

## CHOICE OF ENTITY FOR A STARTUP BUSINESS AFTER TAX REFORM

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When an entrepreneur makes the decision to form a legal entity for a new business, the choice of legal entity generally comes down to a limited liability company (LLC) or a corporation.<sup>1</sup> Prior to the 2017 tax reform act, an LLC generally had significant tax advantages over a corporation. Nevertheless, many startups organized as corporations for reasons of simplicity and perceived financing advantages. After tax reform, the tax advantages of an LLC over a corporation have narrowed, which may reinforce the propensity of entrepreneurs to choose a corporation as the legal entity for their new business ventures.

This paper reviews the principal advantages and disadvantages of using an LLC rather than a corporation as a legal entity for a startup business, taking into account the significant changes in the tax treatment of the entities after the 2017 Tax Cuts and Jobs Act. In doing so, it challenges some of the historical and existing proclivities for using a corporation for a new business.

### Summary

The key distinguishing features between an LLC and a corporation for a startup business are taxation, financing, equity compensation, and governance. Table 1 summarizes those distinguishing features.

There are too many variations in circumstances to distill the choice of entity for a startup business down to one rule or to a manageable decision tree. Ideally, the choice of legal entity for each business should be carefully and comprehensively analyzed with knowledgeable counsel based on all the relevant facts and circumstances. A good starting point for the analysis is to abandon the reflexive choice of a corporation and view the LLC as the default legal entity choice. An LLC will generally be the preferred legal entity except (a) where the business is actively seeking funding from a venture capital (VC) fund or other investor that insists that the business be organized as a corporation, or (b) where the business can meet the requirements for Section 1202 qualified small business stock.

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<sup>1</sup> Not all new businesses need to be operated by a separate legal entity. If the business activities are limited and potential liabilities are not a significant concern (e.g., a business of developing a single mobile phone app), the founder might operate the business directly without any separate legal entity. Where potential business liabilities are more of a concern, a separate legal entity is generally advisable.

## **Table 1 – Summary of Key Distinguishing Features Between an LLC and a Corporation for a Startup Business**

### **Taxation**

An LLC is a more tax efficient legal entity structure for a startup business than a corporation, and this tax advantage holds true even after taking into account the tax changes made by the 2017 tax reform act. The LLC's tax advantage comes at the cost of additional tax reporting complexity, but the incremental complexity is often overstated and should not be a deterrent to choosing an LLC.

An important exception to the tax advantage of an LLC relative to a corporation is if the requirements for Section 1202 qualified small business stock can be satisfied. In such a case, a portion of the gain from the sale of the qualified small business stock is tax exempt, which might favor choosing a corporation rather than an LLC.

### **Financing**

Financing a corporation is less complex than financing an LLC, but an LLC can issue any type of financing instrument that a corporation can issue, and sometimes with more favorable tax treatment. While most VC funds and some other investors will only invest in a corporation (more for reasons of custom and convenience than substance), many investors are very comfortable with LLCs. Moreover, an LLC can be converted to a corporation at any time after formation if necessary to accommodate an investor. Therefore, unless the founder is actively seeking, and expecting to receive, funding from an investor that insists on investing in a corporation, a corporation does not have a material financing advantage over an LLC for a startup business.

### **Equity Compensation**

There is a well-established menu of equity compensation plan choices for a corporation, with generally well-understood economic and tax consequences. An LLC can generally replicate any of those plans, often with more favorable tax consequences. Therefore, equity compensation plan options should not be a material factor in the choice of entity for a startup business.

### **Governance**

An LLC is generally regarded as being preferable to a corporation in terms of requiring less formality, offering greater protections for managers, and permitting greater restraints on equity owners' rights. However, these matters are typically heavily negotiated by significant investors and generally are not a material factor in the choice of entity for a startup business.

## **Introduction**

Most of the elements of organizing and operating an LLC are not materially different from the elements of organizing and operating a corporation, and the comparative cost and compliance burden (other than tax compliance) is rarely a decisive factor in the choice of entity. Critically, an LLC and a corporation are each a separate legal entity that generally protects owners from personal liability for company debts and other obligations. This “limited liability” feature is a primary reason for using an LLC or corporation to operate the new business. As a separate legal entity, the company (whether an LLC or a corporation) owns the assets of the business, contracts with vendors, employees and customers in the company’s name, is responsible for liabilities of the business, and maintains separate financial and tax accounting records.

