Navigating
Income Tax

ENTITY SELECTION

Powerful Ideas: How Are Pass-Through Entities Taxed?

How are Pass-Through Entities Taxed?

Taxation of Pass-Through Entities – In General

Most US businesses are taxed as pass-through (or flow-through) entities that, unlike C corporations, are generally not subject to the corporate income tax or any other entity-level income tax. Instead, their owners or members include their allocated shares of the pass-through's income, loss, deductions, and credits on their own income tax returns. Sole proprietorships (SP), general partnerships (GP), limited partnerships (LP), S corporations, limited liability companies (LLC), and limited liability partnerships (LLP) are pass-through entities, although an LLC can elect to be taxed as a corporation. Tax treatment, however, will vary depending on the type of business entity selected.

Taxation of Sole Proprietorships

A sole proprietor and his or her business are indistinguishable for legal purposes. The owner reports business profits and losses on his or her personal tax return every year and is personally responsible for business debts. The business does not file its own tax return. When the owner dies, a sole proprietorship venture terminates for federal tax purposes. Because a proprietorship and its owner are one and the same for tax purposes, proprietorships generally use December 31 as their year-end. Business income is reported on a separate schedule attached to the proprietor's annual Form 1040 tax return. This is Schedule C, Profit or Loss from Business.

Taxation of S Corporations

In effect, an S corporation conducts business as a regular corporation but is taxed like a partnership. Unlike a C corporation, the S corporation does not pay a corporate tax on income. Rather, the S corporation passes items of income, loss, deductions, and credits through to its shareholders, who report the items and calculate the tax on their individual returns. Thus, the burden of taxation is shifted from the corporation to the individual shareholders. Unlike a C corporation, an S corporation pays no regular income tax, alternative minimum tax, accumulated earnings tax, or personal holding company tax.

One major advantage of the S corporation may be that it avoids double taxation. The term double taxation is often used in reference to a C corporation because a C corporation's corporate income is taxed once to the corporation when earned and again to the shareholders when distributed to them as dividends. In other words, the business profits are taxed twice, once at the corporate level and once at the individual level.

Also, it is important to note that the corporation does not get a tax deduction when it distributes dividends to its shareholders. In contrast, the income of an S corporation is generally only taxed once when it flows through to the individual shareholders. However, if the S corporation was originally a C corporation with accumulated earnings and profits, it may be liable for a 35 percent flat tax on excess net passive income, certain capital gains, and any built-in gains

Taxation of Partnerships

Like an S corporation, a partnership is a conduit or pass-through entity. The partnership business does not pay a tax on income. Rather, the business passes items of income, loss, deduction, and credit through to the partners, who report the items and calculate the tax on their individual returns. Nevertheless, a partnership must keep accurate track of income and expenses, like any business.

Taxation of Limited Liability Companies

For federal tax purposes, the LLC can choose to be treated as a partnership or as a corporation. In general, LLCs choose to be taxed according to partnership rules to avoid the double taxation imposed on C corporations. Because the LLC entity itself does not pay federal income tax, net income is therefore taxed at a single level to the members. The LLC serves as a conduit or pass-through entity, like a partnership or S corporation. It must, therefore, issue each member an Internal Revenue Service Form K-1 at the end of each year, showing the member's proportionate share of the business's profit or loss.

An LLC with a single owner will be treated like a sole proprietorship for federal income tax purposes if it does not elect to be taxed as a corporation. However, some states do not recognize or permit LLCs with a single owner, and although most states tax LLCs according to partnership tax rules, some states tax LLCs as corporations (even though LLCs qualify to be taxed as partnerships for federal tax purposes).

Who Can Own a Pass-Through Entity?

Who can own a pass-through entity depends on what kind of entity is being used. Generally, pass-through entities can be owned as follows:

- Sole proprietorships can only be owned by a single individual.
- Single Member LLCs can be owned by individuals, S corporations, C corporations, and other LLCs.
- Partnerships or LLCs taxed as partnerships can be owned by any other taxpayer.
- S corporation ownership is limited as follows:
    - Only US residents (including resident aliens), single member LLCs owned by US residents, tax-exempt organizations such as 501(c)(3)s, a qualified Subchapter S subsidiary (or QSSS, an S corporation that owns 100% of the S Corporation subsidiary's stock), or certain trusts can be shareholders of an S corporation.
    - There can be no more than 100 shareholders.
    - There can be only one class of stock (this rule applies to a shareholder's rights to distributions; voting and non-voting shares are allowed).