

Choosing Your Business Structure

LLC, S-Corp, C-Corp, and What Actually Matters — A practical guide to the right legal stru...

By Bob Wells, CFO & Financial Advisor | bobwellsco.com

The question I hear most often: "Should I be an LLC, S-Corp, or C-Corp?" The honest answer is that it depends on your specific situation—ownership structure, management needs, tax exposure, and growth plans. There's no universal right answer.

But there are clear wrong answers. I've seen owners create serious problems by choosing a structure without understanding the operational and tax consequences. The goal here is to walk through each structure honestly, show you what actually matters, and help you ask the right questions of your accountant.

The Simplest Structure: Sole Proprietorship

If you're self-employed and haven't formally registered your business with the state, you're a sole proprietor. No paperwork. No business entity. Just you.

Liability: Complete personal exposure. Your business debts are your personal debts. Creditors can go after your personal assets, bank accounts, and home. If someone sues your business, they're suing you.

Taxes: You pay all business income as personal income. You file Schedule C with your personal return. You pay self-employment taxes (Social Security and Medicare) on 92.35% of your net profit—that's about 15.3% of your earnings right off the top, quarterly.

When it makes sense: Very small side businesses where you want zero complexity. A freelancer or consultant with minimal liability risk. Once you're serious about a business, you should register it as something else.

Multiple Owners: Partnerships

General Partnership (GP)

You and one or more partners in business together. No formal registration required (though you should file if required by your state). General partners are all liable for the debts and actions of the partnership—and crucially, for the actions of each other.

Liability: Jointly and severally liable. If your partner makes a bad business decision, takes on debt, or gets sued—you're liable. If your partner commits fraud or runs up partnership debts, you're on the hook. This is dangerous territory.

Taxes: The partnership files Form 1065 (informational). Each partner receives a Schedule K-1 showing their share of profit and loss, and reports it on their personal return. Self-employment taxes apply to your share of profits.

Agreement: You must have a partnership agreement in writing. I've seen too many "handshake" partnerships end in disaster. Define who contributes what, how profits are split, what happens if someone wants to leave, and how decisions are made.

When it makes sense: Rarely. Only if you completely trust your partners and have ironclad agreements. The liability exposure usually isn't worth it.

Limited Partnership (LP)

One or more general partners (with full liability) and one or more limited partners (with liability capped at their investment). This is useful for real estate deals, private equity structures, or family limited partnerships.

The appeal: Limited partners put in money and stay passive. They can't lose more than they invested. The general partner bears the operational and liability risk, but also controls the business.

The catch: Limited partners can't be involved in operations or decisions. If they participate in management, they lose limited liability protection. This is a real constraint.

Taxes: Form 1065 like a GP. Limited partners report their K-1 allocation on personal returns, but without self-employment taxes (they're passive investors). General partners pay full self-employment taxes on their share.

When it makes sense: Acquisition deals with investors, real estate partnerships, or family wealth structures where passive investors put money in and active managers run the business.

Limited Liability Protection Without Simplicity: LLCs and LLPs

Limited Liability Partnership (LLP)

Similar to an LP, but all partners have limited liability. Their personal exposure is limited to their investment. Specific professions—law, accounting, medicine, architecture—are often required by their states to use LLPs.

When it makes sense: Professional services firms where the rules require it. Otherwise, an LLC usually accomplishes the same thing more cleanly.

Limited Liability Company (LLC)

An LLC is a registered business entity that gives owners (called "members") limited liability protection—your personal assets are separate from business debts and liabilities. This is what most small business owners should use.

Liability: Your personal assets are protected from business creditors, lawsuits, and debts. There are exceptions (fraud, piercing the corporate veil), but generally you can only lose what you invested.

Taxes: This is where it gets tricky. An LLC is not a tax entity—it's a legal entity. For tax purposes, the IRS lets you choose how you want to be taxed. By default, the IRS assumes:

- **Single-member LLC:** Taxed as a sole proprietorship
- **Multi-member LLC:** Taxed as a partnership (Form 1065, K-1s)

But you can elect to be taxed as an S-Corp or C-Corp instead. This flexibility is powerful, and it's also where most owners get confused.

