

Structuring Start-Ups

October 27, 2022

www.klgates.com

Overview

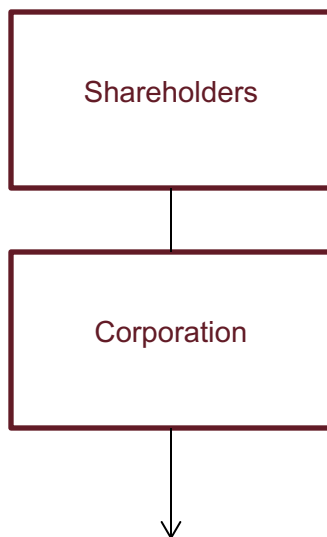
- Choice of Entity
 - For Profits
 - Benefit Corporations/B Corps
 - Non-Profit Corporations
- Founder Arrangements
 - “Clear” the founders
 - Splitting the Pie
 - Founder vesting
 - Restrictive covenants
- Operation of Entity
- Employee Equity

Choice of Entity Choices

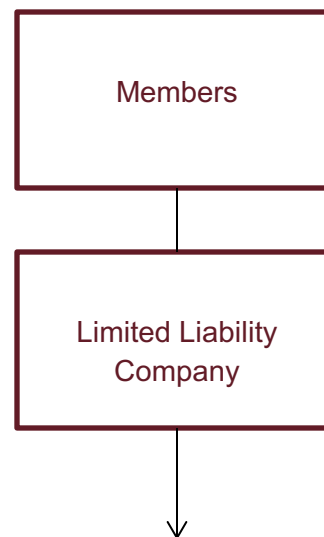
- C Corporation*
 - S Corporation*
 - Limited Liability Company*
 - Sole Proprietorship
 - Partnership
 - Limited Partnership
 - Benefit Corporation* (v. B Corp certification)
 - Non-Profit Corporations
- * Denotes most likely entity choice



Corporate Structure v. LLC Structure



Managed by Directors/Officers



Managed by Managers or Members

Choice of Entity

There is no one answer for all companies
“It depends...”



Limited Liability – Only Expose the Wager

- Form of entity
- Importance of formalities-“piercing the corporate veil”
- Contractual limitations
- Insurance
- Hidden liabilities
 - Unpaid wages and wage taxes
 - Pass-through entities with no cash to pay tax
 - Guarantees



Corporate Formalities

- Bank accounts
- Signatures
- Shareholder/Member and Board Meetings
- Corporate Records (including stock)
- Filings
 - State
 - Tax

