

***LLC'S AND S-CORPORATIONS: PASS-THROUGH ENTITIES FOR START-UP COMPANIES***

One of the many important decisions that a startup faces is the type of legal entity to form. In many cases the decision is made without much thought – “my friend formed an LLC for his business so I will, too.” However, this lack of proper consideration can lead to choosing the wrong form of entity. In other situations, inertia or the difficulty in deciding what form to adopt can lead founders to operate without a legal entity, which is even worse, since the failure to form an entity exposes the owners to potential personal liability to a variety of customers, suppliers, and other third parties, and to tax authorities and other government agencies. As a result, it is vital that the founders form a legal entity and make a well-informed decision when doing so.

Two of the entity choices for an early-stage company are a limited liability company (“LLC”) and an S corporation (“S-corp”). LLCs and S-corps are similar in one key aspect: they are both “pass-through entities” for income tax purposes, meaning that their net taxable income or loss is passed through to the owners (the members for an LLC and the shareholders for an S-corp) in proportion to their ownership percentages, and the individuals report the income or loss on their personal tax returns. (A third, non-“pass-through” option for start-up companies is a C-corporation (“C-corp”) which is briefly discussed at the end of this article.) Pass-through treatment can be useful for early stage companies, which often have losses during their first few years. Such losses flow through to the tax returns of the members or shareholders, who can typically use those losses to offset other income. However, if the business is generating profits, the members/shareholders will be taxed on company profits even if they have not received any cash distributions with which to pay such taxes. In this case, pass-through treatment is only desirable if the owners have adequate liquidity to pay required taxes.

Beyond this superficial similarity, however, LLC’s and S-corps are different in many ways. For example, an S-corp can only have 100 shareholders, they may only have one class of stock, and with limited exceptions all shareholders must be individual persons and U.S. citizens or permanent residents. For instance, an entity that has a founding team participant who is an Indian citizen and resident or an entity that wishes to issue preferred equity at the outset would be eligible to be an LLC but not an S-corp. Another potential downside to an S-corp is that an LLC can convert to an S-corp on a non-taxable basis very simply, but an S-corp that is converted to an LLC will incur taxes on the conversion unless a cumbersome multi-step process is utilized.

Two advantages to S-corps are possible employment tax benefits in certain situations and in the area of employee equity compensation. Compensating employees with some form of equity is often an excellent way to help the cash-constrained early stage company attract and retain employees. However, some forms of incentive compensation are available only to corporations or are difficult and expensive to implement for an LLC.

Another difference is that S-corps are required to follow various formalities such as maintaining boards of directors, appointing officers and holding regular meetings of shareholders and directors, whereas LLCs are not required to have regular manager or member meetings or officers, although even LLC’s must be operated in a manner which reflects their separate existence vis-a- vis their owners. In some cases, it can be advantageous

# FISHERBROYLES

A LIMITED LIABILITY PARTNERSHIP

to form as an LLC under state law but elect S-corp status for income tax purposes. This allows the company to have the reduced formalities of an LLC and the possible tax advantages of an S-corp.

A third option is a C corporation (“C-corp”), which is not a pass-through entity. Other than with respect to tax treatment, S-corps and C-corps are identical; they are both managed by boards of directors, hold required annual meetings, and must comply with the corporate laws of their states of incorporation. However, C-corps are not subject to the limitations mentioned above for S-corps, and accordingly can issue multiple classes of equity (e.g., common and preferred stock), and can have a wide range of investors and shareholders.

C-corps are sometimes the preferred entity of venture capitalists and other professional investors. If the company anticipates investment from outside the founder group in the near to medium term future, one option is to form an S-corp with the intention of changing to C-corp status upon securing investment. The conversion of an S-corp to a C-corp is very simple. It is accomplished by filing a notice with the Internal Revenue Service, is not a taxable event to the corporation or its shareholders, and does not require any filings at the state level. In other situations, especially if the company does not anticipate losses in a start-up phase and is certain that investment from professional investors is imminent, the preferable option may be to organize as a C-corp at the outset.

The above discussion, although not all-encompassing, should make it clear that there are many considerations that factor into making the right choice regarding type of entity. Our corporate and tax partners are pleased to work with you to determine which form of legal entity is best for **your individual situation**.

**If you would like additional information, please contact any of the following FisherBroyles partners:**

Atlanta

Carl Johnston  
(404) 330-8179  
carl.johnston@fisherbroyles.com

Los Angeles

Steven Papkin  
(310) 415-6254  
steven.papkin@fisherbroyles.com

Chicago

Marty Robins  
(847) 277-2580  
martin.robins@fisherbroyles.com

**FisherBroyles, LLP - Cloud-based. Not Virtual™**

*Founded in 2002, FisherBroyles, LLP was the first in the U.S., and now the largest full-service, cloud-based law firm in the world. The Next Generation Law Firm® has grown to approximately 180 attorneys in 21 offices nationwide. The FisherBroyles’ efficient and cost-effective Law Firm 2.0® model leverages talent and technology instead of unnecessary overhead that does not add value to our clients, all without sacrificing BigLaw quality. Visit our website at [www.fisherbroyles.com](http://www.fisherbroyles.com) to learn more about our firm’s unique approach and how we can best meet your legal needs.*

*These materials have been prepared for informational purposes only, are not legal advice, and under rules applicable to the professional conduct of attorneys in various jurisdictions may be considered advertising materials. This information is not intended to create an attorney-client or similar relationship. Whether you need legal services and which lawyer you select are important decisions that should not be based on these materials alone.*

© 2017 FisherBroyles LLP