Tax Classification

of Business Entities. A (very general) Overview.

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This white paper generally discusses the federal income tax classification rules that apply to US corporations, partnerships and LLCs, located in the United States. It is intended to inform and educate the reader on the basics of how the US tax code affects these various business entities. It is not meant to be a substitute for tax advice from a licensed tax professional. Every case is different, so please contact your tax attorney or certified public accountant.

When forming a business, one of the first things to consider is what type of entity is the best form for the business. You have many choices: corporation, limited liability company (LLC), or partnership. Determining the best form of entity depends on many criteria, such as structure, liability, management, and tax considerations. For the most part, a business owner will choose non-tax factors as the primary consideration because, in most instances, a business entity can decide how it wants to be reated for tax purposes.

Overview of Tax Classification of Business Entities

Business entities are formed under state law. Such entites include:

- Corporations.
- Partnerships (including, general partnerships, limited partnerships, limited liability partnerships, or limited liability limited partnerships).
- Limited Liabilty Companies (LLCs).

However, for tax purposes, a business entity is treated as one of the following:

- Disregarded entity.
- C-corporation.
- S-corporation.
- Partnership.

NOTE: State law classification of a business entity is not necessarily the same as the tax classification of a business entity. For example, a state LLC can choose to be taxed as an S-Corp.

Tax classification is important becusae the rules for each business entity are very different.

Disregarded Entity: Treated like a sole proprietorship, branch or division of the owner. The owner owns the assets, is subject to the liabilities, and reports the income and expenses on his/her own income tax return.

C-Corporation: If it's not an S-Corp., it's a C-Corp. and is subject to two levels of tax on its income; one at the entity level when it's earned, and another at the stockholder level when it's distributed. This is commonly referred to as "double taxation."

S-Corporation: is a "pass-through" entity for tax purposes, meaning it does not pay tax at the entity level. Instead, the profits and losses will pass through to the stockholders who will include those items on his/her individual income tax return.

Partnership: A pass-through entity where the profits and losses are allocated among the partners who include their respective share of those items on income tax returns.

S-Corporation Limitations

Because an S-corporation can have only one class of stock, no more than 100 stockholders, and with certain limited exceptions, only US individuals (citizens or residents) allowed to be stockholders, it is a less common entity than C-Corporations.

An eligible US entity can make a timely S-corporation election no more than two months and 15 days after the beginning of the tax year the election is to take effect (see IRC § 1362).

Per Se Corporations

Certain entities are automatically classified as per se C-corporations and cannot make an election to be treated as a disregarded entity or partnership for tax purposes. For example, A corporation incorporated under state law is a per se C-corporation for tax purposes, unless it meets the requirements above for the S-corporation election. Under such circumstances, it can elect S-Corporation status on formation.

However, be careful, if a C-corporation makes an S-corporation election after formation, there are potential adverse tax consequences, e.g. paying taxes on built-in-gains (BIG tax), on assets that appreciated in value during the C-corp period.

Tax Rules: S-Corp. vs. Partnership

- An S-corporation must divide profits according to share ownership split among its shareholders. However, a business entity that is a partnership for tax purposes generally can divide profits in any way it chooses, regardless of ownership split.
- Generally, trade or business income received by a partnership is considered self-employment income to the partners and is subject to self-employment tax. However, with S-corporations, only the compensation income paid to the stockholder-employee is subject to employment tax. Any other income is not subject to employment tax. This difference can sometimes result in substantial employment tax savings for the owners of an S-corporation.
- Partnerships do not qualify for certain statutory benefits available only to C- and S-corporations, e.g. cannot issue incentive stock options.

A NOTE about LLCs: For tax purposes, an LLC is classified as a disregarded entity, C-corp, S-corp, or partnership. A single-member LLC is treated as a disregarded entity and a multiple-member LLC is treated as a partnership for tax purposes unless the LLC elects C- or S-corporation tax status.