Choosing the Right Entity for Your Emerging Growth Company:

"C" Corporation or Limited Liability Company?

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The emerging growth company faces many important decisions as it moves from the concept stage to the practical realities of generating revenue and profits. Among the earliest and most fundamental of these decisions is the legal form in which the business will be conducted—in lawyers' and accountants' parlance, the "choice of business entity."

The number of theoretical choices has grown considerably over the last decade. The list now includes regular corporations, S corporations, limited partnerships, limited liability partnerships, and limited liability companies.

For most emerging companies, however, the practical choice is between a regular corporation—also called a "C" corporation for a chapter of the Internal Revenue Code—and a limited liability company, a relatively new form of entity that became available in most states during the mid-1990s.

This brochure summarizes some of the principal characteristics of C corporations and LLCs from the perspective of the emerging growth company and its founders and investors. Despite some historical factors favoring "C" corporations, we believe the limited liability company is the better choice for most companies, and will continue to gain "market share" as its advantages become more widely recognized.

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Historic Background

Historically there were two principal ways to conduct business, as a corporation or as a partnership. Thousands of pages of print are devoted to the differences, but for the sake of our discussion they may be summarized as follows: the principal benefit of a corporation is that its owners are shielded from personal liability, while the principal benefit of a partnership is that the entity itself is not subject to tax.

> **EXAMPLE:** An employee of your technology business, GreatIdea.com, drives the company van through a store selling expensive china, destroying the entire inventory. If GreatIdea.com is a partnership, you are personally liable for the damage; if it is a corporation, you are not.

> **EXAMPLE:** GreatIdea.com generates $5 million of profits per year. If the company is a corporation, the $5 million is subject to corporate-level tax, and whatever is left over is then subject to tax again when distributed to you. If the company is a partnership, the $5 million is subject to tax only once, on your personal return. The difference: about $1 million per year, after tax.

Over time "hybrid" entities were created, seeking to combine the best of both these worlds. However, none of these "hybrids" has been entirely successful. For example, "S" corporations (also named for a chapter of the Internal Revenue Code) theoretically combine the limited liability of a corporation with the pass-thru tax treatment of a partnership. But because ownership of "S" corporations generally is limited to individuals, while virtually every venture capital fund is an entity, an emerging growth company formed as an "S" corporation has a hard time raising money.

In the absence of an attractive alternative, the choice of the "C" corporation became almost automatic for emerging growth companies. The desire to protect shareholders from personal liability, coupled with the need to attract institutions as investors, left little choice.

The first U.S. limited liability company statute was enacted in Wyoming in 1977. For years the LLC concept was viewed skeptically, partly because it seemed too good to be true and partly because of the ingrained habits of East Coast and West Coast business lawyers.

The logjam was broken when the IRS confirmed that a Wyoming limited liability company would, indeed, be treated as a partnership for

tax purposes. Following announcement of that ruling, the LLC concept spread rapidly as one state legislature after another adopted authorizing statutes. Limited liability companies are now used routinely for businesses of all kinds nationwide.

Switching Legal Forms

A company formed as a “C” corporation may later find itself wishing to be an LLC, and visa versa. At the outset, it is important to consider how easily one legal entity can be converted to the other.

If GreatIdea.com begins life as an LLC, it may convert to a “C” corporation with relative ease. There is generally no Federal or State income tax imposed on the transaction, and with some creativity, the economic rights of the owners and employees of the LLC may be readily transferred to the corporate format.

Switching in the other direction is far more problematic. If GreatIdea.com begins life as a “C” corporation, converting to the LLC format is treated as a taxable *sale of the business* for tax purposes. Once a “C” corporation has substantial value, this tax “toll charge” makes such a conversion virtually impossible.

On the other hand, a “C” corporation without substantial value, especially a company in the early stages of product growth and development, may be able to convert without a toll charge. For these companies, it is especially important to weigh the advantages and disadvantages of the LLC format if they have not done so already.

Conceptually, this difference between LLCs and “C” corporations is like the security devices used by parking garages. Cars may always travel out (from an LLC to a “C” corporation), but seldom travel in (from a “C” corporation to an LLC).

Tax on Operations

If GreatIdea.com generates $5 million of profits per year as a “C” corporation, it will pay Federal income taxes of approximately $1.7 million. The remaining $3.3 million, when distributed to the owners as dividends, will generate more tax at the personal tax brackets of the shareholders. At the highest Federal bracket the shareholder tax would be approximately $1.3 million.

