

Unedited transcript of

LLC Governance Tax & Other Considerations

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>>: Election of managers, just - we kind of mentioned this. You know, you might give a certain group of members the right to designate a manager - maybe the founders, maybe investors. Member approval rights, so we kind of just went over this. But, you know, the protective provisions, so usually this will be, you know, a sale of a company, the creation of subsidiaries. It could include, you know, the issuance of new membership interests. Maybe, you know, some subset of the members want to make sure that the manager is not going around and, you know, selling or issuing, you know, a kind of new membership interest without their consent. And what threshold of member approval is required for these actions? Is it just a majority? Is it both a majority of the common and a preferred? You know, they're very similar sort of considerations to these questions in the corporate context. A few more points or things to think about with respect to tax, so the difference between an LLC and an S corporation election, they both allow for the pass-through taxation. So an S corp is formed as a corporation but basically checks a box, files a form to be taxed as a partnership. So the LLC is a type of legal entity. The S corp is a corporation, but it's a tax classification that the corporation has elected. So an S corp is still a corporation. It still has to follow all the rules under - that corporations have to follow under the jurisdiction of formation, but it gets that tax treatment as a partnership. S corps are - have a number of restrictions, so S corps cannot have more than 100 stockholders. There can be no non-U.S. stockholders, and there can be no entity stockholders, with the exception of certain types of trusts. But generally you can't have, you know, for example, an investment fund invest in an S corp. And the

trick is that as soon as - if a corporation elects - makes an S election, if they make any mistakes, if they - you know, maybe they, you know, don't realize that an investor is a non-U.S. person, or somebody forgets that they made the S election and sells, you know, shares to an entity or a venture fund. That S election is automatically terminated, and therefore, there can be a lot of problems that arise if that S election is terminated, but nobody realizes it, and there's - the company is - the corporation is not paying taxes at the entity level. So just something to be aware of, if, you know, a client wants to make an S election, they've got to be really diligent about who they're issuing shares to and how many stockholders they have. Employee equity in an LLC is - I know we're running short - is - can be tricky because you - because of the pass-through, employees end up becoming members, obviously, and so it's not great for unsustained employees because they will be responsible for reporting their allocation of the gains and losses on their own tax returns and paying those periodic taxes. So it's not a great option for kind of - for rank-and-file employees who might not be sure what to do with the K-1 that they're getting and may not have sort of the periodic cash flow to pay those taxes.

>>: Yeah, and notably, for tax purposes, they can't be treated as employees because they're partners in a partnership. So unlike a normal employee where you would do withholdings for them, you wouldn't be doing that. And so the individual who thinks of themselves as an employee of the company will have to, as Kelly said, pay their own taxes, but they'll be doing so as some sort of self-employed individual and have to pay quarterly estimated taxes. So it can be burdensome for those individuals.

>>: So another thing I just want to mention quickly is profits interest. So this is a way - this is often a way that LLCs provide some equity for their, you know, higher level, you know, employees or service providers. It's a right of - to interest in the future appreciation of the company. So the profits interest is valued as of the date of grant, and the holder then shares in any value created between the date of grant and whenever they sell the profits interest. So it's sort of - you can do options in an LLC, but you typically see the profits interests structure more often. It's not taxable to the recipient on the date of grant. It's - you know, the spread is taxed on the date of disposition. But again, profits interests are equity, so recipients still receive

the K-1. And the, you know, problem that we just discussed is still an issue, so this is generally reserved, again, for sort of higher level, sophisticated service providers.

>>: I know we have one more slide here on conversion, but I know we're running long. Short version of this is just because you start life as an LLC doesn't mean you have to stay as an LLC. Typically, you will see - especially if companies are going to get invested - investment from an institutional fund, that fund will require that they convert to a C corporation. There's a lot of tax-related reasons - particularly on the fund side - that relate to that that are not the topic today. But there are ways to do it, either through a conversion process or basically creating a new corporation in wherever you want to create it and then merging the LLC into the corporation.