

Choice of Entity: C Corporations, S Corporations and Limited Liability Companies (LLC)

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The following post is an excerpt from Roger Royse's upcoming book on building a successful startup. Book details will be announced soon.

The conventional wisdom in Silicon Valley is that every company must be a Delaware C corporation. The theory goes that all the big tech companies started or ended up as Delaware C corporations. This begs the question, who are you to buck a trend that Google, Facebook, Uber, Airbnb and so on have stayed true to.^[i] If you are the next big thing, incorporation as a Delaware C corporation is probably the right answer. But the smart entrepreneurs in the room know that the issue is more nuanced than that, and the result of a bad choice could mean the difference between success and failure; or pocketing a lot more after federal tax proceeds on a successful exit.

The following is a primer on the differences between the three types of entities you might choose for your company.

C Corporation

Most startups are formed as a C corporation—partly due to simplicity and partly since most VCs can and will invest only in C corporations. A C corporation is a state law corporation that has not elected to be taxed under Subchapter S of the Internal Revenue Code.^[ii] As a state law matter, there is no difference between a C corporation and an S corporation.

The benefit of a corporation is that the shareholders, or owners, of the corporation have limited liability. Generally, the management of the company is delegated to a board of directors, who further delegates the day-to-day business to the officers. The corporation should have (and under some state laws *must* have) at least three officers: a president or CEO, a treasurer or CFO, and a secretary. The same person can hold all three offices.

A C corporation is a separate taxable entity. It pays tax on its income, and the shareholders are again taxed when the remainder of its earnings and profits^[iii] are distributed to the shareholders. This is what lawyers and accountants mean when they refer to the “double tax” on C corporations. One tax benefit of a C corporation is that gain from the sale of C corporation stock might qualify for exemption or rollover of gain if the stock is qualified small business stock.^[iv]

S Corporation

The S corporation is a corporation under state law but is taxed as a “pass-through” for federal income tax purposes. So, it offers tax advantages over the C corporation. The S corporation form also allows for more traditional corporate equity compensation, such as an option plan, and

it can be a party to a tax-free, stock-for-stock merger or exchange. S corporations can also minimize social security taxes paid on the business's earnings by the careful planning of bonuses and distributions.[\[v\]](#)

The downsides are that an S corporation cannot issue qualified small business stock ("QSBS"), it can have only one class of stock (i.e., no common and preferred stock structure), all its shareholders must be individuals who are US citizens or residents (for tax purposes), and the corporation must not have more than one hundred shareholders (hardly ever a real concern in the start-up company world). Thus, a VC or other institutional investment will terminate the S election, but the shareholders may enjoy the benefits of pass-through treatment until then (like tax losses, subject to limitations). Unlike an LLC, distributing property from the corporation to its shareholders (on liquidation, for example) is a potentially taxable event.

Limited Liability Company (LLC)

The LLC is a form of entity in which no member has personal liability for the debts and obligations of the company (other than as agreed).[\[vi\]](#) The management of the LLC is vested in a manager, a managing member, or all the members in an operating agreement. The LLC is taxed like a partnership (unless otherwise elected), meaning that its income "passes through" and is picked up on the returns of its members in such proportions as set forth in the operating agreement, subject to the limitations of the Code and regulations.

An LLC is flexible and can accommodate almost any deal that the parties can think up. The downside of an LLC is that due to its flexibility, every LLC operating agreement must address all the deal points that the parties wish to negotiate. The flip side of flexibility is complexity, and the more tailored the operating agreement is, the more complicated it can become. This is usually not a deal breaker, but it is a point to know. An LLC is a pass-through for tax purposes. Whereas the C corporation is subject to two levels of taxation, the LLC's owners pay one level of tax at individual rates and on the LLC's earnings.