Having generated $5 million of profits, GreatIdea.com and its shareholders would therefore pay a total of about $3 million of Federal income tax, or 60% of earnings. They will also pay State income taxes at both the corporate and individual level, except in states like Florida that do not impose a personal income tax.

If GreatIdea.com is an LLC the result is much different. On $5 million of earnings the company itself would pay no tax. Instead, the profits would be taxed only at the owner level. At the highest Federal bracket the tax would be approximately $2 million, or 40% of earnings. The tax savings as compared to the "C" corporation: about $1 million per year.

Saving a million dollars per year after tax is no small feat, especially for a decision that often receives little attention when a business is formed. Yet the issue of saving taxes on operating income is not always so clear. In some situations, a "C" corporation can actually save taxes.

Suppose that GreatIdea.com has begun to generate modest profits (after paying your compensation) of less than $100,000 per year. Suppose also that GreatIdea.com rolls all of these profits into capital improvements such as land, buildings, and equipment, rather than distributing the profits to shareholders. In this situation, the company will actually pay about $18,000 *less* Federal income tax each year as a "C" corporation than the shareholders would pay if the company were an LLC, because of rate differentials.

The scales would begin to tip back in favor of the LLC if earnings exceed $100,000, or if GreatIdea.com starts to pay out profits to shareholders rather than retain them for capital investments. The scale would also tip in favor of the LLC if—as is often the case—GreatIdea.com spends its profits on investment in people rather than hard assets.

Tax On Sale

The sale of a business can take two forms: a sale of stock by the shareholders or a sale of assets by the company itself. Buyers strongly prefer the asset sale alternative for two reasons. One, the buyer generally obtains better tax results when it purchases assets. Two, when a buyer purchases stock, it generally assumes all of the liabilities of the seller along with the assets. Buyers never want to assume liabilities if they can help it.

Because of the strong preference by buyers, almost every sale of a business takes the form of an asset sale rather than a stock sale.

Asset Sale

Suppose all of the assets of GreatIdea.com are sold for $25 million in cash. If the company is a "C" corporation at the time of sale, it will pay tax of approximately $8.75 million. When the company dissolves and distributes the remaining $16.25 million to its shareholders, they will pay another $3.25 million of personal income tax. The total tax bill for the "C" corporation and its stockholders: approximately $12 million.

In contrast, if GreatIdea.com were an LLC at the time of sale, it would pay no tax whatsoever, and its owners would pay approximately $5 million. Choosing the LLC format would have saved approximately $7 million in *after tax dollars* vs. the "C" corporation on the sale.

Viewed from the perspective of company valuation, the situation is striking. For an LLC, a sale price of $25 million leaves the owners with approximately $20 million after tax. For a company operating as a C corporation to give the same return, the price would have to jump from $25 million to almost $42 million. From this perspective the simple choice to use an LLC rather than a C corporation is equivalent to increasing the value of GreatIdea.com by 68%, or $17 million!

If the LLC would increase the after-tax value of GreatIdea.com so dramatically on a cash sale, nearly the opposite can be true for sale transactions that qualify as "tax free reorganizations."

Suppose that GreatIdea.com is sold to Microsoft for $25 million, with the consideration paid in Microsoft stock rather than in cash. If GreatIdea.com is a "C" corporation at the time of the sale, then not only does the company escape entity-level tax, but *the shareholders receive the Microsoft stock tax-free*! This important tax benefit is available only to corporations, and not to LLCs.

This table summarizes the tax costs of a $25 million sale:

	Sale for Cash	Sale for Stock
"C" Corporation	$12 million	$0
LLC	$5 Million	$5 million

All other things being equal, the $0 entry in this table argues in favor of using a "C" corporation for a new business, at least one that anticipates using a tax-free reorganization on sale. However, all other things are not equal.

To begin with, it is impossible to predict the circumstances of sale when the business is formed. And because many (if not most) businesses are sold for cash, an entrepreneur spinning the "C" corporation wheel in hopes of landing on $0 is more likely to wind up on $12 million.

