LLC vs. Corporation: What's the Best Structure for Your Startup?

November 19th 2019

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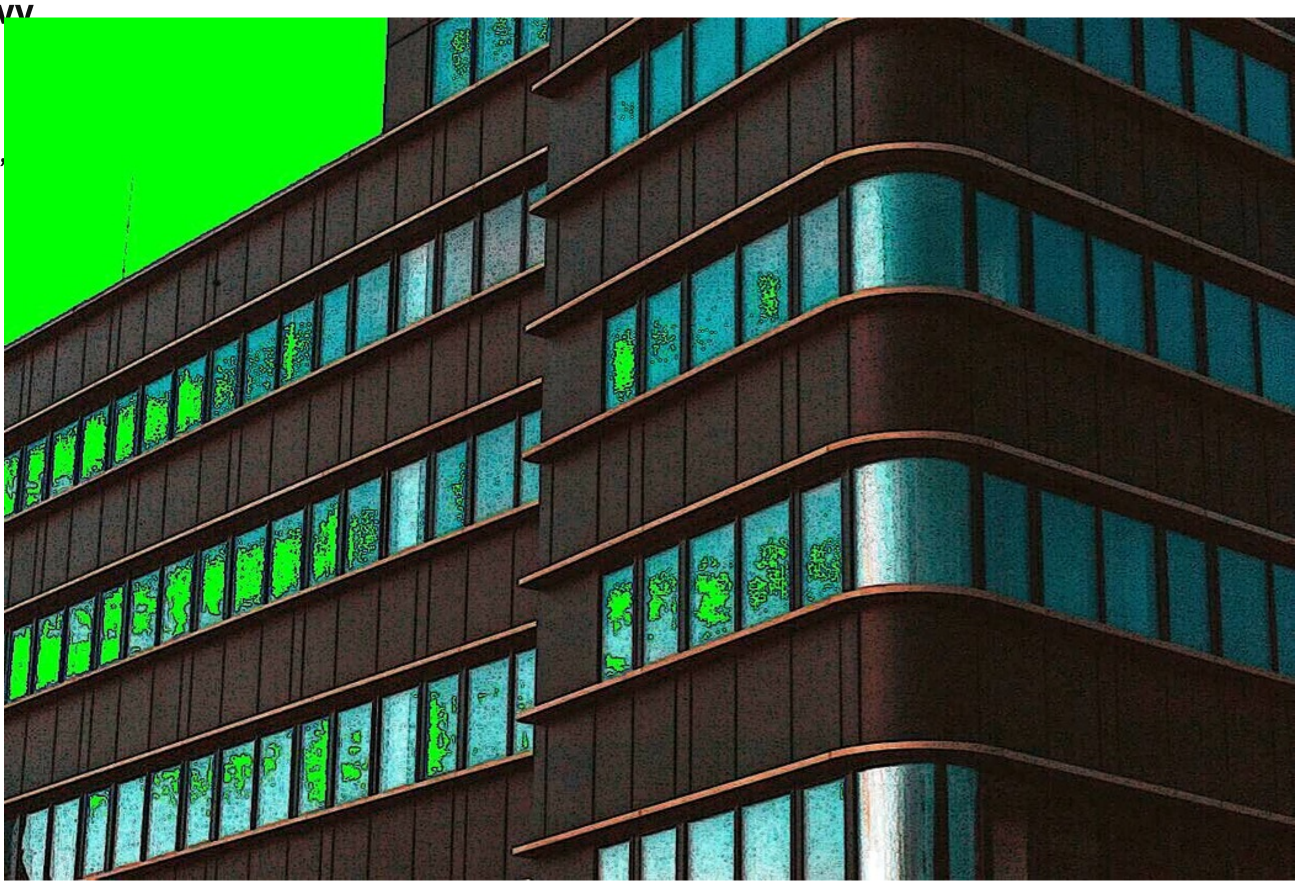


Source: Zuza Gałczyńska, Unsplash

When starting your own business, it may be challenging to choose between an LLC and a Corporation. Here is some information that may make the decision a little less taxing.

What is an LLC?

