Consider a C-Corporation for Your Start-Up

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When starting a business, one of the first and more important decisions is choosing the appropriate legal entity structure. Entrepreneurs often choose a limited liability company or a corporation with a Subchapter S election to avoid the "double tax" that may arise when operating a corporation without an S election (so-called "Subchapter C" corporation). Such tax considerations, however, should be balanced against expectations to generate financing from investment funds, which generally invest only in companies that are structured as C-corporations. Founders of start-up businesses should therefore give greater consideration to operating as a C-corporation, while owners of existing LLCs and S-Corporations should evaluate converting into a C-corporation.

For federal income tax purposes, LLCs and S-corporations are "pass-through" entities. While they calculate their taxable income and loss under normal tax accounting concepts, they generally do not actually pay tax on any of their annual taxable income. Rather, such income is allocated to the owners of the entity and the owners pay tax on the income so allocated to them. The character of the income (e.g., ordinary income, capital gain) allocated to the owners is the same as the character of the income earned by the LLC or S-corporation.

The C-corporation, by contrast, itself pays tax on its own taxable income. Moreover, when the C-corporation pays a dividend to its shareholders, that dividend is then taxable to the shareholder. Thus, income earned by a C-corporation is subject to two levels of taxation – once at the corporate level and then again at the shareholder level when the after-federal tax income is distributed as a dividend – whereas income earned by an LLC or S-corporation is subject only to a single federal tax, at the owner level.

The impact of double taxation on earnings is frequently mitigated or eliminated entirely by C-corporations that pay out most of their earnings to their shareholders in bonuses or other salary, leaving the corporation with little, if any, taxable income, provided that the amount of such shareholder compensation is reasonable. In addition, even when C-corporations do not pay out all of their income in salaries or compensation, they often do not pay dividends to their shareholders and thus defer the taxation of the retained earnings or allow the owner to perhaps obtain capital gain treatment with tax-free recovery of basis by selling stock of the firm.

The more common negative impact of double taxation occurs when the business of a C-corporation changes ownership. Potential buyers of a business, seeking to limit their exposure to the business' liability, usually insist on buying the assets of the corporation, rather than its stock. The result to the selling corporation, however, is that it experiences a taxable gain on the sale of appreciated assets, which is compounded by the fact that, unlike individual taxpayers, corporations are not eligible for the lower tax rates that apply to capital gains. When the C-corporation distributes the proceeds of the sale to its shareholders, those shareholders would then also have taxable income in the amount of their respective distributions.

Notwithstanding the potentially adverse tax treatment attributable to C-corporations, business owners must be mindful of other considerations when selecting a business structure. A primary factor to evaluate is the business's ability to raise financing from angel investors, venture capital, private equity, subordinated debt or other investment funds. Such investment funds will generally not invest in a start-up business that is not structured as a corporation. If the start-up business is an S-corporation, then the status as an S-corporation will almost certainly be deemed revoked because the shareholders of an S-corporation may only be (i) individuals who are U.S. citizens or residents, (ii) estates, (iii) certain eligible trusts or (iv) certain tax-exempt entities.

If the start-up business is an LLC, however, the reason that investment funds will likely not invest in the LLC pertains to the types of individuals and entities that are among the partners of such investment funds. An investment fund is most often structured as a limited partnership, which is a pass-through entity for federal income tax purposes. The partners of an investment fund will often include organizations such as charities and pension funds, which are normally exempt from income tax. Such tax exemption, however, does not extend to so-called "unrelated business taxable income" ("UBTI"), which is taxable even to them. Therefore, a typical investment fund organizational document would contain a provision requiring the fund to use reasonable efforts to avoid generating UBTI. Thus, if the investment fund invested in a C-corporation, the income it would receive would be either dividends or capital gains on selling stock (not UBTI), whereas if it was an LLC, the investment fund would be taxed immediately on its share of income earned by the LLC and such income would likely be UBTI (something to be avoided if the investor is a tax exempt entity).

In addition, the partners of an investment fund may include foreign individuals, pass-through entities with their own foreign owners, or foreign corporations. As a general rule, a foreign investor is not subject to U.S. capital gains taxes on capital gains earned from the sale of U.S. personal property such as the shares of a U.S. corporation. Moreover, foreign investors may be entirely exempt from income tax on interest income (if such interest income constitutes "portfolio interest" under the U.S. Internal Revenue Code) and are subject to a flat rate of 30% tax on any dividend income (which tax rate is often reduced by an income tax treaty between the U.S. and the foreign investors' country of residence). By contrast, income earned by a foreign investor which is effectively connected with the conduct of a trade or business in the U.S. (so-called "effectively connected income," or "ECI") is subject to tax in the U.S. in the same manner and at the same rates as such income would be subject to tax were it earned by a U.S. domestic investor. Moreover, if a foreign investor has ECI, it will be required to file a tax return in the U.S. (which the foreign investor could avoid if its only U.S. source income were capital gain income, or interest income or dividend income, which could have any withholding done at source). Accordingly, a primary goal of a foreign investor making a private equity investment in the U.S., either directly or through an investment fund, is to avoid generating ECI.

Similarly, income generated by the performance of services, or by the conduct of a trade or business, generally is UBTI and is ECI. Dividends, interest and capital gain from the sale of stock or securities are not UBTI (unless the purchase price of the stock or securities providing such income was financed with indebtedness, which is rarely the case in a typical investment fund) or ECI.

To avoid UBTI (or ECI, if foreign investors are a concern), an investment fund generally invests only in companies that are structured as taxable C-corporations. Income of a C-corporation does not "pass through" to its shareholders. Dividends and interest paid by a C-corporation portfolio company, and gain on the sale of its stock or debt, are not UBTI. As described above, S-corporations and LLCs are both treated for tax purposes as pass-through entities. If an LLC were engaged in the active conduct of a trade or a business, such income would "pass through" the LLC to its investors; and if one of those investors were an investment fund, such active trade or business income would "pass through" from the investment fund to its tax exempt investors, and therefore generate UBTI for them (or ECI, for its foreign investors).

LLCs are generally not a good choice for companies that expect to rely on material outside financing. Although LLCs do not suffer from the same inflexibility in capital structure and ownership that S-corporations do, LLCs are much more difficult and expensive to convert to C-corporations. While S-corporations can be converted to C-corporations at no cost, converting an LLC to a C-corporation can sometimes cost thousands or tens of thousands of dollars in legal and administrative costs (and sometimes trigger income tax upon the conversion). In almost all cases, this unnecessary expense could have been avoided if the founders had not selected an LLC as the choice of entity at the formation stage.

The foregoing illustrates that start-up companies need to be mindful of not only their own tax considerations but those of their prospective investors. Those companies that plan on raising capital from investment fund sources will likely need to be, or be converted into, C-corporations.

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