# CHOOSING AN ENTITY

NW CORPORATE LAW

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# C Corporations

## ADVANTAGES

- Excellent for complex financing or raising capital.
- Corporations may issue incentive stock options (partnerships and LLCs may not), which generally give holders favorable long-term capital gains treatment.
- A corporation can have perpetual life: it can continue after the death, disability,or retirement of the original shareholders.
- There is extensive case law about corporations, as opposed to LLCs, so judges are better equipped to handle lawsuits related to corporations.
- C corporations can be owned by an unlimited number of any type of “legal persons” (e.g., corporations, LLCs, partnerships, trusts, and individuals).
- It’s the entity of choice for businesses that want to build long-term value by retaining earnings.
- C corporations may issue different classes of stock with various rights.
- C corporations may offer tax advantages to investing venture capital funds.
- The gains on sales of stock held for >1 year and qualified dividends are taxed to shareholders at favorable capital gains rates.
- Salaries and other reasonable compensation to shareholders who work for the business are usually fully deductible against the corporation’s income.
- Certain fringe benefits for employees may be deductible against the corporation’s income.

## DISADVANTAGES

- Double taxation: the corporation pays tax on its income, and the shareholders pay tax on any dividends.
- C corporations cannot pass losses through to the shareholders.
- Only when shareholders sell their stock at a loss do they have the opportunity to generate a loss for tax purposes that may offset income from other sources.
- There are more extensive requirements for formation, including issuing stock,drafting bylaws,and electing a board of directors and officers.
- Persons performing services for the corporation, including shareholders, must generally be paid through payroll, with state and federal withholdings and deductions made.
- Corporations have a defined and rigid management structure. Shareholders must elect the board of directors, who, in turn, elect the officers to run the day-to-day operations.
- Annual meetings of the directors and shareholders must be held.

# S Corporations

****NOTE:** An S corporation is simply a company that has elected with the IRS to be treated as such. Either a corporation or an LLC may elect to be treated as an S corporation.For more information, see this article: https://www.nwcorporatelaw.com/what-is-an-s-corporation/

## ADVANTAGES

- Pass-through taxation at the corporate level: income and losses pass through to the owners, allowing them to deduct losses from their taxable income.
- An owner-employee of an S corporation can avoid employment taxes to a certain extent, as opposed to LLCs taxed as partnerships.
- S corporations usually are easy to manage and operate, as there can only be one class of stock. (NOTE: If the company was formed as a corporation, as opposed to an LLC, it will still have to maintain a board of directors, elect officers, and hold annual meetings of the directors and officers.)

## DISADVANTAGES

- There may only be 100 shareholders, all of whom must be individuals, certain tax-exempt organizations, qualifying trusts, or estates, and none of whom may be non-resident aliens.
- Only one class of stock is allowed, although it can be issued with voting and non voting rights.
- All corporate level income is treated as if it is distributed to the shareholders, whether it actually is or not.
- Unlike entities taxed as partnerships, S corporations can not allocate items of income, gain, loss, deduction,and credit disproportionately.

# LIMITED LIABILITY COMPANIES (LLCs)

****NOTE:** By default, LLCs with one owner are disregarded entities by the IRS: all of the income and losses of the LLC pass through to the owner. LLCs with two or more owners are taxed by default as partnerships by the IRS.The lists below assume that an LLC has notelected to be taxed by the IRS as an S corporation.

## ADVANTAGES

- Pass-through taxation at the LLC level: income and losses pass through to the owners, allowing them to deduct losses from their taxable income.
- Flexibility in formation, ownership,and management:
    - There may be an unlimited number of owners who may be individuals or other companies.
    - Owners may be divided into different classes or groups, each with different rights, powers, preferences, and limitations.
    - There are few required ongoing formalities. For example, there is no need to elect a board of directors or appoint officers, and, at least in Oregon,annual meetings are not required

## DISADVANTAGES

- Because they are a relatively new type of entity—that is, as opposed to corporations—there is less case law concerning LLCs, the case law is rather inconsistent, and judges may be less equipped to handle lawsuits related to LLCs.
- There is a lack of uniformity among states in regard to the formation, management, operation, and conversion and merger of LLCs.
- LLCs are not suitable for businesses financed by venture capital funds because of tax restrictions on the funds' tax-exempt partners.
- Private money investors are generally less familiar with LLCs and so may be more hesitant to invest.
- Investors and employees commonly prefer offerings of corporate stock rather than partnership or LLC interests because stock offerings are easier to understand.
- If the LLC is owned by two or more owners, it will be taxed by default as a partnership. Partnership taxation is exceedingly complex and may require more payments to accountants to assist with tax preparation, and additional legal fees to draft operating agreements that are consistent with the partnership tax code.