To LLC or Not to LLC

What is the right legal entity for your business?

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If you find yourself struggling with a decision regarding the appropriate legal structure for your business, you are not alone. As a venture capital firm that reviews hundreds of business plans a year, we meet plenty of entrepreneurs who have wrestled with this issue. Unfortunately, there is no one right answer to the question. The good news, though, is that you can reduce the number of future headaches (and possibly your future tax and legal bills) if you choose the structure that is most appropriate for both your current situation and your future goals for the business.

The two primary legal entities we encounter at Ballast Point Ventures are the C Corporation ("C-corp") and the Limited Liability Company ("LLC"). One common advantage of both structures is that the entrepreneur's assets are protected from liabilities associated with the business, which is why they are attractive relative to a sole proprietorship. There are also fewer limits on eligibility and capital structure (e.g. number of owners, classes of stock, eligible shareholders) with a C-corp or LLC compared to an S Corporation that only allows up to 100 shareholders and one class of stock and that does not allow corporations or partnerships to be shareholders. For these reasons, C-corps and LLC's tend to dominate the landscape of venture-backed companies and thus are the focus of our discussion here.

Aside from avoiding personal exposure to business liabilities, the main considerations when choosing a business entity are i) tax consequences, such as maximizing the benefit of start-up losses, avoiding double taxation, ordinary income versus capital gains treatment and state nexus issues, and ii) corporate governance issues. As a venture capital fund that has invested in both structures with success over the years, we have no "dog in this fight" and aim to give you an unbiased perspective. Our goal with this paper is to help educate entrepreneurs on the benefits and potential drawbacks of the LLC and C-corp structures.

Please note that this paper is for informational purposes only and should not be construed as legal or tax advice. Also, this paper is not a comprehensive analysis of the differences between LLCs and C-corps. You should consult with your own legal and tax advisors before taking action with respect to the matters discussed in this paper.

History of the LLC[i]

The LLC is a form of business entity that has gained favor in recent years across the United States. It dates back to 1977 as a product of Wyoming legislation related to an oil company. In 1982, our home State of Florida adopted an LLC act modeled after Wyoming's LLC Act. Due to uncertainty over the tax treatment of LLCs, no other states introduced LLC legislation until after 1988. In that year, however, the IRS issued a revenue ruling stating that it would treat a Wyoming-style LLC as a partnership for tax purposes. By 1996, nearly every state had enacted an LLC statute.

A properly structured LLC today will combine the federal tax treatment of a partnership with the liability protection of a corporation.

Tax Consequences

Many people cite tax advantages as the primary deciding factor in choosing an LLC structure over a C-corp structure. However, the perceived tax benefit and the actual benefit can differ greatly.

Double Taxation. A disadvantage to C-corp taxation is that distributions of profits (known as "dividends") are subject to double taxation. In other words, the corporation is taxed once on its corporate income at the federal and state corporate rates (a combined 35%-45% depending on the state where the company is domiciled), and then the shareholders are taxed on any dividends they receive at the applicable rate (currently 15% at the federal level on qualified dividends).

With an LLC, the business entity is not taxed (unless it chooses to be taxed), but rather profits and losses are "passed through" to the Members (the term for owners in an LLC). Thus, Members report the business's profits and losses on their personal tax returns and pay taxes at ordinary income rates (typically a marginal rate of 35% for high income individuals), regardless of whether they received any cash distributions from the company. This structure can be beneficial to some high net worth individuals looking for personal tax deductions when the business loses money – often the case in the early years of a business – though it can also create additional tax liability when the company is profitable. Since Members are taxed even if no distributions are made, a profitable LLC could produce so-called "phantom income" for the Members – taxable income without a corresponding cash payment – which would require the Members to pay taxes attributable to the LLC with funds from other sources.

Creating Value. In the Venture Capital business, we typically view a capital gain at the time of exit as the ultimate driver of value for both the entrepreneur and the investors. While cash distributions along the way can help realize some value more quickly, most high growth businesses are better served investing "profits" back into the company in a way that creates the greatest value at exit. In our experience, this approach tends to generate superior returns for all shareholders at the exit since an acquirer typically applies a multiple to the cash flow of the business and the proceeds from the sale are taxed at the long term capital gains rate. In this instance, the benefits of avoiding double taxation are diminished when profits are small due to cash flow being re-invested in the business for growth.

