corporation. Property distributed as compensation is deductible, if reasonable. Gain is offset by deduction. Property distributed as dividend is nondeductible to corporation. | <ul style="list-style-type: none"> Gain (FMV - basis) is taxable to shareholders.*** Property distributed as compensation is deductible, if reasonable. Gain is offset by deduction. Built-in gains (recognized from sale or distribution of prior C corporation property) taxable to S corporation at highest C corporation rate. | <ul style="list-style-type: none"> Gain is generally not recognized on distribution; it is recognized at the time of sale by distributee partner. |
| Distributions of Appreciated Property - Owner/Employee Taxation | <ul style="list-style-type: none"> Taxable amount is property's FMV. If dividend, taxable at 15% or 20% (currently). If compensation, taxed as ordinary income at the shareholder's marginal rate. | <ul style="list-style-type: none"> Compensation is taxable at shareholder's marginal rate. Distributions from accumulated adjustments account (if former C corporation) are not taxable but reduce shareholder's basis. Distributions from E&P (if former C corporation) do not reduce basis but are taxable to shareholder. Distributions in excess of basis are subject to capital gain. | <ul style="list-style-type: none"> Gain generally not recognized on distribution; it is recognized at the time of sale by distributee partner. Alternative minimum tax may be recognized by partner. Partner's basis is reduced by distribution. |

* A limited liability company (LLC) may elect to be taxed as a corporation (C or S), partnership, or, if it only has one member, a sole proprietorship. Usually, an LLC elects to be taxed as a partnership, although there is a compelling reason to be taxed as an S corporation if the LLC operates an active trade or business. The owner of an LLC taxed as a partnership is not an LLC employee and is subject to employment taxes (SECA) on all distributions from the LLC. In contrast, an S corporation owner who performs more than minor services for the S corporation will be classified as both an employee and an owner and will be subject to employment taxes (FICA) only on reasonable wages paid by the S corporation. Thus, being classified as an employee will provide the owner with an opportunity to avoid paying employment taxes on any S corporation dividend income.

** Gain on appreciated property is its fair market value (FMV) in excess of tax basis (net cost).

*** Gain on appreciated property is generally taxed as capital gain; but a life insurance policy with appreciation will yield ordinary income.

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