The two primary distinguishing features of LLCs and corporations are their income tax treatment, and their ability to attract certain types of capital. Less critical distinguishing features are their ability to sponsor equity compensation plans for employees and consultants, and their requirements for management and governance.

## **Distinguishing Features of an LLC**

### ***LLC Formation Process and Nomenclature***

An LLC is formed by filing a certificate of formation with the secretary of state’s office for the state in which the entity will be formed. In Delaware, the certificate of formation is generally a one-page form that can be signed by any authorized representative, with no required disclosure of the company’s owners (referred to as “members”) or governing persons. Other states may require disclosure of the owners or managers, and may have other state-specific requirements.

The details regarding the rights and obligations of the LLC owners relative to each other and relative to the company, and regarding the management of the LLC, are typically set forth in a “company agreement” (also sometimes called an “operating agreement” or “regulations”). Key provisions generally include capitalization, management and governance, limitation of liability and indemnification of governing persons, transferability of ownership interests, financial and tax affairs, withdrawal or removal of members, and dissolution and termination of the company.

By default, the authority to manage the affairs of an LLC is vested in the members. But the certificate of formation and company agreement will generally provide for the appointment of one or more “managers” to manage the company’s affairs, and will generally provide that members do not have any such authority in their capacity as members. This is referred to as a “manager-managed” LLC. Even in a manager-managed LLC, the members may have voting or approval rights over extraordinary actions (similar to the requirement of a shareholder vote for certain corporate actions). An LLC manager can be a company (or other legal entity) or an individual.

If there are multiple managers appointed, they may be referred to as the company's "board of managers" and can function in the same manner as a board of directors of a corporation, but with less formality if desired. A board of managers can be given authority to appoint committees of the board. The company agreement can also provide for the appointment of officers to exercise day-to-day management authority delegated to them by the manager(s). Again, the LLC officers can function in the same manner as officers of a corporation.

The equity ownership interests in an LLC are known as "membership interests." The membership interests are often fractionalized into "units" or "shares" to mimic the ownership of shares of stock in a corporation.

In summary, an LLC can be organized to function very much like a corporation from the standpoint of state law rights, obligations, and management. Moreover, the basic organizational documents for an LLC are now well-established and generally do not involve more expense or complexity than corporate organizational documents. Therefore, organizational factors are generally not decisive in the choice of legal entity.

### ***Taxation of LLCs – Flow-Through Taxation***

Unless it elects otherwise, an LLC is classified for federal income tax purposes as a partnership (if it has more than one owner) or as a disregarded entity (if it has only one owner).<sup>2</sup>

An LLC classified as a disregarded entity is taxed in the same manner as a business owned directly by the owner (i.e., a "sole proprietorship"). The LLC does not file a federal income tax return. Instead, the LLC's tax items are reported on the owner's personal income tax return (Schedule C if the LLC is engaged in a business). The advantage over a true sole proprietorship is that the LLC generally provides limited liability for state law purposes.

An LLC classified as a partnership files a federal income tax return (on Form 1065), but is not subject to federal income tax on its taxable income. Instead, the LLC issues to each owner a "Schedule K-1" showing the owner's allocable share of the company's taxable income or loss and other separately stated tax items, and the owner is responsible for paying tax on any taxable income or items reported on the owner's Schedule K-1. For this reason, an LLC is often referred to as a "flow-through entity." Most states follow the federal income tax treatment of LLCs, but some impose income tax or minimum tax on the LLC as an entity.

