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

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Are you are starting a business and confronting the early question of what type of legal entity to use?

If you do a web search you will probably see some recommendations to form a C Corp since it is perceived to be easier, some believe VC's prefer C Corps, or various other reasons. Generally, there is little, if any, meaningful quantitative analysis, but rather more of a "cult-like" belief that C Corps are "good", for reasons that are typically not well analyzed on a cost/benefit basis.

Let's assume, just for sake of discussion, that C Corps are somewhat easier for founders to understand if they don't have any prior experience with LLC's. Why not take the simpler path? Answer: Cost vs. Benefit. What seems to be often missed is the enormous price being paid to gain a little perceived simplicity. When one does a full comparison of the benefits of an LLC to the incremental costs, it is essentially a landslide in favor of the LLC benefits. Any incremental costs would typically be negligible in comparison to the benefits.

But what is typically missing is the objective analysis of cost vs. benefits.

So let's talk about the potential benefits of an LLC vs. a C Corp. There is a very real probability that founders and other investors could realize from 30% to 60% higher gain on exit, simply by having the business in an LLC vs. C Corp. If the business fails, which we all hope won't happen but failure rates among startups are known to be significant (50% or more), investors have a high probability of doubling the tax recovery from their loss – from a 20% recovery to a 40% recovery.

Further, LLC's can benefit founders, employees and directors by offering the equivalent of a Non- Qualified C Corp stock option, called a Profits Interest in an LLC setting, which cuts the tax rate upon exercise by 50% – from roughly 40% to 20%. So, if an exercise results in a $100,000 pre-tax gain, the holder walks away with $20,000 more merely from using an LLC vs. a C Corp. And, it is even better than an Incentive Stock Option in a C Corp, since there is no 1 year holding period requirement after exercise, to obtain long-term capital gain treatment.

If you are a founder, consider the potential benefits of obtaining knowledgeable investors, who understand these benefits. If an investor has an option to invest in an LLC and obtain benefits as noted above, they might well see that as superior to a competing investment option which is formed as a C Corp. Imagine if an investor was offered a publicly traded security, where they could recover 40% rather than 20% if they sold at a loss, and pocket 30% to 60% more if they sold at a gain. That is the competitive advantage a private company has in offering an LLC interest to investors rather than C Corp stock. The vast majority of public companies would love to have this option, but are not permitted to offer it, except in a few limited circumstances permitted by the Internal Revenue Code. But as a private company this advantage is readily available, and should be strongly considered.

Finally, before we dive further in the details, a huge consideration is that an LLC can later be converted to a C Corp, at no incremental tax cost. But the reverse is typically not feasible, since typically a large amount of tax must be paid to convert a C Corp to an LLC. So once you have formed as a C Corp, you have greatly restricted your future flexibility and potentially cost founders, employees, and investors large amounts which will materially impact investment returns.

So, let's drop down to a lower level of detail. More specifically, those sources that "blindly" recommend C Corps when starting a new business, typically fail to consider the following items.

> **(1)** A close examination of the consequences of one alternative vs. another to the **initial** investors, often Angel investors. Some web information suggests that every VC on the planet will want to invest in a C Corp, which seems unlikely for those that understand the following points. But whether that is the case or not, many startups may never receive VC funding. And if they do, it is potentially several years out. Since LLC's are so flexible and can always later be converted to a C Corp, if it makes sense in the future, focus on what is best for your **current** investors, rather than what someone thinks an **unknown future investor** might want.

(2) No analysis of how that selection might ultimately impact how a buyer looks at, and values, your company downstream. After all, isn't that normally the objective, to sell to a buyer – typically a larger company, or perhaps even an IPO? Your choice of legal entity can have a HUGE impact on the selling price and the gain investors ultimately realize.

(3) Have you considered that a buyer may refuse to buy the stock of your company, and insist on buying the assets? Do you understand the difference between a sale of assets vs. sale of stock? Are you aware that if assets are sold instead of stock, which a buyer may insist upon, that you and your investors will incur about 30% incremental tax cost if you are a C Corp, and therefore only walk away with 70% of the cash you would have otherwise received if you had been an LLC?

(4) Have you considered how much less your selling price may be if a buyer acquires your stock, rather than the assets of the Company? Do you know how much more expensive that can be to the buyer, since they have very limited future tax deductions to help reduce the cost of the acquisition? An acquirer can typically pay roughly 30% to 60% more for the assets of your Company, rather than the stock, and be INDIFFERENT! Why, because when the acquirer purchases assets they are entitled to future tax write-offs far in excess of what they are eligible for when purchasing stock. Any sophisticated buyer will also recognize the reverse – if they are buying stock and forgoing the large future tax savings, they should pay less to acquire the stock of your company, rather than the assets.

(5) Have you considered what happens if you develop more than one successful product, and want to sell one product but retain the others? Are you aware that if that occurs, and you are a C Corp, that in order to get that cash out to your investors they will once again incur an additional 30% tax and only receive 70% of the profit that would otherwise have been available with an LLC structure?

(6) While IPO's are relatively rare, when compared to sales of part or all of a Company or its assets, there are huge differences in taking an LLC public vs. a C Corporation. In recent years, a structure has been developed and used repeatedly by well advised LLC's, which results in approximately 60% more sale proceeds over time to founders, employees and investors when an LLC is the legal entity that precedes the IPO. Go Daddy and Shake Shack are two young companies which recently used this technique to greatly improve investor returns in their IPO's.

