The Choice of Entity Decision for VC Financed Start-ups

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I recently published an article focusing on the choice of entity decision for main street businesses in the aftermath of the 2017 Tax Act. After reading the article, Bill Strench, my fellow Frost Brown Todd attorney, experienced venture capital financing lawyer, and high school track and cross-country teammate, pointed out that there are profound differences between how choice of entity decisions are approached by venture capitalists (VCs). A review of the VC literature confirmed that there were indeed profound differences in how the VC investment community views the choice between corporation and LLCs. I also felt that these differences were significant and interesting enough to merit a follow-up article. I decided that a question and answer format would be the best way to draw upon Bill's VC investment industry expertise and experience.

Scott: *Bill, thanks for agreeing to participate in putting together this follow-up article. In your experience, are most VC financed start-ups operating as C corporations or LLCs (taxed as partnerships)?*

Bill: In the eight states where Frost Brown Todd has offices[2], the vast majority of VC financed start-ups operate through Delaware C corporations. In recent years, we have seen a small but slowly increasing number of VC financed start-ups operating through LLCs. These LLCs often have corporate-style equity structures, including voting and nonvoting, common and preferred stock. We also see Delaware LLCs with Simple Agreement for Future Equities (SAFE), convertible debt, options, warrants, restricted and vested equity grants, equity appreciation rights and phantom equity. There could be a higher percentage of VC financed start-ups operating through LLCs in the Midwest than in Silicon Valley, but it's a matter of opinion whether this means that Silicon Valley has surrendered its leadership role in VC financing innovation or simply that the Midwest investment community is more accepting of LLCs.

Scott: *The factors listed below are often cited by the VC industry as support for selecting C corporations.[3]*

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The availability of standardized and familiar corporate organizational and VC investment documents:

- Many VCs will only invest in a Delaware corporation's preferred stock. VCs usually base their choice of entity decision on some variation of the familiarity, efficiency and standardization theme. Another way of saying this is that the VC investment process is form driven, and the corporate form is tried and true;
- VCs and their attorneys know the corporate preferred stock investment forms inside and out (go no further than to review the National Venture Capital Association (NVCA) forms) – the rights, preferences, and privileges of preferred stock do not vary too much in a particular region and over time;
- C corporations are less complex, whether you are looking at investment documentation, partnership versus corporate taxation, or entity governance issues. Another way of saying this is to point out that LLC operating agreements are complex documents from a tax and governance standpoint when compared with corporate articles, bylaws and preferred stock investment documents;
- raising capital is easier if the investment offering is preferred stock rather than LLC units;
- some commentators argue that C corporations provide more management and governance flexibility;
- employees of VC financed technology companies are often more familiar and comfortable with stock options than the various forms of equity compensation available when operating through an LLC. This fact makes it easier to structure the compensation of start-ups operated through C corporations;
- customers of the business may feel that a corporation is more substantial and more "real" than an LLC;

The VCs' investment strategy meshes with the use of C corporations:

- VCs focus on the home run exit strategy – attempting to knock it out of the park either through a stock sale (potentially

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taking advantage of IRC § 1202's generous tax benefits), which might include a put back to the company or a sale of the company) or an IPO. VCs are not concerned with maximizing the tax and business benefits if the start-up is a slow growth, mediocre performer or failed business. Many early-stage VCs want to make their equity investments in the form of a capital asset (C corporation stock), avoid intervening tax or ownership complications between the date of investment and exit, and sell or exchange stock at favorable tax rates;

- VCs are comfortable with the paths to realizing liquidity and return within the corporate form – through IPOs, liquidation events and dividend recapitalizations – they understand the tax treatments associated with those liquidity events;
- professionals charged with structuring VC investments do not personally share in losses, so they have little reason to care about the tax benefits associated with the pass-through of losses. A potential additional attractive feature associated with use of the C corporation to VC professionals is the possibility that they may be able to take advantage of IRC § 1202's tax benefits;

There are tax benefits associated with using the corporate form:

