Company founders often anticipate that their start-ups will ultimately require significant amounts of equity capital in order to succeed. Initially, though, founders focus on getting their start-ups off the ground and securing seed stage capital. While C corporations tend to be the form of organization preferred by venture capital funds (generally due to tax sensitivities of fund investors), founders sometimes form their start-ups as limited liability companies (LLCs) because:

1. LLCs can sell their assets, and distribute the sale proceeds, with income and gain from the sale taxed only at the owner level.
2. Owners of equity interests in LLCs can use losses funded by their capital contributions against other income they may have, subject to applicable deductibility limitations.
3. LLCs can be converted to C corporations fairly easily, and without precluding stock that was issued pre-conversion from being "qualified small business stock."*

When raising capital, founders of new limited liability companies should consider whether the issuance of convertible notes will have negative tax consequences, due to the misallocation of losses.
To raise seed capital without having to negotiate equity financing terms (such as company valuation) with investors, founders may use their start-ups to issue convertible notes. These notes are convertible into the equity to be issued in future, more significantly funded rounds of equity financings (often at discounts or with other "sweeteners," such as warrants). Typically, the founders and other equity holders are not personally liable for the notes. This discussion considers the federal income tax aspects of convertible note issuances by start-up businesses formed as LLCs.

Non-Member Losses. Note holders who are not members of an LLC do not share in its losses before their notes convert to equity. Instead, the losses or gains funded by the notes of non-member note holders are allocated solely among the members of the LLC. The members can include their shares of the losses or gains of the non-members in their basis in their interests, pursuant to Section 752, even though they have no personal liability for the notes. Members who are not personally liable for the notes (and who are subject to the at-risk rules under Section 465), however, are generally not able to include their shares of the notes in their amounts at risk. In such cases, the losses funded by the notes are suspended in their hands until the member's capital account establishes for the member the equivalent of the lesser of the amount the member would have contributed if the LLC had an entity-wide capital account system or the member's share of the amount of the notes as of the close of the applicable taxable year. See Section 704(d).

Conversion of Notes

Sometimes, all goes in accordance with the plan, and the notes are ultimately converted to equity of the LLC. The conversion of a note to an equity interest in the LLC is generally not a taxable event for either the converting note holder or the LLC, except that:

1. The note holder may be taxable on any portion of the equity interest received for accrued and unpaid interest.

2. The LLC has ordinary cancellation of debt (COD) income, under Section 108(b)(4)(B) (subject to any applicable exceptions, such as insolvency, which is applied at the member level), to the extent that the amount of the converted note exceeds the value of the equity issued in exchange for the note.

3. The pre-conversion members (including any note holders who were pre-conversion members) are deemed to receive distributions from the LLC pursuant to Section 752, equal to their shares of the amount of the converted notes. On the conversion of a note to equity, the capital account established for the holder is credited with the "adjustment price" of, and any accrued but unpaid "qualified stated interest" on, the note as determined under the original issue discount rules.

Other Members. Pre-conversion members who were not note holders may have income or gain on the note conversions. Fortunately, the pre-conversion members should be able to use any losses and deductions that remain suspended in their hands against their income and gain from the conversion of the notes. Depending on how the income or gain of the pre-conversion members arises, it may translate into new basis for the LLC in its assets, which may in turn translate into subsequent deductions and losses.

Cancellation of Notes

Sometimes, unfortunately, the LLC does not make it, and the notes are cancelled. Note holders who are not members of the LLC simply have capital losses (assuming they held their notes as capital assets for their rights to share in capital, and thereafter to the capital accounts of the pre-conversion members to reflect the manner in which they would share in the proceeds of a taxable disposition of the LLC's property at fair market value. Disparities between the members' bases and capital accounts are to be eliminated under Section 704(c) as the LLC's properties are depreciated, amortized, or sold. If a converting note holder's capital account still does not reflect his or her right to share in the LLC's capital after the allocations of unrelated income, gain, loss, and deduction, the LLC is to reallocate capital to the converting holder from the pre-conversion members, and make corrective allocations of gross income and gain or gross loss and deduction among the members for tax purposes corresponding to the shift in capital.

