START-UPS: WHY INVESTORS PREFER THE CORPORATE FORM TO THE L.L.C. FOR TAX PURPOSES

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I. INTRODUCTION

"America is the greatest engine of innovation that has ever existed[.]"[1] Thomas L. Friedman is a Pulitzer Prize-winning American journalist[2] who believes the reason why America is the "greatest engine of innovation" in history is due, in part, to "a risk-taking culture with no stigma attached to trying and failing . . . and financial markets and a venture capital system that are unrivaled at taking new ideas and turning

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[1] Thomas L. Friedman, GOOD READS, INC., http://www.goodreads.com/quotes/700-america-is-the-greatest-engine-of-innovation-that-has-ever (last visited Feb. 21, 2017).

[2] Thomas L. Friedman, *The Opinion Pages*, N.Y. TIMES, http://www.nytimes.com/column/thomas-l-friedman (last visited Nov. 11, 2015).

them into global products."[3] Perhaps the organization in which this risk-taking culture is most prevalent is the startup company. So, what exactly is a startup? "A startup is a company working to solve a problem where the solution is not obvious and success is not guaranteed."[4] However, before the company can begin working to solve any problems, someone must first organize the company. The critical question for any innovator, risk-taker, or entrepreneur, is how to organize such a company.

Traditionally, the primary purpose for starting a company or business has been to profit from the business.[5] Often times, though, someone wishing to form a startup does not have capital to adequately fund the company to enable it to reach its full potential.[6] Consequently, startups typically need investors. How a person organizes his or her business plays a critical role in attracting investors because certain types of business entities are taxed differently than others, thus affecting how much money the business or owners of the business ultimately earn.[7]

This paper attempts to answer the question of why investors, particularly angel investors and venture capitalists, prefer to invest in businesses organized under Subchapter C of the Internal Revenue Code ("C Corp"), instead of businesses organized as a limited liability company ("LLC"). Specifically, this paper will examine: the significant differences between tax characteristics of LLCs and C Corps and why investors prefer C Corps.

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[3] *See* Friedman, *supra* note 1.

[4] Natalie Robehmed, *What Is A Startup?*, FORBES (Dec. 16, 2013, 8:42 AM), http://www.forbes.com/sites/natalierobehmed/2013/12/16/what-is-a-startup/. "Those who sip the startup Kool-Aid define it as a culture and mentality of innovating on existing ideas to solve critical pain points." *Id.*

[5] *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (stating that a business corporation is organized and carried on primarily for the profit of the stockholders).

[6] *See generally Getting Started With Angel Investing*, ENTREPRENEUR, https://www.entrepreneur.com/article/52742 (last visited Feb. 22, 2017) (stating that startups occasionally need capital to develop to the next level).

[7] *See generally* Scott Edward Walker, *Choice of Entity For Entrepreneurs*, WALKER CORP. LAW GRP. (Apr. 4, 2010), http://walkercorporatelaw.com/startup-issues/choice-of-entity-for-entrepreneurs/ (discussing the advantages and disadvantages of startup entities).

II. DIFFERENCES IN TAX CHARACTERISTICS BETWEEN LLCS AND C CORPS

Both the LLC and C Corp, as formed, shield owners from personal liability.[8] However, this is not the only advantage to organizing a business. There are other advantages—and consequences—discoverable in the Internal Revenue Code ("I.R.C."), which significantly influences how an entrepreneur organizes his or her business.[9] These differing tax characteristics of LLCs and C Corps are also a concern of prospective angel investors and venture capitalists, which could ultimately dictate whether or not the business survives.

A. Tax Characteristics of the LLC

As noted above, the LLC is a limited liability company.[10] Here, partners or members are also usually the investors.[11] The attractiveness of the LLC business form is largely due to its flexibility and tax treatment.[12] "Because they are taxed as partnerships or disregarded entities, LLCs are able to offer their owners limited liability without the disadvantages associated with the taxation of Corporations."[13] An LLC's treatment as a partnership depends upon three things, the first being that it must have two or more members.[14] If the LLC lacks the minimum number of members to qualify for partnership treatment, it is considered a disregarded entity—since there is only one member/owner—and is taxed differently than a partnership, but it still retains the liability shield.[15] There are other requirements for the LLC to qualify as a partnership for tax purposes. The second requires the LLC to be

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[8] ARI TEAM, *C Corporation Versus LLC: Which Entity Should Angels Invest In?*, ANGEL RES. INST. (Mar. 18, 2010), http://www.angelresourceinstitute.org/resource-center/c-Corporation-versus-llc-which-entity-should-angels-invest-in.aspx.