- C corporation profits are taxed at a 21% federal rate, while individual federal tax rates range up to 37%;
- gains on the sale of C corporation stock are often taxed more favorably than the corresponding sale of LLC interests, particularly if the stock qualifying as QSBS under IRC § 1202;
- C corporation shareholders do not need to worry about self-employment taxes with respect to dividends or capital gains on the sale of their stock. The same cannot be said for LLC members;
- only C corporations can participate in IRC § 368 tax-free reorganizations;
- VCs selling their C corporation stock for a loss are sometimes able to take advantage of the benefits of IRC § 1244 (i.e., ordinary loss on the sale);

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- an often-cited factor is that foreign investors structure investment through C corporations to avoid being allocated effectively connected income associated with the pass-through of profits on a Schedule K-1. Further, tax-exempt investors structure investments through C corporations to avoid unrelated business taxable income (UBTI);
- a factor often cited in favor of a pass-through entity is that a buyer will charge a penalty for lost tax benefits (the tax basis step-up) if forced to purchase a C corporation's stock rather than its assets. But there is a good deal of academic thinking that buyers fail to fully take into account the absence of a basis step-up for tax purposes when pricing their deals, which reduces the perceived benefit of operating as a pass-through entity rather than a C corporation (in other words, buyers who lose out on a tax basis step-up don't sufficiently penalize C corporation shareholders for demanding a stock sale);

The tax benefits of the LLC pass-through entity are exaggerated:

- VC literature often downplays the hypothetical tax advantages of LLCs, arguing that those advantages, such as loss passthrough, are more theoretical than real, and neither of great magnitude nor importance to VCs. Another expression of this attitude is the observation that the bogeyman of C corporation double taxation is rarely a real issue for a start-up company, because in most cases the liquidity event for a successful VC financed start-up is a stock sale, IPO or tax-free merger or stock exchange, rather than an asset sale and distribution of proceeds in liquidation;
- although losses do pass through to the owners of an LLC, VCs don't place much weight on that fact. Corporate net operating losses can eventually be used by a corporation when it becomes profitable. Discounting of the value of loss pass-through returns to the point that VCs are entrepreneurial by nature and entrepreneurs are optimists by nature. Some commentators have suggested that VCs suffer from irrational exuberance, a gambler's mentality that leads them to overestimate their likelihood of success (hence the

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discounting of the value of losses);

- even if the tax benefits associated with the pass-through of losses favors the LLC, the reality is that the passive loss rules (IRC § 469) often act to block the deduction of losses;
- VCs don't want to deal with the complexities of partnership taxation, reporting start-up company losses on their tax returns and potentially being required to file tax returns in multiple states, all of which are associated with a pass-through entity, and not with a C corporation;
- holders of pass-through equity always risk being allocated "phantom income" (i.e., allocation of net profits without a corresponding tax distribution). There is no phantom income risk associated with holding C corporation stock;
- the strategy of starting-up as an LLC taxed as a partnership during the early years to permit loss pass-through and then converting to a C corporation is expensive and requires a good deal of expertise on the part of the professionals handling the transaction;
- equity compensation is more difficult, complex and expensive to draft and administer with the LLC than it is with the C corporation. Incentive stock options (ISOs) are only available for C corporations;
- the reality is that the benefits touted for the partnership tax "profits interest" are actually limited if you compare them to the typical VC fund where investors take convertible preferred stock and founders and managers are issued common stock and make IRC § 83(b) elections. With respect to the common stock issued to founders and managers, low valuations are the norm, and this is seldom if ever challenged by the IRS;
- individuals issued profits interests in an LLC or limited partnership cannot be treated as employees for tax purposes – these individuals often don't want to be partners for tax purposes and treating them as partners increases complexity from a governance, tax and information disclosure standpoint; and

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- the making of an S corporation election is not a viable compromise solution as VCs are often ineligible S corporation shareholders (e.g., pass-through entities or corporations).

