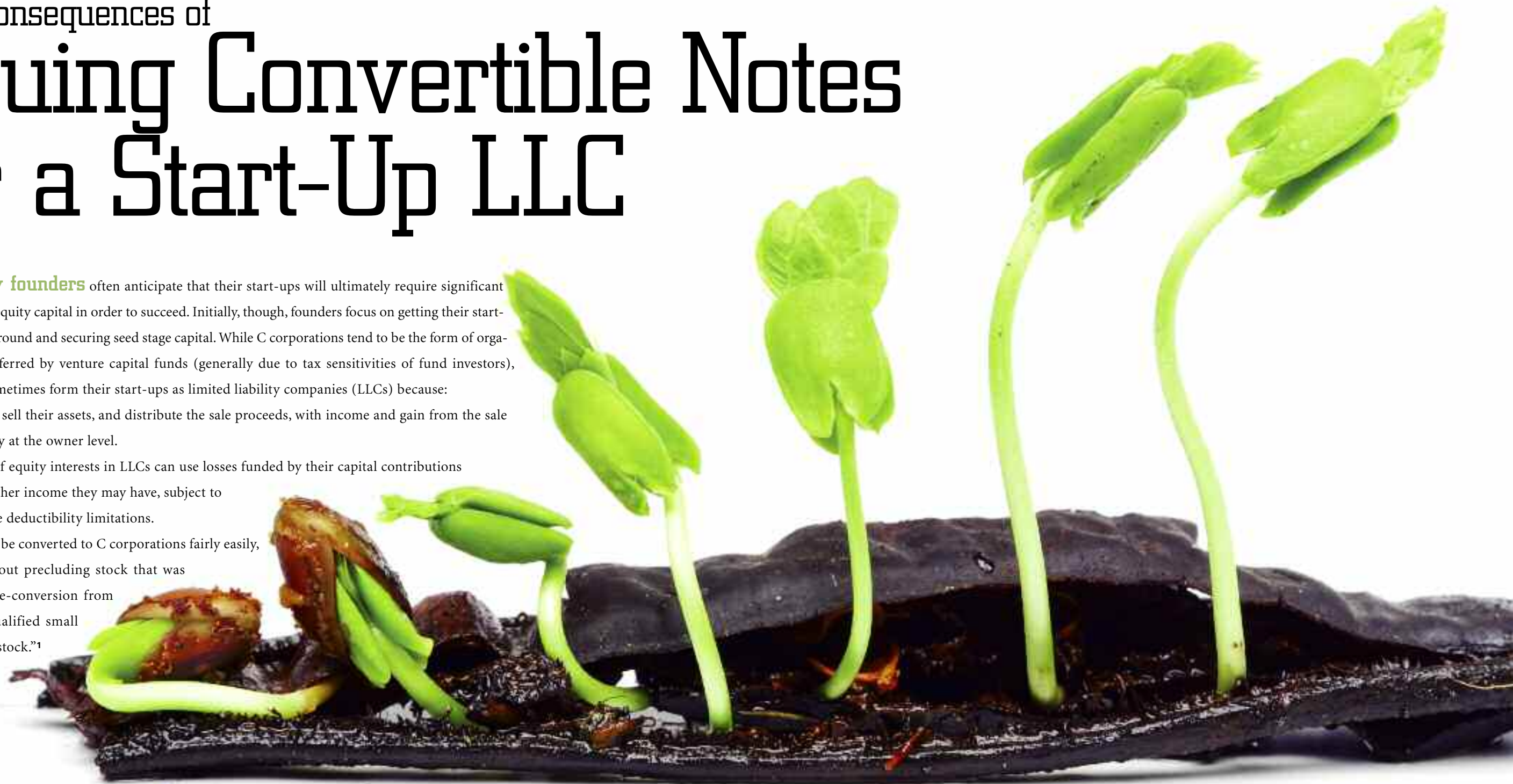


Tax Consequences of Issuing Convertible Notes for a Start-Up LLC

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.”¹



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 cause their start-ups to issue convertible notes. These notes are convertible into the equity to be issued in future, more significant anticipated 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.²

