Choice Of Entity: Matters Startups Should Cogitate When Selecting An Entity Structure

One of the foremost decisions a startup founder makes is selecting a corporate entity structure. Each type of entity has its own benefits and drawbacks. Below are questions and answers intended to assist a founder in choosing the most appropriate US corporate structure for his startup.

Note: This article applies to corporate entities in the U.S. Nonetheless, the insights below may be relevant and helpful to Israeli entrepreneurs who may wish to incorporate a wholly owned U.S. subsidiary for their Israeli Company. There are numerous benefits to doing so, mainly in order to receive certain tax and regulatory benefits connected with business activities in the U.S. markets. A thorough discussion of whether an Israeli Company should incorporate a U.S. subsidiary is beyond the scope of this article.

What types of entities are available?

The business entities most frequently used by startups are limited liability companies (LLCs), C Corporations and S Corporations. C Corporations and S Corporations are distinct by the two wayS Corporations are taxed at the federal and state level. By default, a corporation is 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, analogous to an LLC. A corporation that has made an S election is referred to as an "S Corporation."

Which entity structure is preferred by investors?

The entity structure most preferred by investors is most likely the 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 shareholders.

A limited liability company is likely a less favorable entity for investors. LLCs are a prevalent choice for small businesses due to their simple structure, however that structure often makes the entity less popular with investors. The management of an LLC can be structured in two ways: member-managed and manager-managed. Generally, LLCs are managed 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 can include both members and nonmembers.

Some investors will request that a member-managed LLC convert to a manager-managed structure or a corporation. 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 the individuals who are running the business.

As a practical matter, an LLC may be a good entity choice to start with because of its tax advantages (described below), ease of formation, and absence of franchise tax. But founders should keep in mind that it may be preferable for an LLC to convert to a corporation prior to receiving outside investment. It is also imperative 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.

To be eligible for and maintain S Corporation status, a company must meet the following requirements:

- have only <u>allowable</u> shareholders
  - Allowable shareholders: individuals, certain trusts and estates
  - Disqualifying shareholders: partnerships, corporations and non-resident aliens
- have no more than 100 shareholders
- have only one class of stock (common stock) and
- not be an ineligible corporation (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. 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. For example, an S Corporation which when it takes an investment from a disqualifying shareholder (such as a venture capital fund) will lose its S election status.

<u>How are the entity's profits taxed?</u>

S Corporations and LLCs are taxed as "pass-through" entities. This means that the entity itself generally does not pay income taxes. Instead, the owners (for an LLC) or shareholders (for an S Corporation) report their share of the business profits or losses on their own personal tax returns. In other words, the shareholder will be personally responsible for paying taxes on his portion of all taxable income that the entity receives, regardless of what is actually paid out to them. Thus, there exists only a single layer of tax liability.

C Corporations have an independent tax status separate from their shareholders. Thus, a C Corporation has two tax layers: (1) the entity pays its own corporate taxes, and (2) the shareholders are taxed on distributions from the corporation. The shareholders in a C Corporation are only taxed on actual distributions of profits made to them by the corporation (usually in the form of dividends).

<u>How are self-employed founders taxed?</u>

Often, founders continue working as employees following incorporation. In these situations, self-employment tax is a central consideration. It is essential to remember that a C Corporation's profits are taxed separately from its shareholders. This means that a C Corporation's founders are not subject to self-employment taxes on the corporation's income.

S Corporation shareholders are also not subject to self-employment taxes. S Corporation founders, who are also employees, are treated as both employees and shareholders 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.

<u>Are the startup's business losses deductible?</u>

Generally, losses, deductions, credits and other tax benefit items pass through to both an S Corporation's shareholders and an LLC's members and may offset other income on their individual tax returns. A C Corporation's losses, on the other hand, do not pass through to its shareholders.

<u>How many shareholders can the startup have and what are the eligibility limitations?</u>

There is no limit as to who can be a shareholder of, and what type of equity interest can be issued, in a C Corporation or LLC entity.

S Corporations, in contrast, have strict limitations on ownership participation in order to maintain the S election. S Corporations are expressly limited to 100 shareholders holding a single class of stock. Shareholders must be U.S. citizens or residents (not nonresident aliens), and must be natural persons, so corporations and partnerships are ineligible shareholders. Certain estates, trusts, and tax-exempt corporations, notably 501(c)(3) corporations (non-profit), are, however, permitted to be shareholders.

<u>What types of equity ownership may the startup have?</u>

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.

Characteristically, outside investors, such as angel and venture capital investors, receive preferred stock. 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. Consequently, once an S Corporation issues preferred stock, by default it becomes a C Corporation because it can no longer maintain its S election status.

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 a contractual agreement, customarily an operating agreement, providing for such terms.

<u>What entity is best for allocating equity to employees?</u>
Typically, an aspiring startup's employees will receive equity as part of their compensation package. Both C Corporations and S Corporations are compatible for allocating equity to employees because they can adopt a traditional stock option plan as well as grant "incentive stock options."

Structuring an equity incentive plan for an LLC is more intricate. LLCs cannot issue incentive stock options or adopt traditional stock option plans. However, 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.

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 may prefer to form a C Corporation for such investment purposes.

- *You are in the boot-strap stage 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. If you are considering equity financing in the future and start out with an LLC or an S Corporation, you will eventually need to either convert to a C Corporation. 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 will likely 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. This is a cost deferment strategy − you are essentially delaying the incorporation cost until you get money from investors.

- *You are able to absorb costs now*: If you have funds 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 outside investors, revoking the S election to be taxed as a C Corporation is an unpretentious process.

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