Choice of entity: ten topics startups should consider when selecting an entity structure

By Kerra Melvin

One of the first major decisions a startup founder makes is selecting an entity structure. Each type of entity has its own advantages and disadvantages. Below are ten questions and responses to help guide a founder in choosing the most appropriate entity.

What types of entities are available?

While there are numerous forms of business entities, those most commonly used by startups are limited liability companies (LLCs) and corporations. Founders may have also heard of two distinct types of corporations: "C corporations" and S corporations." These are distinct because of the two ways corporations are taxed by federal and many state governments. By default, a corporation will always be identified as a C corporation for federal income tax purposes. However, a corporation may qualify to make a special "Subchapter S" election (S election) to receive pass-through tax treatment like an LLC a corporation that has made an S election is referred to as an "S corporation." Choosing between these entities involves important legal, financial and tax considerations, some of which are summarized below. For more about LLCs, please see our separate article.

Which entity structure is preferred by outside investors?

Choosing an entity structure that supports investor participation is a crucial consideration. The entity structure most preferred by professional investors is a C corporation. C corporations are investor friendly because they allow for multiple classes of stock, such as preferred stock, which grant the holder certain preferences over common stockholders (traditionally, institutional investors receive preferred stock in private companies), without imputing to the holder its profits and losses.

A limited liability company is a less favorable entity for investors for a few reasons. LLCs are a very popular choice for small businesses due to their simple structure, but that structure often makes the entity less popular with institutional investors. The management of an LLC can be structured in two ways: member-managed and manager-managed. Generally, LLCs are run by their members as a member-managed LLC unless they elect to be managed by a management group as a manager-managed LLC. The management group of a manager-managed LLC functions like a corporation's board of directors and may include both members and nonmembers.

Some venture investors, prior to or upon making an investment, will request that a member-managed LLC convert to a manager-managed structure or a corporation. This may be an investor preference or may be required by the investor's charter documents. Though a manager-managed LLC may be more suitable for investors than a member-managed LLC because it resembles a corporate board structure, allowing for the consolidation of management power to the key investors and individuals who are running the business, the inherent flexibility of an LLC's structure can cause investors some apprehension. As a practical matter, this means that an LLC may be a good entity choice to start with because of its tax advantages (described below) and ease of formation. But founders should keep in mind that it may be preferable for an LLC to convert to a corporation prior to taking outside investment or before entering public equity markets. It is also important to keep in mind that the pass-through nature of an LLC results in members incorporating the company's tax obligations in the members' tax returns, which is not the case with C corporations.

An S corporation is a blend of a C corporation and an LLC it is organized as a corporation at the state level, but elects to be taxed as a pass-through entity for federal income tax purposes. The steps a founder takes to form an S corporation at the state level are the same as a C corporation but to be eligible for and maintain S corporation status, a company must meet the following requirements:

- be a domestic corporation
- have only allowable stockholders
  - Allowable stockholders: individuals, certain trusts and estates
  - Disqualifying stockholders: partnerships, corporations and non-resident aliens

- have no more than 100 stockholders
- have only one class of stock (common stock) and
- not be an ineligible corporation (*ie,* certain financial institutions, insurance companies and domestic international sales corporations are ineligible).

If any of these requirements are no longer met, the company's S election is revoked and the company will be taxed for federal income tax purposes as a C corporation.

As a practical matter, an S corporation will lose its S election status when it takes an investment from a disqualifying stockholder (such as a venture capital fund). This means that while an S corporation may be a good entity choice to start because of its tax advantages, founders should keep in mind that they may eventually lose their S election status and be taxed as a C corporation.

Consider the following scenarios to help guide your entity selection*:*

- *You are a founder and know a venture investor who wants to invest in you now*: If you are forming on the cusp of taking on outside institutional investors (non-individuals and non-friends and family), you will want to form a C corporation for such investment purposes.
- *You are in the boot-strap phase and you don't know if you will ever take on more than friends-and-family money*: If you intend to boot-strap the startup and are only taking outside money from friends and family or small groups of individuals, a corporation that makes an S election or an LLC may be a good option to start. But if you are considering raising venture capital in the future and start out with an LLC or an S corporation, you will eventually need to either convert the LLC to a C corporation (if your state allows conversions) or revoke your S election status (by no longer meeting the requirements for S election or by removing the S election yourself). This change may require additional filings and fees within your state and can result in potentially adverse tax consequences. Choosing between the two can be guided by your current cash flow:
  - *You want to defer costs to a later date***:** If you are short on cash, an LLC may be your best choice. A simple LLC may cost less money than a corporation to form initially but will cost more as the company matures, if and when converted to a C corporation (e.g., upon taking on institutional investors). This is a cost deferment strategy you are essentially delaying the incorporation cost until you get money from institutional investors.

Also, keep in mind that startup costs of an LLC can exceed those of a corporation if the company has several members and needs to adopt a more complex operating agreement. Please see our chart comparing C Corp and LLC structures.

- *You are able to absorb costs now*: If you have some cash to spare, you may want to consider forming a corporation and making an S election. A corporation may initially be more expensive to form than an LLC, but, you will be able to enjoy the advantages of being taxed as a pass-through entity. Later, when you take on investors, with a majority vote of shareholders, revoking the S election to be taxed as a C corporation is a simple process that does not have associated fees and can be done in a day with a single tax form (you will basically uncheck the box for S corporation tax election on an IRS form).

How are the startup's profits taxed?

