Choice of Entity and State of Incorporation Considerations for Entrepreneurs When Forming a Start-Up

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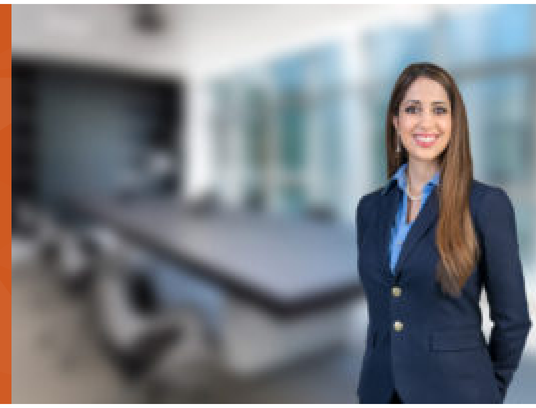
August 15, 2022



Forming a new business can seem like an overwhelming process. However, it is important to officially register your business with the Secretary of State to be afforded certain limited liability protections for your business activities. This article provides a high-level overview of some of the more common types of entities to help you decide what entity your business should be, as well as considerations for what state to incorporate in.

What is the significance of incorporating or forming a business entity?

When you are running your own business but have not yet officially formed with the Secretary of State, you are considered a sole proprietor. Sole proprietors do not have limited liability protections since the business and the founder are the same (e.g., a founder operating a business as a sole proprietorship could be held personally liable for business activities conducted, meaning that someone could go after the founder's personal assets). By incorporating your business with a Secretary of State you are going from being a sole proprietor to an actual registered entity, in which the business and the founders will become legally distinct from one another. This separation means that, if someone sues the business, they likely will only be able to go after the assets of the business rather than the founder's personal assets, unless the founder does something egregious (e.g., comingling the company's bank account with the founder's own personal account) that could persuade a court to "pierce the corporate veil". Because of this, entrepreneurs should consider incorporating their business prior to signing any contracts, before opening a storefront, before taking on any investment or before any dealings with third parties.

What type of entity should my business be?

There are several different types of entities, such as partnerships, limited liability companies (LLCs), C-Corporations, S-Corporations, and Public Benefit Corporations. The most common entity types are limited liability companies, S-Corporations and C-Corporations. Below is an examination of some of the main benefits and drawbacks of each of those three entities.

C-Corporation:

Benefits:

- Limited liability protections for the entity's owners for their business activities.
- This entity structure is preferred by most investors.
- There are no limitations on the number or type of investors. This allows the company to have the opportunity to fundraise from multiple avenues.

    - Ability to have over 100 investors.
    - Allows for both U.S. citizen and non-U.S. citizen investors.
    - Investors do not need to be natural persons (though can be) but also could be an entity investor like a trust or venture capital fund.

- Allows for multiple classes and series of preferred stock.
- 1202 tax benefits if you meet certain criteria (1202 qualified small business tax treatment permits stockholders of certain qualified small businesses to exclude a significant portion of associated capital gains when selling or exchanging that stock, if shares are held for over five years and if certain other criteria is met).
- Ability to issue stock options.

Drawbacks:

- This entity is subject to double-taxation, meaning that taxation occurs at both the entity level and the stockholder level if dividends are distributed.
- 1202 tax benefits are not guaranteed and if an entity does not meet certain criteria its stockholders will not receive this benefit.
- This entity relies heavily on statutory law, and as such there is limited flexibility to "contract your way around" certain stockholder rights.

S-Corporation:

Benefits:

- Limited liability protections for the entity's owners for their business activities.
- Pass-through tax treatment, meaning a single level of tax at the owner level, with income and loss reported on Schedule K-1 prepared by the company and filed with the owners' personal income tax returns.
- Ability to issue stock options of the same class of stock.
- Management owners could pay less in self-employment taxes as compared to LLCs.
- Good entity structure for those who want to make distributions on earnings.
- Ability for owners to deduct the company's losses on their personal returns.
- Potential to be able to engage in corporate reorganizations (and if certain criteria are met, there may be an ability to qualify for tax-free rollover).

Drawbacks:

- Must timely file a Form 2553 with the IRS to become an S-Corporation.
- S-Corporations have limitations on the number and types of owners.
    - Only natural persons (or certain trusts) can be stockholders, meaning no corporate entities or venture capital firms can invest in an S-corp.
    - Investors must be U.S. citizens or legal residents.
    - Limited to having a maximum of 100 stockholders.

- Limited to only one class of stock.
- Inability to obtain 1202 qualified small business stock tax treatment.
- All distributions to all shareholders must be proportionate.

Limited Liability Company:

Benefits:

- Limited liability protections for the entity's owners for their business activities.
- Single level, pass-through tax treatment, which as noted above means that income and loss are reported on Schedule K-1 prepared by the company and filed with the owners' personal income tax returns.
- Ability for owners to deduct the company's losses on their personal returns.
- The LLC is a very flexible model as it is contract-based rather than being heavily regulated by statute (though there are certain statutory baseline rules that must be complied with). Within broad limits, though, the members of an LLC can agree upon their own set of rules in an Operating Agreement.
- Ability to limit certain shareholder rights and certain fiduciary duties.
- Ability to issue profits interests (which could result in capital gain treatment for employees and other service providers).
- Potential ability for purchasers upon an exit to obtain step-up in basis of assets.
- Flexible entity choice if you decide to restructure in the future or convert to another type of entity.

Drawbacks:

- No 1202 tax treatment.
- More complex in design and operations than a corporation.
- Earnings for founders/management may be subject to self-employment taxes.
- Limitations on certain investors that cannot hold interests in an LLC taxed as a US partnership (including certain foreign investors and venture capitalist funds). Investments in LLCs may cause tax problems for the investors in a venture capital fund if the venture capital fund has tax-exempt partners that can't receive active trade or business income due to their tax-exempt status.

Where should I incorporate?

Delaware: Most companies will want to incorporate in the state of Delaware. This is the standard state of incorporation that most savvy investors prefer. Delaware has well-defined case law and statutory law. Delaware also has high quality courts (Court of Chancery).

State of Operation: Entrepreneurs will sometimes prefer to incorporate their new entity in the state in which they are physically located. This allows the entity to save on foreign qualification fees (unless they are doing significant operations in another jurisdiction that would necessitate foreign qualification there) and having to file and pay less annual/franchise tax reports in different states, resulting in a lower administrative burden. Organizing in your home state is often preferable for companies that do not expect to seek outside financing.

Foreign Qualification: Foreign qualifying in a state means to register with the Secretary of State of a state that your entity is not incorporated in. The need to foreign qualify in a state differs from state to state but is typically triggered by things like your entity conducting significant amount of business in that state, or if you have workers in an office there. If you incorporate in Delaware, you will also need to foreign qualify in the state in which you have your principal place of business, in addition to any other states where your business activities may necessitate qualification.

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