State Taxes and Nexus.[ii] The tax discussion does not end there. Forming an LLC might subject your business to unexpected additional state taxes. Any state where the company has "nexus" – defined as the minimum level of business activity subjecting you to tax according to the laws of that state – has a tax claim on the company. Determining nexus is not easily done and varies by state. You need to know where you have employees, property and customers. You need to know what activities you're conducting and where. You need to look at where you are performing services or soliciting orders. You must know where you are registered to do business, and not just where you are currently conducting business. In some states, simply registering to do business can create nexus. Certain states (such as Alabama, California, Kentucky, New York, Pennsylvania, Tennessee, and Texas) also subject LLC's to "franchise taxes" in addition to their state income tax.

So as a Member of the LLC, you may incur tax liabilities in various states where you've never stepped foot. Take it from those of us who live in Florida - not paying state income tax is a huge plus! You can probably hazard a guess as to our view on paying taxes in multiple states. Even if the dollar liability is not high (and it can be very high when each of the "nexus" states want to share in a successful sale of the business), the added complexity of multiple state filings is certainly a negative and particularly for a venture capital partnership with dozens of Limited Partners. In a C-corp, there is no pass through of nexus for state tax issues, so the investors can avoid both the additional taxes and these hassles. However, like the LLC, the C-corp. itself would be liable for taxes in each state that it has nexus.

Asset vs. Stock Sale. The LLC structure can also be beneficial to a business that plans to sell off certain assets independently as part of its value creation strategy.

If the business is structured as a C-corp, and the transaction is structured as an asset sale, the result will be double taxation on the gain for the seller. The seller will be taxed at the corporate level when the assets are sold (consideration is received by the existing corporation in which the seller is the primary shareholder) and again at the individual level when the corporation distributes the proceeds to the shareholders. However, when a C-corp is sold in a stock sale, there is only one level of taxation as the proceeds transfer directly to the individual shareholders selling the entity.

In our experience, partial asset sales of venture-backed companies do happen but are fairly uncommon. Such sales usually occur when the company has various products and related assets which themselves generate unique interest from a strategic buyer, and that buyer is not interested in acquiring the entire business. A good example here would be in the pharmaceutical industry, where companies often sell individual drugs to strategic buyers.

However, in the vast majority of cases, our exits come in the form of selling all the stock of the company, as buyers are usually interested in acquiring the business as a whole and rarely want to pay the higher taxes associated with asset acquisitions. The LLC does have an advantage here, since the sale of 100% of the LLC's equity is treated as a sale of all of the LLC's assets, resulting in a step-up in the tax basis of the LLC's assets. In a stock sale of a C-corp., on the other hand, the tax basis of the C-corp.'s assets are not stepped-up. Buyers typically are very interested in receiving a basis step-up, since it permits them to reduce future taxes through depreciation and amortization deductions, and may be willing to pay a higher purchase price to receive one.

One disadvantage of having the sale of the LLC's equity treated as an asset sale, however, is that the sale will generally produce a mix of ordinary income and capital gain depending on the nature of the assets held by the LLC and the manner in which the purchase price is allocated among the assets for tax purposes. If a significant portion of the gain is ordinary income, the additional taxes may reduce or eliminate the benefit of receiving a higher purchase price from the buyer for the basis step-up.

Tax-free Reorganizations. To the extent a buyer uses its stock as consideration in a sale, the sale of a C-corp. may be partially or entirely tax-free under the reorganization rules in the Internal Revenue Code. In essence, any gain is rolled into the buyer stock received and recognized only when the stock is later sold. LLCs do not qualify under the reorganization rules, and the circumstances in which a LLC may be sold in a partially tax-free transaction is generally much more limited than a C-corp.