[9] *See infra* Part A (Tax Characteristics of the LLC).

[10] ARI TEAM, *supra* note 8.

[11] Jean Murray, *What is a Member of a Limited Liability Company?: Who Can Be Members, Member Tax and Liability and Management*, THE BALANCE, https://www.the balance.com/what-is-a-member-of-a-limited-liability-company-398345 (last updated Jan. 23, 2017).

[12] ARI TEAM, *supra* note 8.

[13] Steven C. Alberty, *What You Should Know About the Taxation of Limited Liability Companies*, 18 PRAC. TAX LAW. 45, 45 (2004).

[14] *Id.* at 46.

[15] *Id.*

organized under the law of a state or other jurisdiction within the United States,[16] which is usually not a problem. The third requirement demands that the "interests of [the LLC's] members [cannot be] publicly traded," and is one of several significant differences between the LLC and C Corp.[17] This will be discussed later. However, it is the tax consequences of the choice of business entity that may be the most important factor to consider.[18]

For tax purposes, LLCs are treated as "pass through" entities, meaning profits and losses are only taxed once at the interest member level.[19] This is called "single-layer" taxation. Additionally, this means the LLC is also not a separately taxed entity, as is the case with a C Corp. The LLC form thus carries with it certain tax advantages for startup companies as they relate to investors. Peter Rosenblum, a senior partner at Foley Hoag, LLP in Boston, Massachusetts, notes "[b]ecause of the ability to flow through losses, the use of an LLC may effectively lower the investors' net investment and raise their internal rate of return."[20]

Investors in a startup may also be able to deduct startup losses currently with certain restrictions, such as a passive investor's limitation to offset passive income with passive losses.[21] Furthermore, LLCs are regularly utilized because "they require few corporate formalities and do not require salaries for the owners."[22] For example, LLCs utilize Articles of Organization, subject to the I.R.C., to determine specific interests of the members, such as profit or loss interests and tax burdens.[23] Accordingly, "[o]wners are taxed on their allocable share of the profits and losses, with self-employment taxes being calculated on the member's individual tax return,"[24] pursuant to the LLC's Articles of Organization.

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[16] *Id.*

[17] *Id.* (citing Treas. Reg. § 301.7701-3(a)–(b)).

[18] Daniel C. Schwartz, *Tax Consequences of Business Entity Choice*, L.A. LAW. MAG., Oct. 2014, at 8, 8.

[19] *Id.*

[20] ARI TEAM, *supra* note 8.

[21] *Id.* Passive investing is a strategy involving limited ongoing buying and selling actions. It relies upon the investor's belief that the investment will be profitable in the long term. *See Passive Investing*, INVESTOPEDIA, http://www.investopedia.com/terms/p/passive investing.asp?header_alt=true (last visited Feb. 22, 2017).

[22] Schwartz, *supra* note 18.

[23] *Id.*

[24] *Id.*

This is the main advantage of choosing a pass-through entity, as it provides significant flexibility in not only determining distributions to the members, but also the time at which they may receive such distributions.[25] It is important to note here that an LLC may elect to be taxed as a Corporation. However, because tax treatment as a partnership or disregarded entity is often superior to corporate tax classification, this election is not frequently made.[26]

In any event, it is the combination of the single-layer tax and flexibility in structuring ownership of the LLC along with strong limited liability for investors that makes the LLC form attractive.[27]

B. Tax Characteristics of the C Corp

There are numerous differences between the LLC and C Corp. The principal way in which they differ is tax treatment under the I.R.C.[28] Unlike LLCs, C Corps are not pass-through entities. Instead, C Corps are taxed once at the corporate level and then again at the shareholder level.[29] "Due to the double taxation regime, any profits not paid out as bonuses or salary by the end of the year are taxed at the corporate level."[30] It does not stop there. Profits are also taxed at the individual level but at more preferential rates[31] in the form of dividends, distributions, or salary.[32] Double taxation of profits—seemingly a deterrent to incorporating as a C Corp—is not the only tax characteristic of the C Corp. Losses are important as well. Under the LLC form, losses (as well as profits) pass through to the individual members of the LLC.[33] However, a C Corp's losses stay trapped at the entity level and can only be carried forward to the next tax year as a net operating loss

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[25] *Id.*

[26] Alberty, *supra* note 13, at 46.

