CENTRAL TEXAS
ANGEL NETWORK

LLC, C Corp, or S Corp?

CTAN's Thoughts on LLC's vs. C Corp vs. S Corp Legal Structures

While CTAN will consider investing in any form of legal entity, the two most commonly seen are Limited Liability Companies ("LLC's") which are electing to be taxed as a partnership and therefore pay no tax at the Company level, and C Corps which are Corporations subject to the Corporate taxation regime in addition to any tax borne by shareholders.

While S Corps are very similar to LLC's taxed as partnerships, and there are far more S Corps in the US than C Corps, they are not often seen in the Angel Investment arena for three reasons:

- Can only have one class of stock, therefore not possible to have typical situation where founders own common, and new investors own preferred
- Can only have 100 shareholders – usually not a problem initially, but we do have portfolio companies now with more than that
- No foreign shareholders – we see many situations with foreign shareholders

LLC's and C Corps are not subject to the S Corp limitations, and are therefore most commonly used.

With regard to LLC's vs. C Corps, it has been our observation that in the Angel Space the "default" choice has appeared to be C Corps. It has also been our observation that many start-ups are not fully aware of the potentially material impact adoption of one structure vs. another can have on both investors and founders downstream. We are focusing on educating our CTAN members and other investors on these considerations, and it is of equal importance to founders.

The headline is that we believe, contrary to what you may have read or heard previously, that startups should consider the LLC vehicle as the default option for legal structure.

The reasons are two-fold:

- LLC structure typically offers materially better economic results downstream, and therefore often significantly improved investment returns, and
- One can always convert to a C Corp later if that is desired, but the reverse is typically not possible

Thus, forming as an LLC opens the door both for both markedly better returns, as well as leaving the C Corp option fully available, if later needed.

Conversely, once a raise is completed and a valuation for the Company established, it will likely be too expensive to convert from a C Corp back to an LLC. Roughly, the tax cost to convert from a C Corp to an LLC is around 35% of the Pre-Money Valuation of the last raise. So, for example, assume a seed round of $500K, based on a Pre-Money Valuation of $2M. To now convert to an LLC, the Company would face a tax bill of roughly $700K, more than the amount of cash raised!

The downsides to an LLC structure which are most commonly raised are typically in the nature of administrative concerns such as:

- Investors needing to receive tax information on a timely basis
- Managing employee compensation and benefits for those that have equity ownership
- Potential for investors to have to file State Income Tax returns in a few states that won't permit filings by the Company (NY and CA, in particular).

These issues need to be considered, any incremental costs quantified, and a plan to address them put in place. However, the costs associated with these items typically are greatly exceeded by the improved economic results. Thus, on a purely quantitative, cost/benefit comparison basis, typically the economic benefits of the LLC structure will greatly outweigh a C Corp structure.

Finally, one often hears that VC's will require a C Corp structure, which in some cases is true, others not. However, roughly 2/3 of our CTAN investments since inception, still have no VC investors. Also, VC's often don't invest in early rounds when the risks of investment losses are greater, and when the use of an LLC may mitigate the after-tax impact of losses. Thus, since an LLC can later be converted to a C Corp if desired, what a VC may or may not want at some future date doesn't appear to be a relevant consideration when forming a new Company.

In summary, CTAN will consider investing in any type of legal structure. However, as explained above, once a raise is completed in a C Corp structure, it will likely never be economic to convert to an LLC which could be very costly to founders and investors. Thus, some of our CTAN members may not wish to invest in C Corp structures, or may expect more favorable terms to compensate for adverse economic impacts.

Want to know more? Please click on the links below:

Reasons You Should Very Carefully Consider an LLC instead of a C Corporation

Investment Return Illustration: LLC vs. C Corp

How to handle administrative issues with LLC's (*coming soon*)

All materials have been prepared for information purposes only. Fact patterns can vary, and changes in law and other authorities may occur over time. You should consult with your accounting/legal advisors before implementing any legal/tax structure.