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

Pass-through entities are entities such as S corporations, partnerships or sole proprietorships (or LLCs taxed as such). They are called pass-through entities because the owners of the entities report their share of income, loss, deductions and credits on their personal return and the income is generally not subject to tax at the entity level. As a result, the income is subject to only one level of taxation. This is in contrast with a C corporation which may have two levels of taxation.

## How Does It Work?

Where an owner reports pass-through income depends on what the entity does, and how it is taxed. Income is therefore generally reported as follows:

- Income and loss from a sole proprietorship or single member LLC owned by individuals is calculated on Schedule C (Profit or Loss from Business) of the owner's Form 1040 and then reported on the first page of the return on Line 12.
- Income and loss from real estate rentals not owned by a partnership, and royalties are calculated on Schedule E (Supplemental Income and Loss), Part I of the owner's Form 1040 and reported on the first page of the return on Line 17.
- Income and loss from S corporations and partnerships are provided on Form K-1 which is provided to the individual owners who report their share of income and loss on Schedule E (Supplemental Income and Loss), Part II of the owner's Form 1040 and reported on the first page of the return on Line 17.
- Single member LLCs owned by S corporations, C corporations or other LLCs are treated as disregarded entities for tax purposes and the income and loss from their operations is reported on the owner's return.
- S corporations, C corporations and LLCs that own interests in partnerships or LLCs taxed as partnerships receive a Form K-1 and report their share of income on their respective returns.

Note that taxpayers are required to prepare and file separate returns for S corporations and partnerships (Forms 1120S and 1065, respectively). The owners then receive K-1s from these returns and use the information provided to prepare their returns.

## Can There Be Double Taxation?

While partnerships and sole proprietorships do not have the potential to be subject to double taxation, S corporations that previously operated as C corporations may be subject to double tax as a result of the built-in gains tax (BIGT). The BIGT applies to the sale of assets from an S corporation within five years of C corporation shareholders electing to have the corporation taxed as an S corporation. The tax is applied on the built-in gain, or the difference between the sale price of the asset and its basis, and is paid at the highest corporation tax rate (currently 21%). The shareholders then pay gain on the income from the asset at their personal tax rate.

## 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).

## How Do I Determine How I'll Be Taxed?

Taxpayers who operate a business individually (or through a single member LLC), and do not elect to be taxed differently, will be required to report their income on Schedule C. If the business has more than one owner but does not elect to incorporate, the taxpayers will be required to file Form 1065 and report the income on their tax returns. If a taxpayer incorporates his business, he will be required to operate as a C corporation, unless he elects to be taxed as an S corporation. Lastly, owners of LLCs can elect to be taxed as C corporations or S corporations, if they so choose.