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Most owners focus on logical steps when launching a new business like choosing a name, filing formation documents, and opening a bank account. Yet one of the most important early decisions is often misunderstood or missed altogether: How will the business be taxed?

At the outset, there are really two separate decisions to make:

- What legal entity to form
- How that entity is taxed

Many business owners assume these are the same choice, but they're not. Treating them as interchangeable leads to unnecessary taxes, compliance issues, or missed planning opportunities.

Legal Structure vs. Tax Treatment

Whether your legal entity is a limited liability company (LLC), corporation, or partnership determines things like liability protection, ownership structure, and governance. Tax classification, on the other hand, determines how the business income is reported and taxed.

The two are connected, but they don't have to match.

For example, an LLC is often described as a flexible entity. That flexibility exists largely because an LLC can choose how it's taxed, rather than being locked into a single tax regime.

Understanding Default Tax Treatment

If you make no special election, the IRS applies default tax rules:

- A single-member LLC is taxed as a *disregarded entity*, meaning the business

income is reported directly on the owner's personal tax return.

- A multi-member LLC is taxed as a *partnership*, with income and losses passing through to its owners.
- A *corporation* is taxed as a C corporation by default, meaning the business itself pays tax on its income.

These defaults aren't inherently good or bad, but they may not fit every business.

S Corporation Elections: What They Do (and Don't Do)

An S corporation isn't a type of entity you form under state law. It's a tax election a qualifying business makes with the IRS.

Both corporations and LLCs can elect S corporation status if they meet certain requirements. The primary appeal is potential savings on self-employment taxes, since some income may be treated differently than standard business profits.

However, S corporation status comes with added responsibilities, including payroll requirements, stricter ownership rules, and more administrative complexity. It's not a one-size-fits-all solution.

When an LLC Might Choose a Different Tax Path

One of the most common planning opportunities involves an LLC choosing how it will be taxed. For example:

- A single-member LLC may start out taxed as a disregarded entity for simplicity.
- As the business grows and generates more income, the owner may elect S corporation taxation to manage self-employment tax exposure.
- In other cases, particularly where profits are reinvested or outside investors are involved, an LLC might elect to be taxed as a C corporation.

The point is that the legal structure can stay the same while the tax treatment changes over time.

Self-Employment Tax: A Frequent Surprise

Many new business owners are caught off guard by self-employment taxes. Income from disregarded entities and partnerships is generally subject to these taxes, which fund Social Security and Medicare.

Forming an LLC doesn't eliminate this obligation. In some cases, an S corporation election may reduce the portion of income subject to self-employment tax, but only if the structure is set up and maintained properly.

This is an area where assumptions can be costly.

How Tax Treatment Can Change

Consider a few typical scenarios:

- A consultant forms a single-member LLC and is taxed as a disregarded entity. All income flows directly to the owner's personal return.
- Two partners form an LLC and are taxed as a partnership, sharing profits and losses according to their agreement.
- That same LLC later elects S corporation taxation as revenue increases, changing how certain income is treated for tax purposes.

In each case, the underlying entity is the same. What changes is how the IRS views and taxes the business.

Why Coordination Matters

Tax elections don't happen in a vacuum. They interact with ownership structure, compensation decisions, and long-term business goals.

That's why coordination between legal counsel and a CPA is vital. An attorney may focus on liability protection and governance while a CPA focuses on tax efficiency and compliance. Without alignment, important considerations can be missed.

A Practical Takeaway

Early tax decisions don't need to be perfect, but they should be intentional. The goal isn't to master the tax code but to understand that choices made at formation can affect how income is taxed, how profits are distributed, and how the business evolves.

Business owners who recognize the difference between entity formation and tax classification and plan accordingly are better positioned to avoid surprises and adapt as their business grows.

A short conversation with the right advisors at the beginning can prevent far more complicated conversations later.

