Boston Executive Briefing Series

Starting an Emerging Technology Company: Solving the Puzzle of C Corp, S Corp, or LLC

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INTRODUCTION

Selection of the form of legal entity is one of the most important decisions facing a founder. The choice of entity affects fundamental matters, including:

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- the tax treatment of the business and its participants;
- the flexibility of capital structure under which financing may be obtained;
- the compensation and motivation of employees;
- the transferability of interests in the enterprise; and
- the relationship between owners and management.

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PRELIMINARY CONSIDERATIONS

Prior to making the decision as to the choice of entity, information should be gathered and consideration should be given to:

- define precisely the probable capital requirements of the venture;
- assess the impact of governing law and regulatory restrictions;
- understand the ease and time of forming and organizing the entity; and
- determine formation and maintenance costs.

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PRELIMINARY CONSIDERATIONS CONT'D.

- equity-sharing arrangements with employees;
- the necessity of protecting proprietary information; and
- the possibility of an initial public offering of the securities of the business or to various other financing arrangements that impact the choice of entity.

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TAX TREATMENT OF ENTITY

Among the most important considerations when choosing a legal entity is the tax treatment of the business and its participants. There are significant differences among a C Corporation, S Corporation, and limited liability company.

A C corporation is taxed as a separate and distinct entity from its owners, or shareholders. Generally distributions from a C corporation are not deductible by the corporation, and are taxed as dividends to the shareholder recipient.

- Corporate Taxation
  - Two Levels of Taxation
  - Losses are trapped at corporate level

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TAX TREATMENT OF ENTITY CONT'D.

An S corporation is taxed as a "pass-through entity". As such, the S corporation calculates the results of its operations, reports the results to its shareholders, and the shareholders are taxed based on their pro-rata ownership of the corporation.

- S Corporation
  - Similar to a partnership but a hybrid
  - Potential SET Savings

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TAX TREATMENT OF ENTITY CONT'D.

The S Corporation Fallacy

- It is a <u>type</u> of pass-through entity
- It is <u>not</u> taxed the same as a partnership
  - No basis for debt
  - Distributions of property creates problems
  - Qualification criteria
  - Pro rata allocations required
  - May have SET benefits

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TAX TREATMENT OF ENTITY CONT'D.

- An LLC can be taxed as a "pass-through entity", or it can "check the box" and be taxed as a C corporation.
- Partnership Taxation
  - Pass-through entity
  - Losses allocated to partners

	C Corp.	S Corp.	LLC
Pass-Through Tax Treatment	X	X	

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TAX TREATMENT OF ENTITY CONT'D.

Comparing C Corporation with LLC

- Advantages of LLC
  - Single level of tax
  - Pass-through of losses
  - Flexibility on contributions
  - Flexibility on allocations

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TAX TREATMENT OF ENTITY CONT'D.

Comparing C Corporation with LLC

- Advantages of C Corporation
  - Gain exclusion under 1202
    - With capital gain rates at 15%, does it matter?
  - Availability of 368
  - Retained earnings taxed at lower rate

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TAX TREATMENT OF ENTITY CONT'D.

Comparison of S Corporation with LLC

- Advantages of LLC
  - Basis for debt
  - No qualification criteria
  - Special allocations permitted
  - Property extracted on tax-deferred basis

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TAX TREATMENT OF ENTITY CONT'D.

Comparison of S Corporation with LLC

- Advantages of S Corporation
  - Avoid self employment tax
  - Beneficial exit strategy rules under Section 368
  - Equity compensation rules are easier to deal with

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CAPITAL STRUCTURE AND EXIT STRATEGIES

- As between a C corporation, an S corporation, and an LLC, the C Corporation form can readily accommodate a wide range of capital structures, using such well-established financing vehicles as common and preferred stock, stock options, warrants, subordinated debt, and convertible securities.
- For many entrepreneurs, the flexibility afforded by the capital structure of the C corporation represents a very substantial advantage over other business entities.

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

- A C corporation is the recognized, approved form of entity for businesses that expect to raise capital through third party institutions (venture capitalists), and grow to an initial public offering or a sale of the business.
- A C corporation also can complete a sale through a tax-free reorganization, an important, often-used sale transaction structure.

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

An S corporation is limited by the tax rules. S Corporations are subject to, among others, the following important restrictions and limitations:

- there can be no more than 75 shareholders;
- non of the shareholders can be non-human or foreign persons; and
- there can only be one class of stock.

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

As a result of the foregoing restrictions, an S corporation does not work for an entity that expects to raise capital from third party institutional investors, or that will ultimately go public. For example, the one class of stock rule prevents giving investors and/or founders differing preferences and liquidation rights.

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

- An LLC offers excellent organizational flexibility, and can be established to have several classes of ownership.
- An LLC is a form of entity for which a tax-free reorganization is not applicable. As a result, the LLC does not offer much to a growth company that expects certain exit strategies.

