



## What Type of Entity Should I Form?

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C corporations, LLCs, and S corporations differ significantly in the areas of taxation, ownership, fundraising, governance and structure, and employee compensation. Almost all technology startup companies that I work with are C corps. Any company that raises venture financing will need to be a C corp in order to issue preferred stock.

If founders want the benefit of flow through tax treatment with respect to losses prior to an outside financing, an S corp election may make sense as long as there are no entity or non-U.S. citizen/resident stockholders. However, S corp losses can only be used to offset personal income up to the founders' basis in the S corp stock, which may decrease the utility of the S corp election. In any event, the S corp election can be easily revoked at the time of a financing. The legal documentation for an S corp is basically identical to an C corp.

I generally avoid LLCs as most technology startup companies need to grant options to employees and consultants, and there is no easy "off the rack" method to do this. In addition, the conversion of an LLC to a C corp results in additional legal and accounting expense. However, LLCs may make sense for businesses like consulting companies. The primary differences between C corps, LLCs and S corps are outlined below.

### Taxation

- C Corporations. A C corporation is a separate taxable entity independent from its stockholders. Thus, the earnings of a C corporation are generally taxed twice: once at the corporate level on the corporation's taxable income and a second time at the stockholder level on dividends or distributions. In addition, C corps often must pay higher state franchise taxes than LLCs or S corps.

Although the double-taxation feature of C corps may be undesirable, its impact may be diminished where a company does not pay dividends or generates taxable income at a lower marginal tax rate than the rate applicable to the individual stockholders. If a C corp generates net operating losses rather than net income, these are carried forward to offset future corporate taxable income. However, such operating losses may not be used to offset taxable income of the individual shareholders.

- Limited Liability Companies. LLCs are flow through entities for tax purposes, meaning that taxable income earned by the entity is passed through to individual members. Thus, earnings are taxed only once, at the member level. An LLC may elect to be taxed as a C corp, an S corp, or a partnership. It may specially allocate items of income or loss among its various members. It may use taxable losses generated at the entity level to offset taxable income of the individual LLC members. However, such flexibility is countered by increased compliance costs due to the application of complex partnership tax rules that also apply to LLCs.

- S Corporations. Similar to LLCs, S corps receive flow through tax treatment. However, an S corp must allocate its taxable income to the individual stockholders according to their ownership stakes in the company. Taxable losses at the entity level may be used to offset personal taxable income of the individual stockholders, but only to the extent of the tax basis of their interests in the entity.

## Ownership

- C Corporations.. C corporations may have an unlimited number of stockholders. The articles of incorporation can create different classes of stock with each class having different rights. The possibilities are limitless. For example, the articles can designate a "preferred" class of stock (in addition to default "common" stock) that provides for guaranteed dividends but with no right to elect directors. Stock holders may transfer their ownership freely and readily (by selling their stock) without affecting the continuing existence of the business or the title to its assets. Thus, the perpetual existence of the entity is unaffected by the death or withdrawal of any one shareholder.
- S Corporations. An S corporation is an ordinary corporation created under state law that has made an election with the IRS to be taxed under Subchapter S of the Code (thus making it a "pass-through" entity with no double taxation). To enjoy that status, however, it must be limited to 100 domestic stockholders. Stockholders must be individuals, with limited exceptions for certain trusts, estates, and exempt organizations. Stockholders must also be U.S. citizens or residents. Ownership transferability is flexible and similar to that of C corporations and has perpetual existence unaffected by the death or withdrawal of any stockholder.
- Limited Liability Companies. Like a corporation, an LLC can protect its owners from many types of potential liability. Compared to corporations, however, LLCs are easier maintain because they don't require that there be a "board of directors" as the source of authority for the corporation to take actions. LLCs are essentially partnerships that provide the owners with limited liability protection similar to that enjoyed by the owners of corporations. Instead of being called "partners", however, the owners are called "members". Instead of calling the governing document a "partnership agreement" it is called an "operating agreement". Similar to a corporation, an LLC may have an unlimited number of owners (i.e. members). However, ownership transferability for an LLC is not as flexible as it is with a corporation. Generally, a member needs the approval of other members before selling an interest in the LLC. Also, a death, withdrawal, expulsion, or other departure of a member may constitute a termination of the LLC and a deemed liquidation for federal tax purposes (though that type of outcome can be avoided by a carefully crafted operating agreement).

## Fundraising

- C Corporations.. Most venture and institutional investors favor C corps because they may have separate classes of stock, allowing for the creation of various levels of preferences, protections, and share valuations. A C corp is also the easiest type of entity to take public in an initial public offering.
- Limited Liability Companies. Although LLCs may be attractive to businesses financed by a small number of corporate investors and/or individuals, they are often not suitable for companies

planning to attract venture capital or pursue multiple rounds of funding. LLCs require complicated operating agreements that may render the operation of the LLC undesirably difficult with a high number of members. They may be unattractive to tax-exempt venture fund investors because their investment in a flow through entity may produce unrelated business taxable income. Finally, investors simply may be less familiar with LLCs and therefore less willing to invest in them.

- S Corporations. S corps are not a popular entity choice because, in addition to presenting the same challenges to tax-exempt venture fund partners as those presented by LLCs, S corps are limited to one class of stock (meaning no preferred stock financings) and 100 stockholders. Such inflexible features are typically unattractive to venture investors.

### **Governance/Structure**

- C Corporations.. C corps have well-defined structural accountability, with governance responsibilities held separate and apart from the owners. Management is accountable to the board of directors and therefore has the ability to transact business without stockholder participation in each decision. However, corporations are required to pay attention to formalities that legislatures and courts have determined to be significant (e.g., meetings of boards of directors and maintenance of corporate bylaws, corporate minute books, stock ledger books, separate bank accounts, etc.).
- Limited Liability Companies. LLCs operate more informally than C corps and are either managed directly by the owners or managed by one or more owners (or an outside party) designated to fulfill such responsibility. Unlike corporations, they are not bound by corporate formalities such as holding regular ownership and management meetings. However, in contrast to corporations, they do not operate under a well-defined regime of uniformity and legal precedent.
- S Corporations. S corps operate in a manner similar to C corps. and must therefore adhere to statutory formalities for decision making.

### **Employee Compensation**

- C Corporations.. Businesses that plan to use equity incentives (e.g. stock options) to attract and retain talent often prefer to operate as C corps. C corps can offer incentive stock option plans that allow employees to defer tax on the equity compensation until they sell the underlying stock. Additionally, C corps. may offer certain fringe benefits to employees that are tax-deductible to the company and also tax-free to the employee.
- Limited Liability Companies. While an LLC may reward employees by offering them membership interests in the LLC, the equity compensation process is awkward and may be unattractive to employees. Furthermore, LLCs are not able to offer certain forms of equity compensation available to C corps., such as incentive stock options.
- S Corporations. Although S corps can grant stock options, they should not be granted to non-U.S. residents. S corps are less flexible than C corps with regard to fringe benefits and must either report the benefits as taxable compensation to the employees or forfeit the fringe benefit deduction available to the company.