Treatment of Interest

While convertible notes remain outstanding, the holders report interest either as it is paid (if the holders are on the cash method) or as it accrues (if the holders are on the accrual method, or accrual is required by the original issue discount rules because interest is not payable at least annually as it accrues). For the start-up, the interest expense with respect to the notes generally offsets LLC income, or increases its loss.³

Losses

Start-ups often operate at losses, at least in their early stages. The losses of an LLC for any period are allocated to its equity interest holders (referred to here as members) during that period, in accordance with the terms of their agreement and subject to the partner distributive share rules of Section 704 and the regulations thereunder.⁴ An individual’s ability to use his or her share of a loss of the LLC for any period is limited to (1) the individual’s tax basis in his or her interest in the LLC as of the close of the period under Section 704(d); (2) the amount the individual is “at risk” with respect to the LLC as of the close of the period under Section 465; and (3) if the LLC is a “passive activity” for the individual, the amount of income the individual had from other passive activities for the period under Section 469.⁵

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 funded by the notes of non-members are allocated solely among the members of the LLC.⁶ The members can include their shares of the notes held by non-members in their basis in their interests, pursuant to Section 752, even though they have no personal liability for the notes.⁷ Members who are not 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*.⁸ In such cases, the losses funded by the notes are suspended in their hands until the members have sufficient amounts at risk with respect to the LLC or until they have income from the LLC.⁹ Nevertheless, losses suspended under the at-risk rules reduce the basis of the affected members in their interests in the LLC.

Losses of Member Note Holders. Note holders who are members include the amounts of their notes in both (1) their bases in their interests in the LLC under Section 752, and (2) their amounts at risk with respect to the LLC, assuming no other members are liable for their notes.¹⁰ Thus, such members are generally able to use the losses and deductions funded by their notes, subject to the passive activity loss rules of Section 469. If the LLC is a passive activity for the holder for any year, the holder may use his or her loss from the LLC for that year *only* against income and gain received from other passive activities for the year. Any loss that the holder may not use for a year is suspended until there is passive income from the LLC or another passive activity, or a taxable disposition of the interest in the LLC is made to an unrelated third party. Losses that are suspended under the passive activity loss rules nevertheless reduce the note holder’s basis in their interest in the LLC.

There is the potential for misallocation of losses.

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(e)(8) (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 “adjusted issue price” of, and any accrued but unpaid “qualified stated interest” on, the note as determined under the original issue discount rules.¹¹ The LLC’s properties are revalued as of the time immediately after the conversion. The unrealized income, gain, loss, and deduction are allocated first to the capital accounts of the converting note holders to the extent necessary to reflect

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 unrealized 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 their 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.¹²

Other Members. Pre-conversion members who were not note holders can have income or gain on the note conversions.¹³ 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.¹⁴ Those deductions and losses may, however, derive from depreciation or amortization of the new basis over some period of time.¹⁵

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.¹⁶ 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.¹⁷ 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.¹⁸

Cancellation of Notes

Sometimes, unfortunately, the LLC does not make it, and the notes are cancelled.¹⁹ Note holders who are not members of the LLC simply have capital losses (assuming they held their notes as capital assets for

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Losses and deductions funded by the notes may be allocated to members unable to use them.