Further, the $0 entry itself is deceptive. Yes, the owners of GreatIdea.com will owe no tax upon their receipt of Microsoft stock. But when they sell that stock, they will pay the same $5 million of tax they would have paid on sale of an LLC (assuming the value of Microsoft stock has not changed). The real savings in a tax-free reorganization is not the $5 million itself, but only the time value of postponing payment. If after-tax interest rates are around 1.5%, the real tax savings is about $75,000 for each year the tax is deferred.

How long will the tax be deferred? In many cases, not for long. Often, the ability to "cash out" was the principal motivation for the entrepreneur to sell the business in the first place. He or she is likely to sell at least a significant portion of the Microsoft stock as soon as possible. This quick "cash out" minimizes the tax benefit.

Ironically, one drawback of a tax-free reorganization is that the entrepreneur is not permitted to sell *soon enough*. Typically, the buyer prohibits the selling stockholders from disposing of their newly acquired shares for some "lockup" period, exposing them to the volatility of the stock market. In one transaction of which we are aware, the sellers obtained tax-free treatment on sale only to see the value of their shares plummet by 70% during the lockup period.

Perhaps most important of all is to bear in mind the parking garage metaphor. A $25 million "C" corporation *must* be sold in a tax-free reorganization to avoid a $12 million tax bill. It may be forced to accept the volatility of the buyer's stock, more restrictive non-compete provisions, stiffer representations and warranties—even a lower price—as the cost of avoiding the high corporate tax rates. In contrast, a $25 million LLC should have little difficulty converting to a "C" corporation if an attractive tax-free reorganization appears on the horizon.

Finally, the table assumes the buyer will be a corporation, as is always the case when a smaller company is sold to a publicly traded company. But if the buyer is an LLC—one privately-held company buying another—then tax-free treatment is available if GreatIdea.com is an LLC, but *is not* available if GreatIdea.com is a "C" corporation!

Stock Sale

Rarely, a business is sold through a stock sale rather than an asset sale.

For a "C" corporation, there is good news and bad news. The good news is that some "C" corporations can qualify for a special tax rule allowing the shareholders to exclude a portion of their taxable gain. However, this special rule is subject to a number of requirements, including:

- Only individuals may benefit. Stockholders that are corporations may not.
- The stock must be held at least five years.
- There are limits on how much gain may be excluded.
- There are limits on the size of the company.

The possibility of qualifying for the special exclusion is the good news. The bad news is that the buyer of stock in a "C" corporation is effectively assuming responsibility for the taxable gain inherent in the corporate assets—if those assets were sold for $25 million the day after the purchase, the buyer would have to pay the tax. Factoring in this assumed tax liability, the buyer will probably pay significantly less for the stock.

In contrast, the sellers of stock in an LLC will have no special exclusion. On a $25 million sale they will pay $5 million of tax. But because the buyer will not assume responsibility for an entity-level tax, the purchase price is likely to be higher.

The tax-free reorganization rules—and the qualifications that go along with them—apply to stock sales the same way they apply to asset sales.

Flexibility and Scope of Governing Law

Corporations have been used for business ventures for hundreds of years. The result can be positive or negative, depending on the circumstances and the perspective of the viewer.

The sheer volume of corporate statutes and the case law interpreting those statutes makes it more likely that a given legal question will find an answer. To the extent this provides greater certainty for the entrepreneur trying to conduct his or her business, and less time spent trying to answer legal questions that have already been answered, this is a positive feature of corporations.

Yet there are negative features as well. For one thing, the answers supplied by lengthy corporate statutes and the voluminous case law will sometimes surprise the entrepreneur in unpleasant ways. For another thing, the corporate statutes are frequently inflexible, in the sense that they do not allow the parties to deviate from an established statutory rule.

An important theme of corporate statutes is that minority stockholders need special statutory protection—or, to put it differently, that the minority stockholders in a corporation cannot protect themselves. As a result, the corporate statutes give minority stockholders special rights that *cannot be changed by contract*, even if the minority stockholders would like to. Whether the paternalism of these statutes is appropriate in today's economy can be debated. As a general matter, however, the inflexibility of the corporate statutes tends to work against the interests of a company's founders and even its investors (who can protect themselves by contract) and in favor of small stockholders.

For LLCs the situation is nearly the reverse. The LLC statutes are models of flexibility, yet the very "newness" of the LLC format has the potential to leave important legal questions unanswered.