Startup businesses often generate tax losses for several years, and some for the entire period the business is owned by the founders and initial investors. For founders and

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<sup>2</sup> An LLC may file an election with the IRS to be classified as a corporation for federal income tax purposes, but this is not common and is generally not advisable. Unless otherwise indicated, this paper assumes that an LLC is classified for federal income tax purposes according to its default classification as discussed in this paper (i.e., as a disregarded entity or as a partnership).

other owners who are active in the company's business and meet IRS requirements for "material participation" in the business, and for corporate owners, their allocable shares of startup losses can generally be deducted against income from other sources (if the owner has any such other income). For non-corporate owners who are not active in the business, their ability to claim deductions for their allocable share of startup losses is generally restricted under the "passive activity loss" rules. Any startup losses that cannot be deducted under the passive activity loss rules ("suspended losses") can generally be carried forward indefinitely and deducted upon a disposition or termination of the business. In contrast, corporate startup losses do not flow through to shareholders, and any loss on termination of a corporate business is generally a capital loss. Given the very high failure rate for startup businesses, the ability to take an ordinary deduction upon termination of an LLC (if not sooner) is a material factor in favor of an LLC relative to a corporation.

If the business is successful and generates cumulative positive taxable income, the income will generally be taxed as ordinary income, which is currently taxed to individual owners at maximum marginal federal income rates of up to 37%.<sup>3</sup>

A new feature of LLCs under the 2017 tax reform legislation is the potential availability of a deduction for the LLC's non-corporate owners equal to 20% of the taxable income generated by the company in taxable years beginning before January 1, 2026. The deduction has the effect of reducing the maximum marginal federal income rate on the company's operating income to 29.6%. The availability of a deduction depends on a complex mix of the owner's taxable income level, the type of business, and the level of wages and investment in fixed assets in the business.

The owners' allocable shares of LLC income (if any) may also be subject to the 3.8% net investment income tax imposed on certain high-income taxpayers. Owners who materially participate in the LLC's business should be exempt from this tax. And, contrary to popular belief, such owners may also be able to avoid self-employment tax on their distributive shares of LLC income, if the LLC is structured correctly and the owners receive reasonable compensation for services provided to the business.

As the preceding discussion suggests, the flow-through treatment of LLC tax items, and the associated federal income tax reporting requirements for the LLC owners, can be complex. In addition, the LLC owners may have corresponding state income tax reporting obligations in states where the LLC does business (although that can often be avoided by having the LLC file composite state income tax returns on behalf of the LLC

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<sup>3</sup> This rate applies for 2018 to taxable income in excess of \$1,000,000 for a joint return, or \$500,000 for a single taxpayer. Prior to 2017, the maximum marginal federal income tax rate was 39.6%, and state income tax on an individual's flow-through business income was generally deductible for federal income tax purposes as an itemized deduction. For 2018 through 2025, the maximum marginal federal income tax rate was reduced to 37%, but state taxes in excess of \$10,000 per year are not deductible. For 2026 and subsequent years, the maximum marginal federal income tax rate is scheduled to return to 39.6% and the \$10,000 limitation on itemized deductions for state taxes is scheduled to expire.

owners). The tax reporting requirements for ownership of corporate stock are much less cumbersome than for ownership of an LLC membership interest.

Because the principal or exclusive economic rewards of a startup business will generally be recognized only upon a sale of a business, the most important tax consideration for a startup business is typically the taxation of gain on a sale of the business. If an LLC business is sold at a substantial gain (after accounting for prior suspended losses), all or a substantial portion of the gain should qualify, according to current tax laws, as long-term capital gain eligible for reduced tax rates (20% for owners who materially participate in the business, or 23.8% for other owners). The form of the sale – i.e., as a sale of assets by the LLC or as a sale of LLC

***The ability of an LLC to deliver capital gains on exit together with a stepped-up tax basis for the buyer is the primary advantage of an LLC over a corporation.***

membership interests by the owners – is generally irrelevant to the amount or character of the owners' gain on sale. Importantly, the buyer can obtain a stepped-up tax basis in the company's assets (again, regardless of the form of the sale), so there is no buyer discount for lack of a stepped-up tax basis (as is generally the case with the sale of a corporation).

The ability of an LLC to deliver capital gains on exit together with a stepped-up tax basis for the buyer is the primary advantage of an LLC over a corporation. It is often the decisive reason why an entrepreneur would choose to organize a new business as an LLC.

