CHOICE OF ENTITY: TAX ISSUES

The first step when forming a business is to decide what type of entity is the best form for the business (for example, a corporation, partnership or limited liability company ("LLC")). Which entity is the best form depends on structure, liability, management and tax considerations. Non-tax factors usually are the primary considerations because in many instances an entity can choose how it is treated for tax purposes.

The following discusses the United States federal income tax classification rules applicable to corporations, partnerships and LLCs, but does not address the tax rules applicable to trusts, specialized industries (such as tax-exempt organizations, banks, insurance companies, mutual funds or real estate investment trusts) or foreign entities.

OVERVIEW OF TAX CLASSIFICATION OF BUSINESS ENTITIES

Businesses are generally formed under state law as corporations, partnerships (as general partnerships, limited partnerships, limited liability partnerships, or limited liability limited partnerships), and LLCs. For tax purposes, a business entity is treated as one of the following: disregarded entity, C-corporation, S-corporation or partnership.
The state law classification of a business entity is not always the same as the tax classification of a business entity (for example, a state law partnership can often elect partnership or corporation tax status). Unlike partnerships and corporations, LLCs do not have a specific set of tax rules that apply only to LLCs. The tax classification of a business entity is important because the tax rules that apply to a disregarded entity, C-corporation, S-corporation and partnership are quite different.

DISREGARDED ENTITY

A business entity that is treated as a disregarded entity for tax purposes is an entity with a single owner that is generally ignored for tax purposes even though it is a separate legal entity for state law purposes. The owner of the disregarded entity is considered to own the assets (and is subject to the liabilities) of the disregarded entity for tax purposes and reports the entity's income and expenses on its own income tax return. In other words, a disregarded entity is treated like a sole proprietorship, branch or division of the owner.
For example, a single-member LLC that is treated as a disregarded entity for tax purposes does not file a United States federal income tax return. Instead, the sole member of the LLC reports the LLC's income and expenses directly on its own income tax return.
Even though an LLC is a recognized type of business entity formed under state corporate law, LLCs do not have their own United States federal income tax regime. For tax purposes, an LLC is classified as a disregarded entity, C-corporation, S-corporation 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.

C-CORPORATION

All corporations other than S-corporations are C-corporations. C-corporations are the most common corporate form and generally are subject to two levels of tax on their income: at the entity level when earned and at the stockholder level when distributed. An eligible C-corporation generally can avoid double taxation by electing on formation to be treated as an S-corporation if it meets the Internal Revenue Code (“IRC”) requirements for an S-corporation election (such as the requirements regarding the number, type and residency of stockholders discussed below). If a C-corporation makes an S-corporation election after formation, there are potential adverse tax consequences.

S-CORPORATION

An S-corporation is a "pass-through" entity for tax purposes, which means it generally does not pay an entity level tax. Instead, the S-corporation's profits and losses generally pass-through to its stockholders who include their respective share of those items on their income tax returns (whether or not distributed).
S-corporations are less common than C-corporations because of the substantial limitations on the availability of the S-corporation election. For example, an S-corporation can have only one class of stock, no more than 100 stockholders, and with certain limited exceptions, only United States individuals (citizens or residents) can be stockholders. In addition, only an eligible United States entity can make the election. An eligible entity makes a timely S-corporation election on IRS Form 2553, no more than two months and 15 days after the beginning of the tax year the election is to take effect.

PARTNERSHIP

Like an S-corporation, a business entity taxed as a partnership is a pass-through entity for tax purposes, which means it does not pay an entity level tax. Instead, the partnership's profits and losses are computed and allocated among the partners annually and pass-through to the partners who include their respective share of those items on their income tax returns (whether or not distributed).

Unlike an S-corporation, a partnership does not have any restrictions on the number (other than the requirement that a partnership have two or more owners), type or residency of its owners. Therefore, a business entity that desires pass-through taxation often chooses partnership tax status.

Although both S-corporations and partnerships are pass-through entities for tax purposes, the tax rules that apply to S-corporations and partnerships are somewhat different. Some examples of the differences include:

- An S-corporation must divide profits according to share ownership. By contrast, a business entity that is a partnership for tax purposes generally can divide profits in any way it chooses.
- All trade or business income of a partnership generally is considered self-employment income to the partners and is subject to self-employment tax. For S-corporations, generally only the compensation income paid to the stockholder-employee is subject to employment tax. Any other income is not subject to employment tax. This often results 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. For example, a partnership cannot issue incentive stock options. However, a partnership can often use a profits interest (meaning, a share of future profits and appreciation, but none of the existing value of the partnership) to achieve the same or better tax result (than an incentive stock option) for its holders.