Mark Roderick, Esquire
Crowdfunding Attorney
www.crowdfundattny.com
FLASTER GREENBERG

Choosing The Right Legal Entity

C Corporation or Limited Liability Company

Among the earliest decision for a startup is the legal form in which the business will be conducted.

There are a lot of choices – C corporations, S corporations, general partnerships, limited partnerships, limited liability partnerships, and limited liability companies.

For most startups, however, the practical choice is between a C corporation (named for a chapter of the Internal Revenue Code) and a limited liability company.

I've summarized below the main characteristics of C corporations and LLCs from the perspective of the startup and its founders and investors. All things considered, a limited liability company is the better choice for most companies. But in some situations – situations more likely to arise in Crowdfunding than elsewhere – a C corporation can make sense.

NOTE: For simplicity, I'm going to use the word "shareholders" to refer to the owners of an LLC, even though technically they're called "members."

Table of Contents

Markley S. Roderick concentrates his practice on the representation of entrepreneurs and their businesses. He represents companies across a wide range of industries, including technology, real estate, and healthcare.

Expanding on his in-depth knowledge of capital raising and securities law, Mr. Roderick spearheads Flaster/Greenberg's Crowdfunding Practice and is one of the leading Crowdfunding lawyers in the United States. He maintains a Crowdfunding blog at www.crowdfundattny.com, which contains news, updates and links to important information on the Crowdfunding industry. A regular speaker at Crowdfunding events, Mr. Roderick represents dozens of portals and other participants in the Crowdfunding industry, providing both technical knowledge and industry insight.

Mr. Roderick has spent more than 30 years representing entrepreneurs and their businesses in a wide variety of transactions, including:

- Counseling entrepreneurs through the formation, development, and growth of their businesses
- Raising money through private placements and venture capital
- Buying, selling, and investing in businesses
- Planning business transactions to minimize corporate and individual taxes
- Preparing Shareholders' Agreements, Partnership Agreements, and Operating Agreements
- Protecting business goodwill through restrictive covenant (non-compete) agreements
- Compensating key employees using options and restricted stock
- Technology licensing and development

You can reach Mark at 856.661.2265 or mark.roderick@flastergreenberg.com.

Protection from Personal Liability

The reason we use legal entities in the first place, rather than doing business in our own names, is to protect ourselves from personal liability. Just because I'm an owner of a company's stock doesn't mean I'm personally liable if the company can't pay its bills.

On this most important of issues, C corporations and LLCs are the same: both provide a shield that protects the shareholders from personal liability.

I'll take the opportunity to dispel a common misunderstanding about personal liability. Say I'm the owner of Startup.com, Inc., a corporation, and am driving to a business meeting after enjoying a few perfectly delicious gin and tonics. I see a group of orthopedic surgeons crossing the road and, having been kept waiting too long at my last doctor visit, swerve to the left, just to scare them. My car slips on gravel, I lose control, and unfortunately I mow all of them down.

I cannot jump out of the car and say "Haha, I'm a corporation so you can't sue me!" Because I personally was driving the car while intoxicated, I am personally liable.

A couple more points:

The owners of a startup are often asked to personally guaranty obligations of the entity, like a bank loan or office lease. The existence of a legal entity does not protect you from a personal guaranty.

The owners of a business often have most of their net worth tied up in the business. In that case the protection from personal guaranty afforded by the entity doesn't do much good, because the creditor can get all the assets of the business.

"Historically, dividends have been subject to a much higher tax rate, and might be again."

Tax on Operations

If Startup.com generates $5 million of profits per year as a C corporation, it will pay Federal income taxes of approximately $1,750,000. The remaining $3,250,000, when distributed to the owners as dividends, will generate more tax at the personal tax brackets of the shareholders. Under the law in effect today, those dividends would be subject to shareholder-level tax of about $773,500. Historically, dividends have been subject to a much higher tax rate, and might be again.

Having generated $5 million of profits, Startup.com and its shareholders would therefore pay a total of about $2.5 million of Federal income tax under today's law, or 50% 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 at the shareholder level.

If Startup.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 shareholder level. At the highest Federal bracket the tax would be approximately $1,980,000, or 39.6% of earnings. The tax savings as compared to the C corporation: about $543,500 per year – and potentially much more, if the historic tax rates on dividends come back into effect.

Saving more than half a million dollars per year, or 10% of your pre-tax income, is no small feat. In fact, that's the best argument in favor of using an LLC. But you knew it couldn't be that simple. In some situations, a C corporation can actually *save* taxes.

Suppose that Startup.com has begun to generate modest profits (after paying your compensation) of less than $100,000 per year. Suppose also that Startup.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 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 Startup.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 normally the case in the tech world – Startup.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, most business sales take the form of an asset sale rather than a stock sale.

Asset Sale

Suppose all of the assets of Startup.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 $8,750,000. When the company dissolves and distributes the remaining $16,250,000 to its shareholders, they will pay another $3,867,500 of personal income tax. The total tax bill for the C corporation and its stockholders: approximately $12,617,500.

