12 Reasons for A Startup Not To Be An LLC

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Very seldom in our lives do we need to make 4,000 decisions in rapid succession. Welcome to the life of the owner of a startup. As decisions are made, founders often find themselves asking, “Can this seemingly mundane decision later profoundly affect the future growth and survival of my company?”

For the majority of the decisions, the answer would be “no,” particularly when one of the decisions is what you’re going to have for lunch in order to fuel you with the energy to make more decisions. However, there is one major decision that can set the tone, not only for founders and employees, but also those who will invest in the company: the type of entity you form.

What Are The Different Types of Business Entities?

I am approached all the time by owners of startups wondering whether to become a C Corporation, an S Corporation, or an LLC (a limited liability company).

What primarily differentiates these business entities from one another is their federal income tax characteristics:

C Corporation – A C Corporation is an entity that, in contrast to an S Corporation or an LLC taxed as a partnership, is subject to federal income tax and pays federal income taxes on its income. Its shareholders are not subject to tax unless the corporation pays amounts to them in the form of dividends, distributions or salary.

S Corporation – An S Corporation is not subject to federal income tax. Instead the company's shareholders pay federal income tax on the taxable income of the S Corporation's business based on their pro rata stock ownership.

LLC – LLCs, like S Corporations, are "pass-through" entities, which means that their owners (referred to as members) pay the tax on the income of the LLC that is allocated to them based on the LLC agreement. For a sole member, unless an election is made to be taxed as a corporation, the LLC is treated as a "disregarded entity," meaning that the sole member reports the LLC's income or loss on his or her tax return just like a sole proprietorship, or division in the case of a corporate owner. For LLCs with multiple members, the LLC is treated as a partnership and must file the IRS Form 1065 (unless the entity elects to be taxed as a corporation). The members of the LLC are treated as partners for federal income tax purposes and each receives a Form K-1 reporting their share of the LLC's income or loss for the members to report on their federal income tax return.

Why Shouldn't I Choose To Form An LLC?

For tech or growth companies planning to follow the traditional path of regular and ongoing equity grants to employees, multiple rounds of financing, and reinvestment of as much capital into the business as possible, with the goal of an ultimate sale to a big, maybe public, company in exchange for cash and/or stock, LLCs are typically not the way to go. There are a number of reasons.

1 – Many Investors Don't Like LLCs - Investors frequently don't want to complicate their personal tax situation by becoming a member in an entity taxed as a partnership and then receiving Forms K-1 and being taxed on the entity's income even if no cash is distributed to them to pay the taxes.

2 – Many Investors Can't Invest in LLCs - Some investors (such as venture funds), can't invest in pass-through companies because they have tax-exempt partners which do not want to receive active trade or business income because of their tax-exempt status.

3- Reinvestment – LLCs taxed as partnerships will typically have provisions in their LLC agreements detailing how and when cash will be distributed to the owners to cover the taxes that they will owe on the entity's income. This can complicate the ability of the entity to reinvest its cash to grow the business.

4 – Potential Taxation in Other States - If the business has an active trade or business and does business in other states, passive investors may become subject to income tax in those other states.

For example: if you are a partner in a partnership which does business in CA, even if you live in WA and are a passive investor, you will receive a California Form K-1 and have to file California income tax returns and pay California income tax.

This can really turn investors off. Foreign investors may not want to invest in an LLC because they do not want to become subject to tax in the U.S.

5 – Simplicity of Stock Ownership - Investors in early stage businesses usually just want to make an investment, acquire a capital asset (the stock), and not have any intervening tax complications (like a Form K-1 and potential taxation in other states) until the stock is sold and there is a capital gain/loss event.

6 – Equity Compensation - Equity compensation in entities taxed as partnerships is much more difficult, complex and expensive to draft and administer than equity compensation in a C or S Corporation. For example, to grant profits interests in an LLC, it is typically necessary or advisable to "book up" the capital accounts of the owners prior to granting the profits interests, and this must happen at each award. If there are successive rounds of equity grants each year, these books-ups can become very expensive and time consuming. This same complication occurs with options or warrants to acquire LLC interests.

7 – Raising Capital - Raising additional capital through an LLC is much more difficult than raising a next round through a corporation. LLC agreements are more difficult and complex to prepare than their corporate counterparts. In addition, you can hit upon sticky and highly complex tax issues in the LLC context that just don't exist or arise in the corporate context.

For example: You give your investors a 2x liquidation preference. If you are an LLC, your investors may have a tax hit in the year of investment! This does not happen in the corporate context.

8 – Stock Swaps - LLCs cannot engage in tax deferred stock swaps in acquisition scenarios, which corporations can.

For example, your startup is acquired by BigCo, for $400M in stock. The stock is subject to a 1 year lockup before it can be sold in the public markets. You will owe tax on the stock upon closing, regardless of the lockup. If you were a corporation, you could probably exchange your startup stock for BigCo stock on a tax deferred basis under one of the reorganization provisions under Section 368 of the Internal Revenue Code.

9 – Documents - LLC agreements are much more complex and difficult to draft than corporate documents.

10 – Familiarity - Investors are less familiar with LLCs than corporations, and so they typically have to spend more time on diligence reviewing the underlying documents before deciding whether or not to invest.

11 – Contract Creatures - LLCs are more “contract” creatures than “statutory” creatures. Meaning, although there are default rules set forth in the LLC statute, in an LLC the general rule is that most anything goes—so whatever you put in your contract will usually govern—as a result, the contracts are longer and more difficult to put together and take more time to be reviewed, negotiated, agreed upon, etc.

12 – Section 1202 – The 100% exclusion from tax (up to $10M per taxpayer) for “qualified small business stock” held for more than 5 years is not available for LLC interests.

The Bogeyman Rarely Comes Out of the Closet

The bogeyman that you will hear about most frequently is the “double tax” bogeyman. You will be told—don’t form a C Corporation because you will be subject to a double tax.

What is meant by this is that if the C Corporation makes money, it will pay tax on that money. And if it pays dividends to its shareholders, they will pay tax on the dividends. This is true. And so if you anticipate your business being a cash cow, and immediately generating so much money that you will earn more than you can reasonably pay out in salary to the owner executives, then maybe an LLC is a good choice for you. But for most growth businesses, whose goal is to raise capital, reinvest capital, grow fast, grant equity incentives, and ultimately be acquired or go public, a C Corporation is the way to go. For these businesses, the double tax bogeyman rarely appears, and most exits are structured as one layer of tax stock sales.

Why Not Start as an S Corporation?

If an LLC is not so great, but you desire pass through tax treatment, an S Corporation could be a great choice for you if you qualify. Keep in mind though that if you are a founder you will forego the potential 1202 stock benefit (the 100% exclusion for qualified small business stock held for 5 years, up to $10M) for your founder shares if you form as an S Corporation.

Lipstick on an LLC

I generally advise my startup clients to go with a C Corporation because it's easier. Investors can be finicky and any sort of obstruction or tax inconvenience can turn a hot investor very cold very quickly. Of all of the decisions you will make in starting your business, perhaps none will affect you more tomorrow than your choice of entity.

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