A Rule of Thumb

By now, you might be wondering when to make an S election and when not to. Most entrepreneurs do not have a good working rule. Most lawyers will tell you to be a C corporation, since it's simpler (and that's what Google did). Whereas your CPA will tell you that you should model it or run some "what if's" and see which option allows you to come out ahead. I agree with all of that, but I have a good working rule of thumb you can use when you talk to your legal and tax advisors. Here it is: ask yourself who you are. Are you a lifestyle business? Or a go big or go home business?

A "lifestyle business" will never be a unicorn, or any other kind of mythical animal. It will generate income and possibly grow at some modest rate. At some point you might sell it, but you will not take VC money (see [infra](#), VCs want explosive growth startups, not lifestyle companies). If that is your case, and especially if the company will generate \$100,000 to \$500,000 of annual net income per owner, then you should be an S corporation to maximize the after-tax income, deduct any business losses, and minimize social security taxes.

If you are a "go big or go home" business, you will probably not have income. You will have

nothing unless you can get an investor to fund you, and VCs cannot hold stock in S corporations. Your odds of failure are high and chances of success low, but the payoff could be huge. If you can get institutional money, you will ramp up development and own the market. If you do not get money, there will only be a smoking crater in the ground where your startup used to be. There is no in between - you will either be a humongous success or a dismal failure. If this is you, be a C corporation.

So that's great, but that is a tough decision to make. What if you could go either way? What if you could be a profitable business on your own, or a high-flying Silicon Valley darling. It's just too early to tell. Is there a middle ground?

As you can see, for the successful business that straddles the fence between lifestyle and explosive growth, the LLC structure works well. There are, of course, a couple of caveats to this strategy. First, many LLCs will finance their early year losses with debt. Incorporating an LLC with debt financed losses will trigger income to one or more members, generally whoever claimed the tax deductions in earlier years.^[vii]

Second, while the founders can be issued QSBS in the incorporation, the gain that they can shield will be limited to the appreciation in the stock after incorporation. See Appendix B for more information on QSBS.

Finally, forming two entities (an LLC and then a corporation) is twice as costly as forming just one. For a multi-million-dollar VC backed company, this cost is not such a big deal. For a cash starved startup, it may be an issue.

^[i] In the late 1990's, Google originally incorporated as a California corporation but then reincorporated as a Delaware corporation in 2002. Facebook and Delaware both started off and continue to be registered as Delaware corporations (Facebook incorporated in 2004 and Uber in 2010).

^[ii] The Code means Internal Revenue Code of 1986, as amended.

^[iii] Earnings and profits or E&P is defined in Code Section 316.

^[iv] Under current federal tax law, gain realized on the sale of certain qualified small business stock ("QSBS") held for at least five years may be exempted from income for federal tax purposes. QSBS, subject to a few exceptions, means stock in a domestic corporation if: (1) such corporation is a "qualified small business" ("QSB") at the time the stock is issued; and (2) the taxpayer acquires the stock, in an original issuance of such stock, in exchange for money, other property, or as compensation for services to the issuing corporation.

^[v] S corporations must pay reasonable compensation to their officers, which will be subject to the Federal Insurance Contributions Act ("FICA"), the Federal Unemployment Tax Act ("FUTA"), and Medicare taxes (social security taxes). Distributions by the S corporation, however, are not subject to social security taxes. Thus, the well-advised S corporation will be incentivized to pay as little of its income in compensation as it can get away with, and as much as it can in distributions. LLCs do not have this break: the income of the LLC allocable to an

active member will be self-employment income.

[\[vi\]](#) Watch out for this. Many off-the-shelf, boilerplate LLC operating agreements have an unlimited “deficit restoration provision,” which means that the LLC members must contribute to the LLC to the extent that they have a negative capital account. Many LLC members have discovered that they had to come out of pocket on liquidation of the LLC because of imprudent drafting.

[\[vii\]](#) The tax analysis is complex, but generally, if an LLC has debt in excess of tax basis, or if a member has a negative capital account, there will likely be a “recapture” of losses or income inclusion on incorporation (that may be soaked up by suspended losses). There are strategies to avoid that result.