- 1 For stock to be qualified small business stock, it must, among other things, be issued by a C corporation. Under Section 1202, a noncorporate taxpayer who has held qualified small business stock more than five years can exclude a portion of the gain recognized on a sale. In general, the maximum excludable portion under Section 1202 is 50%, and the non-excluded portion is taxed at a maximum 28% rate. The aggregate amount that may be excluded by any taxpayer on sales of the stock of any issuer is in any event subject to a cap, equal to the greater of (1) \$10 million or (2) ten times the taxpayer's adjusted tax basis in the stock. If the taxpayer acquired the stock in exchange for property other than money or stock, the taxpayer's adjusted basis is deemed to be not less than the value of the property exchanged for the stock on the date of the exchange. A portion (7%) of any excluded gain is a preference item under the alternative minimum tax.
- 2 For tax purposes in this discussion, LLCs are presumed to be classified as partnerships, and convertible notes are presumed to be debt rather than equity (so that the amounts paid for them are loans rather than capital contributions pending their conversion). An LLC can be disregarded as a separate entity if it has only a single owner, or can elect to be classified as a corporation. The line between debt and equity for tax purposes is not always clear.
- 3 The interest expense of an LLC has to be separately stated under certain circumstances.
- 4 In general, the rules under Section 704 are intended to ensure that the LLC's allocations of income and loss are consistent with the LLC's economics (in general, the allocations must have "substantial economic effect" to be respected). Thus, allocations of income and loss are supposed to have corresponding effects on the amounts of distributions the members ultimately receive.
- 5 The passive activity and at-risk rules apply to individuals and certain closely held C corporations. In the case of any partnership or S corporation, the limitations are applied at the owner level. The at-risk rules are applied before the passive activity loss rules. Disallowed losses are suspended but retain whatever character they had when they were incurred. The deductibility of a loss against other income can also be limited if the loss is a capital loss. Individuals can use capital losses only against capital gains and small amounts of ordinary income (with disallowed capital losses for any year eligible for indefinite carry-forward). In this discussion, losses generated by the use of convertible note proceeds are presumed to be ordinary operating losses.
- 6 Special rules apply to allocations of certain deductions (referred to as nonrecourse deductions) generated by debt for which no member would be liable if the assets of the LLC were to become worthless (referred to as nonrecourse debt). Those deductions, which lack economic effect because the risk of loss is borne by the lender, can generally be allocated in the manner in which valid allocations of other items are made (thus, they may be allocated in accordance with profit-sharing ratios generally). The members who receive the allocations are subject to chargeback

- allocations of items of income and gain as the nonrecourse debt is paid down or discharged.
- 7 Under Section 752, members are deemed for basis purposes to have made contributions to the LLC equal to their shares of the LLC's debts. Members are then deemed to receive distributions from the LLC equal to any reductions in their shares of the LLC's debts.
- 8 Members can include in their amounts at risk their shares of certain nonrecourse debt referred to as "qualified nonrecourse financing" secured by real property used in an activity of holding real property.
- 9 Losses no longer suspended under the at-risk rules may remain suspended, however, under the passive activity loss rules.
- 10 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 nonrecourse deductions, partner nonrecourse deductions are subject to chargeback allocations of items of income and gain as the debt that gave rise to them is paid down or discharged.
- 11 For a note bearing an adequate yield with interest payable on at least an annual basis as it accrues, this number equates to the outstanding principal balance of, plus accrued but unpaid interest on, the note.
- 12 The basis increases resulting from note conversions by members who were note holders can offset any income or gain that such members would otherwise have recognized on account of the deemed distributions to them of their note amounts. Conversions of notes held by members can therefore often be effected without the recognition of income or gain by such members, the LLC, or any other members. The losses and deductions allocated to such members funded by their notes are not reversed and there are no increases in their basis in their interests in the LLC or in the LLC's basis in its assets.
- 13 The items of income or gain reverse prior allocations of loss or deduction and can arise (1) under Section 731 because of deemed distributions pursuant to Section 752 in excess of basis depleted by prior loss allocations, (2) under Section 751(b) because of deemed distributions pursuant to Section 752 in exchange for interests in "hot assets" of the LLC, or (3) from chargebacks of prior losses and deductions allocated to them with items of income and gain (including any COD income recognized by the LLC on the conversion). If the pre-conversion members' capital account balances are booked up in connection with the conversions, Section 704(c) can also apply to allocate income or gain (or less deduction or loss) to the pre-conversion members to close disparities created by the book-up between the pre-conversion members' post-conversion capital account balances and adjusted basis.
- 14 For additional basis to be created as a result of gain recognized under Section 731 by members from deemed distributions pursuant to Section 752 in excess of their basis in their interests in the LLC, the LLC must make an election under Section 754.

