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ENTITY DECODER: STATE VS. IRS

UNDERSTANDING THE DIFFERENCE

READ NOW

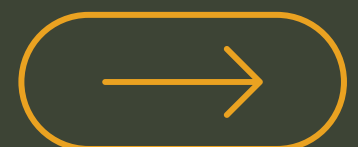


THE MOST CONFUSING PART OF BUSINESS ENTITIES (FINALLY EXPLAINED!)

Here's what trips up 90% of business owners: **your legal entity and your tax entity are completely different things, even though they use the same wording frequently.**

You might form an LLC with your state, but elect to be taxed as an S-Corporation with the IRS. Or you could incorporate as a Corporation with your state, but elect S-Corporation taxation with the IRS.

Think of it like this: **your state cares about legal structure and liability protection. The IRS cares about how you pay taxes.** They're two different systems with two different purposes.



STATE SIDE:

LEGAL FORMATION & PROTECTION

What Your State Cares About:

- Legal liability protection
- Business registration and compliance
- Annual fees and filings
- Operating agreements and bylaws
- Public record keeping

Your State Formation Options:

- **Sole Proprietorship**: No formal registration needed
- **LLC (Limited Liability Company)**: File Articles of Organization
- **Corporation**: File Articles of Incorporation
- **Partnership**: May or may not require registration depending on type
- Plus more depending on the state: we want go into more than this here

Key Point:

When you form an LLC with your state, you get liability protection. The state doesn't care how the IRS taxes you—that's between you and the federal government.

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IRS SIDE:

TAX TREATMENT & ELECTIONS

What the IRS Cares About:

- How business income and expenses are reported
- What tax forms need to be filed
- How self-employment taxes are calculated
- When and how business taxes are paid

Your IRS Tax Implications:

- **Sole Proprietorship/Single-Member LLC:** Default Disregarded Entity -> Schedule C on personal return
- **Partnership & Multi-Member LLC:** Default Partnership (tax entity type) -> Business files Form 1065, partners get K-1s
- **S-Corporation:** A Tax Election have to make by filing form 2553 -> Business files Form 1120S, owners get K-1s and if owners are also employees get W-2s
- **Corporation:** Default C-Corporation -> Business files Form 1120, separate tax entity

Key Point:

The IRS has "default" tax treatments, but you can often ELECT different treatments by filing the right forms.

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HOW STATE FORMATION + IRS ELECTIONS WORK TOGETHER

COMMON COMBINATIONS:

Single-Member LLC (State) + Disregarded Entity Tax Status (IRS)

- **State Formation:** LLC Articles of Organization
- **IRS Default:** Ignored entity (taxed like sole proprietorship)
- **Tax Filing:** Schedule C on personal Form 1040
- **Protection:** Yes (from state LLC)
- **Self-Employment Tax:** Yes, on all profit

Single-Member LLC (State) + S-Corp Tax Election (IRS)

- **State Formation:** LLC Articles of Organization
- **IRS Election:** Form 2553 (S-Corp election)
- **Tax Filing:** Form 1120S + personal Form 1040 (from K-1)
- **Protection:** Yes (from state LLC)
- **Self-Employment Tax:** Only on salary portion

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HOW STATE FORMATION + IRS ELECTIONS WORK TOGETHER

COMMON COMBINATIONS:

Corporation (State) + C-Corp Tax (IRS)

- **State Formation:** Articles of Incorporation
- **IRS Default:** Form 2553 (S-Corp election)
- **Tax Filing:** Form 1120
- **Protection:** Yes (from state corporation)
- **Self-Employment Tax:** Have social security and medicare tax if W-2 employee of company only

Multi-Member LLC (State) + Partnership Tax (IRS)

- **State Formation:** LLC Articles of Organization
- **IRS Default:** Partnership taxation
- **Tax Filing:** Form 1065 + K-1s to members
- **Protection:** Yes (from state LLC)
- **Self-Employment Tax:** Yes, for active members

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DEFAULT TAX TREATMENTS

(WHAT HAPPENS IF YOU DO NOTHING)

If You Form an LLC:

- **Single-member LLC:** IRS treats it as a Disregarded Entity
- **Multi-member LLC:** IRS treats it as a Partnership

If You Form a Corporation:

- **Default:** IRS treats it as C-Corporation

If You Don't Form Anything:

- **Default:** Sole proprietorship at state level (legal purposes) and IRS treats it as a Disregarded Entity

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REAL-WORLD EXAMPLES

EXAMPLE 1: SARAH'S CONSULTING BUSINESS

What Sarah Did:

- Formed LLC with Colorado Secretary of State
- Elected S-Corp taxation with IRS

Result:

- **Legal protection:** Colorado LLC protects personal assets
- **Tax treatment:** Files Form 1120S, pays herself W-2 salary, takes distributions
- **Best of both worlds:** LLC flexibility + S-Corp tax savings

EXAMPLE 2: MIKE & LISA'S PRODUCT BUSINESS

What They Did:

- Formed LLC with Texas Secretary of State (multi-member)
- Accepted default partnership taxation with IRS

Result:

