



# Taxation of Business Entities

## Overview

Certain tax issues arise when distributing assets, including cash from a business. The type of entity the business is organized as largely determines what the tax consequences will be. C corporations, S corporations, partnerships, and sole proprietorships each have certain business advantages and disadvantages and are taxed differently. A limited liability company (LLC) can elect whether it will be taxed as a C corporation, S corporation, partnership, or, if it has only one member, a sole proprietorship. A sole proprietorship is disregarded as an entity for tax purposes, and all property of the business is owned by the sole proprietor.

## Taxation of Income and Transfers of Cash or Property from Various Business Entities

	C Corporation	S Corporation	Partnership/LLC*
Income Taxation in General	<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>May be subject to Corporate Alternative Minimum Tax (CAMT) due to increase in insurance cash value and receipt of death proceeds.</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 on shareholder Form 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>
Cash Distributions	<ul style="list-style-type: none"> <li>Dividends are taxable at 15% (currently) 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 AAA (if former C corp) - not taxable but reduces shareholder's basis.</li> <li>Distributions from E&amp;P (if former C corp) does not reduce basis but is taxable to shareholder.</li> <li>Capital Gain – distributions in</li> </ul>	<ul style="list-style-type: none"> <li>Return of Basis – not tax to partner, but his/her basis is reduced by distribution.</li> <li>Capital Gain – distributions that exceed partner's basis are subject to capital gain.</li> </ul>

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	<b>C Corporation</b>	<b>S Corporation</b>	<b>Partnership/LLC*</b>
<b>Distributions of Appreciated Property**</b> – Business Taxation	<ul style="list-style-type: none"> <li>• Gain (FMV – Basis) is taxable to 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>	<p>excess of basis are capital gain.</p> <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 corp property) taxable to S corp at highest C corp rate.</li> </ul>	Gain is generally not recognized on distribution; it is recognized at the time of sale by distributee partner.
<b>Distributions of Appreciated Property</b> – Owner / Employee Taxation	<ul style="list-style-type: none"> <li>• Taxable amount is property's FMV.</li> <li>• If dividend, taxable at 15% (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 – taxable at shareholder's marginal rate.</li> <li>• Distributions from AAA (if former C corp)- not taxable but reduces shareholder's basis.</li> <li>• Distributions from E&amp;P (if former C corp) does not reduce basis but is taxable to shareholder.</li> <li>• Capital Gain – distributions in excess of basis are 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>• AMT 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.

\*\* Gain on appreciated property is its Fair Market Value (FMV) in excess of tax basis (net cost).

\*\*\* Gain on appreciated property is usually capital gain; but, a life insurance policy with appreciation will yield ordinary income, plus, if the policy is sold, a capital gain to the extent the sales price exceeds the policy's surrender value.