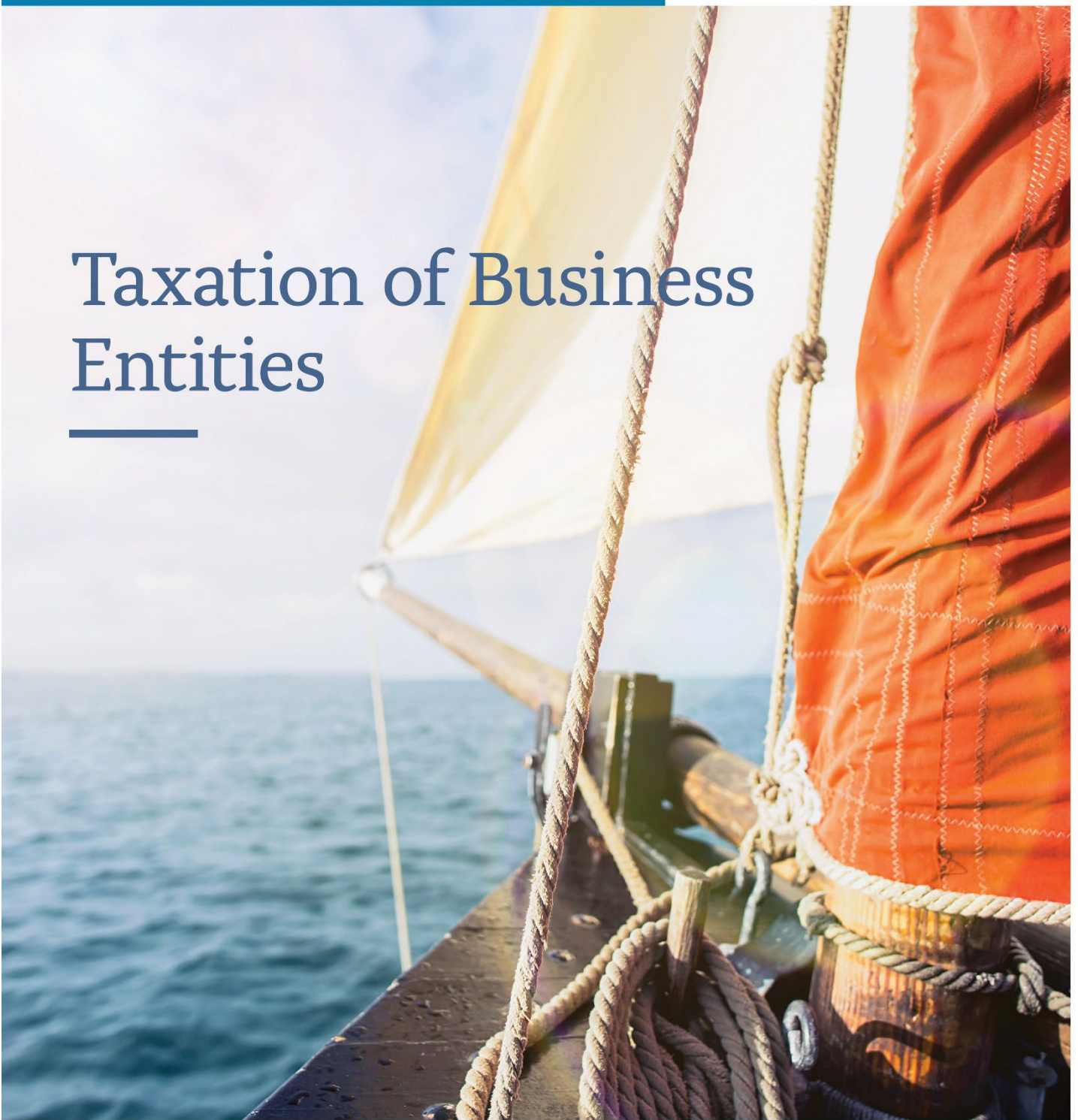




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# Taxation of Business Entities

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# 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 the type of entity formed under state law and the second is how the owners elect for that entity to be taxed for federal income tax purposes.

States offer a variety of legal entities for operating a business or holding assets, most commonly corporations and limited liability companies (LLCs). Both entities generally provide limited liability protection for their owners. Corporations are taxed either as C corporations (governed by Subchapter C of the Internal Revenue Code) or, if eligibility requirements are met, as S corporations (governed by Subchapter S). LLCs offer greater flexibility and may be taxed as C corporations, S corporations, partnerships, or, in the case of a single-member LLC, as a disregarded entity taxed as a sole proprietorship.

