CORPORATE FORMATION & ENTITY SELECTION

Education by Immix Law Group

About Immix Law Group

Immix Law Group specializes in matters of formation (startup, growth, and governance), fundraising, mergers, acquisitions, licensing, multi-party transactions, contract creation and enforcement, estate planning services, and litigation services.

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Author: Jerry Carleton

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Corporate Formation and Entity Selection Considerations

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II. Sole Proprietorships

Sole proprietorships are the structure of default for the single business owner that does not otherwise create an entity. While the business owner can secure an Employment Identification Number ("EIN") for the sole proprietorship, it is not required, and the business owner can just use his or her social security number instead.

A. Liability Protection

Because there is really not an entity in place, there is no liability protection offered. Some business owners are surprised to hear this. Some believe that by filing an assumed business name with the Secretary of State, they have created an entity, but unless the assumed business name is filed for on behalf of an entity, the individual is still operating as a sole proprietor, so even if a client comes to you with a business name established, it is still worth asking what type of entity they have formed.

B. Taxation of the Entity

Sole proprietorships are disregarded for tax purposes, meaning, the Internal Revenue Service ("IRS") will not see the sole proprietorship as separate from the individual. Because of this, there is no real tax planning available under this structure. Revenue received by the sole proprietorship will be taxed as ordinary self-employment income to the individual.

C. Co-Founders and Other Equity Participants

This structure cannot have other equity participants.

D. Fundraising

As stated, this structure cannot have other equity participants, so any fundraising for this type of structure would most likely be a loan of some kind, or even a gift.

E. Flexibility of the Entity and Other Considerations

While this is an incredibly simple structure to establish (because you do not have to actually do anything), it is not very flexible (there can only be one owner), and clients should be advised of the risks involved in having no liability protection (including the added risks if the sole proprietorship has employees). In addition, if the sole proprietorship has sufficient revenue, the owner may be volunteering additional tax under this structure, because use of dividends or other distributions that do not carry self-employment taxes are not available to the owner.

III. Partnerships

Partnerships are the structure of default for when multiple business owners in the same business do not otherwise create an entity. The owners are deemed "partners" under this structure. This does not cover other legal structures that have the word "partnership" in them (such as Limited Partnerships or Limited Liability Partnerships), and those entity types are beyond the scope of these materials.

A. Liability Protection

Similar to the sole proprietorship, because there is really not an entity in place, there is no liability protection offered. In addition, the partners are even worse off than a sole proprietor, because (generally speaking) partners are liable for each other's actions.

B. Taxation of the Entity

Partnerships are taxed as "partnerships" by the IRS (as are some LLCs, which will be discussed below), but are still similar to sole proprietorships in some ways. The taxation of the structure still flows through to the partners, meaning any revenue of the partnership will be taxed by the IRS to each individual partner, based on their ownership interest in the partnership. Because of this (compared to other structures discussed below), there is not as much tax planning available under this structure. Revenue received by the partnership will be taxed, on a pro rata basis, as ordinary self-employment income to the partners.

C. Co-Founders and Other Equity Participants

Unlike the sole proprietorship, you can have multiple owners/partners in a partnership, but remember that each partner will be liable for the acts of their other partners.

D. Fundraising

A partnership could technically fundraise, but an outside investor should be hesitant to become a partner in a partnership due to the liability risks. When a partnership is first formed, it is typical for the partners to contribute capital, but fundraising from outside investors is rare.

E. Flexibility of the Entity and Other Considerations

A partnership is certainly flexible, and like the sole proprietorship, is easy to establish because it can even happen by default. However, liability risks and lack of tax planning or fundraising potential usually make this type of structure unwise for start-up businesses.

IV. Limited Liability Companies

LLCs are an incredibly popular entity for start-up companies, and unlike partnerships and sole proprietorships, forming an LLC does actually involve the creation of an entity. The entity is established by filing Articles of Organization or a Certificate of Formation (depending on the state) with the Secretary of State. The owners of the LLC are called "members" and LLCs can be set up to be run by its members directly, or by specifically designated operators called "managers." Depending on the goals of your client, an LLC could be an excellent choice for a start-up, and many entrepreneurs form LLCs long before even consulting with counsel.

A. Single Member LLCs

A single member LLC is an LLC with only one member, although the LLC could have a different manager (meaning, the LLC might be owned by one person, but run by another).

