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Launching a Start-Up? Consider Forming a Corporation Instead of an LLC

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Different forms of legal entities come with different advantages and disadvantages. The authors provide a summary of considerations high-growth start-up company founders should keep in mind when evaluating the most common company structures—the corporation and the limited liability company—and explain why the former is preferable for these types of ventures.

All founders grapple with the question of which legal entity to form for their start-ups. Among the different available types of entities, the corporation and the limited liability company (LLC) are the most popular. While each form of entity has its advantages and disadvantages, this article summarizes why high-growth start-ups should favor corporations over LLCs.

Institutional Investors Prefer Corporations Formed in Delaware

High-growth start-ups need substantial amounts of capital and advice from experienced partners to grow their businesses efficiently and effectively, and institutional investors and venture capital funds can provide both. Generally, institutional investors and venture capital funds prefer to invest in Delaware corporations. This is largely because Delaware offers the most consistent, reliable, and predictable set of corporate laws, based on a robust body of case law that provides broad protection for board members, officers, and controlling stockholders. This predictability allows directors, officers, and advisers of corporations to more easily make difficult decisions that frequently involve fiduciary duty analyses and numerous conflicts of interests. Being

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able to do so gives investors significant comfort, which results in a lower barrier to entry from an investment perspective.

LLCs, by contrast, do not enjoy the same predictability. This is largely because the case law is not nearly as well-developed and the Delaware Limited Liability Company Act[1] does not provide the same foundation of rules but, instead, defers to the LLC's operating agreement to govern the duties and obligations of a company's members and managers. Each LLC's operating agreement is unique and may contain vastly different rights and obligations of managers and members. As a result, investors feel as if they are reinventing the wheel with each new investment.

Other Benefits to Corporations Realized by Institutional Investors

Investors in corporations may also take advantage of the tax benefits provided to holders of Qualified Small Business Stock (QSBS) (as defined under Section 1202 of the Internal Revenue Code). In short, up to 100 percent of the gains from the sale of QSBS may be excluded from gross income for federal income tax purposes. While there are process-based requirements to receive this tax benefit, including a holding period for the original QSBS, it is clear that only shares in a corporation can be QSBS and membership interests or other securities offered by LLCs cannot.

Furthermore, venture capital and other investment funds that manage investments on behalf of pension funds, profit sharing trusts, and other tax-exempt entities cannot invest in LLCs due to certain tax restrictions. Even if able to invest, these fund investors will not be inclined either to collect Form K-1s from their many portfolio companies or to serve as conduits for the delivery of these Form K-1s to their investors.

Corporations Are Less Costly to Manage

Corporate Organization Documents vs. LLC Operating Agreements. As noted in the previous section, the corporate law in Delaware provides a strong foundation on which to build predictable management and compliance guidelines for directors and officers. The laws and regulations governing LLCs, by contrast, defer to these companies' operating agreements to set forth fiduciary duties and other obligations imposed on their members, managers, and officers. Thus, each LLC will have different compliance requirements in terms of its members' and/or managers' fiduciary duties; as a result, founders, investors, and their advisors need to analyze and

[1] See Delaware Limited Liability Company Act, Del. Code. Ann. tit. 6, §§ 18-101–18-109.

make compliance decisions on a case-by-case basis and cannot simply rely on an established body of common laws and well-tested statutes as they can with corporations. Although this type of flexibility may be desirable (or even required) in certain situations, it ultimately leads to increased administrative costs and legal expenses for the business.

Tax Implications. LLCs have the choice of being taxed as corporations or as partnerships.[2] If an LLC is taxed as a partnership, each member of the LLC includes his or her respective allocation of the LLC's profits and losses in such member's respective individual tax returns. Although this avoids the "double taxation" that can sometimes be applicable to a corporation's profits,[3] taxation as a partnership introduces added complexities that ultimately result in administrative costs that may outweigh the benefits—especially for start-ups (e.g., the tedious, time-consuming, and costly exercise of annually preparing and delivering to numerous investors Form K-1s, as noted above).

On December 22, 2017, President Trump signed into law the Tax Cuts Act.[4] Among its provisions are reductions to the corporate income tax rate, and comparatively fewer reductions in individual income tax rates. In addition, the Tax Cuts Act adds complexities by allowing tax deductions to be made from a portion of the profits derived from qualified trades or businesses conducted through LLCs.[5] As a result of the tax rate differential narrowing, and added burdens resulting from the new deduction-related requirements, any perceived benefit to using a pass-through entity is further eroded, which makes the corporation even more attractive for start-ups.

Generally, and primarily because of the LLC's pass-through characteristics, its annual tax return filing process is more complex than that of a corporation. If the LLC is taxed as a partnership, it can be required to take into account special allocations of tax to its members given the Treasury Regulations' partnership-specific tax rules.[6] In addition, if the LLC is taxed as a partnership, taxes must be calculated on a member-by-member basis at each

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[2] See Treas. Reg. § 301.7701-3 (the "check the box" regulation).

[3] The "double taxation" (i.e., where profit is taxed once at the corporate level and a second time when a stockholder receives dividends) is only "sometimes" applicable because no shareholder-level tax is imposed if no distribution of profit (i.e., dividend) is made. Moreover, privately held corporations (and, in particular, those that are closely held) can often avoid double taxation by distributing their profits in a form that is deductible to the corporation (e.g., as compensation for services).

[4] P.L. 115-97, 131 Stat. 2084.

[5] See Act § 11011(a) (adding IRC § 199A).

[6] See Treas. Reg. § 1.704-1(b)(2).

instance throughout a given year when there has been a change in those members' ownership percentages.[7] This, of course, only adds to administrative burdens and, consequently, cost.

Corporations Can Offer More Favorable—and More Easily Understood—Equity Incentives to Employees

Another key difference between corporations and LLCs is that corporations can grant incentive stock options (ISOs) to their employees whereas LLCs cannot. Employees who receive ISOs do not recognize income upon either the grant or exercise of these options, as payment of tax is deferred until the underlying shares are actually sold. In addition, gains resulting from the sale of stock acquired through the exercise of an ISO can be taxed as long-term capital gains if the shares are held for the longer of (a) the two-year period that follows the date the ISO is granted and (b) the one-year period that follows the option's exercise.[8]

Instead of ISOs, LLCs can, but hardly ever do, offer Non-Qualified Stock Options (NQSOs). However, upon the exercise of NQSOs, the difference between the exercise price and the underlying shares' fair market value is taxed as ordinary income. This can result in an increase to the recipient's tax obligations at a time when there are no liquid proceeds with which to pay the additional tax. Moreover, option awards made by LLCs can be difficult to administer. For example, shifts must be made in the members' capital accounts to avoid giving the recipient a capital interest in the LLC.

Instead of NQSOs, LLCs typically grant profits interests as equity incentive-based compensation. However, these awards can give recipients voting rights, which typically is unintended and is not the case with stock options. Additionally, the recipients of profits interests are required to make quarterly income tax payments as partners (for tax purposes) as opposed to having their tax withheld from wages and paid over on their behalf as is typically the case with W-2 employees. Profits interests are difficult for founders and employees alike to understand and are generally difficult to administer.

Conclusion

This article provides a very high-level summary of the relative advantages of forming a start-up as a corporation rather than an LLC—especially for

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[7] See IRC § 706(d); Treas. Reg. § 1.706-4.

[8] See IRC § 422(a).

start-ups in the tech, life sciences, energy, or other high-growth sector seeking institutional financing. However, not all of the advantages of the corporate form outlined above may apply to every new business and all parties concerned should consult with their own accountants, financial advisors, and legal advisers in considering any of the matters contemplated above.

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