Natalie C. Papagni, CPA

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Choosing Your Business Entity

Why the Legal Form and the Tax Form Are Two Separate Decisions

Scenario: A founder is starting a business and must decide how to organize it — sole proprietorship, LLC, partnership, S corporation, or C corporation — and wants to understand what actually drives the choice.

Executive Summary

Most entrepreneurs conflate two separate decisions: the *legal* entity you form under state law, and the *tax* classification that entity carries federally. They are not the same. An LLC is a legal wrapper that can be taxed four different ways; "S corporation" is a tax status, not a state entity. Getting the legal form right protects your personal assets and governs ownership; getting the tax election right determines how you are taxed. The best structure is usually chosen legal-form-first, then tax-election-second — and the two are decided against different criteria.

Key point

An LLC is not a tax classification. By default a single-member LLC is disregarded and a multi-member LLC is a partnership, but the same LLC can elect to be taxed as an S corporation or a C corporation. The legal entity and the tax treatment are chosen independently.

The Two Layers of the Decision

Layer	Governs	Chosen for
Legal entity (state law)	Liability protection, ownership, governance, transferability	Asset protection, investor requirements, operational flexibility
Tax classification (federal)	How income is taxed and reported	Self-employment tax, double taxation, deduction eligibility, exit planning

The Legal Entities

- **Sole proprietorship.** No separate entity; you and the business are one. Simplest and cheapest, but offers no liability shield.
- **Partnership.** Two or more owners; a general partnership forms by default when partners go into business together, with no liability protection unless a limited or limited-liability form is used.

- **Limited liability company (LLC).** A flexible state entity providing a liability shield, with default pass-through taxation and the option to elect corporate treatment.
- **Corporation.** A separate legal person with the strongest liability separation and the governance structure investors expect; taxed as a C corporation unless an S election is made.

The Tax Classifications

Tax status	How profit is taxed	Self-employment / payroll tax
Disregarded (Schedule C)	On the owner's return; no separate entity return	All net profit subject to SE tax
Partnership	Pass-through; Form 1065 and K-1s	General-partner share generally subject to SE tax
S corporation	Pass-through; Form 1120-S and K-1s	Only reasonable W-2 wages subject to payroll tax
C corporation	Taxed at the entity level; dividends taxed again	Wages subject to payroll tax; profit not passed through

What Actually Drives the Choice

- **Liability exposure.** Any business with real risk should sit inside a liability-shielding entity — an LLC or corporation — not a bare proprietorship or general partnership.
- **Self-employment tax.** Once profit is high enough, an S election can reduce payroll tax on the distribution portion (covered in depth in the S-corporation series).
- **Outside investors.** Venture investors typically require a C corporation, often a Delaware C corporation, for its stock structure and familiarity.
- **Reinvestment vs. distribution.** A business retaining earnings to grow may find the C corporation's flat rate attractive; one distributing profit to owners usually prefers pass-through.
- **QSBS potential.** The §1202 qualified small business stock exclusion is available only for C corporation stock — a significant factor for high-growth companies planning an eventual sale.
- **State-specific cost.** California's $800 minimum franchise tax and its 1.5% S-corporation tax affect the after-tax math.

The C Corporation Trade-Off

A C corporation pays tax at the entity level, and shareholders pay again on dividends — the classic "double taxation." For a profit-distributing small business that is usually a disadvantage. But two factors can flip it: the ability to retain earnings at the corporate rate for reinvestment, and the §1202 QSBS exclusion, which can exempt a substantial amount of gain on a later sale of qualifying stock held more than five years. For a company building toward an exit rather than distributing cash, the C corporation deserves a serious look.

Practical Considerations

Decide the legal entity first, driven by liability and investor needs, then choose the tax election to fit the economics. Many California service businesses land on an LLC for legal flexibility with an S election layered on once profit justifies it; venture-track startups more often begin as Delaware C corporations. The election can be added later, but the legal form is harder to unwind, so it is worth getting right at formation.

Next Step: Separate the Two Questions

The right structure falls out of answering the legal question and the tax question independently, then confirming they fit together. A brief analysis of your liability profile, growth and investor plans, and profit trajectory will point to the legal entity, and a projection will confirm the tax election.

Natalie C. Papagni, CPA • Tax, Planning & Advisory Services • 4275 Executive Square, Suite 200, La Jolla, CA 92037 • (858) 754-8277 • service@lajollataxcpa.com • lajollataxcpa.com