THE NAUTILUS GROUP®

How Are Pass-Through Entities Taxed?



How are Pass-Through Entities Taxed?

Taxation of pass-through entities – In general

Most U.S. businesses are organized as pass-through entities, meaning they are not subject to federal income tax at the entity level. Instead, income, deductions, and credits flow through to the owners, who report the results on their personal tax returns. This structure differs from C corporations, which are subject to potential double taxation—once at the corporate level and again when profits are distributed to shareholders. Sole proprietorships (SP), general partnerships (GP), limited partnerships (LP), S corporations, limited liability companies (LLC), and limited liability partnerships (LLP) are pass-through entities, although an LLC can also elect to be taxed as a C corporation. Tax treatment, however, will vary depending on the type of business entity selected.

Taxation of sole proprietorships

A sole proprietor and his or her business are indistinguishable for legal purposes. The owner reports business profits and losses on his or her personal tax return every year and is personally responsible for business debts. The business does not file its own tax return. When the owner dies, a sole proprietorship venture terminates for federal tax purposes. Because a proprietorship and its owner are one and the same for tax purposes, proprietorships generally use December 31 as their year-end. Business income is reported on a separate schedule attached to the proprietor's annual Form 1040 tax return. This is *Schedule C, Profit or Loss from Business*.

Taxation of S corporations

S corporations operate as corporations under state law but are taxed similarly to partnerships. However, an S corporation must meet eligibility requirements, including a limit on shareholders and a restriction to one class of stock. Unlike a C corporation, the S corporation does not pay a corporate tax on income. Instead, an S corporation allocates its income, losses, deductions, and credits to shareholders, who report them on their personal tax returns. Thus, the burden of taxation is shifted from the corporation to the individual shareholders.

One major advantage of the S corporation may be that it avoids double taxation. The term double taxation is often used in reference to a C corporation because a C corporation's corporate income is taxed once to the corporation when earned and again to the shareholders when distributed to them as dividends. In other words, the business profits are taxed twice, once at the corporate level and once at the individual level.

If an S corporation was previously a C corporation, it may be subject to a built-in gains tax on certain appreciated assets sold during a 5-year recognition period. It may also be taxed on excess net passive income if it has accumulated C corporation earnings and profits and substantial passive income.

Taxation of partnerships

Partnerships are classic conduit or pass-through entities. The partnership business does not pay income tax at the entity level. Rather, the partnership allocates all items of income, loss, and deduction among partners. Partnerships will issue Schedule K-1 to each partner annually and require accurate accounting of books and tax capital accounts. Partners are taxed on their allocable share, even if profits are not distributed.

Taxation of limited liability companies (LLCs)

LLCs are hybrid entities offering flexibility in tax classification. For federal tax purposes, the LLC can choose to be treated as a partnership or as a corporation. A single-member LLC is a disregarded entity by default and reports income on the owner's personal return (like a sole proprietorship), unless it elects corporate taxation. A multi-member LLC is generally taxed as a partnership unless it elects corporate status.

LLCs are generally taxed as partnerships to avoid double taxation, with income taxed once at the member level rather than at the entity level. As pass-through entities, they must issue each member a Form K-1 reporting their share of profits or losses.

A single-member LLC is typically disregarded for federal tax purposes unless it elects corporate status via Form 8832; however, some states do not recognize single-member LLCs or may tax LLCs as corporations or impose franchise taxes, even when federal treatment is as a partnership.

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, corporations, or other LLCs.
- Partnerships or LLCs taxed as partnerships can be owned by any individuals or entities.
- S corporation ownership is limited to U.S. residents (including resident aliens), single-member LLCs owned by U.S. residents, tax-exempt organizations such as 501(c)(3)s, qualified Subchapter S subsidiaries (QSSSs), and certain trusts. The number of shareholders cannot exceed 100, and the corporation may issue only one class of stock, although differences in voting rights (e.g., voting and non-voting shares) are permitted.

Summary of Federal Tax Treatment of Pass-Through Entities

Entity	Entity-Level Tax?	Form Used by Owner	Ownership Limits
Sole Proprietorship	No	Schedule C (Form 1040)	One individual
Partnership (GP/LP)	No	Schedule K-1 (Form 1065)	Flexible; any individuals or entities
S Corporation	No	Schedule K-1 (Form 1120-S)	≤100 U.S. shareholders; limited stock classes
LLC (multi-member)	No (if taxed as partnership)	Schedule K-1 (Form 1065)	Flexible
LLC (single member)	No (if disregarded)	Schedule C or E (Form 1040)	One owner; subject to state rules

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