### ***Financing an LLC***

There are generally no legal or tax restrictions on an LLC's ability to raise capital through issuance of any type of financing instrument, including common or preferred equity, convertible or non-convertible debt (whether secured or unsecured, or recourse or non-recourse), or options, warrants, forward purchase agreements, or other derivatives. An LLC can generally issue any type of financing instrument that a corporation can issue, and may be able to achieve tax results more favorable than those possible with a corporation.<sup>4</sup>

One limitation is that an LLC's equity ownership interests generally cannot be traded on an established securities market or readily traded on a secondary market without causing the LLC to be classified as a corporation for federal income tax purposes (thereby sacrificing its tax advantages over a corporation). This limitation on access to public equity markets is sometimes cited as a disadvantage of organizing a startup business as an LLC. However, access to the public capital markets is generally not an immediate concern for a startup entity. And, if and when the entity seeks to access the

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<sup>4</sup> As an example, an LLC can effectively deduct dividends paid on preferred equity without regard to the new limitations on deductions of interest expense imposed by the 2017 tax reform act.

public capital markets, the entity can be converted to a corporation as part of preparing the company for the offering without any taxable gain and without undue expense or delay. Moreover, a public offering for a company initially formed as an LLC can often be effected in a more tax-efficient matter than for a company initially formed as a corporation.<sup>5</sup> Therefore, the mere potential for a future public equity offering is generally not a valid justification for initially organizing a startup entity as a corporation rather than as an LLC.

Perhaps the most commonly cited disadvantage of LLCs is their inability to attract capital from most VC fund investors and certain other institutional investors. These investors object to the complexity of the flow-through tax treatment of LLCs, and to the repercussions for non-U.S. persons or tax exempt organizations.<sup>6</sup> On a more practical level, the VC industry has invested substantial time and money in designing financing documents based on the corporate entity model, and the per-deal investment size is generally not sufficient to justify the expense of modifying the document terms to accommodate an LLC entity structure. Some VC and institutional investors will consider an investment in an LLC, and their ranks have grown over time, but they are still a small minority, particularly for relatively small investments.

Many advisers counsel startup businesses to organize as a corporation at the outset as a means of demonstrating financial sophistication and avoiding potential complications when seeking VC or institutional funding. This might make sense for an entrepreneur actively seeking VC or institutional capital at the time the business is formed. But for a startup business that might be able to rely on other sources of capital (e.g., “friends and family,” wealthy individual investors, strategic investors, etc.), initially organizing as an LLC is generally a better choice. If the founder later determines that the company needs to convert to a corporation facilitate a VC investment (or for any other reason, including to take advantage of the tax benefits of Section 1202 qualified small business stock), the founder can generally convert the LLC to a corporation at that time inexpensively, quickly, and with no adverse tax effects.

But once a company is organized as, converted to, or elects to be classified for tax purposes as, a corporation, it generally cannot convert to an LLC without adverse tax effects. In this respect, a corporation has been likened to a lobster trap: easy to get into, but hard to get out of.

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<sup>5</sup> See Gregg D. Polsky and Adam H. Rosenzweig, *The Up-C Revolution*, Univ. of Ga. School of Law Legal Studies Research Paper No. 2016-40 (2016).

<sup>6</sup> Non-U.S. persons object to investing in an LLC that operates a U.S. business because the investor will be required to file a U.S. tax return and pay U.S. tax on any income from the business or gain from a sale of the LLC membership interest. Similarly, tax exempt organizations object to investing in an LLC that operates a business because the investor can be required to report unrelated business taxable income with respect to the investment. These concerns are often addressed by having the affected investors invest in the LLC through a “blocker corporation” which limits the tax inefficiencies of the corporate form to the affected investors.

### ***LLC Equity Compensation Plans***

An LLC can generally issue any type of equity compensation awards that a corporation can issue, and can often achieve tax results more favorable than those possible with a corporation.<sup>7</sup>

Notwithstanding the flexibility and potential tax advantages inherent in LLC equity compensation plans, the flow-through tax treatment of an LLC makes owning most LLC equity compensation awards more complex than owning comparable corporate stock compensation awards. This is a legitimate consideration, but should not lead to a reflexive rejection of an LLC as a choice of entity. Key employees and consultants regularly accept LLC equity compensation arrangements, and do not view corporate variations as a material competitive advantage.

