Launching a Startup? Consider Forming a Corporation Instead of a Limited Liability Company

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Every founder of a startup must form a legal business entity and, to do so, the founder must choose the legal form the business entity will take. From among the different types of entities that a founder can choose, the corporation and the limited liability company are the most popular.

Each entity has its benefits and pitfalls. For example, limited liability companies (LLCs) may choose flow-through tax treatment, which results in lower overall taxes to shareholders; however, due to their more flexible tax treatment, corporate governance standards and fiduciary duties, LLCs are typically associated with higher administrative and legal costs. This article provides a high-level comparison of the corporation and the LLC.

Institutional Investors Prefer Corporations Formed in Delaware

Generally, the Delaware corporation remains the standard form of entity that is preferred by institutional investors and venture capital funds. This is largely because Delaware offers the most consistent, reliable and predictable set of corporate laws, and a robust body of precedent case law that historically has provided the broadest protection for board members, management and controlling stockholders. This predictability, and the ease with which directors, officers and advisers of corporations are able to form guidelines to ensure that they do not violate any fiduciary duties imposed by the Delaware corporate laws, give investors significant comfort, which results in a lower barrier to entry from an investment perspective. LLCs, by contrast, do not enjoy the same predictability, largely because the case law is not nearly as well-developed and the Delaware Limited Liability Company Act does not provide the same foundation of rules from a statutory perspective, instead deferring to the LLC's operating agreement to govern managers, members and management's duties and obligations. This means investors feel like they need to reinvent the wheel with each new investment.

In addition, investors in a startup can take advantage of the tax benefits of Qualified Small Business Stock (as defined under Section 1202 of the Internal Revenue Code) if the startup is organized as a corporation. Qualified Small Business Stock enjoys tax-free treatment upon sale or other disposition if the stock is held for more than five years. Membership interests or other securities offered by LLCs do not qualify for Qualified Small Business Stock treatment, and are subject to normal capital gains tax (if the security is held more than one year) and ordinary income tax (if the security is held less than one year).

Furthermore, many venture capital and other investment funds are unable to invest in partnerships and LLCs because their major investors are pension and profit sharing trusts and other tax-exempt entities that are subject to certain tax restrictions. Consequently, transfers of corporate stock can be easier than transfers of limited liability company interests because the limitations described in the previous sentence may not apply.

Corporations Are Less Costly to Manage

Corporate Organization Documents vs. LLC Operating Agreements

As mentioned in the previous section, the corporate law in Delaware provides a strong foundation on which to build predictable management and compliance guidelines for directors and officers. The laws and regulations for LLCs, by contrast, defer to the LLC's operating agreement to set forth fiduciary duties and other obligations imposed on its members, managers and officers. This means that each LLC may have different guidelines to follow in terms of compliance with fiduciary duties – leading to the need to analyze and form compliance guidelines on a case-by-case basis, rather than relying on a more established body of statutory laws and regulations. Although this type of flexibility is desirable (or even required) in certain situations, it ultimately can lead to increased administrative costs and legal expenses.

Tax Implications

LLCs have the choice of being taxed as a corporation or as a partnership. If taxed as a partnership, the Internal Revenue Service (IRS) ignores the LLC and the members of the LLC include the profits and losses of the LLC in their respective individual tax returns. Although this avoids the "double taxation" that stockholders of a corporation sometimes encounter (taxed once at the corporate income level, then again as a stockholder when receiving dividends), taxation as a partnership introduces added complexities that ultimately result in administrative costs that may outweigh the benefits – especially for startups. For example, the annual exercise of preparing and delivering Form K-1s to numerous investors can be tedious, time-consuming and costly.

On December 22, 2017, President Trump signed into law "An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018" (2018 Tax Act). Among its provisions are deep cuts in the corporate income tax rate, and comparatively less reductions in individual income tax rates. As a result of the tax rate differential narrowing, the corporation is now even more attractive as a vehicle for startups.

Generally, the administration of filing annual tax returns for an LLC is more complex than corporate tax returns because of its pass-through characteristics. If the LLC is taxed as a partnership, it can be required to take into account special allocations to its members, based on the partnership tax rules under the Treasury Regulations. In addition, if the LLC is taxed as a partnership, taxes must be calculated on a member-by-member basis at each instance throughout a given year where those membership percentages might have changed. This, of course, only adds to its administrative burdens. Lastly, the 2018 Tax Act adds complexities by introducing the concept of tax deductions to a portion of earnings derived by taxpayers from qualified trades or businesses conducted through LLCs.

Corporations Can Offer More Favorable (and Certainly More Easily Understood) Equity Incentives for Employees

Another key difference between corporations and LLCs is that corporations can grant incentive stock options (ISOs) to their employees. Employees who receive ISOs do not recognize income upon either the grant or exercise of these options and payment of tax is deferred until the underlying shares are actually sold. In addition, stock acquired through the exercise of an ISO and held for the longer of (i) two years after the date of grant of the ISO and (ii) one year after its exercise, gets capital gains treatment upon sale (i.e., the sale is taxed at a lower tax rate than ordinary income rates).

The difference between the exercise price and the underlying share's fair market value for Non-Qualified Stock Options (NQSOs), by contrast, is taxed as ordinary income, and the subsequent sale of the stock acquired through exercise of the NQSO is only treated as ordinary income if the stock is sold within one year after the date of exercise and as capital gains if sold after one year after the date of exercise.

LLCs typically grant profits interests as equity incentive-based compensation . These are difficult to understand for founders and employees alike, and results in the recipients becoming K-1, instead of W-2, recipients and are generally difficult to administer. LLCs can grant options (but not ISOs) to their employees; however, an option grant by an LLC also includes added administrative burdens, such as recording a capital shift upon exercise of the option to avoid giving the employee a capital interest in the LLC, as well as compliance with other Treasury Regulations.

The analysis of how individual ISOs, NQSOs, profits interests and other equity incentive awards must be considered on a case-by-case basis and one should consult with their accountant, tax and legal advisers to determine specific tax treatment of any equity incentive award.

Conclusion

This article serves to provide a very high-level summary of the relative advantages of forming a startup as a corporation rather than an LLC – especially for startups in the tech, life sciences, energy or other high-growth sector seeking institutional financing. Furthermore, all of the advantages of corporations outlined above may not apply to every startup company and founders should consult with their accountant, financial advisers and legal advisers in making a determination, based on their specific circumstances.

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