

What Tax Classifications Are Available for an US LLC?

When forming a U.S. LLC, many business owners initially focus on the company formation process, the state of formation, and ongoing compliance costs. However, an important tax consideration is often overlooked after the company is established: which tax classification should the LLC use for tax reporting purposes? Unlike a Corporation, an LLC does not have a fixed tax classification under U.S. federal tax law. Depending on the number of members and the election made by the company, an LLC may be taxed as a Single-Member LLC (Disregarded Entity), Multi-Member LLC (Partnership), or Corporation.

These tax classifications only affect the LLC's tax treatment and do not change its legal structure under state law. Regardless of the selected tax classification, the entity remains an LLC registered under applicable state law. Different tax classifications may affect the company's annual filing requirements, profit allocation, potential double taxation, members' individual tax reporting obligations, and future financing or expansion flexibility. This article provides an overview of the three common tax classifications available to LLCs, including their filing requirements, tax characteristics, advantages, and potential considerations.

1. Single-Member LLC (Disregarded Entity)

A Single-Member LLC is an LLC owned by one individual or entity. Unless the LLC elects a different tax classification with the IRS, it is treated by default as a Disregarded Entity for federal income tax purposes. A Disregarded Entity is not treated as a separate taxpayer. Instead, the LLC's income, deductions, expenses, and profits are reported directly on the owner's tax return. For this reason, the default tax treatment is commonly referred to as pass-through taxation.

(1) Filing Requirements

Under the default classification, a Single-Member LLC generally is not subject to federal corporate income tax. Instead, all business income is attributed directly to its sole member. If the member is an individual, the LLC's business income is generally reported on the individual's federal income tax return. For California tax purposes, the LLC is generally required to file California Form 568 (Limited Liability Company Return of Income) to satisfy its state filing obligations.

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(2) Advantages and Disadvantages

The default tax classification provides a relatively simple tax structure because the LLC does not need to file an entity classification election with the IRS. Items of income, deduction, gain, loss, and credit pass directly to the owner, avoiding entity-level federal income taxation.

However, because all business income is attributed directly to the member, the member's taxable personal income may increase as the LLC becomes more profitable.

2. Multi-Member LLC (Partnership)

A Multi-Member LLC is an LLC with two or more members. Unless it elects another tax classification with the IRS, it is generally treated as a Partnership for federal income tax purposes. This is one of the most common tax structures for LLCs in the United States and is widely used by family-owned businesses, jointly operated startups, and cross-border investment LLCs.

(1) Filing Requirements

Under the Partnership tax classification, the LLC itself generally does not pay federal income tax. Instead, the LLC is required to file an annual Form 1065 (U.S. Return of Partnership Income) with the IRS to report the company's income, expenses, deductions, and allocation of profits among its members. Form 1065 is primarily an informational return and does not result in federal income tax being imposed on the partnership itself.

After filing Form 1065, the LLC must issue a Schedule K-1 (Form 1065) to each member. Schedule K-1 reports each member's allocated share of income, losses, interest income, capital gains, and other tax-related information. Each member then uses the information reported on the K-1 to complete their individual tax filings. For California tax purposes, the LLC is generally required to file California Form 568 (Limited Liability Company Return of Income).

(2) Advantages and Disadvantages

A Partnership tax classification does not result in federal-level corporate income tax because the company's profits pass directly through to the members. It also avoids the double taxation issue commonly associated with traditional Corporations. However, because the profits are allocated directly to the members, whether a member is required to file a U.S. individual income tax return must be determined based on the member's tax status and the nature of the income received.

For foreign members, if the LLC generates income that is treated as Effectively Connected Income (ECI), the LLC may also be required to comply with withholding obligations under IRC Section 1446. Therefore, foreign investors using a Partnership

structure should evaluate the LLC's business activities and income sources to determine potential U.S. filing and withholding requirements.

3. LLC Electing to Be Taxed as a C Corporation

In addition to the default tax classifications, U.S. federal tax law allows an LLC to affirmatively elect to be taxed as a Corporation.

(1) Filing Requirements

An LLC electing C Corporation tax treatment must file Form 1120 (U.S. Corporation Income Tax Return) with the IRS and calculate its taxable income under the rules applicable to C Corporations. At the California state level, the LLC generally files California Form 100 (California Corporation Franchise or Income Tax Return). Under this structure, the company becomes a separate taxable entity. The company's profits are first subject to corporate income tax at the entity level. If profits are later distributed to shareholders in the form of dividends, shareholders may also be required to pay applicable taxes on dividend income, potentially resulting in double taxation.

(2) Advantages and Disadvantages

For certain businesses, electing C Corporation taxation may provide several advantages, including a flat federal corporate income tax rate, greater flexibility to retain earnings; and a structure that may better facilitate future equity financing.

However, compared with default pass-through taxation, an LLC taxed as a C Corporation generally faces additional tax and compliance obligations, including the potential for double taxation of corporate profits. Furthermore, if the company later seeks to change its tax classification again, it must consider the IRS rules and limitations relating to entity classification elections.

(3) Tax Classification Conversion Rules

An LLC that wishes to change from its default tax classification to C Corporation taxation must file Form 8832 (Entity Classification Election) with the IRS. Under IRS rules, after an LLC makes an entity classification election, it generally cannot make another entity classification election within five years, unless an applicable exception applies. Therefore, an entity classification election should be viewed as a long-term tax planning decision, rather than a short-term strategy designed solely to obtain a tax benefit in a particular year.

4. Common Situations for Different LLC Tax Classifications

After understanding the different tax classifications available to LLCs, many business owners are left with the following question: Should the LLC maintain its default tax classification, or should it elect to be taxed as a C Corporation? There is no single tax classification that is suitable for every business. The appropriate choice depends on various factors, including the company's business model, expected profitability, ownership structure, profit distribution plans, and long-term growth strategy.

(1) When the Default Tax Classification May Be Appropriate (Single-Member LLC / Partnership)

For the majority of small and medium-sized businesses, maintaining the default pass-through tax classification remains the most common and practical choice. For example, companies that are newly established, have relatively small operating scale, expect profits to be distributed regularly to members, and do not plan to retain significant profits within the company for long-term investment may generally benefit from default taxation. Under the default tax classification, company profits flow directly through to the members, avoiding federal corporate-level income tax and eliminating the double taxation issue that may arise with a traditional C Corporation structure.

(2) When C Corporation Taxation May Be Appropriate

Although most LLCs continue to use their default tax classification, certain businesses may find that electing C Corporation taxation better aligns with their long-term objectives. Examples include companies that expect significant profits and plan to retain earnings within the company for reinvestment, do not intend to frequently distribute profits to shareholders in the short term, plan to raise capital through equity financing, and may pursue institutional investment or a future public offering.

However, it is important to understand that profitability alone does not determine whether C Corporation taxation is the better option. Even if a company generates substantial profits, if those profits are regularly distributed to shareholders, the overall tax burden may not necessarily be lower than that under a Partnership structure.

Reference:

<https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc>

<https://www.irs.gov/pub/irs-pdf/f8832.pdf>

<https://www.ftb.ca.gov/file/business/types/corporations/index.html>

<https://www.irs.gov/businesses/partnerships>

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