The inability of an LLC to issue incentive stock options to employees, or to adopt an employee stock purchase plan, is sometimes cited as a disadvantage of organizing as an LLC. However, those plans are subject to significant limitations. In addition, the potential tax advantages to employees under such plans are often not realized and, if realized, are generally offset by the corporation's loss of a corresponding deduction. Therefore, the ability to adopt those types of equity compensation plans is generally not a sufficient justification for organizing the startup entity as a corporation rather than as an LLC.

### ***LLC Governance***

An LLC has potential advantages over a corporation with respect to a variety of governance matters. For example,

- There are typically no statutory requirements for annual meetings of managers or members of an LLC.
- The fiduciary duties and liabilities of LLC managers and officers are generally no greater than, and potentially less than, the fiduciary duties and liabilities of a corporation's directors and officers.
- An LLC may have greater flexibility than a corporation in terms of restricting members' rights with respect to the company (including restrictions on members' access to company records).

Because governance matters are generally negotiated with significant investors, the potential advantages of an LLC relative to a corporation with respect to governance matters are rarely a significant factor in the choice of legal entity.

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<sup>7</sup> These issues are explored in more detail in a separate paper available [here](#).

## Distinguishing Features of a Corporation

### ***Corporation Formation Process and Nomenclature***

The process for forming a corporation is generally identical to the process for forming an LLC. It is formed by filing a one-page certificate of formation (usually called the certificate of incorporation or articles of incorporation) with the applicable secretary of state’s office. If the corporation will have separate types, classes, or series of stock, the relative rights and obligations of the various types, classes, typically must be designated in the certificate or articles of incorporation. Other details regarding the rights and obligations of shareholders relative to the company, and regarding the management of the company, are typically set forth in a the corporation’s “bylaws,” and any agreements among the shareholders is typically set forth in a “shareholders agreement.” The key provisions are generally the same as those for an LLC as described above.

The authority to manage the affairs of a corporation, except for certain actions that are reserved by governing law or the bylaws to the shareholders, is vested in the corporation’s board of directors, which is elected by the shareholders. The bylaws will typically grant the board of directors the authority to organize one or more committees of the board and delegate authority to such committees to act on behalf of the board with respect to specified responsibilities. A corporate director can generally only be an individual.

The company’s bylaws will typically provide for the establishment of offices and appointment of officers to exercise day-to-day management authority delegated to them by the board of directors. State law will generally require at a minimum that a president and secretary be appointed, which may be the same person.

The equity ownership interests in a corporation (i.e., its “stock” or “capital stock”) may be divided into one or more types, classes, or series, which are fractionalized into “shares.”

### ***Taxation of Corporations – No Flow-Through Taxation***

A corporation is a separately taxable entity and pays tax on its taxable income at a flat rate of 21%, down from graduated rates of up to 35% for 2017 and prior years.<sup>8</sup> If a corporation has a net operating loss, that loss does not flow through to the shareholders. Instead, the loss carries forward and can be deducted against up to 80% of the corporation’s taxable income recognized in future years. If there is a change in ownership of the corporation, the ability to utilize the loss carryforwards can be severely

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<sup>8</sup> This summary generally does not address certain corporations that may subject to special rules, such as regulated investment companies, insurance companies, and banks.

limited. If the business is unsuccessful and is terminated at a loss, the shareholders generally recognize a capital loss that can only be deducted against other capital gains (plus a \$3,000 per year allowance for excess losses).

If the business is successful and generates after-tax earnings, the distribution of those earnings to investors as a dividend is subject to a second tax in the shareholder's hands at a maximum rate of 23.8% (20% capital gains tax plus 3.8% net investment income tax). The combination of the corporate tax on the corporation's income and the shareholder tax on dividends is commonly referred to as "corporate double taxation" and results in a combined maximum tax rate of 39.8% on fully distributed corporate earnings.<sup>9</sup>

If a corporation retains its after-tax earnings and reinvests the earnings in its business, the shareholders can defer paying the shareholder level dividend tax until the earnings are distributed. Eventually, those after-tax corporate earnings are either paid out as a taxable dividend, or monetized by the shareholder in the form of taxable gain on the sale of the corporation's stock. So the shareholder level tax can be deferred, but not avoided.