Also important for potential investors/purchasers

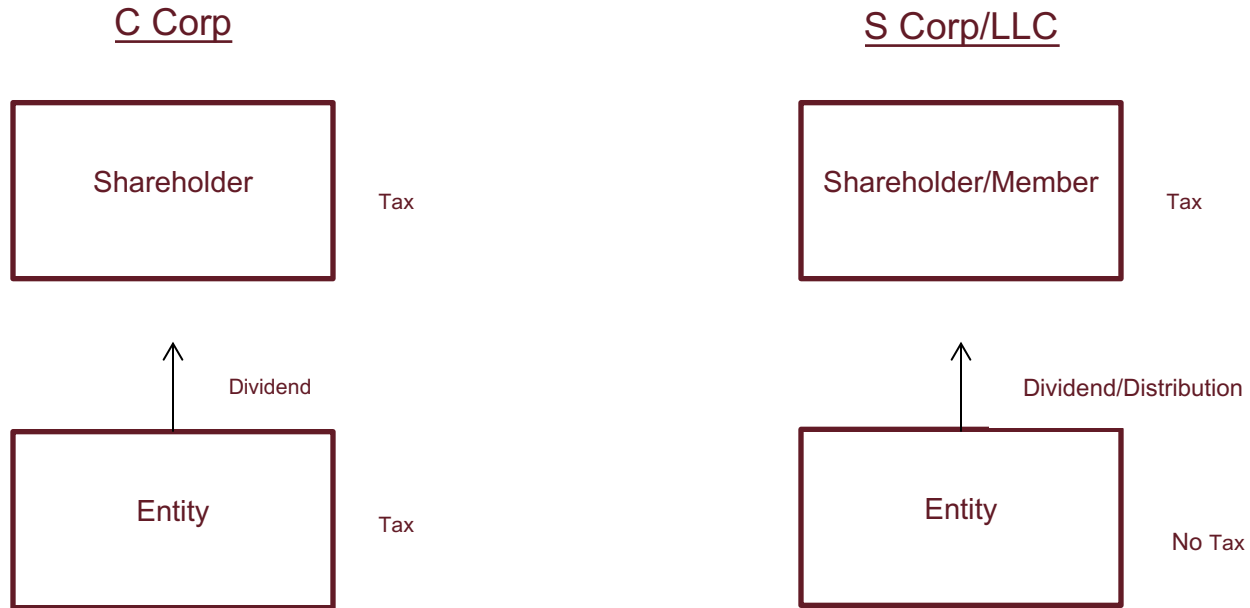
Formalities

Tax – Why you should care!

- Double Taxation (C Corporation)
 - Corporate
 - Individual
- Significance
 - Material cash distributions/dividends
 - Sale of the Company



Illustration of Double Tax



Example of Double Tax on Sale of Assets

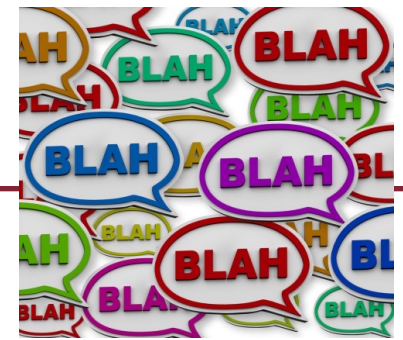
	<u>C Corp</u>	<u>S Corp/LLC</u>
Gain	\$100	\$100
Corporate Tax	\$ 21	\$ 0
After-Tax Entity Income	\$ 79	\$100
Individual Tax - capital gain	\$ 16	\$ 20
Individual After-Tax Cash	\$ 63	\$ 80

Assumed Tax Rates

21% corporate

20% capital gain

Point: Single Layer of tax is better – LLC's, S Corporations



More reasons to care about tax

- Section 1202 – Qualified Small Business (benefit for C Corporations)
 - **100%** exclusion from capital gains/Potential **50%**
 - 5 year minimum holding period
 - Excluded businesses: professional service businesses; real estate companies; financial services businesses
 - Maximum: \$10 million exclusion per shareholder
- Tax-Free Mergers (benefit for corporations)
- “Partner” implications (issue for limited liability companies – benefit for corporations)
 - Self-employment taxes (2.9% of wages)
 - 1099’s and estimated payments
 - Income on tax returns

S Corporations

- Benefits
 - Simplicity
 - Pass-through treatment
- Down-side
 - Single class of stock (other than voting)
 - Limitation on number of shareholders – 100
 - Only individual and certain non-profit corporation shareholders
 - Only citizens or residents of the United States may be shareholders

Other Considerations in Deciding Entity

- Investor Favorable (C-Corporations)
- IPO Favorable (C-Corporations)
- Ease of use (e.g., option pools) (corporations)
- Relative ease of switching from LLC to C-Corporations



	C Corporation	Limited Liability Company	S Corporation	Sole Proprietorship/ Partnership
Limited Liability	Yes	Yes	Yes	No
Flexibility in Ownership	Yes	Yes	No	Yes
Taxation				
• Eliminates Double Taxation/Flow-Through (losses, sale)	No	Yes	Yes	Yes
• Tax-Free mergers on sale	Yes	No	Yes	No
• Section 1202 tax favorable treatment	Yes	No	No	No
Flexibility In Structure	Yes	Yes	No	Yes
IPO Favorable	Yes	No	No	No
VC Favorable	Yes	No	No	No
Employer Eligible	Yes	No	Yes	No
Ease of Use	Yes	No	Yes	Yes
Ease of Switching	No	Yes	Yes	Yes

