ENTREPRENEUR GUEST

Your startup should not be an LLC

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I'm a big believer in keeping things simple. Don't make more work for yourself, especially if you're a launching a startup. Growing a business, staffing it, and keeping ahead of the competition is more than enough for anyone to tackle.

So when I see a startup has organized as an LLC, a limited liability company, I know that the founders were probably thinking something like this: "The paperwork for an LLC is a single page, man. Let's fill it out, file it in Delaware, and get back to work."

The initial documentation for an LLC may appear straightforward, but LLC status is extremely complex. An LLC is a partnership for tax purposes, which affects how startups must allocate income, expenses, and distributions. In some cases, choosing LLC status means you'll not only forgo VC financing but also find yourself on a first-name basis with an expensive specialist in partnership tax issues.

A little background: An LLC blends features of a corporation and a partnership. Like a corporation, an LLC limits liability for equity holders. Like a partnership, it is a "pass-through" for tax purposes, so income or losses pass through the LLC to its owners, and the LLC itself pays no income taxes. Most startups don't generate any income, so the founders aren't stuck with a big tax bill. They may even be able to deduct losses on their personal tax returns. This may seem like a plus but can, as you'll see, become a headache.

An LLC can cause problems for your employees, too. Workers who are granted equity interests in a corporation typically receive stock options. When startup employees get equity interests in an LLC, they are usually granted profits interests, which entitles them to a share of the company's future appreciation in value. If the company becomes the Next Big Thing, they'll profit handsomely. While the young business struggles to gain traction, they pay no taxes because the LLC's value hasn't increased.

However, the founders must determine the company's value on the day they grant profits interest. That's a challenge when a business has little or no revenue, intangible assets that are hard to value, no operating history, and an inexperienced management team. Founders take their best guess. If they're wrong, their employees could face serious, morale-crushing tax problems.

Another quirk of an LLC is that its owners are classified as "partners" for tax purposes — even if they're employees. As a result, they must receive Schedule K-1 tax forms, which disclose information about the LLC's finances. I'm sure you'd rather not share these details, but under tax law, you have no choice. And more bad news: The IRS requires these "partners" to handle their own quarterly tax withholdings.

Tax issues are no picnic for your employee-owners, and VCs don't like them any better. They typically refuse to invest in LLCs because they don't want income or loss passing through the LLC to its investors. VCs are also structured as tax pass-through entities, so this income or loss passes on to the VC's limited partners. Some of these limited partners could be subject to tax (when they otherwise would not pay) or have to file tax returns (when they otherwise would not need to file). Once they file a return, they open the door to IRS audits, which they, like everyone, would prefer to avoid.

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VCs and other investors will be very curious about your capitalization and structure. They need perfect clarity on who owns what so they can avoid potential disputes and costly, soul-sucking litigation over ownership. Unfortunately, by the time you realize your entity structure has repelled prospective investors, it's too late to woo them back.

Even if you catch a break and discover that investors aren't deterred by your LLC structure, they may insist that you convert into a corporation, which comes at a cost and, once again, raises tax issues.

Despite the potential perils of LLCs, there are some narrow cases where they're the right choice. If your startup requires little capital but generates a lot of cash, congratulations. You don't need any advice from me. An LLC is the logical structure in this situation because owners pay taxes only on the income, so they aren't taxed twice.

Remember Henry David Thoreau, the guy who disappeared into a cabin at Walden Pond? He never had to weigh the merits of various entity structures. But if he did, I have no doubt he would have opted for a corporation because he famously urged "Simplicity, simplicity, simplicity." More than 150 years later, entrepreneurs should heed that advice.

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