LLCs are organized under an Operating Agreement, a contract between owners ("members"), specifying how the business will be run and how costs and profits will be shared.

A limited liability company can either be owned by one person, which is known as the single-member LLCs, or by more than one owner, which is known as a multi-member LLC.

Limited liability can protect the member(s) against lawsuits, reduces the paperwork needed by other types of companies, simplifies taxation, and establishes credibility as a business.

Features of an LLC include:

Limited liability for founders — moving liability for debts and obligations of the business from the entrepreneurs into the company itself;

Pass-through taxation which allows LLC's owners to pay personal income taxes on the income of the business.

What is a Corporation?

Corporations are structured based on the principle that control and ownership can be separate. Owners are called shareholders, and they may or may not be involved in the day-to-day operations of the company. Ownership of the business is tracked by shares, with each share corresponding to a defined portion of control of the business and of entitlement to profits.

Features of a Corporation include:

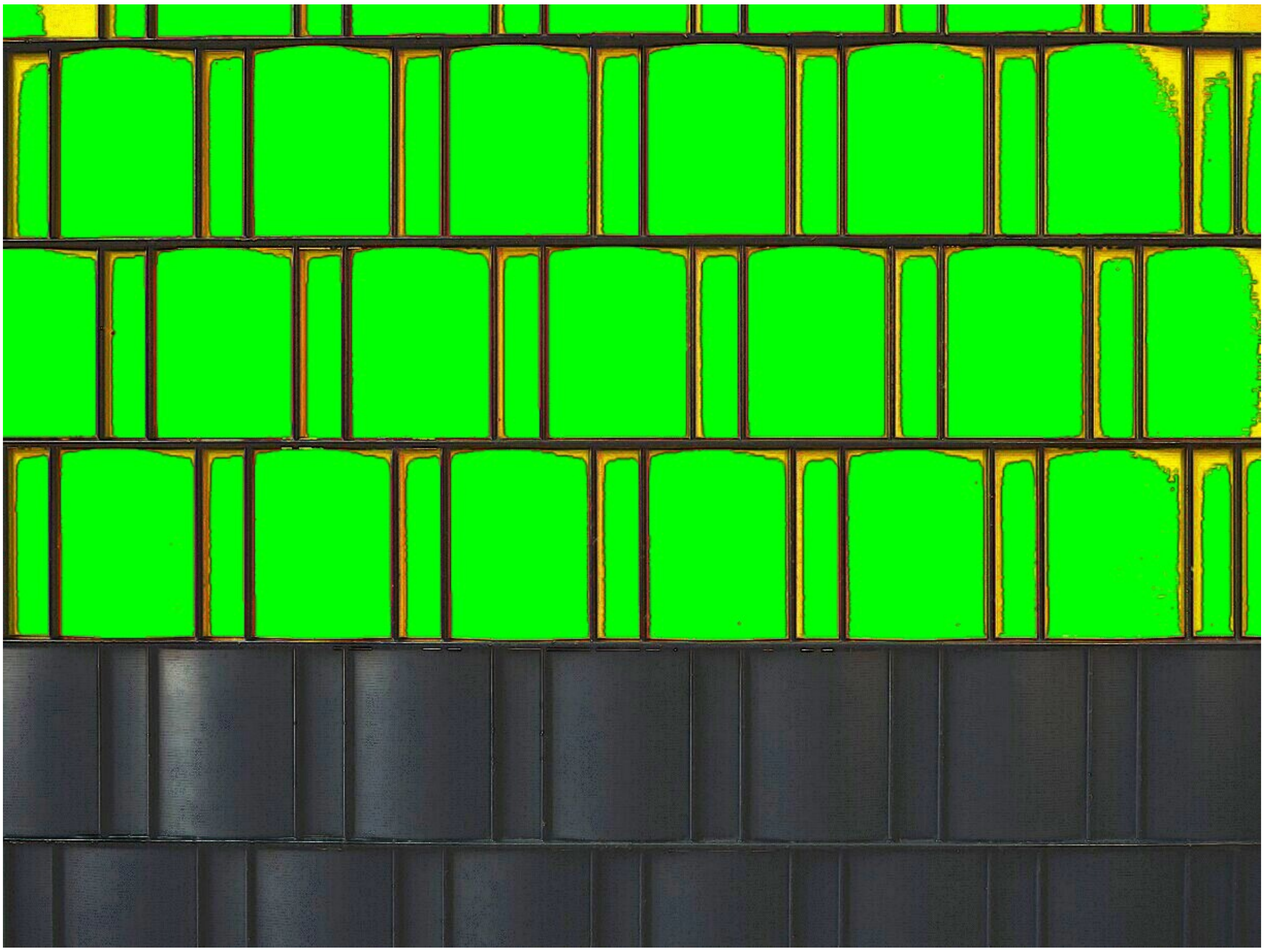
Corporations *also* provide limited liability — shareholders are generally not individually liable for the debts and obligations of the company.

