The Smart Tax Question - Invest In LLC Or C Corp Startups?

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Angels have many factors to consider when reviewing investment opportunities. Here's another one that not many angels think about: which type of startup entity is better for your taxes? Should you insist on a C Corporation startup, with the potential for the Qualified Small Business Stock (QSBS) perk of no federal tax on your investment gains? Or, should you hedge your bets and invest in a startup formed as a Limited Liability Company (LLC), which offers more flexibility, ensures you pay only a single tax, and also is the structure that many acquirers prefer?

I consulted a tax expert who has advised angel investors through this decision. Jeffrey Kelson, Tax Partner at EisnerAmper LLP, says, "Whatever you do, don't go in with blinders on - you have to be educated."

Great point. When we talked through the pros and cons using a real potential investment scenario, the benefits and risks of LLCs or C Corps quickly became apparent. Consider this scenario:

You've invested in a C Corp startup. You understand that you need to hold the investment for five years to reap the benefit of zero taxation on an exit. You're fine with that because by your assessment and others, it's going to take that long to get to an acquisition. Three years in, there is a good opportunity to sell the company.

But here comes Uncle Sam. You've lost the 100% tax exemption on your capital gain because the company was sold before the five-year window – unless you invest in another QSBS company quickly. If your sale doesn't qualify for QSBS treatment and the exit is in the form of an asset sale you have the worst of all worlds. There are two delightful steps that further reduce your return. First your portfolio company has to pay its corporate taxes, reducing the returns by one-third. And then you're taxed a second time on your personal income taxes for the capital gain, taking out another 20-plus percent.

With this double tax hit suddenly that C Corp investment doesn't look so good compared to an LLC startup entity. In the same scenario, had you invested in an LLC, you would have only paid one tax. Which brings us back to the smart tax decision. Is it wiser to invest in a C Corp that offers the potential to pay zero federal tax, or in an LLC which guarantees you will never be double taxed?

Fortunately, advisors like Kelson can help clarify the choice, although he adds, “The decision to invest in an LLC or C Corp is not black or white. It’s highly nuanced and personal.” If you invest through an angel group or accredited platform, these decisions may have already been made as many will only invest in one type of business structure, but if you do have the flexibility to add business structure to your evaluation criteria and really care about tax results you can consider these five important questions:

1. **Will the company need follow-on professional capital, and how soon?** If capital is needed, most VCs will require the company to be a C Corp. A startup can convert to a C Corp any time with a little time and money. If follow-on investment is likely and within a short time frame, you may want to start the five-year “clock” ticking by having the company convert to a C Corp and potentially get the 100% exemption on gains from an exit.

2. **How active of an angel investor are you?** Portfolio size is something to consider. Angel investing requires mitigating risks. If you’ve been investing for a long time and have built up your portfolio, it’s likely that you can weather any C Corp investment risks, while reaping the potential benefits. Conversely, when you’re just starting out and learning the game, your investment in an LLC provides the flexibility your portfolio might need to have to achieve gains.

3. **What is your threshold for risk?** Clearly, the C Corp benefit of potentially zero taxes is appealing—especially if you’re an all-in, risk taker type. However, if just pulling the trigger on an angel investment is risk enough, mitigating any further risk with an LLC investment might be more attractive. Naturally, if you’re investing as part of an angel group or platform, your choice may be limited to which investment opportunity is right for you, not the type of entity—but you can factor this into your portfolio strategy.

4. **How important is flexibility?** Although related to risk, having options is still a separate consideration. An LLC can be converted into a C Corp in the future, which provides the flexibility of using both entity types in a single investment to your advantage.

5. **How much do you care about paperwork?** With C Corps, there aren’t any tax filings for investors until there is a positive or negative exit, although there are 1099 forms for any dividends paid. With LLCs, however, there is the dreaded K-1 tax form. Companies are often late in providing the tax forms needed for a K-1 filing, which can lead to investors having to file their income taxes last minute or usually late, in addition to possibly needing to file in multiple states.

There is a lot to think about when selecting a company to invest in—and clearly, the tax impact following an exit can have a major impact on any potential gains or losses. So what is the smart money choice when it comes to LLCs v. C Corps? For me the first objective is to be informed. For that I attend educational events like the ACA Summit and monthly webinars, where experts like Kelson freely share their expertise and knowledge. And talk with accountants and fellow angels about how they address this issue, too.