Notes from the ACA Leadership Conference

The State of the LLC vs C Corp Investment Preference

I spent 2 days in Houston at the annual Angel Capital Association Leadership Conference. It was held at the Texas Medical Center TMCx Accelerator which is part of the world's largest Medical Center. It's Texas… Big is, well BIG. The Texas Medical Center is larger than the next two largest medical centers combined, and the TMCx Accelerator space mirrored this in every way.

Since starting K4-MA 10 years ago I have attended 9 leadership conferences and have met and established relationships with lots of other angels and angel groups. This year I focused on developing a working relationship with CTAN – the Central Texas Angel Network. CTAN is, according to the ACA HALO Report, the largest single location angel group, (Keiretsu is, as you know, the largest multi-location angel group) and since we attract lots of DealFlow from Texas I thought that we could strengthen our capabilities if we formalized a working relationship with this great group. For those of you new to K4-MA and K4-SE we have Austin, TX to thank for Savara, the first Texas deal I found while there at my first ACA event, followed by UnaliWear, Salarius, and many others.

What I did not know was that they share my conviction that we should almost always try to invest in early-stage deals structured as LLCs vs C-Corps. While discussing our future collaboration efforts I met Gene Betts, a CTAN Board Member who is the CTAN LLC bigot. Gene co-led a session on investments at the conference as well and we spent a great deal of time together elaborating how our groups are on the same (LLC) page.

CTAN is so focused on this point that they have published a number of papers on the subject that I will share with you at the end of this article. They have also developed articles on the pros and cons of Section 1202 QSBS (Qualified Small Business Stock) which offers the investor a tax-free position on their investment if held for 5 years. You should take the time to read all the articles, if for no other reason than to help you better understand our motivation for pushing LLC investments here in K4 as well as better understanding your tax obligations as a holder in each.

Here is my summarized list of some of the points from the papers – admittedly biased towards the LLC as I have always believed that this offered the early-stage investor the best possible returns and flexibility while minimizing the tax exposure to the companies and their investors.

1. FLEXIBILITY – An LLC, once created, has a future option to convert to a C Corp for very little cost ($270 in Delaware) and with no tax penalties. A C-Corp cannot convert without (typically) serious tax consequences.
2. TAX EXPOSURE – An LLC pays no federal taxes. Profits are distributed to the Members who have tax consequences, effectively structuring a single tax burden on the profits. C-Corps that issue distributions on profits must first pay taxes on those profits (think 30+%) which reduces the profits by 1/3! Then the shareholders pay another +/-20% tax on the distributions effectively giving Uncle Sam HALF of the profits the Company worked so hard to create.
3. PAPERWORK – Here the C-Corp is the winner. Although the accounting for a C-Corp is more complex, the C-Corp files their Company tax returns but they do not have to create additional paperwork for the investors. In the LLC the Company must create (the dreaded) K1 for every member of the LLC. This short IRS document details the portion of the Members profit or loss in the Company that year and is then used on our personal income tax returns. The negative? If the Company does not get us our K1s in a timely manor it has an impact on our personal tax filings. We were successful in delivering K1s on time every year until 2019 when our accounting firm let us down.

As a result of lots of research we have converted our LLC holdings into trusts that do not require K1s (unless there is a distribution).

4. FOLLOW-ON VC FUNDING – There is a thought carried by most entrepreneurs that when they go to their next round it will be with a Venture Capital firm and the VC they find will only invest in a C-Corp. First – see # 1 above, and Second – 66% of CTAN portfolio companies have NO VC investors and more than 85% of K4-MA and K4-SE portfolio companies have NO VC Investors (that required a C-Corp vehicle). BTW – None of the deals done in the last 9 years at K4-MA have had full follow-on VC run rounds (but we do have one in process now) and the reality is that almost none of the early-stage deals that angels fund will ever get to this level of funding traction. Research by the ACA indicates that less than 1% of all companies that are funded by angels ever receive funding from VCs.
5. EOC – EARLY RETURN OF CAPITAL – Most of you know that I try to structure our Term Sheets as participating preferred with Early Return of Capital (we get our invested money back first). Under this structure when the LLC returns its first distributions to us we treat it as "return of capital" – the money we invested, and pay NO taxes on it. We also get the early losses that are passed from the LLCs to us that serve as deductions on our taxes. Under a C-Corp we would also get these distributions but after the corporate taxes the company paid as described above.
6. EXCEPTIONS – There will always be exceptions… We (K4-MA & K4-SE) will invest in C-Corps if already created since a conversion is almost never feasible. We had a situation with a portfolio company, Touchjet USA, that I actually helped structure and create as a Delaware LLC. A foreign investor from Taiwan offered to invest more than $600k in the company but required that it convert to a C-Corp. While many foreign investors can invest in an LLC they rarely understand the LLC structure and try to follow the path of least resistance. Had we known of this investment at creation we would likely have just gone ahead and setup the C-Corp at the start.

Many entrepreneurs we have worked with tell us that they went ahead and converted to a C-Corp because of a potential investment. Then (you guessed it) the investment never materialized. The best advice we can give to early-stage companies is to live for today – structure your company with the greatest flexibility possible, and NEVER convert until you get the check in hand.

Here is the list of papers you can download;

1. LLC vs C CORP - CTAN OVERVIEW
2. Reasons You Should Very Carefully Consider an LLC instead of a C Corp - CTAN
3. Investment Return Illustration - LLC vs C CORP - CTAN
4. Handling Common Administrative Issues with LLC - CTAN
5. Failing to qualify for Section 1202 has serious tax consequences - ACA
6. Section 1202 Benefits and Pitfalls- Godfrey Kahn – Golden Angels Investors
7. The Smart Tax Question - Invest in LLC or C Corp Startups – Marianne Hudson, ACA
8. About the Authors - CTAN

All 8 files are in a ZIP File located here: CTAN ARTICLES