The choice of legal entity does not, by itself, determine federal income tax treatment. Rather, owners may elect how the entity is taxed, subject to statutory and regulatory requirements. 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, while a single-member LLC taxed as a disregarded entity reports business income directly on the owner's individual income tax return (Form 1040).

## Differences in taxation between business entities

A primary distinction among business entities is whether income is subject to double taxation. C corporations are subject to entity-level income tax, and shareholders are taxed again when profits are distributed as dividends. In contrast, S corporations and partnerships are generally pass-through entities: income, deductions, and credits pass through to owners and are reported on their individual returns, avoiding entity-level income tax.

Owners of S corporations and partnerships receive Schedule K-1 reporting their share of income. While this income is generally taxable to the owner, the employment tax treatment differs depending on the type of entity and the owner's role in the business.

## State and local tax (SALT) considerations for entities

Under OBBBA, the expanded individual SALT cap does not apply to pass-through entity taxes. No SALT limitation applies at the entity level, preserving the effectiveness of state pass-through entity tax (PTET) regimes adopted by many states. As a result, partnerships and S corporations may continue to deduct state income taxes paid at the entity level, even while individual SALT deductions remain subject to statutory caps.

## Qualified business income (QBI) deduction

The 20% qualified business income deduction under IRC §199A was made permanent by OBBBA. The Act also expanded the phase-in range and introduced a minimum deduction of \$400 for taxpayers with at least \$1,000 of QBI, subject to statutory requirements. This provision significantly enhances the long-term tax benefits of operating through pass-through entities.

## Entity selection after OBBBA — Planning considerations

OBBBA permanently reshaped the tax landscape for business owners, making entity selection a long-term strategic decision rather than a temporary planning exercise. Key considerations include:

- **Rate certainty:** The permanent 21% corporate tax rate favors C corporations for businesses intending to reinvest earnings, while pass-through owners benefit from individual rate stability and the permanent QBI deduction.

- **Employment taxes:** S corporations may reduce employment tax exposure by splitting compensation between reasonable wages and distributions, while partnerships generally subject active owners to self-employment taxes.
- **Loss utilization:** The permanent excess business loss limitation affects pass-through owners with large losses, while C corporation losses remain subject to corporate NOL rules.
- **SALT planning:** PTET regimes continue to provide meaningful state tax deductions for pass-through entities, even with individual SALT caps.
- **Exit strategy:** C corporations may benefit from qualified small business stock (QSBS) planning, while pass-through entities often offer greater flexibility in basis recovery and asset sales.

Entity choice should be evaluated in light of current operations, long-term growth expectations, and exit planning objectives.

## QSBS vs. QBI — Exit-planning considerations

### Qualified small business stock (QSBS) -C corporations

Owners of eligible C corporations may exclude up to 100% of gain on the sale of qualified small business stock under IRC §1202, subject to holding-period and eligibility requirements. The exclusion is generally limited to the greater of \$10 million or 10 times the taxpayer's basis in the stock. OBBBA modified QSBS to allow tiered gain exclusion based on holding period (50% after three years, 75% after four years, and 100% after five years) and increased the gross asset threshold for eligibility. QSBS can provide substantial benefits for founders and early investors anticipating a stock sale exit.

### Qualified business income (QBI) deduction - Pass-through entities

Owners of S corporations, partnerships, and LLCs taxed as pass-through entities generally benefit from the permanent 20% QBI deduction under IRC §199A. The deduction reduces taxable income annually but does not reduce the tax rate on gain realized upon a business sale. In asset sales, pass-through owners typically recognize taxable gain, although basis step-ups and favorable capital gain rates may mitigate the impact.

For businesses targeting a stock sale or IPO, C corporation status with QSBS eligibility may offer superior exit-tax efficiency. For businesses expecting ongoing cash flow distributions, asset sales, or flexible ownership structures, pass-through taxation with the permanent QBI deduction may be preferable. Entity choice should be evaluated early, as QSBS eligibility requires stock to be issued by a C corporation and held for the requisite period.

## Summary of taxation by entity type

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

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

\* 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.

As a result of H.R.1 of the 119th Congress (commonly known as the One Big Beautiful Bill Act), the estate, gift, and generation skipping tax exemptions amounts enacted under the Tax Cuts and Jobs Act of 2017 were made permanent. Effective January 1, 2026, the exemption amount will be \$15 million per person (\$30 million for a married couple), with annual adjustments for inflation. For asset transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40%. In addition, under different rates, rules, and exemption amounts (if any), there may be state and local estate, inheritance, or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not give legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents and, as a courtesy, to select agents of New York Life Insurance Company. SMRU 5016504 Exp. 01/31/2029