1. Liability Protection

The single member LLC provides greater liability protection than the sole proprietorship, since the entity exists separately from the member. This is especially true if the LLC has employees and/or a manager separate from the member. If the member creates liability while working on behalf of the LLC, that member will still most likely have liability for his or her actions individually, but if an employee creates liability while working on behalf of the LLC, the member has a greater chance of not having personal exposure. Limiting personal exposure does require that the member treats the LLC separately from him or herself (often referred to as "observing the corporate formalities"), or else the distinction between LLC and member will not be honored (called "piecing the corporate veil"). To preserve the liability protection of the LLC, it is worth reminding your client that the LLC must have a separate existence (i.e. the member must keep personal and business expenses and cash separate), and that the LLCs annual renewal should be filed on time.

2. Taxation of the Entity

Similar to the sole proprietorship, single-member LLCs are disregarded for tax purposes (unless the LLC makes an S-election, which will be further discussed below). This means that the IRS will not see the LLC as separate from the individual. Because of this, there is no real tax planning available under this structure. Revenue received by the LLC will be taxed as ordinary self-employment income to the member.

3. Co-Founders and Other Equity Participants

Similar to the sole proprietorship, this structure cannot have other equity participants.

4. Fundraising

As stated, this structure cannot have other equity participants, so any fundraising for this type of structure would most likely be a loan of some kind, or even a gift.

5. Flexibility of the Entity and Other Considerations

Similar to the sole proprietorship, the single member LLC is not very flexible (there can only be one owner), and if the LLC has sufficient revenue, the member may be volunteering additional tax under this structure, because use of dividends or other distributions that do not carry self-employment taxes are not available to the member. However, the added liability protection is a key benefit to this structure over the sole proprietorship structure.

B. Multi Member LLCs

Multi member LLCs are LLCs that have more than one member, making them one of the most popular entity choices for start-ups. The flexibility of the LLC, along with tax planning possibilities that LLCs can offer, will generally bring LLCs into consideration depending on your clients' goals and objectives.

1. Liability Protection

Multi member LLCs enjoy the liability protection discussed above regarding single member LLCs, and care should similarly be taken to observe corporate formalities. In addition, while LLCs are not required by law to have an Operating Agreement (the core governing document for an LLC, also referred to as a Limited Liability Company Agreement in other states such as Washington), having an Operating Agreement can further bolster liability protection. In addition, the Operating Agreement should carefully plan around how members might put additional capital into the LLC over time, and be sure to limit each member's liability to the amount of any capital contributions already made.

2. Taxation of the Entity

a. Straight Partnership

As discussed under partnership above, the taxation of an LLC taxed as a partnership flows through to the members, meaning any revenue of the LLC will be taxed by the IRS to each member, based on their ownership interest in the LLC. If not structured differently, revenue received by the LLC will be taxed, on a pro rata basis, as ordinary self-employment income to the members. However, the members can also choose to allocate profits and losses contrary to their pro rata ownership interests. In addition, the LLC can establish different types and classes of ownership interests (referred to as "units"), which are further discussed below.

b. Partnership with Truly Passive Owners

While LLCs may also be taxed as an S-Corporation (which is further discussed below), there are planning opportunities in LLCs taxed as partnerships to still gain some of the benefits of S-Corporation taxation, without adding some of the limitations of S-Corporation taxation. For example, if an LLC is formed to purchase real estate and the purchase is made with borrowed money, as long as it is recourse debt to the members (meaning, the bank can collect against the members if the LLC defaults), the members can many times treat the loan as a contribution of capital. That alone can provide significant tax deferment possibilities, and it is not possible with S-Corporation taxation. In addition, an S-Corporation can only have one class of equity, so if multiple classes of units are desired (to be further discussed below), the LLC will need to opt for partnership taxation.

However, it can still be possible to gain some of the savings on self-employment taxes possible with S-Corporation taxation while still being an LLC taxed as a partnership. In a white paper written by tax attorney Darin Christensen titled “Reducing LLC Member Self Employment Taxes,” he explains how proposed treasury regulations and conversations with the IRS have shown their (non-binding) position that achieving tax treatment as a limited partner (without self-employment tax) within an LLC is possible. If the LLC has at least two classes of units (an “active” class and a “passive” class, similar to the distinction between general partners and limited partners), and is at least 20% owned by truly passive members (meaning, those members are not involved in the operation of the LLC), then income allocated to the passive class of units can be free from self-employment taxes.