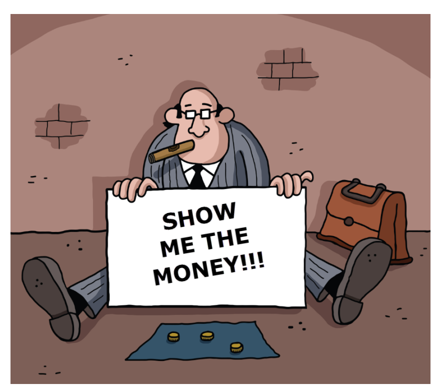
In contrast, if Startup.com were an LLC at the time of sale, it would pay no tax whatsoever, and its shareholders would pay personal income tax of approximately $5,950,000. Choosing the LLC format would have saved approximately $6,667,500 million in *after tax dollars* vs. the C corporation on the sale.

Viewed from the perspective of company valuation, the situation is striking. For an LLC, a sale price of $25 million leaves the shareholders with approximately $19,050,000 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 about $38.5 million. From this perspective the simple choice to use an LLC rather than a C corporation is equivalent to increasing the value of the company by more than half!

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

Suppose that Startup.com is sold to Google for $25 million, with the consideration paid in Google stock rather than in cash. If Startup.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 Google stock tax-free*! This important tax benefit is available only to corporations, and not to LLCs.

"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."



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

	Sale for Cash	Sale for Stock
C Corporation	$12.6 million	$0
LLC	$6 Million	$6 million

"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."

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 $12.6 million.

Further, the $0 entry doesn't tell the whole story. Yes, the shareholders of Startup.com will owe no tax upon their receipt of Google stock. But when they sell that stock, they will pay the same $6 million of tax they would have paid on sale of an LLC (assuming the value of Google stock has not changed). The real savings in a tax-free reorganization is not the $6 million itself, but only the time value of postponing payment.

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 Google 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.

Perhaps most important is that it's very easy to change from an LLC to a C corporation, but very difficult to change from a C corporation to an LLC. A $25 million C corporation *must* be sold in a tax-free reorganization to avoid a $12.6 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 Startup.com is an LLC, but *is not* available if Startup.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 $6 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.

Going Public

Sometimes founders and investors cash out not by selling the startup outright, but by taking the startup public in an IPO (initial public offering), then selling their shares in the open market. In almost all situations, an LLC that wants to go public will first convert to a C corporation. But even if it doesn't, an LLC whose shares are publicly-traded is treated as a C corporation for tax purposes anyway.

The bottom line: there's no difference between a C corporation and an LLC if you're looking toward an IPO.

Switching Legal Forms

A company formed as a C corporation may later find itself wishing to be an LLC, and *vice versa*. Think about those sharp-toothed security devices used by parking garages. Cars may always travel out (from and LLC to a C corporation), but dare not travel in (from a C corporation to an LLC).

If Startup.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 shareholders and employees of the LLC may be readily transferred to the corporate format.

Switching in the other direction is far more problematic. If Startup.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.

"A company formed as a C corporation may later find itself wishing to be an LLC, and vice versa."

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.

"Nearly every business generates losses during its early stages."

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 sometimes 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.

In contrast, LLC statutes are models of flexibility, and the shareholders are free to agree to just about anything they want. The Delaware LLC statute provides explicitly:

It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

With this backdrop mirrored in other states, the shareholders 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.

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: Startup.com starts business as a C corporation on 01/01/2015. 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 2017, the loss from the earlier years will offset the current income and eliminate corporate-level tax liability.

EXAMPLE: Startup.com is an LLC instead. Subject to limitations discussed below, the shareholders could use the $1 million loss in 2015 and 2016 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 2017.

Since a dollar of tax savings is usually 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 the 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 Startup.com against $50,000 of income from another passive 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.

"Equity-based compensation comes in many flavors."

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, 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.

"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."

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 of the LLC.

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 Startup.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, however, which is typically the most expensive fringe benefit, the founder will also be entitled to a personal deduction for the full amount of the premium. As a result, the treatment of health insurance premiums are essentially 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

Most C corporations may use any taxable year. For example, if Startup.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, with some exceptions.

Making Acquisitions

The startup 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 "Tax on Sale" on p. 3). 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.

"Most C corporations may use any taxable year."

Social Security and Medical Taxes

Social Security and Medicare taxes are imposed at a maximum rate of 16.2%, of which 12.4% is Social Security taxes and 3.8% is Medicare taxes. In an employment relationship, half of the Social Security tax is imposed on the employer and half on the employee, while the employer pays Medicare tax at the rate of 1.45% and the employee at the rate of 2.35%.

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

Owning stock in C Corporations or LLCs is easy.

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.