The critical issue I see all the time: LLC taxed as a partnership. If you're a multi-member LLC with a partnership tax election, the owners cannot be employees of the LLC. You receive only distributions of profit. You cannot take a W-2 salary.

This matters because distributions are not subject to self-employment taxes, which sounds great—until you don't have payroll and your accountant is filing K-1s with zero W-2 wages. The IRS notices this. If your business generates substantial income but you have no W-2, expect scrutiny. The safer approach: take a reasonable W-2 salary, then take distributions on remaining profit.

Operating agreement: You need one. It defines member rights, profit splits, management structure, and what happens if a member wants to leave. Without one, your state's default LLC statutes apply—which may not be what you want.

When it makes sense: Most small businesses. You get liability protection with simpler administration than a corporation. You can grow into S-Corp or C-Corp taxation later if it makes sense.

The Tax-Efficient Option for Owner-Operators: S-Corporation

An S-Corp is not a separate legal entity—it's a tax election. Your LLC or Corporation (C-Corp) "elects S-Corp status" by filing Form 2553 with the IRS. You must do this within 75 days of startup or by March 15 of the second tax year, or you'll default to C-Corp taxation.

The fundamental difference from an LLC taxed as a partnership: S-Corp owners CAN be employees. You take a W-2 salary for work actually performed. Any remaining profit distributes to owners as non-W-2 distributions, which avoid self-employment taxes.

Important: The S-Corp advantage applies only to payroll taxes (Social Security and Medicare), not to income taxes. The S-Corp is a pass-through entity—all profit flows to your personal return and is taxed at your ordinary income tax rate regardless of whether it came as salary or distributions. There is no income tax advantage. Here's a simple example:

- Your business generates \$100,000 profit
- **As a sole proprietor or LLC partnership:** You pay 15.3% self-employment tax on the full \$100K = \$15,300 in payroll taxes (Social Security + Medicare, both the employer and employee portions)
- **As an S-Corp:** You take a reasonable salary of \$60K and distribute \$40K as profit. Payroll taxes apply to the salary only: 7.65% employee share + 7.65% employer share = \$9,180. The \$40K distribution avoids payroll taxes entirely. Savings: \$6,120

In both cases, you pay ordinary income taxes on the full \$100,000. The only savings is the 15.3% in payroll taxes on the \$40,000 that was distributed instead of paid as salary.

At higher income levels, the strategy gets more nuanced. Social Security taxes cap at \$184,500 in wages (2026). Many S-Corp owners set their salary at or near this cap so they maximize their eventual Social Security retirement benefits, while still saving on Medicare taxes (2.9% combined) on all income above the salary amount. For a business with \$1 million in profit, setting salary at \$184,500 means \$815,500 avoids Medicare taxes entirely—a savings of about \$23,650 per year.

A word of caution: When you pay less into Social Security, you reduce your future Social Security retirement benefits. Those benefits are calculated based on your lifetime earnings subject to Social Security tax. Some owners accept this tradeoff; others deliberately set their salary at the Social Security maximum to protect their retirement income while still saving on Medicare taxes above that threshold.

The catch: The salary must be "reasonable compensation." You can't pay yourself \$1,000 a year and distribute \$99,000 to dodge payroll taxes. The IRS will recharacterize distributions as wages. But if you're performing work, a reasonable split between salary and distribution is acceptable.

Compliance: You must file Form 1120-S (separate tax return for the S-Corp entity), issue K-1s to owners, run payroll (even for a one-person company), and file payroll tax returns quarterly. More

administrative burden, but the tax savings often justify it.

Limitations: S-Corps are limited to 100 U.S. shareholders, all of whom must be individuals (not corporations or trusts, with narrow exceptions). If you have outside investors, an S-Corp might not work.

When it makes sense: Owner-operated businesses generating \$60,000+ profit where the owner is actively working. The payroll tax savings need to exceed the cost of additional accounting and compliance. Below \$60K in profit, the savings usually don't justify the extra complexity.

The Traditional Corporation: C-Corporation

A C-Corp is a traditional corporation—separate legal entity, separate tax entity, board of directors, formalities (meetings, resolutions, bylaws).

Liability: Strong protection. Shareholders' liability is limited to their investment. The corporation is the legal "person."