Ideal candidates for truly passive owners can be passive investors, or the spouse of an active member of the LLC. And because of the large difference in taxation between income allocated to the active class versus the passive class, it is desirable to have most of the ownership in the LLC held in the passive class. An example capitalization table (redacted and excerpted directly from an operating agreement I created for one of my clients), including the explanation for the difference between the two classes of units, is as follows:

> Member interests in the LLC shall be issued in the form of Membership units (“Units”). The LLC initially authorizes two classes of Units: Class A Voting Units and Class B Nonvoting Units. Class A Voting Units and Class B Nonvoting Units shall be identical except that only Class A Voting Units have a vote unless otherwise expressly provided in this Agreement; however Class B Units will have a vote if there are no Class A Units held by Members.
>
> This LLC initially has four Members. The names and addresses of the initial Members, together with the number of Units owned by the Members are shown below:

Name and Address of Member	**Initial Class A Units**	**Initial Class B Units**
Member A Address	50	1,950
Member B Address	50	1,950
Member A's Spouse Address	0	3,000
Member B's Spouse Address	0	3,000

In the above example, you will see that two members own the voting units equally (and yes, there is tie-breaker language later in the Operating Agreement), and that their spouses own non-voting units in large enough quantity to ensure the 20% threshold will not be an issue. You will also see that the voting class of units only makes up 1% of the LLC (since the voting units will be subject to self-employment tax). I have heard arguments for only placing .1% (or even less) of the total ownership in the voting class of units (to further decrease taxes), but have not adopted that aggressive of a strategy.

Using this type of LLC will also require enlisting the services of a CPA or tax preparer who understands how to utilize the structure for the LLC's tax returns.

3. Co-Founders and Other Equity Participants

Unlike the various structures discussed above, the multi member LLC taxed as a partnership enjoys very similar flexibility to the C-Corporation when it comes to co-founders and other equity participants. Where a C-Corporation can use restricted stock, stock options, warrants, and phantom stock for providing incentive equity to team members, the LLC can use restricted units, profits interests, warrants, and phantom equity. The restrictions available for incentive equity, such as vesting, forfeiture, and repurchase rights, can be very important protections for your clients, so if they will need the use of incentive equity, that will usually steer them into the use of a multi member LLC (taxed as a partnership) or a C-Corporation.

4. Fundraising

Multi member LLCs can also be surprisingly useful for fundraising, depending on the goals of your client. It was largely believed that in order to do any level of fundraising, the choice of entity had to be a C-Corporation. To be clear, that is still largely true for fundraising from institutional investors such as venture capital funds or private equity funds. However, and especially when downturns in the economy lead to scarcity of early stage institutional dollars, many clients can secure the funding they need from core groups of friends and family angel investors. Those investors may wish to enjoy the pass-through taxation benefit of LLC ownership, including the ability to take losses generated by the LLC against other income they may have, and that benefit is not available in C-Corporations. Plus, as will be discussed further below, C-Corporations are subject to a double-layer of taxation (at the entity level, and then at the individual level), so if a client does not actually need to be a C-Corporation, there can be substantial tax savings to the owner/operators to use an LLC instead.

Securing angel investment will generally entail offering the investors certain rights and preferences over the original owners in the company. C-Corporations use common stock versus preferred stock (where the preferred stock is sold to the investors). LLCs can also make the distinction between common units and preferred units, to emulate those same rights and preferences sought by the investors. This also compliments the tax strategy discussed above regarding truly passive owners, as many angel investors qualify. In those cases, assuming the angel investors also want rights and preferences over the common units, the LLC can have three or more classes of units (i.e. Class A Voting, Class B Nonvoting, and Class C Preferred).

5. Flexibility of the Entity and Other Considerations

This is another category where LLCs can outperform the other structure choices. Plain and simple, LLCs are a product of contract. The members agree to how they would like the LLC to operate (in a well drafted Operating Agreement), and there is not the same level of statutory and case law build up present for Corporations. That is because the LLC is a relatively new type of entity (versus the Corporation), and while the Corporation has default mandates (such as annual shareholders meetings and use of a board of directors), many of the Corporation mandates are not present for LLCs. For example, the members can agree to only call a member-meeting if necessary (but go years without one), and to elect a manager for life in the interim. And while the LLC can be structured to largely mirror a Corporation, it is not required.

An additional consideration for a trend that is growing popular – if your client does not know if they will need institutional investment, so they start as an LLC with the intent to convert to a C-Corporation if needed, be mindful of the tax consequences of conversion at a later date. It is a relatively simple legal process to convert an LLC into a C-Corporation, but if the members had been enjoying tax losses up to that point, the conversion could trigger a taxable event for the members. The impact can be minimized or eliminated with proper timing and planning, but it is an important issue to have on your radar.