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

Specific Comparisons

- Formation
  - Generally non-taxable
  - LLC is better choice where service partner receives more than 20% or where property contributed is encumbered

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

- Equity Compensation
  - ISOs only available to corporations
  - Profits interests vs. restricted stock
  - Generally favors corporations due to simplicity

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

- Exit Strategies
  - Tax-free reorganization rules apply to corporations only
  - Asset sale in C Corporation results in double tax
  - Section 338(h)(10) election allows S Corporation a best of both worlds
  - Conversion of LLC to corporation typically non-taxable but not the other way around

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CAPITAL STRUCTURE AND EXIT STRATEGIES CONT'D.

In summary, we have the following considerations related to capital structure and exit strategies:

	C Corp.	S Corp.	LLC
Financing/Flexible Capital Structure	X		X
Recognizable Exit Strategies	X	X	X
Limit on number of Shareholders/Owners		X	

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FLEXIBLE EMPLOYEE COMPENSATION

Employees and their commitment to the success of an enterprise are crucial to the success of any business. Choice of entity will affect how the business and management can provide employees with strong compensation and incentive packages and prevent scenes like the one below.

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FLEXIBLE EMPLOYEE COMPENSATION CONT'D.

- A corporate form of entity offers several, recognized, well-known forms of compensation and incentives, as well as a traditional form of management that employees understand and with which employees are familiar.

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FLEXIBLE EMPLOYEE COMPENSATION CONT'D.

- An LLC, although it offers a flexible capital structure, does not have the ability to offer stock options to employees, in the traditional sense of a corporate entity.

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FLEXIBLE EMPLOYEE COMPENSATION CONT'D.

- From the viewpoint of raising capital and providing for an "exit" strategy, a C Corporation easily accommodates a wide variety of forms of capitalization tailored to the requirements of the business.
- An LLC can offer a great deal of organizational flexibility and structure, but, offers less flexibility in possible exit strategies.

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FLEXIBLE EMPLOYEE COMPENSATION CONT'D.

In summary choice of entity employee considerations may be summarized as follows:

	C Corp.	S Corp.	LLC
Flexible/Recognized Compensation Plans	X	X	
Recognized Management Structure	X	X	

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LIMIT OF OWNER LIABILITY

A C corporation, S corporation, and LLC all provide its owners with protection against personal liability for the obligations of the business.

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GOVERNING LAW

The term "governing law" refers to the law governing the organization, existence and operation of a particular business entity. Consideration should be given to incorporating in a jurisdiction whose laws provide the maximum flexibility in matters of internal governance and management. The following factors should be considered:

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GOVERNING LAW CONT'D.

- whether state law permits or facilitates classification of the board by term of office of specific groups;
- provisions relating to removal of directors;
- provisions relating to indemnification of directors and officers;
- procedural and voting requirements for amending the Charter and dissolving the corporation; and
- remedies afforded dissenting shareholders and availability of appraisal rights.

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CORPORATE GOVERNANCE

The ability of a business to make decisions that are crucial to successful implementation of a business plan or exit strategy is another important factor to consider when choosing a legal form of entity.

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CORPORATE GOVERNANCE CONT'D.

- Corporations and LLCs are established pursuant to a particular state's laws and statutes.
- State laws vary, and some may restrict the type of business that may be conducted.
- Delaware (and New York, California, Nevada, and Maryland to a lesser extent) is recognized as the preferred state in which to establish a corporate entity because its corporate laws provide shareholders and management with greater flexibility to implement and complete important "organic" events.

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CORPORATE GOVERNANCE CONT'D.

One factor that may favor LLCs for some entrepreneurs is that LLCs are not obligated to adhere to many corporate "formalities", like periodic meetings and a tiered approval structure. In summary:

	C Corp.	S Corp.	LLC
Recognized Corporate Governance	X	X	
Limited Corporate Formalities			X

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OTHER CONSIDERATIONS

A corporation and an LLC are relatively easy to establish. Once one has decided on a form of entity, a corporation or LLC can be legally established in a matter of days with appropriate filings with the proper state offices.

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OTHER CONSIDERATIONS, CONT'D.

The costs of formation can vary, depending on whether there are multiple founder/owners, thus possibly requiring the negotiation and drafting of a Stockholders' Agreement, deadlock resolution mechanisms, an Operating Agreement and the like.

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SUMMARY
CONSIDERATIONS

	Type of Entity		
	C-Corp.	S-Corp	LLC
Pass –Through Tax Treatment		X	X
Financing/Capital Structure	X		
Recognizable Exit Strategies	X	X	X
Limit on Number of Shareholders/Owners		X	
Flexible Employee Compensation Plans	X	X	
Recognized Management Structure	X	X	
Limit of Owner Liability	X	X	X
Established Governing Law	X	X	

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