[27] Marianne Hudson, *The Smart Tax Question–Invest in LLC or C Corp Startups?*, FORBES (July 21, 2016, 11:23 AM), http://www.forbes.com/sites/mariannehudson/2016/07/21/the-smart-tax-question-invest-in-llc-or-c-corp-startups/#43f6b5a33b8a.

[28] Davis W. Tremaine, *Choice of Entity*, STARTUP L. BLOG, http://www.startuplawblog.com/choice-of-entity (last visited Feb. 23, 2017).

[29] *Id.*

[30] Schwartz, *supra* note 18.

[31] *Id.*

[32] Joe Wallin, *12 Reasons for a Startup Not to Be an LLC*, STARTUP L. BLOG (Sept. 30, 2011), http://www.startuplawblog.com/2011/09/30/12-reasons-for-a-startup-not-to-be-an-llc/.

[33] *Id.*

("NOL"), which is less valuable to some investors.[34] It is important to remember, though, that NOLs may be used to offset capital gains the company experiences. However, while it seems all signs point to the LLC as the most pragmatic form for an entrepreneur's start-up, entrepreneurs seeking venture capital investments experience significant obstacles in obtaining such investments if the company is first organized as an LLC.[35] The following sections examine the various tax consequences influencing a venture capitalist's ("VC") preference in investing in companies organized as a C Corp.

III. CHOOSING THE C CORP FOR YOUR STARTUP

For any entrepreneur, determining which entity form to use largely depends on whether or not he or she has a plan for the direction of the business. Some things to consider are whether the entrepreneur wishes to keep the business in the family, or whether it is simply a venture to be sold later for profit to a larger company. With small businesses in which the entrepreneur seeks to raise little (if any) outside capital, it may be more advantageous to organize as an LLC.[36] However, some startups—specifically tech companies—often hope to sell to a big, perhaps public, company.[37] These companies, usually seeking outside capital from a group of investors, are usually organized with the hope of one day going public.[38]

While there are different types of entities an entrepreneur may use for his or her startup, "if your startup is absolutely determined to raise venture capital, there's only one viable legal entity decision your startup can make—the [C] Corporation."[39] This begs the question: "why?" C Corps and LLCs shield members and shareholders from liability, and LLCs aren't themselves subject to the federal corporate tax rate.

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[34] Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 138 (2003–2004).

[35] Wallin, *supra* note 32.

[36] Jim Smith, *Should a Tech Startup Incorporate as an LLC, a C-Corp, or an S-Corp? If So, Why?*, QUORA (Apr. 4, 2011), https://www.quora.com/Should-a-tech-startup-incorporate-as-an-LLC-a-C-Corp-or-an-S-Corp-If-so-why.

[37] *See* Wallin, *supra* note 32.

[38] *See* Smith, *supra* note 36.

[39] *Why Startups Are a Corporation for Venture Capital,* STARTUP LAW., (July 17, 2008), http://startuplawyer.com/venture-capital/why-startups-are-corporation-for-venture-capital [hereinafter "*Why Startups Are a Corporation*"].

So, why do the vast majority of new businesses intending to seek venture-funding form as C Corporations? The answer lies in money. Entrepreneurs may not have enough money on their own to fully fund a company. Therefore, they may seek funding from angel investors or VCs. The four classes of venture capital investors include: U.S. individuals, U.S. corporations, tax-exempt investors, and foreign investors.[40] Angel investors and VCs typically prefer to invest their money in companies organized as a C Corp, but the reasons for doing so vary depending on the class of investor.[41] "Various 'frictions'—nontax business costs such as transaction costs, information problems, reputational concerns, and adverse accounting treatment—currently prevent deal planners from using the theoretically tax-favorable [LLC] form."[42] Still, significant tax benefits exist in organizing as a C Corp instead of an LLC. It seems there are three significant reasons for preferring the C Corp to the LLC. First, the ability to reinvest back into the company money earned without being taxed on that money. Second, losses are valuable in an LLC, but not as valuable to VCs looking to invest in a startup. Finally, the corporate form provides VCs with favorable tax treatment regarding exit strategies to see a return on their investment.

