

Taxation With Regard To Different Business Entities

Many clients are aware that business entities are taxed differently, so I often get asked what are the differences in how C-corporations, S-corporations, and Limited Liability Companies (LLCs) are taxed for income tax purposes? Lets look at them.

C-corporations are subject to two layers of tax: a corporate level tax on the corporation's net earnings and a shareholder-level tax on funds that are distributed.

There is no entity-level tax for S-corporations or LLCs. Both S-corporations and LLCs are subject to "pass-through" taxation. With pass-through taxation, income earned by the entity and deductions attributable to the entity's operations are "passed-through" to the shareholders/members in proportion to their interest in the entity, shown on the shareholders'/members' individual income tax returns, and taxed at that individual's ordinary income tax rate.

However, be aware that publicly traded limited liability companies and LLCs that specifically elect to be taxed as corporations are taxed as corporations.

With that all as a background, clients ask if there are differences in how income received by or allocable to the shareholder- employees and member-employees of the entity is treated for payroll tax purposes. The simple answer is yea.

With either a C-corporation or S-corporation, only the amounts received by the shareholder-employee as compensation are subject to payroll taxes. The compensation must be "reasonable," or the IRS may re-characterize a portion of the compensation as a non-deductible dividend or distribution. The different types of corporations have different incentives to either inflate or depress salaries of owner-employees.

In a C-corporation, the tendency is to designate large amounts as compensation to enable the corporation to deduct the payments to the shareholder and reduce the amounts available for payment of dividends, which are subject to the dual taxation mentioned above. (Dividends are not deductible.)

An S-corporation shareholder-employee may desire a lower salary and wish to receive a larger amount in distributions to avoid the payroll taxes on the distribution amount. By comparison, the full distributive share of a LLC owner- member who is employed by the business is subject to employment taxes.

Now lets switch to a look at the rules for deductibility of fringe benefits for owner-employees. Basically, a C-corporation can deduct fringe benefits received by owner-employees, such as hospitalization, to the same extent as it can deduct benefits to non- owner employees. Although an S-corporation can deduct the cost of these ordinary and necessary business expenses, the portion that can be allocated to a shareholder-employee who owns two percent (2%) or more of the corporation's stock is treated as self-employment income to the shareholder-employee receiving the benefit. Then, under the applicable rules for deducting the costs of the benefits for self-employed individuals, the shareholder may deduct the cost on his or her individual return.