Roger Royse in Silicon Valley Business Journal: Choosing a Business Entity

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PRACTICES Emerging Companies and Venture Capital

Now that you have decided to start a company, the first decision you will make as an entrepreneur is what kind of business entity to select. As a practical matter, you have three likely choices: a C corporation, an S corporation and an LLC. Unfortunately, there is no one-size-fits-all solution, or a single right answer.

All three types of entities, if properly formed and maintained, will provide a measure of liability protection so that if the business fails, you will not have personal liability to creditors (with some notable exceptions).

A corporation taxed under subchapter C of the IRS code is often called a C corporation for short. The distinguishing tax feature of a C corporation is that it is a separate tax-paying entity. The C corporation pays corporate tax on its earnings. If the corporation then distributes those earnings to its owners (also called shareholders), the shareholders are again taxed (albeit at a lower rate for most dividends). To avoid this double taxation, a corporation will attempt to distribute as much of its earnings as possible in the form of deductible payments, such as compensation. That compensation, however, will be taxable to the recipient at a rate potentially higher than the dividends would have been, and will also attract employment taxes, including FICA and FUTA.

If double taxation is the bad news, the good news is that the federal corporate tax rate on C corporations is a flat 21%, as opposed to individual tax rates that can be as high as 37% (plus state). Importantly, gain from the sale of stock issued by some C corporations can qualify for an exclusion from federal tax as qualified small business stock. Most venture-backed and public companies are C corporations.

A state law corporation (or other qualifying entity) that elects to be taxed under subchapter S of the IRS code is called an S corporation. Unlike a C corporation, an S corporation is not generally a separate taxpayer entity. Instead, its earnings pass through and are taxed to the owners (shareholders) pro-rata based on share ownership. Thus, S corporations are sometimes grouped with partnerships as pass-through entities. S corporations differ, however, from partnerships in that the owners can potentially avoid self-employment taxes on the income of the S corporation. Largely for that reason, many closely held small businesses (and some large ones) elect to be taxed as S corporations. Even Joe Biden famously runs his business income through an S corporation.

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