

# Corporate Structure and Tax Primer

As a general proposition, the differences in tax treatment and tax classifications relating to the type of entity chosen for corporate structure are not significant. How the entity will be taxed is dependent upon whether it is a pass through or at the entity level.

## Partnerships

In a general partnership, each partner is taxed on his or her income derived from the partnership activity. The partnership is treated as a pass-through entity for income tax purposes while the partners are charged with the income, expenses, deductions, losses and gains. The partnership may file an informational return; however, it does not pay income taxes at the entity level.

Unless the partnership agreement provides for a specific allocation of the income and loss derived from partnership activity, it will be proportioned equally to each partner. For this reason, it is important that the partnership be evidenced by a written agreement to avoid disputes and provide clarity with respect to allocation of income and loss.

## Corporations

A corporation may be taxed as an s-corporation or a c-corporation depending upon the financial and legal strategy of its owners. The default tax treatment for a corporation is to tax the corporation as a separate entity—apart from its shareholders—and to tax the corporation's income directly. A corporation files an annual tax return just like individuals. Dividends distributed by the corporation are treated as income to the shareholder and are not deductible to the entity.

Corporations with a limited number of shareholders may elect S status which is treated as a pass-through entity and taxed in a manner similar to a partnership. In this case, the shareholders of an S corporation report the gains and losses of the corporation and are taxed on those gains and losses individually which avoids the double taxation of corporate income tax. It is important to note that electing S status as a corporation is restrictive in that the corporation may only have individuals (or qualified trusts or estates) as shareholders (as opposed to another corporate entity), is limited to 100 shareholders, and may only have one class of stock which may be split between voting and non-voting. The latter restriction limits the benefits of this corporate form and if the corporation if the corporation no longer meets the above requirements or has more than 25% of its gross income derived from passive investment income, the S election would be terminated, and the entity will be treated as a C corporation effective as of the date of termination. Attorneys and accountants should be engaged to decide on the form of entity and navigate the challenges associated with the tax rate.

## Limited Liability Company (LLC)

LLCs may be taxed in two ways. The IRS primarily treats an LLC as a pass-through entity, just like a partnership or an s-corporation; however, if the LLC is owned by one member it is taxed just like a sole proprietorship requiring the sole member to itemize income expense on his or her tax return. The members of an LLC may elect S corporation status for tax purposes or continue as a pass-through and treated as a partnership for tax purposes. The members should consult an accountant in making a decision to elect S status which may be driven by the level of income or distributions to be paid to its members. While an LLC may change its tax classification in subsequent years, there are consequences to changing the classification. It is important to seek input from an attorney on these consequences and the pros and cons of each classification for your business.



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