

Analysis of Partnership versus S Corporation Tax Structures

Prepared by Glasgow Knight Financial PLLC



GLASGOW KNIGHT
Financial Well-Being, Reimagined

Background Information

- A limited liability company is a creature of state law.
- LLCs with two or more members can *choose* their form of taxation for Federal income tax purposes.
- The default Federal tax classification is a partnership.
- S corporation and C corporation structures are elective and available at any time.
- Because of the double-taxation regime of C corporations and their shareholders, C corporations are not advised at this time.



Two Scenarios

- The next slide presents the following two scenarios:
 - Comparison between a partnership and an S corporation structure with relatively high and relatively low taxable incomes.
- For the sake of simplicity, no bifurcation has been made for two 50/50 partners.



Description	Partnership	S Corp	Partnership	S Corp
Gross Receipts	200,000	200,000	35,000	35,000
Officer compensation	-	70,000	-	20,000
SEP retirement contribution	-	20,000	-	-
Other expenses	90,000	90,000	27,500	27,500
Taxable income	110,000	20,000	7,500	(12,500)
FIT	17,262	714	-	tax benefit
SE Tax 15.3% (ignore SE 1/2)	16,830		1,148	
ER FICA (7.65%)		5,355		1,530
EE FICA (7.65%)		5,355		1,530
Total Taxes	34,092	11,424	1,148	3,060
Monthly tax deposits	No	Yes		
Retirement savings	Maybe	Yes		



Notes on the Scenarios

- Distributive shares of partnership income are generally subject to both Federal income tax and self-employment taxes (at a rate of 15.3%).
- Partners in a partnership do not get “paid” wages.
- Distributive shares of S corporation income are not subject to self-employment taxes.
- S corporations are operating under a watchful eye of the IRS empowered by the U.S. Congress to adjust S corporation officer compensation when those amounts do not appear to be reasonable.



Recommendation

- As the two scenarios illustrate, setting up a limited liability company taxed as a partnership in the earlier years of operation appears to be a prudent step.
- At a certain point, an S corporation election may need to be made. After this election is made, former “partners” would become “officers” and the S corporation would be required to pay reasonable officer compensation subject to Federal income and FICA taxes.
- An added benefit of an S Corporation: it is much easier to set up a Simplified Employee Pension plan in an S corporation than in a partnership. The maximum contribution to SEP plan is 25% of earned income (W-2 wages), limited to \$61,000 in 2022.