- 15 Effectively, then, prior operating losses may have been converted to future depreciation or amortization deductions. If the start-up had been formed as a C corporation, there would be no reversal of the losses due to the conversion of the notes to stock worth at least the amount of the notes, and the prior losses would have remained available to offset income of the start-up going forward (subject to the ownership change rules of Section 382).
- 16 Rev. Rul. 84-111, 1984-2 CB 88 provides that, from a tax standpoint, the incorporation of a partnership is effected in one of three ways. Either (1) the LLC contributes its assets to the corporation in exchange for stock of the corporation and then distributes out the stock to its members in its liquidation, (2) the LLC distributes its assets to its members in liquidation, and the members then contribute the assets to the corporation in exchange for stock of the corporation, or (3) the members contribute their interests in the LLC in exchange for stock of the corporation, and the LLC then liquidates into the corporation. Under subsequent rulings and regulations, incorporations effected by merger, conversion, or by electing corporate classification are treated as if they had been effected under the first manner.
- 17 Either way, any suspended losses should be usable against income or gain resulting from the conversion.
- 18 If the conversion of the notes to equity of the LLC would not result in the recognition of income or gain by any of the note holders or members, it might be preferable to avoid triggering income or gain under Section 357(c) (perhaps by converting the notes to equity of the LLC and then converting the LLC to the corporation). Also, if notes of the LLC are to be converted to stock of the corporation, it might be worth considering whether the conversion might somehow be taxable to the note holders (which is generally not the case where notes of an entity are converted to equity interests in that entity).
- 19 It is assumed in this discussion that there is no transfer of assets by the LLC to the note holders in satisfaction, full or partial, of the notes.
- 20 This is the same result the note holders would have had if the start-up were a C corporation.
- 21 There may have at least been some deferral benefit for holders who have been able to use their prior losses free of deductibility limitations. Of course, that a note holder has been able to use a loss in a prior year may not be much consolation if the note holder has ordinary income and a capital loss in the current year. An alternative, the practicability of which may be limited (particularly if the LLC has other creditors), may be to have the note holders contribute cash in the amounts of their notes to the LLC and then have the LLC repay the notes with their cash contributions. That way, subject to step-transaction challenges, the note holders avoid the COD income and corresponding capital losses.
- 22 The suspended losses cease to be passive activity losses to the extent they exceed the member's income and gains from other passive activities.

deduction funded by their notes, and leave them with capital losses for their note investments.²¹

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 ordinary 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.²²

Other Members. Members who were not note holders generally have their shares of any losses and deductions funded by the notes reversed by COD income when the notes are cancelled. Fortunately, the members should be able to use any such losses and deductions that remain suspended in their hands against their income from the cancellation of the notes.

Conclusion

When an LLC raises seed financing by issuing convertible notes, there is the potential for misallocation of losses

investment purposes) equal to the outstanding principal amounts of their notes (plus any accrued but unpaid interest they have reported on their notes) when their notes are cancelled.²⁰

Member Note Holders. The tax consequences of cancellations for note holders who are members depend on whether the cancellations generate COD income for the LLC. Section 108(e)(6) provides that, if a shareholder of a corporation contributes a debt of the corporation to the corporation's capital, the corporation has COD income only to the extent that the amount of debt exceeds the shareholder's basis in the debt. Congress has not made Section 108(e)(6) applicable to partnerships.

If there is no counterpart to Section 108(e)(6) for partnerships and the LLC has COD income on the cancellation of the notes, the note holders who are members report their shares of the income (which may include all or substantially all of the COD income from the cancellation of their notes). Their bases in their interests in the LLC are (1) *increased* by their bases in the notes they contribute to the LLC and by their allocations of COD income and (2) *decreased* by the distributions they are deemed to receive pursuant to Section 752 in the amounts of their notes. The additional basis caused by the COD income leaves the note holders with basis in their interests in the LLC that they will not recover and, therefore, capital losses. In effect, their allocations of COD income reverse their prior allocations of ordinary loss and

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, who may be unable to use them. If the note purchasers are otherwise members, they may be able to use losses and deductions funded by their notes, but if their notes are ultimately contributed to capital, they may be allocated ordinary COD income reversing their prior losses and deductions and leaving them with capital losses. The misallocations arise from the treatment of the notes as debt rather than equity for tax purposes. To avoid such misallocations, it may be preferable for start-up LLCs to issue equity, rather than debt securities that convert into subsequent financing rounds. ■