A. Reinvestment of Money Earned

A big concern for entrepreneurs with a newly formed business is how to grow the business. Under the LLC-partnership form, this can present problems for some members because, as mentioned above, members are typically allocated their share of the tax burden before receiving any distribution from the LLC.[43] Thus, should a "capital call" arise under the operating agreement without any distributions from the LLC, paying taxes on profits before receiving them reduces the amount of overall capital that may be reinvested later.[44] This creates a problem for reinvestment of profits due to the consequential tax burden that exists when the profits are earned.

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[40] Fleischer, *supra* note 34, at 151.

[41] *Id.* at 152–53.

[42] *Id.* at 139.

[43] *Id.* at 137.

[44] *See* Pat Hill, *S-Corporation or C-Corporation: Which Should You Use?*, ALLLAW (2015), http://www.alllaw.com/articles/business_and_corporate/article3.asp (discussing the payment of taxes by different corporate structures).

Unlike an LLC, shareholders of a C Corp do not pay taxes when profits are earned.[45] Indeed, "the dividend tax paid by owners of the corporation is only levied at the point that dividends are actually *paid out* to the shareholders."[46] Therefore, the shareholder-owners may choose to forego making dividend distributions and instead reinvest profits not used for salary and other business expenses back into the company. Consider the following example highlighting the difference between LLCs and C Corps for reinvestment purposes:

> [I]f you own 50% of an [LLC] and that company makes $50,000 in profit, you need to report $25,000 in income on your personal tax return. It doesn't matter whether that $25,000 actually ended up in your pocket or you decided to keep it in the business in order to boost your marketing efforts next year. This is known as "phantom income" and can obviously cause a problem for some [members].[47]

Conversely in the C Corp, that $25,000 tax obligation would not exist unless the corporation made a $25,000 dividend payment to the shareholder. Should the board of directors of a C Corp decide not to issue dividend payments—and instead reinvest the earnings and profits back into the company—they can do so and still avoid the double-taxation that would have arisen otherwise.[48] This is important for many VCs because, more likely than not, a startup will experience losses in its first few years of existence rather than profits.[49] Venture capitalists looking to capitalize on their investment prefer to be able to grow the company through reinvestment to increase its value, and thus increase the return on their initial investment. The role of losses, valuable to members of an LLC but not shareholders of a C Corp, is discussed below.

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[45] *Id.*

[46] *C Corporation vs. S Corporation: A Short Primer*, EVERGREEN SMALL BUS., http://evergreensmallbusiness.com/small-business-faq/c-corporation-versus-s-corporations-a-short-primer/ (last visited Feb. 23, 2017) (emphasis added).

[47] Nellie Akalp, *Why the S Corporation Might Not Be the Right Legal Business Structure for Your Startup*, ENTREPRENEUR (Feb. 28, 2012), http://thenextweb.com/entrepreneur/2012/02/28/why-the-s-corp-might-not-be-right-for-your-startup/.

[48] Chad Brooks, *What Is a C Corporation?*, BUS. NEWS DAILY (Jan. 16, 2013, 12:29 PM), http://www.businessnewsdaily.com/3771-c-corporation.html.

[49] Fleischer, *supra* note 34, at 145–46.

B. The Perceived Value of Losses

Some scholars claim many entrepreneurs, thinking about only the potential gains of the business, discount the value of tax losses generated by a startup.[50] These starry-eyed entrepreneurs are likened to "blackjack players on their way to Las Vegas[] [who] refuse to even think about losses, and they are hardly willing to plan the adventure with losses in mind."[51] For startups, though, the treatment of losses is the key to the puzzle in determining how best to organize the company.[52] Under the LLC form, deductible losses pass through to the individual members the same way as their income tax liabilities.[53] Utilizing the C Corp, however, provides the business with the ability to offset any losses against past or future income at the corporate level, the NOL.[54] A C Corp may accumulate NOLs to offset profits in the future, or have value to an acquiring corporation.[55] Conversely, in an LLC, an investor's ability to deduct losses personally depends on his or her basis—the value of a person's overall financial investment.[56] Accordingly, an investor may deduct losses to the extent they do not exceed his or her basis, provided the operating agreement does not dictate otherwise, and so long as the losses do not exceed the limits imposed by the rules pertaining to passive losses.