- **Legal protection:** Texas LLC protects both partners' personal assets
- **Tax treatment:** Partnership files Form 1065, Mike and Lisa each get K-1s
- **Simple structure:** LLC operating agreement + partnership tax treatment

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REAL-WORLD EXAMPLES

EXAMPLE 3: TECH STARTUP

What They Did:

- Incorporated as C-Corp with Delaware Secretary of State
- Accepted default C-Corp taxation with IRS

Result:

- **Legal protection:** Delaware corporation structure
- **Tax treatment:** Separate corporate tax entity, good for investors
- **Growth ready:** Easy to raise capital and go public

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COMMON CONFUSION POINTS

“I HAVE AN LLC, SO I’M TAXED AS AN LLC”

Wrong! There’s no such thing as “LLC taxation.” LLCs are taxed as disregarded entities, partnerships, S-Corps, or C-Corps depending on elections and membership (meaning number of owners).

“S-CORP IS A TYPE OF BUSINESS ENTITY”

Not exactly! S-Corp is a tax election. For instance, you can be an LLC that elects S-Corp taxation, or a corporation that elects S-Corp taxation.

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COMMON CONFUSION POINTS

**“I NEED TO CHANGE MY ENTITY TO GET DIFFERENT TAX
TREATMENT”**

Often false! You might just need to make a tax election with the IRS. Check before dissolving and reforming entities.

“MY STATE TAX FOLLOWS FEDERAL TAX ELECTION”

Sometimes, but not always! The most common hiccup is that some states don't recognize S=Corp elections. Some have their own entity taxes regardless of federal treatment,

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IMPORTANT TIMING RULES

S-CORP ELECTIONS:

- **New entities:** Must elect within 75 days of formation OR by March 15th of tax year they want to elect for
- **Existing entities:** Must elect by March 15th of the year you want it to take effect (for example, electing for 2026, need to file by March 15, 2026 to be treated as an S Corporation for 2026)
- **Late elections:** Possible but requires special procedures

C-CORP TO S-CORP:

- Must elect by March 15th of tax year
- Once you elect S-Corp, you generally can't go back to C-Corp for 5 years

STATE FORMATIONS:

- Can generally be done anytime
- Some states have expedited processing for additional fees

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STATE FORMATION VS. TAX ELECTION FRAMEWORK

In the next page are some typical ways that people think through state formation and tax entity types. This does not take into account all of your personal goals. PLEASE REACH OUT TO US OR ANOTHER TAX PROFESSIONAL ABOUT YOUR SPECIFIC CIRCUMSTANCES.

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In addition, the below don't take into account what happens when you have multiple of these situations going on and is just a helpful framework for thinking through what different legal and tax entities do. THIS IS NOT LEGAL ADVICE.

Your Goal	State Formation	IRS Tax Election
Liability Protection	LLC or Corporation	Any doesn't affect protection
Simple Taxes	LLC or None	Sole Prop or Partnership
Self-employment tax savings	LLC (preferred)	S-Corp Election
Raise Investment	Corporation	C-Corp (usually)
Multiple Partners	LLC	Partnership or S-Corp
Retain Earnings	Corporation	C-Corp

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COMMON CONFUSION POINTS

Step 1: Identify Your Current Status

- State side: What did you file with your state? LLC? Corporation? Nothing?
- IRS side: How did you file taxes last year? Schedule C? Form 1120S? K-1?

Step 2: Check for Misalignment

- Are you getting the protection you think you have?
- Are you paying more taxes than necessary?
- Are you filing the right forms?
- What are your goals? (Selling the business, making it a lifestyle business, etc.)

Step 3: Research Changes Needed

- Would different tax election save money?
- Do you need liability protection you don't have?
- Are there compliance issues with your current setup?

Step 4: Understand Timing

- When would changes take effect?
- What are the deadlines for elections?
- What forms need to be filed?

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RED FLAGS THAT NEED PROFESSIONAL HELP

- You're not sure what entity you actually have
- Your tax filings don't match your entity formation
- You have multiple states involved
- You have foreign ownership or international operations
- You're considering major changes close to year-end
- You have multiple business entities or complex ownership

BOTTOM LINE

State formation gives you legal protection and business structure. IRS elections determine how you pay taxes. They're separate decisions that work together.

Next step: Use our "What Entity Am I?" worksheet to identify your current status and any needed changes.

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PRO TIPS

Tip 1: Keep Good Records

- Document both your state formation AND your federal tax elections. These are two separate decisions with two separate paper trails.

Tip 2: Review Annually

- Your optimal structure can change as your business grows. What made sense at \$30k revenue might not make sense at \$100k.

Tip 3: Consider State Taxes

- Some states have entity-level taxes regardless of federal elections. Factor this into your analysis.

Tip 4: Plan Ahead

- Most elections have timing requirements. Don't wait until December to make changes for the current tax year.

Tip 5: Get Professional Help for Complex Situations

- The cost of getting it wrong often exceeds the cost of professional guidance.

Remember: This guide covers federal tax rules. State tax rules can vary significantly. When in doubt, consult with a professional familiar with your specific state's requirements.