Under IRS proposed regulations, 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 Startup.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 $118,500 (for 2015) 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 3.8% of the non-sale income allocated to shareholder/ employees. If management owns 70% of Startup.com and the company generates $5 million of operating income that would not otherwise be distributed as bonuses, the "extra" tax liability is $133,000.

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 – Facebook, 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 shareholders. The other, far more straightforward, is simply to provide by contract that the LLC will distribute enough money each year to its shareholders 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.

Foreign Investors

If Startup.com is an LLC, each of its shareholder has to file a U.S. tax return with the friendly Internal Revenue Service. That's not a problem for U.S. investors, who have to file returns with the IRS anyway, but it can be a problem for foreign investors, who don't want to file U.S. tax returns unless they absolutely have to. They often prefer to own stock in a C corporation, where no personal tax returns are required, even if it means ultimately paying more tax.

Fortunately there's a way to give everyone what they want. Startup.com itself can be an LLC, and any foreign investors can own their interests through a separate C corporation, commonly referred to as a "blocker" corporation.

Unrelated Business Taxable Income

Organizations like pension plans generally are not subject to income tax. But when an otherwise tax-exempt organization engages in a regular business – United Way opens a McDonald's – it is subject to tax on the "unrelated business taxable income," or UBTI.

Pension plans, endowment funds, and other tax-exempt organizations invest a lot of money in startups, both directly and through venture capital funds. And when the startup is an LLC, the tax-exempt organization's share of the LLC's income constitutes UBTI. Tax-exempt organizations don't like paying tax! This is the principal reason why institutional investors like VC funds prefer C corporations, which do not generate UBTI.

Fortunately, there is at least a theoretical fix. Where Startup.com is an LLC and a prospective investor is afraid of UBTI, we can form a new C corporation solely to hold the interest of the new investor. The income flowing in the direction of the new investor will be "blocked" by the C corporation (which will pay tax) and never turn into UBTI on the tax return of the investor.

I say "theoretical" because now and again we come across an institutional investor that simply says "No." In that case – assuming you have no other funding alternative – you switch to a C corporation and take the check.

You could end up with 500 shareholders in a Crowdfunding offering.

Cost of Having Shareholders

For a C corporation, there is little or no cost of having shareholders. Two shareholders or 200, the cost is the same: around zero.

It's a different story for LLCs. For one thing, an LLC is required to send an IRS K-1 schedule to every shareholder every year. For another thing, some states, including New Jersey, charge a fee for each shareholder. It's not a big deal if you have, say, 50 shareholders, but in a Crowdfunding offering you might end up with 500. At that point the cost may become material.

Attracting Investors

Which format do prospective investors prefer, the C corporation or the LLC?

Today the answer is that most investors prefer the LLC because they don't want to pay double tax. Now and again we come across and institutional investor that prefers the C corporation because of unrelated business taxable income, but that's increasingly rare.

In reality, if a given format is best for the startup 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 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 by both groups. Investors are about IRR, and adding $7 million to the top line does wonders for total return.

Most investors prefer the LLC over C Corporations because they don't want to pay double tax.

Mark Roderick, Esquire
Crowdfunding Attorney
www.crowdfundattny.com
FLASTER GREENBERG®

Contact Mark:

Mark Roderick, Esq.

T: 856.661.2265

E: mark.roderick@flastergreenberg.com

www.crowdfundattny.com

@CrowdfundAttny

Summary Chart

Characteristic	"Winner"	Comments
Liability Protection	**Tie**	• LLCs and C corporations protect shareholders equally.
Tax on Operations	**LLC**	• One level of tax on operations for LLCs. • However, C corporations may pay lower rates if limited income is invested in land or other capital assets.
Tax on Sale	**LLC**	• One level of tax on asset sale for LLCs, two levels of tax for C corporations. • On taxable stock sale, same tax for LLCs and C corporations. • Tax-free reorganizations generally limited to C corporations.
Planning for IPO	**Tie**	• If an LLC is publicly-traded, it's treated as a C corporation.
Switching Forms	**LLC**	• Conversion works smoothly from LLC to C corporation. • Conversion from C corporation treated as taxable sale.
Governing Law	**LLC**	• LLC statutes are very flexible, giving parties ability to make business deal. • C corporation statutes are more paternalistic, protecting minority shareholders.
Using Tax Losses	**LLC**	• Subject to limitations, owners of LLCs may deduct the company's losses against their other income.
Use of Options	**C Corporation**	• C corporations may offer Incentive Stock Options as well as non-statutory options.
Shareholder Fringe Benefits	**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	**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	**LLC**	• Easier to make tax-free acquisitions with LLC.
Self-Employment Taxes	**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	**C Corporation**	• No burden of owning shares in C corporation. • Possibly subject to tax on share of LLC earnings.
Foreign Investors	**Tie**	• Using a "blocker" corporation avoids need to file U.S. tax returns.
Attracting Investors	**LLC**	• Investors like one level of tax on sale, increasing IRR. • Some institutional investors concerned about UBTI.