Scott: *The list of factors cited by the VC industry in support of using LLCs is much shorter:*

- a pass-through LLC is basically the most tax efficient vehicle, allowing for losses to pass-through to investors and in many instances, allowing for the lowest overall tax rate for investors (when you compare the highest individual marginal rates to the C corporation's double tax regime of 21% at the corporation level and the additional 20% tax on dividends), and avoiding the risk of double taxation;
- using a pass-through entity eliminates the risk of double taxation if a buyer wants to purchase assets instead of equity – relying solely on the hope of achieving the "home run" is a risky approach and the potential benefits of the single level of tax is worth any additional complexity associated with LLC agreements and partnership taxation;
- LLC agreements for Delaware LLCs can be crafted to deal with troublesome governance and fiduciary duty issues associated with using the corporate form where board governance is basically dictated by statute and case law;
- the "profits interest" (referred to in various contexts as being a "carried interest" or "promote") is a flexible and useful tool available for structuring equity compensation for LLCs;
- concerns of foreign investors (wanting to avoid effectively connected income) and tax-exempt investors (wanting to avoid UBTI) can be addressed through the use of blocker C corporations rather than by requiring the operating business itself to be a C corporation; and
- pass-through entities can take advantage of IRC § 199A's 20% deduction, introduced as part of the 2017 Tax Act.

Scott: *Bill, I have divided the factors outlined above into four main categories to dive deeper into each one. First, there seems to be a perception that VCs prefer C corporations because they perform well when the investment succeeds in a big way. Conversely, VCs*

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don't seem swayed by the fact that LLCs may perform better when the start-up's performance is mediocre, or the business fails. Commentators point out that these tendencies are consistent with the focus of VC professionals, who benefit only when the investment succeeds:

Bill: I agree with VCs that the C corporation is the best choice if the exit is a successful stock sale or IPO. The fact that a corporation is taxed at a 21% flat rate on earnings, and that stock sales either qualify for IRC § 1202 (QSBS) treatment or at least the 20% capital gains rate, presents an unbeatable combination of tax benefits. But don't forget that there are several pitfalls associated with banking on future QSBS treatment. These issues include whether the corporation qualifies as a "small business corporation," whether the stock continues to qualify as QSBS during the entire required five-year holding period, and whether the exit is structured as a stock sale.

I agree that in many cases, VCs would not be able to use losses passed through because of the passive loss rules or insufficient profits to offset against. I also agree that many VC investments are exited through stock sales or stock redemptions, which negates some of the potential benefits of the pass-through tax structure. On the other hand, we do recognize that a number of VC investments would have had a better overall tax and economic result if they had operated through a pass-through LLC rather than a C corporation. The key is that many in the VC industry are unwilling to trade the incremental benefits associated with poorly performing investments operating through LLC for the additional complexity, uncertainty, and loss of certain tax benefits associated with operating through a C corporation.

Perhaps there is less focus in the Midwest on the pure "home-run" scenario. We work with many VCs who have profits to offset against their start-up losses, and they do seem factor the benefits of singles and doubles into their overall investment strategy. Some of these VCs are willing to suffer through the additional complexities and expense of operating through an LLC in order to take advantage of the LLC's tax benefits (pass-through tax treatment, including pass-through of start-up losses).

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As for the observation that the interests of investors and VC professionals are not always aligned, there could be some truth to this, but our experience has been that a start-up's founders are usually involved at the front end in the process of selecting the C corporation, and usually for the reasons out in this article.

Scott: *Second, the organizational (articles, bylaws, shareholder agreement) and investment documentation associated with the C corporation is familiar, efficient and standard:*

Bill: It's certainly true that there is value associated with using generally standardized corporate organizational documents and preferred stock investment documents. VCs are almost always serial investors and expect the tax and governance terms of the key documents to function in a familiar fashion from one deal to the next. But it would be misleading to assume that there isn't any variation in the terms of these documents. VCs should always carefully review the organizational and governance documents, regardless of how generally familiar they are with the form of those documents. The bottom line is that the overall importance to the VC investment community of having familiar investment documents and terms can't be overestimated.