Bottom Line of Entity Choice



- No simple answer
- “Life-style company” or significant dividends/distributions—consider S Corporation or LLC
- Venture-capital oriented
 - Lean toward a C Corporation
- If model is build/sell after 5 years, consider C Corp
- Easier to go from LLC to C Corp than reverse

Benefit Corporations and LLCs

- For-profit entities that are intended to produce a public benefit(s) and to operate in a responsible and sustainable manner.
- Affirmative duties on directors to consider different stakeholders.
- 39 States (including DE and PA) have adopted legislation authorizing Benefit Corporations/LLC's and/or other forms of social benefit entities.
- May be Taxed as a C Corporation, S Corporation, Partnership, or LLC.
- Limited tax benefits in some cities, including Philadelphia



Benefit Corporations and Companies

Advantages

- Great Marketing Tool
- Strong Commitment to Social Purpose
- Legal Protection for Directors
- Flexibility for the Board in Case of Sale of the Company
- May help with attracting grants or social impact investors

Disadvantages

- Traditional Investor Hesitancy / Raising Funds.
- Legal Uncertainty/Few Legal Precedents.
- Additional Reporting and Disclosure Requirements.
- No Tax Incentives (except for small local tax reductions in some cities, including Philadelphia).

B Corp Certification

Advantages

- Commitment to Social Purpose
- Access to Community of Other B Corps
- Marketing Tool for Consumers