Many advisers and commentators note that the significant decrease in corporate tax rates as a result of tax reform may reduce (or eliminate) the tax advantage of LLCs relative to corporations. Some note that the tax rate on corporate income is only 21%, whereas the tax rate on LLC income can be as high as 40.8% (37% maximum personal income tax rate plus 3.8% surtax on net investment income). But this comparison ignores several factors:

- Even successful startup businesses generally do not generate cumulative taxable income for several years, and many are sold before that occurs. Consequently, corporate losses often build up in the corporation without any current benefit, and are subject to limitations on future use that may be more restrictive than LLC startup losses.
- The additional 18.8% shareholder level tax on corporate earnings (23.8% x 79%) is only deferred and not avoided (except, perhaps, at death).
- LLC income may qualify for the 20% deduction under Section 199A (reducing the maximum tax rate to 29.6% with no second level of tax).
- An LLC owner that is active in the business may avoid the 3.8% surtax.
- Any gain on sale of a corporation's business representing unrealized appreciation in assets and future earnings will be subject to 39.8% corporate

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<sup>9</sup> On \$100 of corporate earnings, the corporation pays a \$21 corporate tax, and the individual pays a maximum dividend tax of \$18.80 (23.8% x \$79). The total tax is \$39.80.

double tax (a portion of which may be deferred), whereas gain on sale of an LLC is subject to a single tax of only 20% or 23.8%.

Regarding the last bullet point, the sale of a profitable corporate business will almost always be structured as a sale of the corporation's stock by the shareholders, typically resulting in long-term capital gain taxed at a maximum rate of 23.8%. On the surface, this suggests that the tax rate for a sale of a corporation is approximately the same as the tax rate for the sale of an LLC. What this fails to account for is the buyer's tax consequences. When a buyer purchases a corporation's stock, the buyer does not obtain a stepped-up tax basis in the corporation's assets. As a result, the buyer inherits the corporation's deferred tax liability on net built-in gain in the corporation's assets. Therefore, the buyer of corporate stock will likely discount the purchase price to account for the lack of a stepped-up tax basis and the associated inherited tax liability. This has the effect of driving up the effective tax rate on the shareholder's sale of its stock beyond the headline rate of 23.8% (perhaps by an additional 10% or more). In contrast, the buyer of LLC membership interests can obtain a stepped-up tax basis in the LLC's assets at no cost to the owners, and therefore there is no corporate double taxation purchase discount on the sale of an LLC business.<sup>10</sup>

***The buyer of corporate stock will likely discount the purchase price to account for the lack of a stepped-up tax basis and the associated inherited tax liability ... driving up the effective tax rate on the shareholder's sale of its stock beyond the headline rate of 23.8%.***

In most cases, state income tax on corporate earnings will not be materially less than the personal income tax on flow through earnings, and therefore the tax preference for an LLC over a C corporation will not be materially influenced by state income tax considerations. However, from 2018 through 2025, state income taxes are not deductible by individuals, and therefore there is an advantage to having business income earned through a corporation. This factor will generally not be sufficiently material to change the choice of entity decision, particularly when taking into account the fact that startup businesses typically generate losses or modest operating income.

If, as is often the case, the principal or exclusive economic rewards of a startup business will be recognized only upon a sale of a business (including by way of a public offering), the most important tax consideration for a startup business should be the taxation of gain on a sale of the business. In that respect, and subject to the discussion of qualified small business corporations below, a corporation is likely to have a higher effective tax rate on the economic gains than an LLC.

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<sup>10</sup> Some investors and advisers assert that there is no purchase discount because buyers value growth businesses based on EBITDA or other pre-tax measures. The tax receivable agreements in Up-C transactions (see footnote 5) illustrates how LLC owners can preserve most of their premium.

