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Formation: C-Corporation vs. LLC for Your Startup - Which Should I Choose?

A Q&A with David Waizer on one of the most frequently asked questions for startups, "C-Corporation vs. LLC, which should I choose for my startup?"

In short, form an LLC if you're putting up a lot of your own capital or not seeking Venture Capital (VC) financing. Otherwise, save yourself time, aggravation, and money and form a C-Corp.

Q: Many first-time entrepreneurs wonder whether to form their startups as a limited liability company (LLC). Do you recommend this approach? What are the pros and cons?

A: This question comes up frequently because entrepreneurs often hear about the ease with which an LLC can be formed, the flexibility of the LLC structure, and that it can be converted into a C-Corp at a later date. Throw in some beneficial tax treatment, and it's easy to understand why people think forming their startup as an LLC is compelling.

What's less known by first-time entrepreneurs is that VC firms rarely invest in LLCs for contractual and tax reasons and LLCs are more complicated than people think.

Having been the General Counsel of an early stage venture firm for nine years, the venture capital part of me wants to tell them to form a C-Corp or it's unlikely they will get VC funding.

On the other hand, the lawyer in me understands that the answer is actually rather complex and recognizes that there are differing views on the topic. And in a few narrow circumstances, an LLC may be the preferred choice.

Q: What are some of the benefits of an LLC over a C-Corp?

A: There are some significant benefits to the LLC over a C-Corp, namely:

- Easy formation process
- Pass-through taxation
- Flexible structure

Formation

LLC: There are a number of differences between the formation documents of an LLC (Certificate of Formation) and a corporation (Certificate of Incorporation). State law dictates what is required to be included in each document.

Most states only require a few simple pieces of information to be included on a Certificate of Formation to form an LLC. Governance is handled by a contract between the members, called an Operating Agreement, rather than on the Certificate of Formation. Therefore, the hardest part of the LLC formation process is picking the name.

C-Corp: Unlike the LLC's Certificate of Formation, a corporation's Certificate of Incorporation (together with its Bylaws) is the primary governing document of the company.

Each state determines what information is required in a Certificate of Incorporation. While each state's requirements may be slightly different, this generally includes some basic information about the company and stock. Each state also has a set of comprehensive laws that deal with corporate governance. These laws contain a large number of "defaults" unless the corporation's Certificate of Incorporation or Bylaws provide differently.

Therefore, if you are willing to accept the defaults, your Certificate of Incorporation is relatively simple. However, you may not want all these defaults to apply to your corporation. Because the only way to change them is in your Certificate of Incorporation (or sometimes your Bylaws), forming a corporation requires more thought and attention than forming an LLC.

Taxes

LLC: Another, and probably the biggest, advantage of the LLC is that it is treated as a pass-through entity for tax purposes. This means that the LLC does not pay taxes on income. Instead any profits or losses "pass through" to the personal tax returns of the LLC owners.

In a very rudimentary example, if the LLC has losses of $10,000 in its first year and has two owners who each contributed $5,000 to own fifty percent of the LLC, each owner gets to take a loss of $5,000 against their income on their personal tax return. This is a great benefit, because most startups expect to lose money in the first few years and the owners get to offset income from other sources.

Therefore, from LLC income to your pocket, the cash only gets taxed once.

C-Corp: Simply put, C-Corps cannot compete with the tax structure of the LLC. C-Corps are taxed on income and incur losses the same as any other taxpayer. This results in what is called "double taxation."

Unlike an LLC distribution, if a C-Corp distributes some of the income it earned back to its shareholders (i.e., a dividend), the IRS taxes the shareholder on the dividend. Because the C-Corp pays taxes on the income and the shareholder pays taxes on the same money when received as a dividend, you have "double taxation."

As mentioned previously, because the LLC is a pass-through entity, in an LLC this money is only taxed once.

While corporations have a structure that allows for pass-through taxation called an S-Corp, these entities have a whole host of other issues beyond the scope of this article that generally make an S-Corp an unsuitable choice for most startups.

Structure

LLC: An LLC has an incredibly flexible structure. It allows entrepreneurs and investors to get very creative with respect to profit sharing, control, and exit strategies. Additionally, all the governing documents are located in one place – the LLC Operating Agreement.

C-Corp: The C-Corp structure is also flexible, although arguably not as flexible as an LLC's. The governance and contractual provisions contained in an LLC's Operating Agreement are spread across a corporation's governing documents and various agreements between its founders and investors. This requires tight integration and coordination to avoid inter-agreement conflicts.

Q: So, why wouldn't someone form an LLC?

A: At first blush, the benefits of an LLC appear to be rather compelling. But there are a number of reasons to avoid an LLC as your startup structure.

- *Most Entrepreneurs Don't Realize Much of the Tax Benefit*. Most first-time entrepreneurs do not invest too much of their own cash in their startup (often because they have limited funds). Because as a general rule you cannot deduct more losses on your tax return than cash you put into the startup, the benefit of the tax losses is limited.
- *Most VC firms will not invest in LLCs*. There are a number of reasons why VC firms cannot or will not invest in LLCs. Two of the main reasons are (i) VC funds are contractually prohibited from investing in them by their limited partners for tax reasons, and (ii) ***investors (and the entrepreneur) can have taxable income without receiving any cash***. That's right—if the LLC makes money, the owners of the LLC must report income on their tax return—even if the LLC does not distribute any cash to them.
- *LLCs are actually more complicated than C-Corps*. Although the LLC has only one governing document, the LLC Operating Agreement is actually far more complicated than most people realize. These are not "off-the-shelf" documents. Because of complicated tax laws, a good LLC operating agreement will have many pages of legalese dedicated to addressing a host of tax scenarios and issues. Changes to the Operating Agreement are also often difficult and complicated (which means expensive). These changes get exponentially more complicated once you try to create profit sharing plans or equity plans for employees. Instead of explaining an option plan to them, you will have to explain the concepts of phantom income, membership interests, and capital accounts. Setting up C-Corps in the startup world, however, has become incredibly efficient. Most law firms with significant startup practices have created specialized documents and can have you up and running relatively quickly without incurring significant legal fees.

Q: Are there any other issues or considerations that should be made?

A: I am often asked, **when would it be appropriate to form an LLC?** It's appropriate to form an LLC for your startup when you are either (i) planning to invest a lot of your own money into your startup or (ii) not going to be seeking VC capital. If you do not meet one of these criteria, save yourself time and money and form a C-Corp.

Another question I am asked frequently is can't I start as an LLC and convert into a C-Corp? The answer is yes—you can convert your LLC into a C-Corp—in theory. In certain states and under certain circumstances, it is not too hard to convert from an LLC to a C-Corp. However, in practice, it can often get very complicated and expensive. Therefore, if you don't meet the criteria in Question 1 above, my guidance remains: go with a C-Corp.

Authors

David M. Waizer

Partner

Parsippany, NJ | (973) 966-8089

New York, NY | (212) 297-2439

dwaizer@daypitney.com