This may be problematic for prospective VC investors. Although losses may seem valuable to the entrepreneur at first, they may not be valuable depending upon the goals for the direction of the company. An entrepreneur must consider *what* his or her endgame is in starting the company and *who* may seek to invest in the company. If the entrepreneur has the goal of selling his or her company or taking it public—an initial public offering ("IPO")—then the "who may seek to invest" question becomes significant. For a company whose goal is an eventual IPO, organizing as a corporation is the only choice because the

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[50] *Id.* at 137.

[51] *Id.* at 138–39.

[52] *Id.* at 143.

[53] Michael F. Schaff & Robert J. Chalfin, *Basic Factors to Consider When Advising Clients in Choosing an LLC or a Corporation*, 239 N.J. LAW. MAG. 55 (Apr. 2006).

[54] *Id.*

[55] Carter Mackley, *What Type of Entity Should I Choose, LLC, C Corporation, or S Corporation?*, STARTUP L. TALK (Sept. 8, 2012), http://www.startuplawtalk.com/what-type-of-entity-should-i-choose-llc-c-corporation-or-s-corporation/.

[56] Schaff & Chalfin, *supra* note 53, at 55.

fact remains that corporations go public and LLCs do not.[57] On paper, there is no debate that LLC partnerships are more tax-efficient than corporations.[58] Indeed, the main advantage of the LLC is the pass-through of losses.[59] However, for VCs looking to invest, the tax advantage of pass-through losses may not be a consideration, and therefore, the choice of the LLC over the C Corp would be ill advised.

Losses are not as valuable to VCs because many VC investors view the pass-through structure of the LLC as a disadvantage due either to the creation of new tax liabilities or elimination of tax benefits otherwise available under the C Corp form.[60] This actually makes losses less attractive. Consider the following:

> In a typical partnership agreement with [venture capitalist] investors, the venture capital professionals contribute just 1% of the capital to the fund but receive a carried interest of 20%--they receive 20% of the profits of the entire fund despite only putting up a small amount of money. The carry gives the venture capitalists a large share of the upside potential but almost none of the downside. The tax losses generated by the pass-through structure therefore have almost no value to them.[61]

This virtually neutralizes the value of losses as a bargaining chip for members of an LLC seeking capital investments, therefore making the LLC unattractive to those managing venture funds.

Additionally, agency costs may also play a role.[62] Most venture capital firms are organized as LLCs or limited partnerships.[63] The managers or general partners act as the primary investors for the firm, and the members or limited partners are those investing in the venture fund.[64] Because many VC firms are organized as LLCs or limited partnerships, the managers or general partners managing the firm's funds

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[57] William C. Staley, *The Choice of Entity Decision for an IPO Candidate: Incorporation Provides the Smoothest Path to Public Stock Offering*, 23 L.A. L. MAG. 16, 16 (2000).

[58] Fleischer, *supra* note 34, at 139.

[59] *Id.* at 137.

[60] *Id.* at 137–40.

[61] *Id.* at 151–52.

[62] "Agency cost," is the "tendency for agents investing other people's money [(individual VCs investing the VC firm's money)] to do so in a way that enhances their own personal benefit." *Id.* at 152.

[63] Pradeep Tumati, *Venture Capitalists*, GO4FUNDING.COM, http://www.go4funding.com/articles/venture-capital/venture-capitalists.aspx (last visited Feb. 21, 2017).

[64] *Id.*

receive income on all deals and their individual percentage share of tax liabilities incurred by the venture capital firm.[65] However, they typically do not receive the benefit of any tax losses incurred by the startup in which they invested. These losses are often allocated to the members or limited partners—the ones funding the venture capital firm. "The advantages of the pass-through structure inure almost entirely to the benefit of the [members or limited partners of the VC firm]; the venture capitalists, acting as agents for the [members or limited partners], ignore this benefit in favor of their own interests."[66] Thus, the managers or general partners generally cannot offset income earned with losses incurred by the VC firm as a consequence of the manager or general partner's initial investment because they do not have any interest in those losses under the VC firm's firmoperating or partnership agreement.

