6 types of tax classifications for businesses

Businesses generally fall into six different classifications for tax purposes, including:

1. Sole proprietorship
2. Partnership
3. C corporation
4. S corporation
5. Limited liability company
6. Nonprofit

1. Sole proprietorship

A sole proprietorship is a business owned and operated by one individual. For federal tax purposes, sole proprietorships aren't considered separate from the owner—the business and the owner are legally the same entity. This means the owner's personal assets can be targeted in the event of bankruptcy or legal action taken against the owner.

Sole proprietorships are pass-through entities: The company's profits (or losses) are passed through to the business's owners or shareholders as income to report on their personal tax returns. They then pay tax based on their individual income tax rates. However, because sole proprietors are considered self-employed, they must pay additional self-employment taxes that cover both the employee- and employer-paid portions of Medicare and Social Security taxes.

A single-member limited liability company (LLC) also is considered a sole proprietorship for tax purposes.

2. Partnership

Your business is a partnership if it's owned by two or more individuals who also share the responsibility for management of the business as well as any profits and losses.

For tax purposes, the business's profits pass through to the partners—who report the proceeds on their personal income tax returns. They'll pay federal taxes at their individual income tax rates, typically including self-employment taxes.

There are three main types of partnerships:

General partnerships, in which partners equally share management responsibility as well as any income or losses the business generates.

Limited partnerships, which let outside investors buy into a business while limiting their liability and involvement based on their contributions. This is a more complicated, yet more flexible, form of partnership.

Joint ventures, which often are short-term projects among multiple partners. (If the venture performs well, it may continue as a general partnership, and if it doesn't, the venture can be more easily shuttered.)

3. C corporation

A C corporation, or just corporation, pays corporate income tax because it's separate from its owners and shareholders. Owners or shareholders also must pay tax on any distributions of profits at their personal tax rates. C corporation owners don't pay self-employment taxes, but if they receive a salary, this amount is subject to payroll taxes.

A C corp is the business structure and tax classification most commonly used by major companies, but some small-business owners can choose to take advantage of the benefits as well—such as issuing stock to raise capital. An investor who buys stock holds a fractional interest in the company, reducing an owner's stake in the business.

4. S corporation

S corporations are both a business entity class and a tax structure available to other private entities, such as LLCs and partnerships. S corporations are considered legally separate from their owners, but they generally don't pay corporate income tax.

This avoids the double taxation issue: Any profits or losses pass through to the owners or shareholders, who would pay income tax at their individual rates. Additionally, if owners of an S corp pay themselves a salary, they are subject to payroll taxes on those wages.

To qualify as an S corp, your business must be a domestic company operating in the US, and all shareholders must be US citizens or permanent residents. An S corp can have no more than 100 shareholders, and those shareholders must be actual people—not other corporations, partnerships, or investment funds.

They must have boards of directors, hold annual meetings, and adhere to company bylaws.

Certain industries, such as banks, insurance agencies, and import-export companies cannot be S corps. Plus, some states and cities—such as New York—don't recognize S corps and instead treat them as C corps for tax purposes, which means an S corp and its owner would pay double taxes at the local level.

5. Limited liability company

A limited liability company is a structure commonly used by US small business owners, whether with one owner (single-member LLC) or several (multi-member LLC).

From a legal perspective, LLCs ensure owners' personal assets are insulated from business debts, lawsuits, and other liabilities.

LLC taxation typically depends on their structure. For a single-member LLC, the default tax designation is as a sole proprietor; for multi-member LLCs, the default designation is as a general partnership.

But if LLCs qualify for the rules of corporations, they can choose to be taxed that way. They may petition the IRS to receive a C corporation or S corporation tax classification by filing specific tax forms.

Here are four of the most common types of LLC tax classifications:

Sole proprietorship. This category is for single-member LLCs only. In sole proprietorships, the business and the owner are not considered separate entities: The business's profits or losses pass through to the owner, who pays income tax at their personal rates (along with self-employment tax).

Partnership. This is only for multi-member LLCs, and it's another pass-through entity: The business's profits are reported on each partner's individual tax return, and each pays personal income tax on their disbursement.

C corporation. This can be a single-member LLC, or a multi-member one. The business is considered a separate entity, so the company pays corporate income tax on profits. Any disbursement of profits to the LLC members are subject to taxation again, this time at individual income tax rates. C corp LLC members don't have to pay self-employment taxes, but if they draw a salary they'll remit payroll taxes for Social Security and Medicare.

S corporation.. This may be a single- or multi-member LLC. S corps are considered separate entities from their owners, but the business doesn't pay corporate income tax. Instead the business's profits pass through to the owner or owners as income, and the owners pay individual income tax (although not self-employment tax). Additionally, if owners of an S corp receive a salary, they'll pay payroll taxes on those wages.

6. Nonprofit

Nonprofits are businesses that have been granted tax-exempt status by the IRS, with the reasoning that they are beneficial to society. Churches, public schools, legal-aid societies, public health clinics, museums, and research institutes are examples of nonprofits. They maximize revenue to supply funds for the causes they support, which differentiates them from other tax-exempt organizations that generate revenue simply to pay overhead.

Under this designation, an organization does not pay corporate income tax — though they typically must pay employment taxes for wages paid to staff. On the state level, some nonprofits enjoy even more benefits, such as exemption from paying sales tax on products and services purchased for business use.

To receive this tax-exempt status, an organization must file with the IRS to be recognized as a nonprofit. Once registered as a nonprofit, they must follow state-level charity rules, as well as IRS regulations: promoting welfare, typically avoiding political involvement, adhering to their core mission, and paying all staff fair wages.