Disadvantages

- No Tax Incentives
- Stringent Requirements
- Burdensome Reporting

Nonprofit Corporations

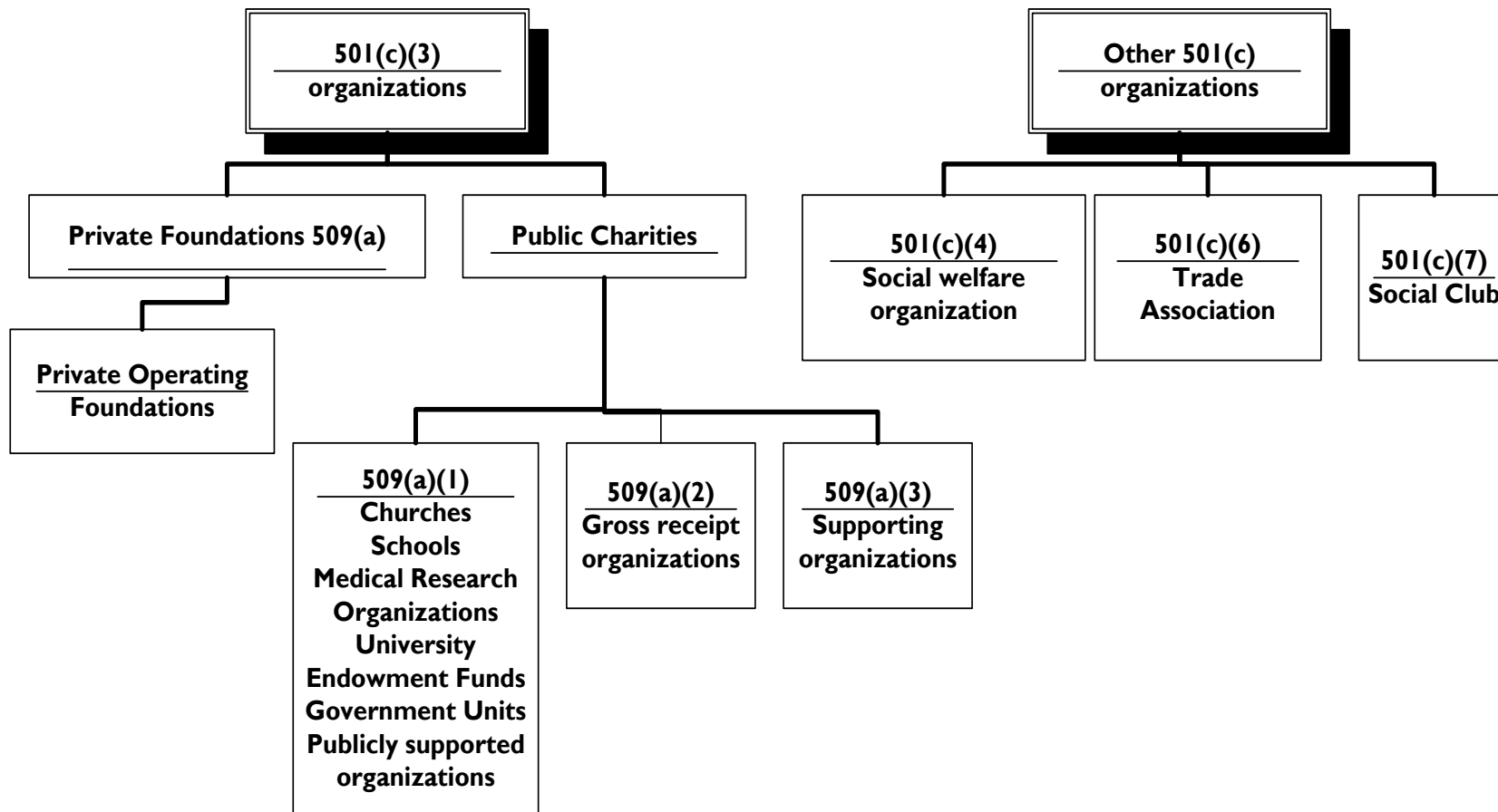
Advantages

- Liability protection
- Tax-exempt status
 - Exemption from federal income tax
 - May be prerequisite for state tax benefits
 - 501(c)(3) status – tax-deductible contributions

Disadvantages

- Sharing control and governance
- Limitations on distributions
- Restrictions associated with tax-exempt status
- Public scrutiny

U.S. Tax-Exempt Organizations



501(c)(3) Organizations

- Purposes include
 - Religious
 - Charitable
 - Scientific
 - Testing for public safety
 - Literary or educational
 - To foster national/international sports competition
 - Prevention of cruelty to children, animals
- Most favorable status
 - Exempt from federal income tax
 - Contributions deductible
- Subject to most stringent requirements
- Must apply to IRS for tax-exempt status (Form 1023)

501(c)(3) Organizations

Two Types of 501(c)(3) Organizations

- **Default: Private Foundation**
 - Typically supported by small number of individuals or corporation
 - Subject to more stringent rules
 - Typically grant maker; may also be private operating foundation

- **Public Charities**
 - School, church, hospital
 - Donative organization
 - Gross receipts organization
 - Supporting organization

501(c)(3) Organizations

Organizational and Operational Tests

- Purposes limited to exempt purposes
 - Noncharitable activities may not constitute more than an insubstantial part
- No private inurement (distribution of earnings to directors, officers and members)
- No political activity
- Limited lobbying activity
- Dissolution clause → assets devoted to charitable purposes in perpetuity

501(c)(3) Organizations

Prohibition on Private Inurement

- No part of net earnings may inure to benefit of insiders
- Insiders include founders, directors, officers
- Examples
 - Excessive salaries – Not reasonable & ordinary or necessary
 - Payment of greater than FMV for property without justification for a premium
 - Free use of the organization's property in a manner different from the public
 - Loans without adequate security or interest

501(c)(3) Organizations

Prohibition on Private Benefit

- Private Benefit – Occurs where the organization provides more than an “incidental” benefit to a non-insider
- Examples
 - All examples in inurement slide
 - Benefit received disproportionately by some
 - Charitable class too small
 - Joint ventures with for-profit entities (if not properly structured)

501(c)(3) Organizations

Excess Benefit Transactions – Excise Tax

- Transactions between insiders and the organization, where the insider receives funds or property worth more than value of goods/services provided
 - Includes compensation arrangements
- Insider is someone who has substantial influence over affairs of organization (“disqualified person”)
 - Includes directors, officers, family members, and entities controlled by them
- Significant excise taxes
 - Disqualified person pays 25% of the excess benefit
 - Board members, if they knowingly participate in the transaction, may pay 10% of the excess benefit

501(c)(3) Organizations

Unrelated Business Income

- IRC §512 taxes an exempt organization on its unrelated business income (UBI).
- UBI is income from:
 - A regularly carried on
 - Trade or business activity
 - Unrelated to the exempt organization's charitable purposes
- Several exemptions
- Penalties
 - Taxed at standard corporate rates
 - Revocation of tax-exempt status if substantial

Name of Entity

- Check availability
- Quick trademark search
- Quick “Google” search

Caution: The name of the entity can be changed – don’t overthink it!!!