A recent example of where the standardization of investment documentation through corporations is ahead of LLCs is the proliferation of SAFE investments over the past several years. SAFEs are basically debt instruments issued at the time when a start-up needs a quick and dirty capital raise that are usually convertible at a discount into preferred stock when a company subsequently undertakes a more traditional capital raise. Unlike convertible notes and other convertible instruments, SAFEs leave the terms of the conversion, including pricing, to a later date when the corporation undertakes a round of equity financing. The documentation for C corporation SAFEs has existed for several years, but so far, there has been little standardization of SAFE documentation for LLCs;

There's no doubt that tax and governance terms of a typical LLC agreement are much more variable and infinitely more complicated. Working with documents that include partnership tax provisions requires advanced tax expertise. Although there are no standard

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LLC organization or investment documents on the NVCA website, we have developed fairly standardized LLC organizational and VC LLC investment documents. These documents include governance arrangements that track the corporate model (i.e., boards of director, officers, and shareholders), and have preferred and common units and incentive compensation arrangements that are similar to those found in corporations. Start-ups operated through LLCs take advantage of the ability to issue profits interests as equity compensation. Once VCs have cut their teeth on investments structured through LLCs, the learning curve is behind them and the benefit of standardized corporate forms becomes less of an issue.

Scott: *Third, there is a perception that the tax benefits associated with pass-through LLCs are illusory when you take a close look under the hood and consider whether those benefits are available in real life to VCs. What about operating a VC start-up in an LLC from a tax standpoint?*

Bill: When comparing the tax cost of an exit from an investment through a C corporation versus an LLC, a key question is whether the buyer will purchase the C corporation's stock or exchange C corporation stock for stock, or whether the buyer will demand the transaction be structured as an asset purchase. If the exit is a stock sale, particularly where the stock qualifies as QSBS under IRC § 1202 or a tax-free reorganization under IRC § 368, operating the start-up through a C corporation is often the best choice. But lacking foresight about the structure of the future exit, the LLC may be the better choice if there is any meaningful risk that a buyer will either demand that the transaction be structured as an asset purchase transaction or would fully discount the acquisition price if it agrees to a stock purchase. If the other factors that historically pointed towards the C corporation over the LLC weren't enough already, the reduction of the corporate tax rate from 35% to 21%, and the continued availability of the benefits of IRC § 1202 have solidified the choice of the C corporation in the VC investment community as the start-up entity of choice. Even in our "main street" start-ups, entrepreneurs are taking a hard look at the C corporation because of the 21% tax rate and the continuing availability of IRC § 1202's benefits.

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In order to use a VC start-up's losses, the owner has to have other operating profits to offset against the losses. It's true that many founders don't have other income to offset against a start-up's losses. And many start-ups continue to throw off losses throughout the development stage. There are several Internal Revenue Code provisions that further limit the use of losses, in particular the IRC § 469 passive loss rules. These rules prevent an investor from offsetting losses passed through from the start-up against wages, other compensation, dividends, interest and a variety of other income sources. Some investors will have passive income to offset against a start-up's passive losses, but for every one of those investors, there are investors who either can't use the LLC's losses, such as tax-exempt investors, or are at a point where tax losses are of little interest. So, while I wouldn't say that an LLC's losses are illusory benefits, they certainly don't always work as advertised. Finally, it is important to note that it is possible to take advantage of ordinary losses with respect to a C corporation's stock if IRC § 1244 applies, but many VC financed start-ups won't qualify as a small business corporation with capital not exceeding $1,000,000.

It is very important to take note of the fact that for VC start-ups, the potential for double taxation associated with a C corporation isn't an issue. Most start-ups throw off losses during the early stages, and often well into the growth stage, and in some cases, up to the date the business is sold. For these businesses, double taxation associated with the C corporation is a hollow threat until the business is sold because very few start-ups will ever pay dividends subject to double taxation. If the start-up becomes profitable, it's still unlikely that it will pay dividends and its net operating losses (NOLs) can be utilized to offset profits and net profits are now taxed as the highly attractive 21% rate, versus the old 35% rate. And if the start-up's assets are eventually sold, any pent-up NOLs can be offset against the corporate level gain on the asset sale. If the eventual exit is a stock sale or IPO, VCs will come out fine from a tax standpoint. But we agree that where the eventual exit is an asset sale, the overall tax cost will often be much higher if the business is operated through a corporation rather than an LLC.