A principal purpose of the LLC statutes is to let the parties agree among themselves. Almost every statutory rule may be changed by contract, and the New Jersey LLC statute provides explicitly:

> This act is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements [the agreement among the owners of owners of stockholders].

With this backdrop mirrored in other states, the owners of an LLC have tremendous flexibility to establish their respective rights and obligations, comparatively unfettered by rigid statutory constraints. The flexibility should be of special value to two groups: the founders, who can establish the company as they see fit; and investors, who can negotiate their own terms.

Yet the uncluttered landscape of the LLC world is not without pitfalls. As the use of LLCs becomes more widespread, questions may arise that find no answers either in the statutes or the contracts among the parties. To the extent the lack of clear guidance invites litigation or interrupts business development, this is a downside to the use of a relatively new business format.

Using Start-Up Tax Losses

Nearly every business generates losses during its early stages. If the business is a "C" corporation, these losses stay within the corporate shell, available only to offset future corporate income. If the business is an LLC, the losses can, under some circumstances, be used directly by the shareholders.

> EXAMPLE: GreatIdea.com starts business as a "C" corporation on 01/01/2002. During the first two years of operation, the business loses $1 million. Neither the company nor the shareholders benefit during those years. But if the business generates $1 million of income in 2004, the loss from the earlier years will offset the current income and eliminate corporate-level tax liability.

> EXAMPLE: GreatIdea.com is an LLC instead. Subject to limitations discussed below, the shareholders could use the $1 million loss in 2002 and 2003 to offset $1 million of *other income* on their personal tax returns. If the loss is not used by the shareholders because of the limitations, then it would offset the $1 million of business income in 2004.

Since a dollar of tax savings is worth more today than tomorrow, the LLC format is more attractive from this standpoint. However, three tax rules limit the ability of the LLC shareholders to use the business losses:

- *Tax Basis Limitation*. A shareholder may not deduct losses that exceed his or her tax "basis" — generally the amount the shareholder has invested plus his or her share of the company's debt.
- *At Risk Limitation*. A shareholder may not deduct losses that exceed his or her amount "at risk" — generally the amount invested (debt is not taken into account).
- *Passive Loss Limitation*. A shareholder may not deduct losses from investments that are "passive" — generally companies in which the shareholder does not personally participate.

How these rules will affect the founders and investors in a given company can be difficult to predict depending on their individual tax situations. The actual impact tends to be mitigated by several factors.

First, institutional investors such as banks or large venture capital funds operating as "C" corporations generally are not affected by any of the limitations in practice.

Second, the "passive loss" limitations apply only to the net losses of a shareholder from all of his or her investments. An angel investor may offset $50,000 of loss from GreatIdea.com against $50,000 of income from another investment. For investors with a portfolio of companies (hopefully realizing net income on the whole), the "passive loss" limitations can disappear.

Third, until a company borrows money from someone other than a shareholder (such as a bank), the "at risk" limitation generally does not come into play. For the typical company, this limitation has little effect in the early and middle stages of growth.

To complete the picture, we also note that while a "C" corporation incurring losses in the early years cannot use those losses immediately, they do constitute an "asset" in the sense that they will decrease taxes (and increase net income) in later years. Like other assets, these losses will potentially increase the valuation of a company in connection with a merger or IPO.

Options for Options

Almost without exception, emerging growth companies use equity-based compensation to attract and retain key personnel. From the viewpoint of the company, tying a manager's compensation to the value of the stock makes good business sense. And because of well-publicized success stories in the technology industry, prospective employees tend to value equity-based compensation with open arms.

Equity-based compensation comes in many flavors. Possibilities include outright grants of stock, options to acquire stock, phantom stock rights, and stock appreciation rights.

In many respects, "C" corporations and LLCs act the same vis-à-vis equity-based compensation. In two respects they are different.

Perhaps most important is the area of stock options. An LLC may issue only "non-statutory" options, while a "C" corporation may issue "statutory" options as well. The key difference: an employee who exercises a non-statutory option will recognize ordinary income at the time of exercise equal to the difference between the fair market value of the stock and the exercise price. An employee who exercises a statutory option will recognize *no* income at the time of exercise, and at the time the stock is sold generally will recognize long-term capital gain. From the perspective of the employee's tax treatment, a statutory option is better.