*What’s in a
Name?*

State of Formation

- Taxation
- Predictability
- Cost
- Attractive to capital
- In general

(a) “Fancy capital structure” or “Venture capital”-
Delaware

(b) Otherwise-PA





Founders Roadblocks

- Non-competition/non-solicitation
- Confidentiality agreements
- Fiduciary duties
- Intellectual property assignments
 - Agreements
 - Policies

Founder Employment/Consulting Arrangements

- Role of Founder going forward
- Compensation
- Intellectual Property Assignments—critical
- Restrictive Covenants
 - Confidentiality – no limitation
 - Non-compete
 - Non-solicit (employees and customers)
- Term and geographic limitations
- Severance

Founder Equity Arrangements—Splitting the Pie

- Lessons Learned
 - Keep in mind the inevitable dilution
 - Keep it simple (i.e., Avoid fancy formulas)
 - Err on the side of incenting those who are providing value going forward
 - Even splits are not usually the right answer
 - Beware of the dreaded “50/50”
 - Shot-gun
 - Third party director
 - Arbitration



- Use Demmler's Founders' Pie Calculator
 - Evaluate related contributions
 - Weight
- Consider relative contributions (current and anticipated)
 - Idea
 - Business Plan
 - Domain Expertise
 - Commitment and Risk
 - Responsibilities

Demmler Founder Pie Chart – Example

- (1) Inventor – leader in domain
- (2) “Business guy” – business and industry knowledge
- (3) Technology – Inventor’s right-hand man
- (4) Research team member – no future

Demmler Founder Pie Chart (Example)

	Weight	Founder 1 Inventor	Founder 2 Business Guy	Founder 3 Technologist	Founder 4 Researcher
Idea	7	10	3	3	0
Business Plan	2	3	8	1	0
Domain Expertise	5	6	4	6	4
Commitment & Risk	7	0	7	0	0
Responsibilities Going Forward	6	0	6	0	0

Demmler Founder Pie Chart (Example)

	Founder 1 Inventor	Founder 2 Business Guy	Founder 3 Technologist	Founder 4 Researcher
Idea	70	21	21	0
Business Plan	6	16	2	0
Domain Expertise	30	20	30	20
Commitment & Risk	0	49	0	0
Responsibilities	0	36	0	0

Total Points	106	142	53	20	321
% of Total	33.0%	44.2%	16.5%	6.2%	100.0%

Founder Equity Arrangements

- Vesting Arrangements
 - Amount of vested stock
 - Length of time of vesting
 - Buy-back arrangements
 - Effect of termination and/or sale of company
- Consider impact of Seed/Venture Financing

Operational Considerations

- Decision-Making/Management
 - Directors/Managers
 - Right to appoint
 - Officers
- Majority v. super-majority decision-making
 - Board
 - Member/Shareholder
- Restrictions on Transfer
 - Absolute prohibition or Company consent
 - Rights of first refusal

Employment/Consulting Arrangements – Similar to Founders

- Term/severance
- “At-will”
- Intellectual Property Assignments—critical
- Restrictive Covenants
 - Confidentiality – no limitation
 - Non-compete [Difficult to enforce with consultants]
 - Non-solicit (employees and customers)
- Term and geographic limitations

Employee Equity

- Types of Equity
 - Restricted equity (corporations; LLC's)
 - Options
 - Qualified Options (corporations only)
 - Non-Qualified Options (corporations; LLC's)
 - Profits Interests (LLC's)
 - Phantom Equity (corporations; LLC's)



Other Terms

- Vesting
 - Time-Based
 - Performance-Based
- Repurchase Right
 - Vested
 - Non-vested

Amount of Employee Equity

- Amount necessary to attract and retain talent
- A huge option pool may work against you
- Don't go too low in the employment pool