C. LLCs Taxed as an S-Corporation

LLCs taxed as S-Corporations are entities formed as LLCs, but that then elect to be taxed as if they were S-Corporations. The s-election is achieved by filing a Form 2553 with the IRS, and allows the LLC to capture the pros (and cons) of S-Corporation taxation.

1. Liability Protection

These LLCs also enjoy the liability protection discussed above regarding single member and multi member LLCs, and care should similarly be taken to observe corporate formalities.

2. Taxation of the Entity

Filing the s-election as an LLC is typically done for the tax benefit. Filing a Form 2553 allows the entity to be taxed under "subchapter S" of the Internal Revenue Code. Details of subchapter S are beyond the scope of these materials, but as alluded to above, the largest tax planning tool used under this structure is the ability to distinguish between salary and dividends. The tax difference between salary and dividends is the application of self-employment tax, which can lead to significant savings depending on the cash flow of the business.

As mentioned to above, this is not only available for multi member LLCs. A single member LLC can elect s-status rather than being disregarded for tax purposes, giving the sole-owner the chance at some tax savings.

An important reminder for clients, to pass muster with the IRS, they must be paying themselves a reasonable salary. If a CEO is paying herself a $12,000 salary and then taking home $12,000,000 in dividends, the IRS is likely to believe that the salary is not reasonable. Reasonableness is a fact-specific inquiry, but having clients benchmark against other salaries paid in their industry by other companies is a good tool.

3. Co-Founders and Other Equity Participants

While not as flexible as the LLC taxed as a partnership or the C-Corporation, the LLC taxed as an S-Corporation still provides opportunity for incentive equity, but it must be carefully regulated. The main constraint in this regard is that an S-Corporation can only have one type of equity. However, the IRS has approved use of voting and nonvoting equity (as long as it is still the same class of equity), which can provide a planning tool. If restricted stock or options are desired though, it is important to consult with a tax professional, because if done incorrectly, even those more basic tools can violate the single class of equity rule.

In addition, there are constraints on the number of owners and the types of owners possible under the S-Corporation rules. Most applicable to incentive equity in a global society, there cannot be any non-resident alien owners in an S-Corporation. As for numbers, an S-Corporation can only have 100 owners, so if greater numbers are desired, the S-Corporation tax status would not be a fit.

4. Fundraising

As mentioned above, the S-Corporation structure only allows for one type of equity, so that can pose constraints on the type of investment capital available. If an investor were to receive any additional rights and preferences for making the investment, that would constitute a different class of equity and the entity's s-election would terminate. However, if the fundraising can be achieved from non-institutional investors and investors not expecting a preferred return of any kind, it is permissible to sell equity for investment under this structure.

5. Flexibility of the Entity and Other Considerations

The LLC taxed as an S-Corporation is more flexible than some of the other structures discussed (such as the sole proprietorship or the single member LLC that is disregarded for tax purposes), but is extremely constrained compared to a partnership LLC or a C-Corporation due to the subchapter S rules. Additional subchapter S rules include the need to be on the calendar year, and a prohibition on most entities being owners in the S-Corporation.

However, this entity structure can be useful for self-employment tax savings (especially for the single-owner who would otherwise be disregarded for tax purposes), and for closely held companies that do not plan on buying real estate and prefer the slightly relaxed environment of still being an LLC rather than an actual S-Corporation.

V. Corporations

Corporations are very different than sole proprietorships, partnerships, and LLCs (although LLCs can be created to mirror corporations), so your client's goals must be considered in making the decision to incorporate.

A. C-Corporations

C-Corporations are the default corporation. If an entity is incorporated (by filing Articles of Incorporation or a Certificate of Incorporation, depending on the state), the IRS will assume it is a C-Corporation unless the s-election is filed.

1. Liability Protection

Corporations are largely believed to offer the best liability protection, as long as corporate formalities are followed. This is largely because there are more traps for the unwary in LLCs (allowing creditors to force members into paying more into an LLC to satisfy a judgment or debt).

2. Taxation of the Entity

C-Corporations can also be one of the worst entities for tax planning, due to the double-taxation structure. In a C-Corporation, the entity is a tax reporting and tax paying entity, unlike the other pass through structures discussed, which are only tax reporting entities. Because of this, unless there are specific reasons (usually fundraising related) that a client should be a C-Corporation, the negative tax consequences of the structure can make it a bad idea.