S corporations and LLCs are taxed as "pass-through" entities. This means that these entities generally do not themselves pay income taxes. Instead, the owners report their share of the business profits or losses on their own personal tax returns. In other words, owners will be personally responsible for paying taxes on their portion of all taxable income that the company receives regardless of what is actually paid out to them resulting in a single layer of tax liability (appearing on the owner's personal tax return).

C corporations, on the other hand, assume an independent tax life separate from their owners. Thus, a C corporation has two tax layers the entity pays its own taxes at the C corporation-level and the owners are taxed on distributions from the corporation. The owners in a C corporation only get taxed on actual distributions of profits made to them by the corporation (usually occurring in the form of dividends) owners do not pay taxes on the corporation's entire taxable income.

Will the startup's tax status remain the same over the life of the company?

If at any time the company no longer meets all of the requirements to maintain an S election, then the election will be revoked and the company will be taxed as a C corporation. Unlike S corporations, LLCs generally do not have to worry about qualifying or continuing to qualify for pass-through tax treatment.

How are self-employed owners taxed?

Often, founders will want to continue working as employees of the newly formed business entity. In these situations, self-employment tax is an important consideration. It is essential to remember that a C corporation's profits are taxed separately from its owners (the stockholders). This means that a C corporation's stockholders are not subject to self-employment taxes on the corporation's income. S corporations are similar S corporation stockholders are also not subject to self-employment taxes. S corporation stockholders, who are also employees, are treated as employees and stockholders in their distinct capacities (as long as they are paid "reasonable compensation" for their services rendered). In contrast, all income of a member-managed LLC engaged in an active business that is allocated to a member is treated as self-employment income of the member—this is true whether or not the income is distributed to the member. On the other hand, in a manager-managed LLC, while the managers have to pay self-employment taxes, the non-managing members may not have to pay self-employment taxes if they are not active in the business.

Are the startup's business losses deductible?

Generally, losses, deductions, credits and other tax benefit items pass through to both an S corporation's stockholders and an LLC's members and may offset other income on their individual tax returns (subject to certain potential limitations). A C corporation's losses, on the other hand, do not pass through to its stockholders.

How many owners can the startup have and what are the eligibility limitations?

When an investor puts money into a business entity in exchange for equity, that investor becomes an owner; therefore, it is important to understand the ownership limitations of these entity structures. Neither C corporations or LLCs are limited with respect to their ownership. In other words, there is no limit to who can be an owner and what type of equity interest in such entity can be issued. That said, the logistics of making collective decisions with an LLC ownership structure militate toward having a manageable number of members (around 35). S corporations, in contrast, have strict limitations on ownership participation in order to maintain the S election S corporations are expressly limited to 100 stockholders holding a single class of stock, generally cannot have non-individual stockholders and cannot have foreign stockholders (all stockholders must be US residents or citizens).

What types of ownership may the startup have?

In general, corporations issue stock; for most corporations, stock comes in two main classes: preferred stock and common stock. Preferred stock has preferential terms, rights and privileges compared to common stock. Typically, outside investors, such as angel and venture capital investors, receive preferred stock. There may be times when friends and family will receive preferred stock or situations in which angels and VCs may be willing to take common stock but these situations are less typical. As a practical matter, a startup wants the flexibility of being able to issue both classes of stock because this will provide greater flexibility for valuation in later investment rounds with different valuations.

Unlike C corporations, S corporations can only have one class of stock; thus, once an S corporation issues preferred stock, it becomes a C corporation by default because it can no longer maintain its S election status. Violation of this requirement can arise unexpectedly and must be considered whenever issuing equity, including stock options or warrants. It is also important to keep in mind that venture capital investors generally receive preferred stock.

Unlike corporations, LLCs do not issue stock. Instead, they issue membership interests. Given the contractual flexibility of LLCs, an LLC can issue several different classes or series of membership interests that mimic the common stock and preferred stock structures of C corporations. However, instead of filing a certificate of incorporation with the state that sets forth the rights, preferences and privileges of the different membership classes, the members enter into private contractual agreements providing for such terms.

What entity is best for allocating equity to employees?

Typically, an aspiring venture-backed startup's early hires will receive (and expect) equity as a reward for betting on an unproven company. Depending on the startup's hiring expectations, selecting a structure which allows for easy issuance of equity may be an important consideration. Both C corporations and S corporations (subject to the above-referenced ownership limitations) are well-suited for allocating equity to employees because they can adopt a traditional stock option plan as well as grant "incentive stock options." To learn more about incentive stock options and corporate equity incentive plans in general, please see our separate article.

In contrast, structuring an equity incentive plan for an LLC is more complex. LLCs are similar in many ways to S corporations, but ownership is evidenced by membership interests rather than stock. As a result, LLCs cannot issue incentive stock options or adopt traditional stock option plans. LLCs have found creative ways to reward their employees with an equity stake in the company, such as by granting "profits interests," which provide employees with a right to share in an increase in the value of the LLC over and above the value of the LLC upon grant of such interest. Structuring equity incentives such as profits interests is complex and requires careful valuation and tax analysis.

Should my startup incorporate in Delaware?

Many companies choose to incorporate in Delaware either by default or are persuaded by the widely recognized benefits of being a Delaware corporation, including its flexible, business-friendly corporate statute, its well-developed and widely understood body of corporate law and sophisticated Court of Chancery (a special court that hears only Delaware business entity cases). But, there are also many reasons why incorporating in Delaware should not be the "one-size-fits-all" choice for incorporation. For more information regarding state of incorporation, please see our separate article.

These questions and responses were crafted with aspiring venture-backed startups in mind and may not be particularly applicable for closely held companies that are not expecting outside investment.