(7) Are you aware that when a conventional C Corp stock option is granted to an employee, that when it is exercised that the entire difference between the value at date of exercise, and the strike price of the option, is considered compensation for services for tax purposes? That means the amount of the gain at exercise is included in the employee's W-2 and taxed at individual income tax rates – often approximately 40%. The LLC equivalent of a stock option, referred to as a profits interest, is treated differently under the tax laws. If held over 2 years, upon exercise the gain in the option is treated as Long-Term Capital Gains and taxed at approximately 20%. Thus, employees pay only half the amount of income tax when exercising an LLC profits interest compared to a normal C Corporation stock option. And, this is even better than an Incentive Stock Option ("ISO") which is sometimes issued by C Corps, since there is no 1 year holding requirement after exercise to obtain long-term capital gains tax rates.

(8) Are you aware that with proper planning and execution, an LLC can always later be converted to a C Corporation, with no incremental tax cost, should that be desirable at some future date? But did you know that typically it is tax cost prohibitive to convert a C Corp back to an LLC after any meaningful value is created? Thus, if you decide on Day one of your business to form as a C Corp, you are likely locked in to that forever – and you will potentially be contending with the adverse consequences discussed above, and not be able to do anything about it. Conversely, the LLC provides you with a free pass downstream to convert to a C Corp should that be desired.

(9) So, you may be wondering whether there are circumstances where a C Corp is preferred to an LLC. There are several situations where it could be beneficial, but none apply to the early days of a start-up, and all can later be obtained by merely converting an LLC to a C Corp:

> **(a)** If a Company is generating a lot of free cash flow, AND is reinvesting it in the business rather than distributing it to shareholders, the Corporate Federal Income Tax Rate of 35% is somewhat lower than the top maximum individual income tax rate of 40%. Thus, an argument can be made to keep all the cash inside the C Corporation and pay a slightly lower tax rate....if the owners have no plans to exit for many years into the future. However, if the C Corp starts distributing the cash to shareholders as dividends, or the owners seek to exit or go public, now double taxation occurs and the advantage becomes a disadvantage. Thus, this is usually only a strategy for large public companies.

(b) Many acquisitions of start-up companies are paid for in cash, rather than stock of the acquiring company, especially if the acquirer is a public company. Public companies must go through expensive and time consuming registration processes with the SEC, and perhaps obtain a shareholder vote, in order to issue shares in an acquisition. Thus, for acquisitions of smaller companies, cash is often preferred. But, sometimes an acquisition for stock rather than cash, or perhaps a combination of stock and cash is preferred. In those circumstances, an LLC may be converted to a C Corp before a contractual arrangement is reached, to facilitate a tax-free exchange of acquirer stock for the selling company stock.

(c) With certain exceptions (e.g., Master Limited Partnerships, Real Estate Investment Trusts) the Internal Revenue Code requires that publicly traded stocks be C Corporations. However, many public companies have LLC's and partnership entities below the public company due to the numerous advantages associated with LLC's as discussed previously. And, as explained previously, there is a huge potential advantage to being an LLC before initiating an IPO.

(10) What about administrative and simplicity considerations?

(a) Since an LLC does not pay tax at the Company level, all of its elements of income or loss are reported to shareholders who then include those amounts in their returns. This is reported to shareholders on a standard IRS form called a Form K-1. Since typically Angel investors must be Accredited Investors, meaning they must possess minimum levels of income and net worth, it is common that these investors already receive Form K-1's from other investments they own. For example, virtually all real estate investments are formed as LLC's for all the same reasons explained previously, as are hedge funds, PE funds, VC funds, and many other investments. Thus, to those who already receive K-1's from other investments, they will likely have little, if any, concern about receiving another K-1, especially since they realize the benefits of an LLC vs. a C Corp will virtually always exceed any ancillary tax preparation costs.

(b) However, there are a couple situations where concern may be expressed:

> **(i)** An investor who has never before invested in an LLC and received a K-1 may be concerned about what it entails, especially if they prepare their own tax return. Entering information from a Form K-1 into TurboTax or similar tax preparation program is typically very straightforward, however, essentially the same as entering information from a Form 1099.
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> **(ii)** Texas residents benefit from not having to file State Income Tax returns, as long as they don't have business activities outside the State. However, if a Texas resident invests in an LLC which has a business presence in other states, that could cause the investor to have to file individual state income tax returns in those states. Most states offer an option, where the LLC can file in the state on behalf of all the investors. However, New York and California are notorious for being very "tax-unfriendly" States with both very high State

Income Tax rates, and making complying with their laws and procedures difficult. Neither State permits an LLC to file on behalf of investors. Thus, if an LLC has a meaningful presence in NY or CA requiring it to file in those states, the investors would receive K-1's for each State and be required to file an individual income tax return in each State (assuming the Company is profitable). Investors who already have other LLC investments may already be filing in NY or CA, so this is of little consequence to them since it is merely one more K-1. However, for an investor who was not already filing in those states, it can result in incremental tax return preparation costs to make those filings.

(iii) Once again, this is a situation where these "nuisance and administrative" issues need to be quantified and weighed against the benefits. As a practical matter, most startups have losses for at least the first few years of operation, and thus even if business is being conducted in NY or CA they may not be required to file in those states until the Company is profitable. And, the Company can always convert to a C Corp if they want the Company to handle the NY and CA filings, although it is unlikely that the incremental costs of filing in those States would could close to the potential tax savings from using an LLC.

Summary

It is strongly recommended that founders consider the benefits of an LLC vs. a C Corp up front, as the potential negative consequences of a C Corp are likely nonrecoverable, whereas an LLC provides the ability to convert to a C Corp later, if that makes sense. Also, talk to your initial primary investors, which often will not be VC's or accelerators, but rather Angel Investors. See what they want and think, before taking a decision they may find sub-optimal, and may well discourage them from investing in your company.

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