3. Co-Founders and Other Equity Participants

C-Corporations offer wonderful opportunities and tools for incentive equity (including restricted stock, stock options, warrants, and phantom stock), and also enjoy the benefit of being understood by large segments of the population as well. As mentioned earlier, multi member LLCs can offer many of the same incentive tools that the C-Corporation can offer, but even the different terminology used in LLCs can provide a hurdle for use of the tools. For example, many potential recipients of incentive equity know about and understand the basic workings of stock options. However, it is less common for those same potential recipients to know about and understand how a profits interest in an LLC works, and in a competitive hiring environment, even that type of hurdle can make a difference.

4. Fundraising

C-Corporations are largely heralded as the go-to entity for fundraising. This is certainly the case for institutional investors such as venture capital funds and private equity funds, which are not structured to be able to handle the pass-through tax structure of any other entity. C-Corporations can also structure special classes of equity with rights and preferences that professional investors are seeking. And professional investors appreciate how defined the C-Corporation is at law. In fact, many institutional and other professional investors will insist that the C-Corporation be formed in a particular state (most commonly Delaware), because treatment of C-Corporations by the courts can be better predicted due to the volume of case law that has built up over time.

While there has been some evolution with regards to institutional investment into LLCs, it pales in comparison to the continued trend of C-Corporation use. If your client will need institutional money and wants to remove any potential barriers to receiving institutional money, use of a C-Corporation will likely be required.

5. Flexibility of the Entity and Other Considerations

As discussed above, C-Corporations are much less flexible than LLCs due to how long they have been in existence (versus the LLC), but because of the statutory and case law build up surrounding C-Corporations (as well as the tax structure), most institutional investors require use of them. The additional mandated mechanics will require clients to pay even greater attention to corporate formalities, but learning about those formalities should not present too large of a hurdle. The main detraction for the client from becoming a C-Corporation will likely be the double-tax, so clarifying fundraising and other equity ownership goals is key.

B. S-Corporations

S-Corporations are corporations that have filed s-elections, in order to avoid double-taxation and be a pass-through entity for tax purposes instead.

1. Liability Protection

As mentioned above, corporations are largely believed to offer the best liability protection, as long as corporate formalities are followed.

2. Taxation of the Entity

As mentioned above in the discussion of LLCs taxed as an S-Corporation, filing the s-election is typically done for the tax benefit (and is achieved by filing a Form 2553). To recap, S-Corporations are allowed to distinguish between salary and dividends, and the tax difference between salary and dividends is the application of self-employment tax. However, make sure clients understand the importance of paying themselves reasonable salaries.

3. Co-Founders and Other Equity Participants

Also discussed above under LLCs taxed as S-Corporations, this structure is not the most flexible for incentive equity, but bringing co-founders and other team members into an equity position is possible. Ensuring that any such equity does not violate the requirement to only have one class of stock is key to maintaining the s-status, and keeping shareholder count under 100 is required. Plus, S-Corporations cannot issue stock to most entities, and cannot have non-resident alien shareholders either.

4. Fundraising

To recap the treatment above, the S-Corporation structure only allows for one type of equity, so investors cannot receive any additional rights and preferences. However, if the investors are not expecting a preferred return of any kind, it is permissible to sell equity for investment under this structure.

5. Flexibility of the Entity and Other Considerations

The LLC taxed as an S-Corporation is slightly less flexible than the LLC taxed as an S-Corporation (due to additional case law and statutory build up surrounding corporations), and as mentioned above, S-Corporations must also be on the calendar year. A practical reason to choose between forming an actual S-Corporation versus an LLC taxed as an S-Corporation can be the preference of the client's tax preparer.

VI. Conclusion

These materials are intended to give an overview of typical entity structures and the types of topics that clients should consider as they choose between those structures. Many other structuring possibilities and additional details around the structures presented (especially surrounding taxation) are beyond the scope of these materials, but the goal is to provide you with a roadmap of things to consider. Based on client responses, you might advise them on other add-ons to the structures discussed above, for example, the ability to become a Benefit Company (which can be done by most entities, not just corporations).

Reviewing liability protection, tax treatment, incentive equity needs, anticipated fundraising needs, and flexibility for changing circumstances, is very important in advising clients on the type of entity to consider, plus whether you will need to advise a client to change structures if they have already created one. Enjoy the process! This is certainly a critical step for your clients where they will need your advice and counsel.