The favorable tax treatment of the employee does not come without costs:

- The company itself loses the tax deduction it would have had upon the exercise of a non-statutory option.
- The employee is required to hold the stock for mandatory periods.
- The exercise price must be at least equal to the fair market value of the stock at the time the option is granted. There can be no "compensation" element as of the grant date.
- The favorable tax treatment is subject to annual dollar limits.
- The favorable treatment under the "regular" tax system may subject the employee to liability under the "alternative minimum tax," a complex sister system to the regular tax. Especially for large grants, this can defeat the very purpose of the statutory option plan.

For all of these reasons, statutory option plans may work best for established companies making relatively modest grants, while non-statutory option plans, being less encumbered by statutory requirements, may work better for early and middle-stage companies.

The other option-related difference between "C" corporations and LLCs concerns the tax impact on the company when an option is exercised. A "C" corporation recognizes no income or loss, while an LLC might (the law is not completely clear) be required to recognize taxable gain as if it sold a small piece of its assets. Any such gain would likely be offset by the company's compensation deduction.

Fringe Benefits for Shareholders

Emerging growth companies, even those in the early stage of development, typically provide fringe benefits such as health insurance and life insurance to their founders and other key employees.

When a "C" corporation pays insurance premiums or similar fringe benefits, the cost is deductible to the company and excluded from the employee's income. The same is true when an LLC pays the premiums, except for employees who are also shareholders (not just option holders). For these employee/shareholders, the cost of the fringe benefit is still deductible by the company, but the amount of the fringe benefit is included in the employee's income.

For example, if GreatIdea.com pays a $1,000 insurance premium for its founder, the founder will have $1,000 of extra income on his or her personal tax return.

If the premium is for health insurance—typically the most expensive fringe benefit—the founder will also be entitled to a personal deduction. The deduction will be 70% in 2002, and 100% for all years thereafter. At that point, the treatment of health insurance premiums will essentially be identical for LLCs and "C" corporations.

NOTE: When we use the phrase "fringe benefit" here, we are referring to a group of expenses that confer a personal benefit to employees. We are not referring to things like a car used for company business, season tickets used for entertaining customers, or a company-paid business trip to Bermuda. These items are treated identically whether the company is a "C" corporation or an LLC.

Taxable Year

A "C" corporation may use any tax year it chooses. For example, if GreatIdea.com is in the computer retail business, it may find it easier to use a tax year ending on January 31st to take into account returns from the Holiday shopping season.

As a general rule, an LLC must use a year ending on December 31st unless it can justify a different year to the satisfaction of the IRS. A company with more than 25% of its gross receipts during the last two months of its chosen year automatically qualifies under the IRS tests. Hence, GreatIdea.com may qualify for a January 31st year even as an LLC.

Making Acquisitions

The emerging growth company seeking to acquire another company may pay the sellers with cash, stock, or some combination of the two. In a cash purchase, the "C" corporation and the LLC are essentially identical. In a purchase for stock, they are similar, although the LLC has a slight advantage.

When a "C" corporation uses its own stock to purchase another company, the transaction can qualify for special treatment whereby the sellers do not recognize taxable gain on receipt of the buyer's stock (see discussion under "Tax on Sale", page 5). The ability to offer tax-free treatment can make it easier to acquire companies that might otherwise be reluctant to sell.

An LLC can use its stock to make tax-free purchases as well, but with an important difference. Whereas a corporation seeking tax-free treatment must satisfy a host of complex tax rules, when an LLC uses its own stock

to purchase another company, the transaction is almost *always* tax-free. As a result, an LLC has more flexibility to structure a transaction that addresses the business and economic concerns of the buyer and the sellers, rather than staying within the artificial boundaries of the Internal Revenue Code.

Self-Employment Taxes

Self-employment taxes are imposed at a rate of 15.3%, of which 12.4% is Social Security taxes and 2.9% is Medicare taxes. In an employment relationship, half of each tax is imposed on the employer and half on the employee.

If GreatIdea.com is a "C" corporation, the company and its employees pay self-employment taxes in the normal fashion, through payroll deductions. Investors who are not also employees never pay self-employment taxes, even when they receive dividends.

The situation is similar in an LLC, except that when the company generates income, some shareholders may be required to pay self-employment tax on their allocable share.