Having a single level of tax may be a real and tangible benefit of operating through an LLC. But a recently introduced downside of

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operating through an LLC that hasn't received much attention in the VC industry is the new partnership audit rules that became effective for most LLC on January 1, 2018. There are a host of new rules requiring the handling of audits at the partnership level. Most start-ups won't be able to opt-out of the rules because they will have LLCs or trusts as members. The LLC will be responsible for the tax liability unless the partnership representative "pushes-out" the liability to the LLC's members. Even if the LLC agreement provides for the push-out of tax liabilities, which by the way comes at an additional tax cost, arrangements will need to be made at the LLC level for the expenses and responsibility associated with handling tax audits and litigation after an asset sale by the LLC. These new audit rules simply add yet another layer of complexity to operating a start-up through an LLC.

Scott: *Fourth, proponents of both corporations and LLCs argue that their entity of choice is best for structuring equity compensation arrangements. Both camps can't be right?*

Bill: I don't believe that either the LLC or C corporation has much of an edge when it comes to structuring equity compensation. If VCs want to use options, then the exercise of those options in connection with a liquidity event will trigger ordinary compensation income whether the entity is an LLC or corporation. If the business is a start-up, grants of common stock (vested or unvested) by a C corporation or the issuance of an LLC profits or capital interests will trigger little if any compensation income at the time of issuance. When the equity is sold years later, either stock or LLC interests will permit the service provider to benefit from favorable capital gains rates. If a business is already up and running when the equity compensation is issued, the LLC may have an edge because a grant of a profits interest can be structured to avoid immediate compensation income for the participant, while a stock grant will result in immediate tax consequences (assuming that a Section 83(b) election is made if the stock is restricted). Papering an LLC equity or option grant may be a little more complicated from a tax standpoint, but not meaningfully so for those experienced with LLCs. On the practical side, service providers may be more familiar with C corporation options and there are some disadvantages associated with an LLC's equity compensation. The holder of an LLC

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interest will be treated as a partner rather than an employee for tax purposes. Many employees prefer employee status for tax purposes rather than dealing with the LLC's estimated tax payments, and in some cases filing returns in multiple states.

Scott: *Based on your comments above, one thought I have is that if a significant benefit of an LLC is the pass-through of losses, why not operate through an LLC during the initial start-up phase and then convert to a C corporation after the losses have passed through to investors? Won't this eventual conversion allow the start-up to take advantage of the tax-free reorganization provisions or Section 1202's tax benefits down the road when the business is sold?*

Bill: A two-step choice of entity plan for a start-up does make sense in terms of taking advantages of the losses, but the caveats regarding the real value of losses to VCs outlined above should be considered. If the VCs include foreign or tax-exempt investors, we would need to use a blocker corporation to hold their LLC interests. Also, the two-step plan doesn't address the concerns voiced by those desiring the familiarity and uniformity of the C corporation in connection with the initial organization and investment documentation. Another issue is that the five-year holding period for IRC § 1202 QSBS is deferred until the LLC is converted into the corporation. QSBS treatment won't be available if the value of the LLC's assets exceeds $50 million in value at the time of conversion. If those problems aren't enough, there are complicated issues associated with converting profit interests into stock. Overall, the idea of the two-step plan is a good one, but we suspect that most VCs will either select the corporate form for the start-up at the outset for the reasons outlined in this article, or go with the LLC because they have decided that the potential benefits of pass-through tax treatment during the operating years and upon sale outweigh the C corporation's benefits.

Scott: *One commentator strongly suggested that the LLC should be considered the best entity choice because of the fiduciary duty and governance concerns associated with a Delaware corporation. What are your thoughts on this as a significant choice of entity consideration?*

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Bill: There are Delaware cases involving a breach of fiduciary duty claims against directors who were seen to favor the controlling owners who appointing them to the detriment of common shareholders. In one case, the court noted that the board of directors' duties were to the holders of common stock in a case where the controlling VCs caused the company to sell divisions to fund redemption payments to investors.[4] Cases like this one have riled the VC industry. Here the VCs even had a contractual right to put their preferred stock back to the company, but the Delaware court pointed out that the board of directors should have considered breaching that contract obligation if that was right from the standpoint of operating the business for the long-term to benefit the common shareholders.[5] The common shareholders would have received nothing if assets of the company were sold and the preferred stock redeemed as agreed-to in the preferred stock agreements. It has been suggested that if the VCs had operated through a Delaware LLC, they could have taken advantage of the LLC's greater freedom to contract away fiduciary duties. Most investors have seen clauses in LLC agreements that attempt to contract away all of the fiduciary duties of the VCs' directors. These provisions also usually explicitly provide that equity owners and board members are permitted to take into account any personal or other interests they desire to in making their management decisions, rather than focusing on the best interests of the common equity holders. It's true that these contractual fiduciary duty waivers have generally been upheld.[6]

