**8798. How is an LLC taxed? How is it determined whether an LLC is taxed as a partnership or corporation?**

An LLC may be treated as either a corporation (see Q 8779), partnership (see Q 8764), or sole proprietorship (see Q 8760) for tax purposes. An *eligible entity* (a business entity not subject to automatic classification as a corporation, see below) may elect corporate taxation by filing an entity classification form, otherwise it will be taxed as either a partnership or sole proprietorship depending upon how many owners are involved. Eligible entities can elect how they would like to be classified for tax purposes on IRS Form 8832.

Certain entities, such as corporations organized under a federal or state statute, insurance companies, joint stock companies, and organizations engaged in banking activities, are automatically classified as corporations. An LLC with only one owner will be considered a corporation or a sole proprietorship. In order to be classified as a partnership, the entity must have at least two owners.[[1]](#footnote-1)

If a newly-formed domestic eligible entity with more than one owner does not elect to be taxed as a corporation, it will be classified as a partnership. Likewise, if a newly-formed single-member eligible entity does not elect to be taxed as a corporation, it will be taxed as a sole proprietorship with its profit and loss being reported on Schedule C of the owner’s personal income tax return. Therefore, no separate federal return is required. But even though there is no federal return, some states may still require a separate tax return.2 Also, under most circumstances, a corporation in existence on January 1, 1997 does not need to file an election in order to retain its corporate status.[[2]](#footnote-2)

If a business entity elects to change its classification, rules are provided for how the change is treated for tax purposes.[[3]](#footnote-3)

Revenue Ruling 95-37[[4]](#footnote-4) provides that a partnership converting to a domestic LLC will be treated as a partnership-to-partnership conversion (and therefore be “tax-free”) provided that the LLC is classified as a partnership for federal tax purposes. The partnership will not be considered terminated under IRC Section 708(b) upon its conversion to an LLC so long as the business of the partnership is continued after the conversion. Further, there will be no gain or loss recognized on the transfer of assets and liabilities so long as each partner’s percentage of profits, losses and capital remains the same after the conversion. The same is true for a limited partnership converting to an LLC.[[5]](#footnote-5)

An LLC formed by two S corporations was classified as a partnership for federal tax purposes.[[6]](#footnote-6) An S corporation may merge into an LLC without adverse tax consequences provided the LLC would not be treated as an investment company under IRC Section 351 and the S corporation would not realize a net decrease in liabilities exceeding its basis in the transferred assets pursuant to Treasury Regulation Section 1.752-1(f). Neither the S corporation nor the LLC would incur gain or loss upon the contribution of assets by the S corporation to the LLC in exchange for interests therein pursuant to IRC Section 721.[[7]](#footnote-7) A corporation will retain its S election when it transfers all assets to an LLC, which is classified as a corporation for federal tax purposes due to a preponderance of corporate characteristics (see below), provided the transfer qualifies as a reorganization under IRC Section 368(a)(1)(F) and the LLC meets the requirements of an S corporation under IRC Section 1361.[[8]](#footnote-8)

An LLC that was in existence prior to January 1, 1997, may continue under its previous claimed classification if it meets the following requirements: (1) it had a reasonable basis for the classification; (2) the entity and its members recognized the consequences of any change in classification within the sixty months prior to January 1, 1997; and (3) neither the entity nor its members had been notified that the classification was under examination by the IRS.[[9]](#footnote-9)

Prior to January 1, 1997, whether an LLC was treated as a corporation or partnership for federal income tax purposes depended on the existence or nonexistence of a preponderance of six corporate characteristics: (1) associates; (2) an objective to carry on a business and divide the gains from it; (3) limited liability; (4) free transferability of interests; (5) continuity of life; and (6) centralized management.[[10]](#footnote-10)

Characteristics (1) and (2) above are common to both corporations and partnerships and were generally discounted when determining whether an organization was treated as a corporation or partnership.[[11]](#footnote-11) These former regulations provided an example of a business entity that possessed the characteristics of numbers (1), (2), (4) and (6) above, noting that since numbers (1) and (2) were common to both corporations and partnerships, these did not receive any significant consideration. The business entity did not possess characteristics (3) and (5) above and, accordingly, was labeled a partnership.[[12]](#footnote-12)

1. . Treas. Reg. §301.7701-2.

2. see instructions for form SS-4 [↑](#footnote-ref-1)
2. . Treas. Reg. §301.7701-3. [↑](#footnote-ref-2)
3. . Treas. Reg. §301.7701-3(g). [↑](#footnote-ref-3)
4. . 1995-1 CB 130. [↑](#footnote-ref-4)
5. . Let. Rul. 9607006. [↑](#footnote-ref-5)
6. . Let. Rul. 9529015. [↑](#footnote-ref-6)
7. . Let. Rul. 9543017. [↑](#footnote-ref-7)
8. . Let. Rul. 9636007. [↑](#footnote-ref-8)
9. . Treas. Reg. §301.7701-3(h)(2). [↑](#footnote-ref-9)
10. . Treas. Reg. §301.7701-2(a)(1), as in effect prior to January 1, 1997. [↑](#footnote-ref-10)
11. . Treas. Reg. §301.7701-2(a)(2), as in effect prior to January 1, 1997. [↑](#footnote-ref-11)
12. . Treas. Reg. §301.7701-2(a)(3), as in effect prior to January 1, 1997. [↑](#footnote-ref-12)