Corporations must pay corporate taxes on their own profits (and have extensive filing obligations).

Shareholders are taxed separately if the company distributes dividends to them, or if it pays them a salary.

Corporations are generally most suitable from an investor's perspective because their structure is designed to distribute ownership.

Corporations adhere to a standard structure for the distribution of options to buy that stock, which can then be used to attract, retain, and incentivize key talent, contributing to the success of the business.



Source: Daniel von Appen, Unsplash

LLC vs. Corporation

Business formation

An LLC is owned by one or more business owners, and these members hold a designated percentage in the company called a "membership interest." As profits and losses are passed onto the members depending on their share of membership, it is considered to be a pass-through type of business and allows for flexibility in management. It has the freedom to distribute ownership without considering a member's financial contribution.

For example, a member of the LLC may not have invested as much capital as another member, but can still receive an equal share of the profits. This allows for flexibility when establishing the ownership of the business.

They also have to file Articles of Organization and set out an Operating agreement — an agreement, which defines whether and how membership interests can be transferred and also specifies the sharing of profits.

A *corporation*, on the other hand, requires that officers organize the post-incorporation documents. For a corporation, shareholders are represented by their holding of common stock to pursue a common goal.

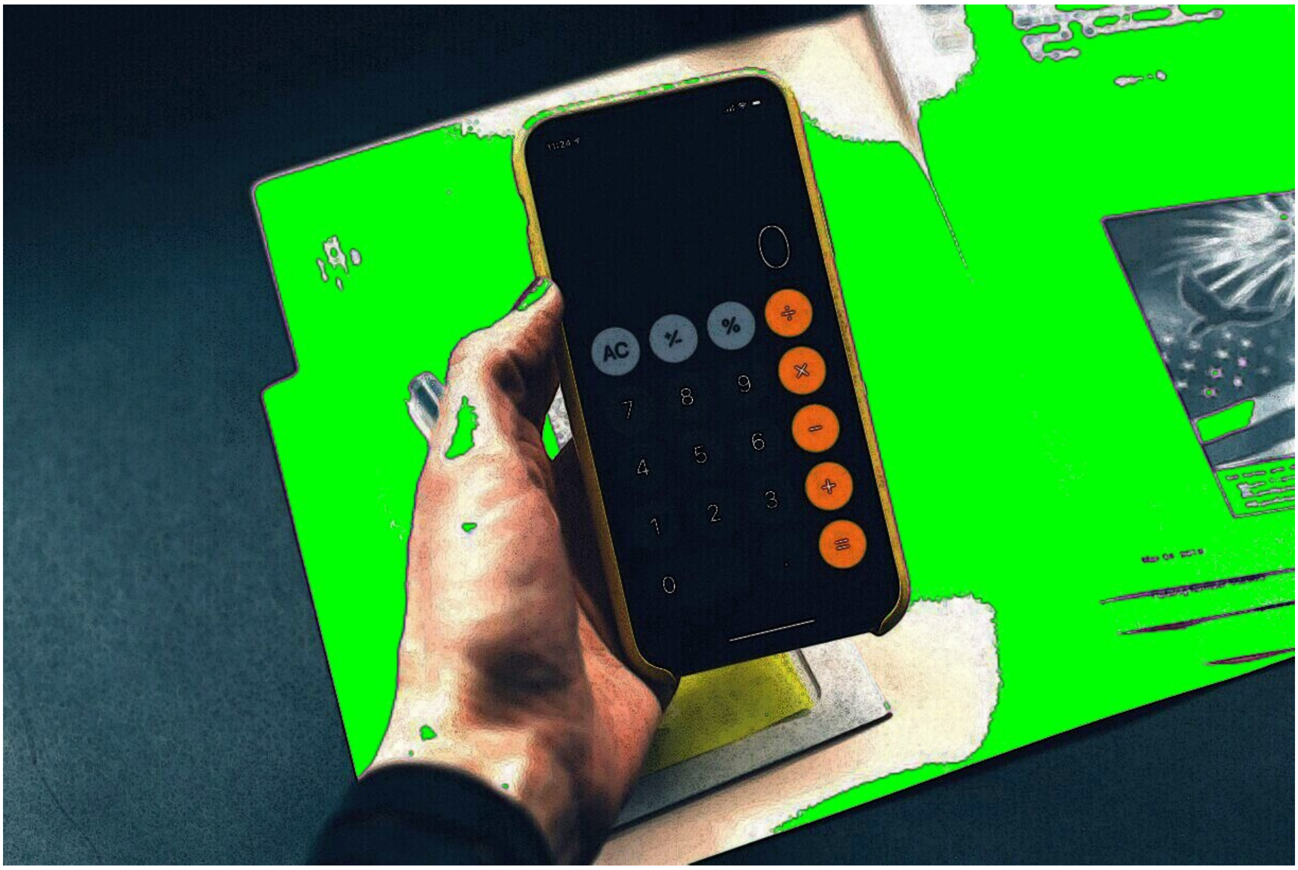
The shareholders own a percentage of the corporation and are responsible for the payment of their shares to the company's treasury upon issuance. These shares are easy to transfer from one owner to another. A corporation is, therefore, a right choice if the shareholders decide to bring on outside investors or make a public stock offering. Startups can use easily use this option to raise capital.