As previously mentioned, VC firms are not the only class of venture capitalists. Though the heavy majority of the venture capital investor pool is comprised of VC firms, there are also tax-exempt VCs and individual VCs looking to invest in startups.[67] These investors may not value losses as readily as one would expect. Tax-exempt investors comprise the largest investor class in the venture capital industry.[68] These investors, such as pension funds and university endowments, do not have to pay tax on investment income, but are subject to a tax on any unrelated business taxable income ("UBTI").[69] This creates problems when investing in a startup organized as an LLC or partnership. Due to the pass-through structure of the LLC, any income generated by the business passes through to the tax-exempt VC investor, who invests as a member or limited partner.[70] "The venture capital firm does not want the accounting and tax matters of a funded venture to be passed down to the firm, and thereby be attributed to the venture capital firm's tax exempt and foreign limited partners."[71] As a member or limited partner, the VC investor is also deemed to be an owner of the business, and this generates unwanted, unrelated income that could jeopardize the VC's tax-exempt status.

[65] *Id.*

[66] Fleischer, *supra* note 34, at 152.

[67] *Id.* at 158.

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Why Startups Are a Corporation*, *supra* note 39.

Thus,

> [t]ax-exempt entities prefer to receive returns on their investments in the form of returns not taxable to them (for example, most investment interest, dividends, and capital gains), and they scrupulously avoid deal structures that pass through a *pro rata* portion of the ordinary income from a business, which is subject to [UBTI].[72]

This also means the tax-exempt member or limited partner owns a *pro rata* share of the business directly, making any income generated by the business unrelated income.[73] For many tax-exempt VCs, this is a great concern because "having even a small amount of unrelated income is thought to greatly increase the risk of audit."[74] This may also increase the risk of an entire organization losing its tax-exempt status. The tax-exempt VC investor typically does not want to risk losing such status. Therefore, because a tax-exempt VC investor typically avoids any UBTI, tax losses are worthless because said investor has no tax liability to offset with such losses.[75]

Finally, the less common individual VC investor faces significant limitations in his or her ability to take advantage of losses when investing in an LLC. An individual who invests in a startup organized as an LLC becomes a member.[76] Due to legislation from the 1986 Congress, passive loss rules now limit the possibility of abusive tax shelters.[77] However, "[a]n unintended consequence of this legislation was to make passive investing in partnerships a tax-disfavored activity, even for 'real' deals not generally considered abusive."[78] Congress enacted § 469 of the I.R.C., which in part provides:

> (a) Disallowance
>
> (1) In general
>
> If for any taxable year the taxpayer is described in paragraph (2), neither—
>
> (A) the passive activity loss, nor
>
> (B) the passive activity credit,
>
> for the taxable year shall be allowed.

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[72] Fleischer, *supra* note 34, at 158 (emphasis added).

[73] *Id.*

[74] *Id.*

[75] *Id.* at 159.

[76] *Id.* at 173.

[77] *Id.* at 154.

[78] *Id.*

> (2) Persons described
> The following are described in this paragraph:
> (A) any individual, estate, or trust,
> (B) any closely held C corporation, and
> (C) any personal service corporation.[79]

Passive activities are those involving the conduct of trade or business in which the taxpayer does not materially participate.[80] This section of the I.R.C. disallows current deductions to offset passive losses, except to the extent the individual VC investor also has passive income. Consequently, when an individual VC investor becomes a member in the LLC in which he or she invested, any passive losses are instead "suspended or carried forward and only may be used to offset passive income, or to offset other income when the [member] sells the interest in the passive activity."[81] This mandatory deferral of passive losses diminishes the value of the tax loss for individual investors because the very purpose of the pass-through structure is to be able to individually take advantage of losses incurred by the LLC. "For individual investors, the passive loss rules suffocate the very purpose of the pass-through structure by eliminating much of the benefit of the flow through of tax losses."[82]

Therefore, because of low downside potential, agency costs, and the effect of losses for tax-exempt and individual VC investors, the C Corp structure is the more attractive business form for VC investors.

C. C Corporations Provide Preferable Exit Strategies

The C Corp is the more attractive business form because of the exit strategies afforded to VC investors. "The 'exit strategy' element—that is, the VC fund's ability to take the company public or flip it in another private sale—provides the distinguishing characteristic between VC funds and other types of investors."[83] Venture capitalists value exit strategies because their sole purpose for investing in a business in the first place is to profit from either significant growth of the business or

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[79] I.R.C. § 469(a)(1)–(2) (2012).

