O'Connor
LAW OFFICE

LLC or C-Corporation?

This is intended as a general guide to the question to consider when deciding on the form of business entity to use for your venture. Needs of individual founders, investor expectations and other factors may influence the decision. Start-up entrepreneurs should always consult with qualified tax and legal professional advisers before making this decision, as the factors facing their venture may be complex and/or unique. Also, another form, such as a subchapter-S corporation, might be desirable in some cases.

As a very general rule, a start-up that envisions early losses followed by gains, intends to seek venture capital financing, intends to use incentives to attract and retain management, and intends to use all profits and cash to grow the company toward a profitable exit/sale, will probably benefit from the C-corp. form. A company that intends to be profitable from the start, does not plan to raise VC funding, and plans to keep control and ownership of the company in the hands of the founders and their affiliates for the foreseeable future, may benefit from the LLC form. Again, this choice should be made in each case with the appropriate legal and tax advice.

Factor/Question	LLC	C-Corp.	Comments
General	Considered a partnership for tax purposes. Entity is a "pass-through"; i.e., results of operations and tax attributes, e.g., profits and losses, "pass through" to the partners/members in the manner described in the operating agreement. Results are reported and taxes are paid proportionally by the partners/members.	Entity is a taxpayer in its own right. Operating results and tax attributes belong to, and results are reported and taxes paid by, the entity. Shareholders pay a tax on any dividends distributed by the corporation. This is often referred to as "double taxation."	There is no right answer. Choice should follow from consideration of the factors below.
Will the entity experience losses in the initial operating periods, followed by periods of taxable profit?	Losses pass through to the members; however; whether or not a member can use all of those losses in a given year to offset other income will depend on the member's individual circumstances (e.g., basis, at-risk amount, passive loss limitation).	Losses carry back (2 years) and forward (20 years subject to limitations) and may be used by the taxpayer corporation.	An entity that (a) has passive owners and (b) will experience early periods of losses, followed by periods of taxable income, might be able to use tax attributes more efficiently as a C-corp.
Will the entity be cash-flow positive and earn taxable income from inception? Will cash be distributed to members?	Income passes through and is allocated members per the LLC agreement. Members pay taxes on their allocable share of income regardless of whether the LLC distributes cash to the members. Most LLC operating agreements will provide for cash distributions to members that is intended to allow members to pay their estimated and annual taxes on their allocable share of company income. Companies are not required to make such distributions, however, if cash is not available to distribute. In this situation, a member must use cash from another source to satisfy its tax liabilities arising from the LLC's operations.	Corporation pays taxes at the applicable corporate rate on income. If dividends are to be paid to owners, these are again taxed at the applicable dividend rate. This is the "double taxation" that is referred to in respect of C-corporations.	Certain businesses, such as restaurants, consulting firms, services business, franchising businesses, family operations that are intended to provide long-term employment and income for family members, and entities that will primarily license technology out, generally are better off as LLC's. Other businesses, that do not intend to pay out dividends but rather use earnings to re-invest in and grow the company, with the objective of maximizing value toward an exit, might be better off using the C-corp. form.
Will the entity seek outside equity financing from venture capital firms?	Operating losses and income pass through investors.	Entity records losses and income.	Most VC investors will require the portfolio company to be a C-corporation for tax purposes. If the entity is already an LLC and conversion is not feasible, then the VC may be able to utilize a 'tax blocker" corporation to hold the shares.
Will the entity seek to retain and incentivize management with equity?	LLC can issue "profits interest," which are partnership interest with no initial capital account. Profits interests and their terms and conditions are written into the LLC operating agreement.	Standard option plan. Also, founders' shares, and other, more complex forms of equity compensation are available.	Equity incentive compensation can be much simpler and more straightforward in a C-corp. However, it can be done in an LLC.
When is the expected liquidation event? What kind of exit is projected?	If equity is held for more than one year, then asset sale or equity sale will generally produce capital gain.	Equity sale will produce capital gain; asset sale will be "taxed twice" and usually is not economically feasible.	Section 1202 excludes from taxation certain capital gain, if shares qualify and are held for more than 5 years; possible strong advantage of C-corp. if an equity sale after more than 5 years is contemplated, and if requirements are met.