## ***Taxation of Corporations – Qualified Small Business Stock***

A potentially significant tax consideration in the choice of legal entity for a startup business is the special rule in Section 1202 of the Internal Revenue Code for gains from the sale of qualified small business stock (QSBS). A non-corporate shareholder can exclude from income gain from the sale of QSBS held for more than five years, subject to a limit equal to the greater of \$10 million or 10 times the amount the shareholder paid for the stock at original issuance. This provision is subject to a number of complex requirements, including a five-year holding period requirement, a requirement that the corporation have not more than \$50 million in aggregate gross assets immediately following the issuance of the applicable stock, and a requirement that the corporation be engaged in a “qualified trade or business” (which is defined to exclude most businesses involving professional services, financial services, oil and gas extraction or production, lodging or restaurant operations, or any similar businesses).

A companion rule is provided in Section 1045 of the Internal Revenue Code, which provides for non-recognition of gain from the sale of QSBS held for more than six months to the extent the stock sale proceeds are used within 60 days to purchase other QSBS. The gain not recognized reduces the cost basis of the new QSBS.

***For an eligible business that can satisfy all of the complex requirements, Section 1202 may provide a significant tax advantage over an LLC in terms of gain on a sale of the business.***

For an eligible business that can satisfy all of the complex requirements, Section 1202 may provide a significant tax advantage over an LLC in terms of gain on a sale of the business. The benefit of the limited exclusion of capital gains will generally more than offset any buyer purchase discount resulting from the transaction being structured as a stock sale rather than an asset sale. One concern is that the advantage of Section 1202 may be eroded or eliminated for any shareholder whose gain on sale exceeds the limits allowed under Section 1202. This is more likely to be the case for founders (who have a low cost basis in their stock) than for investors making an investment in the corporation significantly in excess of \$1 million. Another concern is the risk that future changes in law might reduce or repeal the Section 1202 benefits, leaving the business stuck in the corporate lobster trap without the benefits that initially lured the owners into the trap.

A business that is initially organized as an LLC can later convert to a corporation and qualify for the benefits of Section 1202 (if all of the numerous requirements are otherwise satisfied). However, the five-year holding period is measured from the conversion date, and any gain accruing with respect to the LLC equity interests prior to the conversion will be ineligible for Section 1202 benefits on a later sale of the corporation’s stock.

Another tax benefit reserved to small business corporations is the ability to claim an ordinary loss of up to \$50,000 (\$100,000 in the case of a joint return) on the disposition

or worthlessness of “Section 1244 stock.” This allowance is subject to various limitations, including a condition that the corporation have no more than \$1 million in contributed capital at the time the applicable stock is issued (including the amount paid for the applicable stock). Given the limits on the amount of loss that can be claimed and the capitalization limit, the potential benefits of Section 1244 stock are not a material factor in the choice of entity for a startup business.

### ***Financing a Corporation***

A corporation has almost unlimited flexibility in the type of financing instruments it can issue, and there is a substantial body of precedent for the types and terms and conditions of financing instruments commonly issued by a startup business organized as a corporation. An LLC has essentially the same flexibility in terms of the types of financing instruments it can issue, but there is less uniformity in the types, terms, and conditions of instruments issued by an LLC.

In addition, the tax reporting for a corporate stock investment is generally much less complicated and much more timely than the tax reporting for an LLC. Shareholders receive a simple Form 1099 only for those years in which a dividend is paid on the stock or in which the stock is sold, and the Form 1099 is generally received no later than January 31 of the succeeding year. In contrast, LLC owners may receive a very complex Schedule K-1 for each year in which they hold their investment in the LLC, and the Schedule K-1 can be issued by the LLC as late as September 15 of the following tax year. If an LLC investor is itself organized as an LLC or partnership, there can be a cascading delay effect, as the investor must wait for the Schedule K-1 from the business before the investor can issue its own Schedule K-1s to its owners. In addition, the reporting obligations and gain calculations associated with the sale or redemption of an LLC membership interest are much more complicated than for a sale of corporate stock.

State tax compliance is similarly much less complex for a corporation shareholder relative to an LLC owner. If the business is doing business in multiple states, the LLC owners may be required to file income tax returns in the states in which the business earns income (although the LLC can generally file a composite return and pay state income taxes on behalf of its owners). In contrast, corporate dividends and gains are generally only taxed on the shareholder’s home state.