Taxes: The corporation pays federal income tax at a flat 21% rate. When you distribute profits as dividends to shareholders, they pay personal tax on those dividends (capital gains rate, 0/15/20%, or ordinary income depending on the dividend type). This creates double taxation.

The math on double taxation: Federal tax alone on C-Corp profit is 21% at the corporate level plus up to 20% at the shareholder level = approximately 36.8% combined on qualified dividends. The maximum personal income tax rate is 37%, so for high-income owners, C-Corp double taxation isn't much worse than personal taxation—especially if profits are retained in the business for growth.

Advantages: Unlimited shareholders (investors), multiple classes of stock, separate tax entity, corporate structure appeals to some investors or lenders. You can also retain earnings tax-efficiently for growth or to pay them out as salaries (which are deductible to the corp).

Disadvantages: Double taxation, more formalities, more compliance. You must maintain corporate records, hold meetings, file separate tax returns, and keep personal and corporate assets clearly separate.

When it makes sense: Growing companies planning to raise institutional capital, companies with outside investors, or companies retaining significant earnings for reinvestment where double taxation is acceptable. Rarely the right choice for solo operators or small family businesses.

Structure Comparison at a Glance

The Decision Framework

Don't choose your structure in a vacuum. Ask yourself these questions:

1. What's my liability exposure?

Are you in a high-liability business? Professional services, manufacturing, healthcare? You need liability protection. Sole proprietorship is out. You need at least an LLC or corporation.

2. What's my ownership structure?

Are you solo? Partners? Outside investors? Solo owner-operators often end up as LLC-taxed-as-S-Corp. Partnerships need clear agreements. Investor-backed businesses often use C-Corps or LLC-taxed-as-C-Corp.

3. What's my profit level and growth trajectory?

Below \$60K profit, an LLC taxed as partnership is probably fine. \$60K-\$250K? S-Corp election usually saves money. Above \$250K with multiple owners or outside investors? C-Corp or more complex structures may make sense.

4. Do I need flexibility to take a W-2 salary?

Owner-operators managing their own payroll taxes usually benefit from S-Corp treatment. Passive partnerships or investor groups typically use partnerships or C-Corps.

5. What are the state and local requirements?

Some states require specific structures for certain professions. State fees and annual filings vary. Don't ignore the operational costs.

The Bottom Line

Most growing small businesses should start as an LLC. It gives you liability protection, simplicity, and the option to change your tax treatment later. An LLC is not permanent—you can always elect S-Corp status, convert to a corporation, or restructure as your situation changes.

The mistake I see most often is overthinking this at startup. You don't need a perfect structure on day one. You need protection, clarity, and flexibility. An LLC with a solid operating agreement checks all three boxes for most businesses.

The second most common mistake: choosing a structure without understanding the tax implications. "I heard S-Corps save taxes" is not a strategy. You need to model your specific numbers with an

accountant who understands your business, your profit projections, your ownership, and your risk tolerance.

One more critical point: if you're a multi-member LLC taxed as a partnership, you must have a written operating agreement defining profit splits, member roles, and what happens when someone wants to leave. Handshake deals on this create expensive legal messes.

Your structure should support your business. If you're spending more time managing filings than growing the business, it's too complex. If you're taking unnecessary tax risk to avoid complexity, it's too simple. The right structure is the one you can actually maintain while staying compliant.

If you're wondering whether your current business structure is still the right one as you grow — that's a question worth exploring.

Next Steps

Sit with your accountant and model your specific scenario. Show them your projected profit, your ownership structure, your state requirements, and your growth plans. The cost of an hour of competent accounting advice now is nothing compared to the cost of fixing the wrong structure later.

Have questions about your specific situation? I'm happy to discuss your business structure and what might make sense for your goals.

This article is for general informational purposes and does not constitute legal, tax, or financial advice. Consult with qualified professionals before making decisions based on this content.

If you'd rather know than guess about your financials, let's have a conversation. A conversation costs nothing. Clarity might be worth everything.

bob@bobwellscfo.com | bobwellscfo.com | [linkedin.com/in/bobwellscfo](https://www.linkedin.com/in/bobwellscfo)