Formal requirements

Corporations must hold an annual shareholder meeting each year, documenting the details as well as any discussions. These are usually called corporate minutes. It must also file an annual report to update the Secretary of State of any changes. Such changes or actions in business require a corporate resolution to be voted on at a meeting with a board of directors.

LLCs have fewer records that they need to keep as they are not required to keep minutes or have a board of directors.

Corporations are taxed at the corporate rate as they are separate legal entities.



Source: Kelly Sikkema, Unsplash

Also, corporations face “double taxation” as the corporation may pay off taxes on the profit. Still, shareholders will have to declare the dividends on their personal tax returns once profits get distributed to them.

LLCs are a bit more flexible when it comes to taxation. It is usually referred to as an entity that allows for pass-through taxation as all income or losses would be reported on the personal tax return.

A single-member LLC is taxed like a sole proprietorship, and a multi-member LLC is taxed like a partnership.

For example, if a corporation makes a profit of $350,000, this would be taxed at the corporate rate. However, if an LLC makes the same profit, it will be taxed on the personal level (Form 1040 or 1040NR) and is included along with other income for the individual for that year. LLCs can also choose to be taxed as a Corporation.

Source: Caleb Jones, Unsplash

Which one should you choose?

You should always consider your long term and short term goals when choosing between an LLC and a Corporation. You should also consider the nature and purpose of your business before deciding which entity would be better.

Small E-commerce stores are usually better off as an LLC.

The process of managing an e-commerce store as an LLC can be less complicated and a more practical choice.

A tech startup, on the other hand, benefits from being structured as a corporation as it would be easier to bring on investors to raise capital as shares and roles are clearly defined for a corporation.

Each has its' own advantages and disadvantages, and making such a decision should not be rushed. The information provided should make this decision much easier so that you can have your US business up and running in no time.

More Stuff to Read:

- The Complete Guide—Incorporating a Startup by Josh Ephraim
- Why is your business formed in Delaware? by Eric Lamison-White
- How Proposed Changes to Delaware Corporate Law Enable Blockchain Corporations by Jason Civalleri
- How to Start a Startup by Paul Graham

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