These considerations generally give a corporation an advantage over an LLC in terms of efficiently raising capital and attracting investors. But the degree of advantage can depend on the profile of the applicable investors. Some private investors are willing to negotiate the terms of their investment, and deal with the complexities of LLC tax reporting, to obtain the tax advantages offered by an LLC.

Many advisers steer entrepreneurs into using a corporation for their new business based solely or primarily on the alleged simplicity and financing advantages of a corporation (with the legitimate thought that financing is the lifeblood of a new

business). This “one-size-fits-all” approach to legal entity selection – with a corporation being the one entity that fits all situations – is not always the best approach, and there are likely many circumstances where an LLC is a better choice.

### ***Corporate Equity Compensation Plans***

A corporation can choose from a well-established menu of equity compensation plans having relatively uniform terms and conditions and relatively well understood economic and tax consequences. To the extent the plan participants are issued, or purchase, company stock, the tax reporting obligations for the stock (Form 1099) are much simpler than for LLC equity interests (Schedule K-1). But the tax planning flexibility is greater with LLC equity plans (particularly for equity interests granted after the formation period). On balance, the advantages and disadvantages of corporate equity compensation plans relative to LLC equity compensation plans tend to neutralize each other and this feature should not to be a material factor in the choice of entity.

A separate paper comparing LLC equity compensation plans to corporate equity compensation plans is available on the [Barnes & Thornburg website](#).

### ***Corporate Governance***

As noted above with respect to the governance requirements for an LLC, governance requirements for a corporation are more stringent than the governance requirements for an LLC, but these factors are highly negotiated and are generally not a material consideration in the choice of organizing a startup business as a corporation or as an LLC.

## **S Corporations and Limited Partnerships**

Advisers often cite a third common choice of legal entity for a startup business: an S corporation. An S corporation is a corporation that meets certain requirements relating to its shareholders and capital structure and that files an election with the IRS to be treated as an S corporation. An S corporation’s taxable income generally passes through to its owners, but the company is otherwise classified as a corporation for tax purposes. It is a quasi flow-through entity.

It will rarely make sense to organize a startup business as an S corporation. If flow-through tax treatment is desired, an LLC classified as a partnership is almost always better choice for numerous reasons.<sup>11</sup>

An entity organized as a limited partnership under state law operates and is taxed in most material respects in the same manner as an LLC. One difference is that a limited

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<sup>11</sup> See David R. Sicular, *Subchapter S at 55 – Has Time Passed This Passthrough By? Maybe Not*, 68 *Tax. Lawyer* 185 (2014). S corporations are often promoted as providing self-employment tax savings for owners, but those alleged savings are often negligible or zero and can generally be replicated in a properly structured LLC.

partnership requires some person or entity to serve as the general partner and assume unlimited liability for the debts and liabilities of the limited partnership. Although the requirement of having a general partner can be met with a special purpose entity, an LLC eliminates the need to deal with the general partner requirement. For that reason, an LLC is usually preferred over a partnership.

## Conclusion

The choice of legal entity for a startup business requires a careful consideration of the relevant current and expected facts and circumstances of the startup business, including a consideration of the expected business operations, its near term financing sources, and its expected sale or other monetization scenario. As a general rule, an LLC should be the default legal entity choice, except (a) where the business is actively seeking funding from an investor that insists that the business be organized as a corporation, or (b) where the business can meet the requirements for Section 1202 qualified small business stock.

## Additional Information

To obtain more information regarding the legal and tax considerations relevant to the choice of legal entity for a startup business, please contact either of the Barnes & Thornburg LLP Entrepreneurial and Emerging Companies industry group Co-Chairs, Jeffrey P. Gray at (312) 214-8325 or [Jeff.P.Gray@btlaw.com](mailto:Jeff.P.Gray@btlaw.com), or Joshua P. Hollingsworth at (317) 261-7854 or [Joshua.Hollingsworth@btlaw.com](mailto:Joshua.Hollingsworth@btlaw.com).

*This publication is intended as a general summary of certain material legal and tax considerations relevant to the choice of legal entity for a startup business, and is not a complete description of all such considerations that might be relevant to a person forming a startup business. The considerations could be affected by future changes in law, which could be retroactive. This publication should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer on any specific legal questions you may have concerning your situation.*

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