The LLC shareholders potentially liable for self-employment income are those who (i) have personal liability for the debts of the company, (ii) have authority to enter into contracts on behalf of the company, or (iii) participate in the business for more than 500 hours during the year. In general, this means that only shareholders who are also employees of the LLC are potentially liable for self-employment tax, not the investors. Employees who hold options, but not stock, are not affected.

How meaningful is this extra tax? It depends.

- The "extra" self-employment tax arises only when the company is generating net income. For an early-stage company generating net losses, there is no extra tax.
- Self-employment tax does not apply to income from the sale of a company. If the assets of GreatIdea.com, L.L.C. are sold for $25 million, no self-employment tax is due from the shareholder/employees or anyone else.
- The 12.4% Social Security part of the tax is imposed on only the first (approximately) $80,000 of income. For shareholder/employees receiving regular compensation of at least that amount, there will be no "extra" Social Security tax.

Normally, the "extra" self-employment income arising from LLC status boils down to 2.9% of the non-sale income allocated to shareholder/employees.

If management owns 70% of GreatIdea.com and the company generates $5 million of operating income that would not otherwise be distributed as bonuses, the "extra" tax liability is $101,500.

The Burdens of Ownership

Owning stock in a "C" corporation is easy. Millions of people do it every day, simply by owning shares of a corporation whose stock is traded in the public markets—General Motors, Amazon, all of them.

Owning stock in an LLC is easy, too, with one important qualification. If you own stock in an LLC and the LLC reports taxable income, then chances are that some of that taxable income will find its way onto your personal tax return, creating a tax liability for you. Theoretically, that "phantom income" (income without cash) can leave you with a net cash loss for the privilege of owning the stock.

This risk can be minimized in at least two ways. One involves the method by which the LLC allocates income and loss among its owners. The other, far more straightforward, is simply to provide by contract (recall the flexibility of LLCs) that the company will distribute enough money each year to its owners to satisfy their personal tax liabilities.

In any case, the risk of reporting taxable income from the company is of little or no concern to the founders themselves, who are in a position to control both the allocation of income and the distribution of cash. The real concern is on the part of prospective investors. They must assure, via contract, that they do not pay tax on "phantom" income.

Attracting Investors

Which format do prospective investors prefer — the "C" corporation or the LLC? There are several answers.

Even two years ago, the perception was that many large institutional investors felt more comfortable with the "C" corporation, if only because it was more familiar. In contrast, many "angel" investors, whether individuals or funds, were early adapters to the LLC format. Our unscientific observation is that in today's market both institutional and small investors have become comfortable with investing in LLCs. Indeed, many investors operate as LLCs themselves.

In reality, if a given format is best for an emerging growth company and its founders, it should also be best for the company's investors. In nearly

all important respects, the interests of the two groups should be almost identical with regard to the choice of legal entity.

For example, if a company cannot attract an outside CEO without tax-qualified Incentive Stock Options, then both the founders and the investors likely would prefer a "C" corporation. If using an LLC would save $7 million of tax on sale, that benefit will be shared equally.

Represented by sophisticated lawyers and wielding enormous bargaining leverage, investors are in a unique position to maximize the advantages of the LLC format. For example, while it is sometimes said that investors fear the "phantom" income that LLCs can generate, in reality the sophisticated investor can almost entirely protect himself from this risk. Options range from requiring a cash distribution to fund tax liabilities, to holding the power to force conversion to "C" corporation status if the distributions are not made.

Similarly, an investor that is tax-exempt (*e.g.*, a pension fund) may in theory object to the possibility that its share of an LLCs income could be subject to the tax on unrelated business taxable income. But this risk can be minimized with proper structuring, and in all events the tax-exempt investor—like all other investors—ultimately benefits from the lower overall tax cost of the LLC format.

The investment climate has changed dramatically over the last several years and the attitude of the investment community toward LLCs has changed along with it. When stratospheric returns on investments were commonplace, the extra after-tax return that could be provided by an LLC was less important and perhaps outweighed by the small nuisances of LLC ownership. Today, saving $7 million on sale looks much more attractive.

Conclusion

When starting a new business, many entrepreneurs have in mind the business model of Netscape, AOL, and several dozen of the technology highfliers of 1998 and 1999. These companies rocketed straight from the idea stage to an initial public offering (IPO) on Wall Street.