Note Holders. Thus, the note holders generally are not taxable on their note conversions (except to the extent they have income due to receiving equity for accrued but unpaid interest), and their bases in their interests in the LLC are increased by their bases in their converted notes (plus any income they recognize on converting their notes on account of accrued but unpaid interest). In addition, note holders who were members before such conversions are deemed to receive distributions from the LLC pursuant to Section 752 equal to their shares of the notes (which are the amounts of their notes if no other member was liable for their notes) and can be allocated any COD income recognized by the LLC on the conversion of their notes.

Conversion of LLC to Corporation

If the LLC is to be converted to a corporation in connection with the conversion of the notes, there may be a question as to the sequence of the steps that will culminate in the note holders holding stock of the corporation. If the note obligations are assumed by the corporation and exceed the aggregate basis of the assets contributed to the corporation, the LLC or its members recognize income or gain in the amount of the excess under Section 357(c). Of course, as described above, the conversion of the notes may result in the recognition of income or gain by members of the LLC even without the assumption of the note obligations by the corporation. In addition, any income or gain recognized under Section 357(c) generally increases the basis the corporation takes in the assets contributed to it. Depending on the circumstances, therefore, the note holders and members may be indifferent as to the sequence of events.

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The interest expense of an LLC has to be separated from the LLC’s debt. Under Section 752, members are deemed to have made contributions to the LLC equal to their shares of the LLC’s debt. Loan losses and deductible interest payments are then deemed to increase distributions from the LLC equal to any reductions in the LLC’s pre-liquidation capital accounts.

Members can include in their amounts at risk their shares of certain non recourse debt referred to as “qualified non recourse financing” secured by real property used in an activity of holding real property.

Loans no longer suspended under the IRS rules may remain suspended, however, under the passive activity loss rules.

Members who make loans to the LLC for which no other member is liable are to be specially allocated certain deductions (called partner nonrecourse deductions) funded by their notes. As with non-recourse deductions, partner non-recourse deductions are subject to chargeback allocations of items of income and gain as the debt becomes due. However, if the note holder has ordinary income and a capital loss, it may be preferable for startup LLCs to issue equity, rather than debt securities that convert into subsequent financing rounds.

When an LLC raises seed capital by issuing convertible notes, it is not clear what the note holders would do if the note holders would have had the startup were a C corporation.

There may have been at least some securities offering. The note holder’s ordinary income and a capital loss in the current year. An alternative, the practice that has been followed, may be to have the note holders contribute cash in the amounts of other members’ notes to the LLC and then have the LLC recognize the contributions. That way, subject to step transaction challenges, the note holders receive COD income and corresponding capital losses.

The suspended losses cease to be passive activity losses to the extent they exceed the note holders’ capital loss in the amounts of their notes. The additional basis caused by the COD income leaves the note holders with basis in the interests in the LLC that they will not reduce and, therefore, capital losses. In effect, their allocations of COD income reverse prior allocations of ordinary loss and deduction funded by their notes, and leave them with capital losses for their note investment.

No COD Income. If note holders who are members can contribute their notes to the LLC without causing the LLC to have COD income, they should simply have offsetting basis increases and decreases due to their note cancellations (without the corresponding income and capital losses they would have if the contributions of their notes caused the LLC to have COD income).

If the LLC is being terminated, any losses of the members that remain suspended under the passive activity loss rules should be freed up.

Other Members. Who were not note holders generally have their shares of any losses and deductions that remain suspended in their hands against their income from the cancellation of the notes.

Conclusion

When an LLC raises seed capital by issuing convertible notes, there is the potential for misallocation of losses funded by the notes. For example, if the note purchasers are not otherwise members, losses and deductions funded by the notes are allocated to the members, and may be unallocated to the note holders. If the note purchasers are otherwise members, they may be able to use losses and deductions funded by the notes, but if their notes are ultimately contributed to capital, they may be allocated ordinary COD income reversing their prior allocations of ordinary losses and capital losses.

For more information, see AICPA’s Guide to Start-up and Early Stage Issues and the Hinge Fund’s Guide to Convertible Notes.