So, the point of all of this is that VCs must decide whether choosing an LLC for its flexibility in dealing with governance issues is worth the other problems associated with the LLC entity. LLCs do afford VCs more flexibility to waive fiduciary duties and address by contract other governance and business opportunity issues. On the other hand, addressing these issues through customized LLC agreement provisions requires a good deal of drafting expertise and a thorough knowledge of the underlying legal concepts. If the choice between the LLC and the C corporation is hanging completely in the balance, I agree that these governance and fiduciary duty issues could tip the balance in the LLC's favor. But we don't think that drafting flexibility alone is a good reason to choose the LLC over the

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C corporation.

Scott: *Bill, what's your bottom line on the best entity choice for VC financed start-ups?*

Bill: For VC financed start-ups, there really isn't much of a contest between C corporations and LLCs. The VC investment world for the most part both expects and demands start-ups to operate through Delaware C corporations. VCs often strongly encourage founders to convert their LLCs to C corporations prior to closing a VC investment round. These are accepted realities for those who work on VC financed deals.

If you compare objectively the legal and tax pros and cons of the C corporation and LLC, I believe that for VC financed start-ups, the combination of the 21% corporate tax rate, Section 1202's generous tax benefits, and the pluses associated with the ability to draw upon familiar and standardized documents all point in favor of selecting C corporations. And if these positive benefits of the C corporation are not compelling enough, the fact that the tax benefits usually associated with LLCs are often not fully available or utilized in VC financed start-ups provides further support for selecting C corporations. Two points I mentioned above are worth repeating here. First, tax losses generated by a pass-through LLC are often unusable at the VC investor level. Second, the threat of the C corporation's double taxation is a weak one where the expected exit is a stock sale, tax-free reorganization or IPO. So, while we rarely recommend that our main-street business clients operate through a C corporation, we have no problem recommending C corporations for VC financed start-ups.

Finally, I don't want to discount the fact that we have seen a gradual increase in the use of LLCs for start-ups due to their perceived tax efficiency. For the most part, we see LLCs selected in situations where the founders are financially independent and have a successful track record operating through LLCs. Obviously, we'll work with either entity choice to achieve the VCs' and founders' objectives.

More resources

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In spite of the potential for significant tax savings, many experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 and related planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- View all QSBS Resources

Contact Scott Dolson if you want to discuss QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] Scott Dolson, *Revisiting the Choice of Entity Decision for the Closely Held Business*, Frost Brown Todd LLC: Publications (Jan. 4, 2019); also available through Lexology (October 9, 2018), https://fbtgibbons.com/resources-full-article-revisiting-the-entity-decision-for-closely-held-business.html; https://www.lexology.com/library/detail.aspx?g=56a7f1be-b79d-415c-9702-89f0088aceea.

[2] Texas, Pennsylvania, Ohio, Kentucky, Indiana, Tennessee, Virginia and West Virginia.

[3] Listed in what appears to be the order of importance placed on the factors by the VCs.

[4] *The Frederick Hsu Living Trust v. ODN Holding Corp.*, C.A. No. 12108-VCL, 2017 WL 1437308, at *22 (Del. Ch. Apr. 25, 2017). See also, *In Re Trados Inc. Shareholder Litigation* (Trados I), C.A. No. 1512-CC, 2009 WL 2225928, at *7 (Del. Ch. July 24, 2009); *In re Trados Inc. Shareholder Litigation* (Trados 2), 73 A.3d 17, 30–40 (Del. Ch.

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2013).

[5] *Frederick Hsu*, 2017 WL 1437308, at *24 (Del. Ch. Apr. 25, 2017).

[6] See *Feeley v. Nhaogg, LLC, et. al*, 62 A.3d 649, 659–665 (Del. Ch. 2012).

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