



How Should You Incorporate? 5 Factors to Consider

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What kind of business should you form? An LLC, C-Corp, or S-Corp?

Unfortunately, the answer is always the same: It all depends. But the following factors may help clarify the decision for you. Given that an LLC, C-Corp, and S-Corp all offer the same level of liability protection, here are five key factors to consider when deciding which business entity to form:

Consider a C-Corp if you:

- 1) plan to attract venture capitalists or other larger investors who want to avoid pass-through tax entities;
- 2) expect that the tax rate from a marginally profitable C-Corp will be lower than your tax rate for other ordinary income, and you do not intend to distribute the profits from the C-Corp.

Keep in mind, however, that many small business owners find that a C-Corp is not the best tax entity because of double taxation: first on the profits of the corporation and second on the shareholders who must pay taxes on the distributions of profits. In addition, owners of C-Corps cannot apply business losses to offset the taxes on their other personal income.

You should form an LLC if you:

- 1) expect your company to have losses, and you would like to offset them against ordinary income;
- 2) do not plan to pitch to venture capitalists, but you may have investors that are corporations or non-U.S. residents (which you cannot do with an S-Corp).

If you are trying to choose between an S-Corp and an LLC, talk with your accountant about which of the two entities would be best for state taxes. As an owner of an LLC, if you also manage it, you will be subject to self-employment taxes as well as fees based on gross receipts whereas S-Corps are subject to net income tax. You can, however, opt to treat the LLC as a C-Corp for taxation purposes.

What are the advantages of an S-Corp? Many people believe that forming an LLC is much easier than an S-Corp. On the contrary, LLC operating agreements for multiple members can be much more complicated than an S-Corp because the terms of operating agreements can vary substantially. The legal framework of an S-Corp is essentially the same as a C-Corp, and the basis for bylaws and minutes is well-established and predictable. If your corporate attorney is drafting an operating agreement even for as few as two members, you must carefully consider who will manage the business, who will be responsible for contracts and finances, how capitalization will be structured and other key matters.

Resist the temptation to pull an LLC operating agreement off the Web because poorly drafted terms may cost you significantly more legal fees in the long run. On the other hand, an LLC operating agreement for a single-member LLC is fairly straight forward.

If you are considering an S-Corp, are any annual legal filings required?

Yes. You must still keep annual minutes for an S-Corp and file a statement of information with the Secretary of State. These documents are far less

intimidating than they sound. Annual minutes in California and Delaware can take the form of shareholder- and director-written consents.

The Statement of Information is a form to update the Secretary of State and the public on where you are located, your agent for service, and other basic information. Although an LLC does not require minutes, you must still file a version of the statement of information biannually with the Secretary of State in the state where your company was incorporated.

If you start out as one entity, can you convert to another? Yes. However, it is much easier to convert from an S-Corp to a C-Corp or vice versa. The conversion requires simple corporate resolutions from the directors and shareholders, and your accountant will need to file Form 2553. However, you cannot convert back for a certain number of years. Converting an LLC to either an S-Corp or C-Corp does not take long but is more complicated and may result in varying tax treatment.

Before choosing an entity, you should speak with your accountant about how your choice will affect your personal tax situation.

Keep in mind that forming a business entity — whether an LLC, S-Corp, or C-Corp — does not diminish the likelihood that your business could be sued. These entities only serve as a liability “buffer” between your business and your personal assets, provided the entities maintain all requisite legal compliance. If not properly maintained, these “corporate shields” may be pierced, making your personal assets vulnerable. For this reason, the cost of an ounce of prevention to properly form and maintain your business entity is a sound investment in comparison to the pound of legal fees you may otherwise have to face down the road.