Ability to Attract Venture Investors. Venture capital funds often have their own investors which are tax-exempt entities or foreigners not generally subject to US tax. These investors are typically very sensitive about not recognizing income from a US business, which is taxable income to them – called "unrelated business taxable income" (UBTI) for tax-exempts and "effectively connected income" (ECI) for foreigners. If the business income of an LLC is passed through to one of these types of investors, it would have UBTI or ECI; therefore, these investors generally prefer investing in C-corps, which do not pass through UBTI or ECI. While it is possible to structure investments in LLCs in a manner that limits the exposure to UBTI or ECI, your ability to attract investment capital from funds with these types of investors may be hampered if you are an LLC.

Governance

The LLC is guided by an Operating Agreement that sets forth in detail how the business is to be managed, with a Member or Manager often designated to manage the business. Members of an LLC set up the governance structure as they choose, and the LLC is not required to hold annual meetings or record meeting minutes. In contrast, the C-corp has a more standard structure and by-laws with Board of Directors that is tasked with oversight of the business, while officers of the corporation have day-to-day responsibilities for running the business.

Since responsibilities are less distributed and there is no formal Board structure or meeting minutes available for referral, the Managing Member of an LLC often takes on more liability for potential issues that may surface after a sale of the business than a CEO in a C-corp structure.

In addition to this fiduciary gray area associated with LLC's, Operating Agreements are often long and very complex. They take longer to draft and lawyers sometimes get carried away with arcane structures (often resulting in higher legal fees). In almost every instance, it takes more time and costs more money to draft acceptable legal agreements under an LLC structure.

Finally, the Corporation is the most common business entity and is governed by the most highly developed laws. Since the LLC is a relatively new form of business organization and each LLC is different, its governance laws are not as well understood, whereas the Corporation has the advantage of familiarity and permanence. This can be a huge benefit should a company become embroiled in shareholder suits or similar litigation.

Conclusion

In summary, the areas where C-corps and LLCs differ the most are in tax treatment and governance *(see the table below for a more exhaustive comparison).* We believe there are very few venture-backed LLCs that benefit much in the area of tax avoidance, and the defined governance structure of a C-corp is almost always preferable. Moreover, the high legal costs and ambiguity associated with some Operating Agreements that accompany the LLC structure make it a potentially disadvantageous approach relative to the C-corp.

That being said, at Ballast Point Ventures we have seen situations where an LLC structure makes sense for everyone involved, and we discuss that with entrepreneurs when it is the case. We only suggest that you proceed with caution and think hard about your long term goals for the business when getting advice on your legal structure. Just as people shouldn't decide to have children for the tax benefits, we advise that you don't view tax considerations in a vacuum when choosing the legal structure of your business.

Pros and Cons of C-Corp vs. LLC	**C-Corp**	**Limited Liability Company**
Limited liability	Yes	Yes
Flow through taxation	No	Yes
State Nexus Pass-through to Individual Shareholders	No	Yes
Well understood / long precedent	Yes	No
Limitations on eligibility	No	No
Limitations on capital structure	No	No
Basis step-up on equity acquisition	No	Yes
Flexible charter documents	No	Yes
Ability to change structure without tax	No	Yes
Favorable employee incentives (including incentive stock options)	Yes	Yes (1)
Qualified small business stock exclusion for gains	Yes (2)	No
Special allocations	No	Yes
Tax-free in-kind distributions	No	Yes
Tax-free Reorganizations	Yes	No

1. LLCs permit the grant to employees of "profits interest," which can be tax-favorable. However, while LLC interests can be provided to employees, they are poorly understood by most employees. Moreover, ISO's are not available.
2. Special low capital gains rate for stock of U.S. C corporations with not more than $50 million in gross assets at the time stock is issued if the corporation is engaged in an active business and the taxpayer holds his or her stock at least five years.

Source: Bagley, Constance and Craig Dauchy. The Entrepreneur's Guide To Business Law. Mason: Thomson, 2003.

Endnotes

[i] Wikipedia
[ii] Understanding nexus: How to prevent audit surprises and minimize state taxes. Interview by Meredyth McKenzie. Brown Smith Wallace LLC. http://www.bswllc.com/Understanding%20Nexus