[80] § 469(c).

[81] Fleischer, *supra* note 34, at 155.

[82] *Id.*

[83] Christopher W. Cole, *Financing an Entrepreneurial Venture: Navigating the Maze of Corporate, Securities, and Tax Law*, 78 UMKC L. REV. 473, 492 (2009).

from its eventual sale.[84] Typically, VC funds prefer to invest in high-growth companies, thus alienating most small business ventures from receiving VC funding. "Indeed, while VC funds may initially invest in small companies, the VC fund is actually betting that the company has the ability to grow into one it could take public or sell down the road."[85] However, such high-growth is difficult to achieve in many industries, and, consequently, "VC funds tend to focus their investing efforts on high-technology industries where new products can penetrate or create large markets."[86]

Venture capital investors typically prefer the C Corp to an LLC because these exit strategies are easier to exploit if the company has been structured as a C Corp from the beginning.[87] It is important to remember, however, that an LLC may be converted into a C Corp, but this later incorporation may cause unwanted delays, as it requires management of the business to face further complications at the most important time for a startup—when it is valuable enough to be sold to a third party or shopped to investment bankers for a potential IPO.[88] Two particular sections of the I.R.C. should be considered in this scenario: sections 351 and 368.[89] Under section 351 of the I.R.C., "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."[90] "Control" under section 368(c) means "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."[91]

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[84] *Venture Capital 101*, MY CAP., http://www.mycapital.com/companies/venturecapital101_8.php (last visited Feb. 28, 2017).

[85] Cole, *supra* note 83, at 492.

[86] *Id.*

[87] *See* Fleischer, *supra* note 34, at 175 (discussing how it is "easier for investors to sell their stake in a venture capital start-up if it has been structured as a corporation from the beginning.").

[88] *Id.* at 176.

[89] I.R.C. §§ 351, 368 (2012).

[90] § 351(a).

[91] § 368(c).

Sale to a third party is the first exit strategy important to venture capital investors. One reason for VC investors to prefer the C Corp when it comes to selling the company is the option for different classes of stock. With an LLC, no stock is issued (there can be different levels of membership, including "preferred", and corporations don't necessarily have to issue stock certificates either).[92] Instead, investors become LLC members through direct ownership of the business. With a C Corp, however, stock is issued to investors, but they have no direct control and no liability for debts incurred by the C Corp. Venture capitalist firms will typically demand preferred stock in return for their investment,[93] which would allow VC investors to see a return on their investment before holders of common stock.

Venture capital investors demand preferred stock due to their higher dividend payments and priority treatment for preferred stockholders in the event of liquidation of the company.[94] Because of this preferred status, VC investors feel safer investing in a company organized as a C Corp, should the company eventually sell. Upon sale (or liquidation), the VC pays tax only on the difference between the amount realized and his or her adjusted basis in the stock (a capital gain), whereas with an LLC, the liquidating distribution is made in accordance with the positive balance of the member's capital account.[95] Additionally, for tax purposes, the member's distributive share upon liquidation is usually determined via operating agreement, which may create unfavorable tax burdens instead of the distributive share being determined by how much the VC has invested, as with the C Corp.[96]

Furthermore, sale to a third party buyer may be done tax-free for a C Corp, and is much more difficult to achieve for an LLC. "For a C corporation, merger with or acquisition by a third party is relatively painless and affords potential acquirers a fair degree of flexibility."[97] In

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[92] *See* CARTER G. BISHOP & DANIEL S. KLEINBERGER, Limited Liability Co.: Tax & Business Law ¶ 5.04 (Thomson Reuters 2017).

[93] *Why Startups Are a Corporation*, *supra* note 39.

[94] Melody Peng, *Why VCs Only Invest in C Corporations*, LIGHTER CAP. (June 16, 2015), https://www.lightercapital.com/blog/why-vcs-only-invest-in-c-corporations/.

[95] *See* Jeramie J. Fortenberry, *Tax Consequences from Distributions from LLCs and Partnerships*, FORTENBERRY L., http://www.fortenberrylaw.com/distributions-partnerships-llc/ (last visited Feb. 21, 2017) (discussing the tax consequences of sale of liquidation).

[96] *See* Fleischer, *supra* note 34, at 173–74.