The "C" corporation ended up as the perfect choice for these companies. They never generated taxable profits before going public and were never sold, at least not until Netscape was sold to AOL in a tax-free reorganization long after both companies were public. With this growth model, the principal benefits of the LLC format—the tax savings on sale—never came into play.

Indeed, the fact that so many entrepreneurs and their advisors were thinking about the Netscapes and AOLs of the world probably goes a long way toward explaining why many emerging growth companies were formed as "C" corporations even after the bubble had burst.

Yet the road to success does not always, or even usually, lead from start-up to funding to IPO. The big IPOs of the late 1990s received media attention, but in reality thousands of successful companies are formed every year, of which only a tiny fraction ever go public. The huge majority of successful companies either remain private, generating profits indefinitely, or are sold.

For these companies, choosing the "C" corporation format simply because "that's what AOL did" may turn out to be a costly and irrevocable mistake. On balance, the flexibility of the LLC format as well as the potential tax savings often make it the better choice for the emerging growth company and its founders and investors.

Summary Chart

Characteristic	Importance	"Winner"	Comments
Liability Protection	1 . . . . ***10***	None	✓ LLCs and "C" corporations protect shareholders equally.
Switching Forms	1 . . . . ***8*** . . 10	LLC	✓ Conversion works smoothly from LLC to "C" corporation. ✓ Conversion from "C" corporation treated as taxable sale.
Tax on Operations	1 . . . . ***5*** 10	LLC	✓ One level of tax on operations for LLCs. ✓ "C" corporations may pay lower rates if limited income is invested in land or other capital assets.
Tax on Stock Sale	1 . . ***2*** 10	"C" Corporation	✓ On taxable stock sale, same tax for LLCs and "C" corporations. ✓ Tax-free reorganizations generally are limited to "C" corporations.
Tax on Asset Sale	1 . . . . ***9*** . 10	LLC	✓ One level of tax on asset sale for LLCs. ✓ Asset sale is much more likely than stock sale. ✓ Tax-free reorganizations generally limited to "C" corporations.
Governing Law	1 . . . . ***3*** 10	None	✓ LLC statutes are very flexible, but new and relatively untested. ✓ "C" corporation statutes are less flexible, but have fewer gaps.
Using Tax Losses	1 . . . . ***5*** 10	LLC	✓ Subject to limitations, owners of LLCs may deduct the company's losses against their other income.

Use of Options	1 . . . . ***6*** . . . 10	"C" Corporation	✓ "C" corporations may offer Incentive Stock Options as well as non-statutory options.
Shareholder Fringe Benefits	1 . . . ***3*** 10	"C" Corporation	✓ All fringe benefits are deductible to "C" corporation. ✓ In LLC, some fringe benefits are taxable to employees who are also shareholders, though shareholders may be entitled to personal deduction.
Taxable Year	1 . . ***2*** 10	"C" Corporation	✓ "C" corporation may use any taxable year. ✓ LLC must use December 31st year unless it can justify a different year to IRS.
Making Acquisitions	1 . . . . ***6*** . . . 10	LLC	✓ Easier to make tax-free acquisitions with LLC.
Self-Employment Taxes	1 . . . . . ***4*** 10	"C" Corporation	✓ In "C" corporation only the wages of employees are subject to self-employment tax. ✓ In LLC, the dividends of company "insiders" may also be taxable.
Burdens of Ownership	1 . . ***2*** 10	"C" Corporation	✓ No burden of owning shares in "C" corporation. ✓ Possibly subject to tax on share of LLC earnings, though little practical risk.
Attracting Investors	1 . . . . ***9*** . 10	Uncertain	✓ In the late 1990s, many large investors chose "C" corporations. ✓ Investment market has changed as benefits of LLC became recognized.

Notes

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Cherry Hill
1810 Chapel Avenue West
Cherry Hill, NJ 08002-4609
(856) 661-1900
FAX (856) 661-1919
E-mail: firm@flastergreenberg.com

Philadelphia
300 Walnut Street
Philadelphia, PA 19106
(215) 922-4000

Egg Harbor Township
2900 Fire Road, Suite 102A
Egg Harbor Township, NJ 08234
(609) 645-1881

Cranford
216 North Avenue
Cranford, NJ 07016
(908) 245-8021

Vineland
190 S. Main Road
Vineland, NJ 08360
(856) 691-6200

For more information, visit our web site at:
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