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Choice of Entity

Issues to Consider

Congratulations, you have decided to become an entrepreneur! You've come up with a "can't miss" idea, carefully done your market research, put together a business plan and even have some funding set aside to open your new business. So now what? One of the first major decisions you will be confronted with is regarding the type of entity you will form to run your business. While you've undoubtedly heard about corporations, partnerships and limited liability companies, how do you decide which type of entity is the right one for you? Below are some issues to consider when deciding what structure to put in place- particularly for corporations and limited liability companies since those are the structures most often used by start-ups.

Corporations

Corporations are formed under state corporation laws. Unless the founders of the corporation make an election under Subchapter S of the Internal Revenue Code of 1986 to be treated as a pass-through entity for federal tax purposes, a corporation will be a "C" corporation. If the election is made, the corporation will be treated as an "S" corporation.

Some advantages of a "C" Corporation:

- Shareholders have limited liability with respect to corporate debts and obligations.
- Multiple classes of stock permitted.
- Ability to engage in traditional VC-style preferred stock financings.
- A well-established body of law exists with respect to both the legal and tax treatment of corporations.
- No limit on the type or number of shareholders a C corporation may have.

Some disadvantages of a "C" Corporation:

- Corporate income is taxed at two levels, first at the corporate level and then on the shareholder level when dividends are distributed.
- Shareholders do not benefit from corporate losses.
- Less flexibility for special allocations of profits or expense items.
- Shareholders and directors must adhere to formalities and regulations to ensure that the liability protection which the corporate structure affords is not "pierced".

Some advantages of an “S” Corporation:

- Shareholders have limited liability with respect to corporate debts and obligations.
- Corporate losses flow through to the shareholders, which shareholders may be able to use to offset other income.
- S Corporations may have the ability to use the cash method of accounting, which is much simpler than the accrual method.
- A well-established body of law exists with respect to both the legal and tax treatment of corporations.

Some disadvantages of an “S” Corporation:

- Cannot have more than 100 shareholders.
- Cannot have more than 1 class of stock (which makes preferred stock financings impossible).
- Can have only certain types of shareholders (individuals, certain trusts and estates).
- Cannot include entities (partnerships, LLCs or corporations) as shareholders.
- All shareholders must be treated the same.
- There can be tax obligations for income allocated to shareholders but not distributed.

Limited Liability Companies (LLCs)

Some advantages of an LLC:

- Members have limited liability with respect to company debts and obligations.
- No limitations on the number or type of members, as is the case for the S corporation.
- Different classes of membership are permitted.
- An LLC is permitted to specially allocate income and losses among its members.
- Similar to S corporations, LLC losses flow through to the members.

Some disadvantages of an LLC:

- LLCs formed or qualified to do business in New York are required to “publish”, which can add up to $1500 in initial formation costs.
- Tax obligations for income allocated to members but not distributed.
- LLC law is less established than corporate law.

The form of entity through which you choose to operate your business should be carefully considered. To make the best decision, the type of business, the day-to-day operations and the business’s long term goals should be reviewed with your attorney and accountant before making your choice.
