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INSIGHTS

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. 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.

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

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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 a 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.

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