[97] *Id.* at 182.

the case of a C Corp, a buyer can usually acquire the stock of the target C Corp in a tax-free exchange for stock of the buyer corporation or for a combination of stock and cash.[98] LLCs differ in this regard because of the limitations on incorporation prior to acquisition. "Unlike the IPO context, where case law and IRS rulings are generous to the taxpayer, in the reorganization context common law tax doctrines preclude a tax-free incorporation immediately before the merger."[99] Though it may be possible for certain buyers to acquire an LLC in a tax-free transaction, such transactions—in the § 351 context—often require the acquirer's shareholders to contribute all of their stock in the acquiring corporation to the company being acquired in exchange for common stock in that company.[100] "Although tax-free, the structure has a notable weakness: Larger trade buyers whose stock is publicly traded are not likely to want to undergo a major change in capital structure in order to acquire a small start-up."[101] Therefore, for an entrepreneur whose goal it is to eventually sell his or her company, incorporating as a C Corp from the outset creates a smoother acquisition process.

Finally, the IPO is the second preferred exit strategy allowing new investors in the general public to buy shares of stock in the company. As mentioned above, LLCs cannot be publicly traded. Also, "[t]he membership interests of an LLC are typically not freely transferable by state statute,"[102] making an LLC a particularly worthless entity for VCs looking to offer stock purchasing to the general public. The availability of a public stock market is especially significant to the existence of the venture capital industry.[103] This is due to the fact that VCs eventually want to see some return on their investment, and public offerings enable VCs to estimate such return. Moreover, the availability of the IPO exit strategy "allows venture capitalists to enter into an implicit contract with entrepreneurs concerning the future control of the startup."[104] How so? When shares are purchased in the IPO, control of the company once shared by the entrepreneur and the VCs can pass back to the entrepreneur when the VCs liquidate their shares in preparation for the IPO.

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[98] *Id.*

[99] *Id.*

[100] *Id.* at 183.

[101] *Id.*

[102] *Why Startups Are a Corporation*, *supra* note 39.

[103] Fleischer, *supra* note 34, at 177.

[104] *Id.* at 178.

An exit strategy like the IPO raises critical tax questions, particularly regarding the control of the company. This occurs when the company incorporates from an LLC right before the IPO. Incorporating from an LLC to a C Corp right before the IPO may trigger taxation if the VCs—who have contributed property in exchange for shares of stock—do not own eighty percent of the company immediately after the exchange.[105] Well, if the VCs sell a considerable stake in the company in an IPO, but the company has just incorporated the day before, this "immediately after" requirement may not be satisfied.[106] This is yet another reason why organizing as a C Corp from the company's outset is not only advantageous, but also less cumbersome. However, "[c]ase law in this area is generally taxpayer-favorable, indicating that absent a 'binding commitment' to sell shares at the time of incorporation, the incorporation will be viewed as an independent § 351 transaction."[107]

Therefore, due to the considerable tax advantages regarding exit strategies, it is more advantageous for an entrepreneur seeking VC funding to incorporate as a C Corp instead of organizing as an LLC.

IV. CONCLUSION

For the reasons above, organizing as a C Corp is truly the best decision a "starry-eyed" entrepreneur can make. The C Corp provides favorable pathways for reinvestment in the company, thus enabling growth and an increase in overall value of the startup. Additionally, while losses are favorable in the LLC due to its pass-through structure, VCs typically cannot take advantage of those losses, and investing in the LLC would potentially create unwanted business taxable income. Furthermore, C Corps provide exit strategies capable of receiving favorable tax treatment unavailable to LLCs. Finally, it is important to remember that because VCs typically dictate the structure of the deal at the point of initial investment, they are essentially the "customer" the entrepreneur is hoping to attract. Knowing the ultimate purpose behind the startup—whether it is to sell, to seek an IPO, or to keep the business closely-held—is essential for any entrepreneur. If an entrepreneur envisions the startup as a family business, then he or she may benefit more using the LLC form. However, should the goal be to sell or take

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[105] I.R.C. §§ 351(a), 368(c) (2012).

[106] § 368(c).

[107] Fleischer, *supra* note 34, at 180.

the company public, acquiring VC funding may prove necessary. Therefore, structuring a startup as a C Corp is imperative for entrepreneurs seeking venture capital funding.