Structuring Start-Ups

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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

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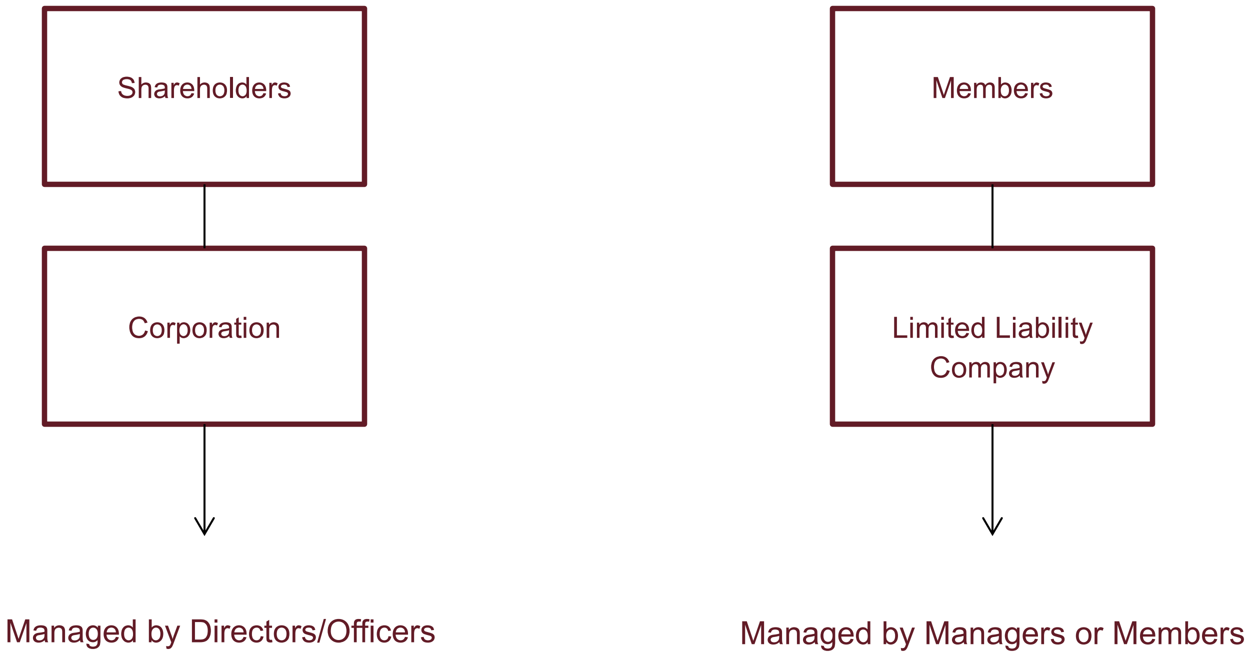
Choice of Entity Choices

- C Corporation*
- S Corporation*
- Limited Liability Company*
- Sole Proprietorship
- Partnership
- Limited Partnership
- Benefit Corporation/ B Corp*
- Non-Profit Corporations

* Denotes most likely entity choice

Corporate Structure v. LLC Structure



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

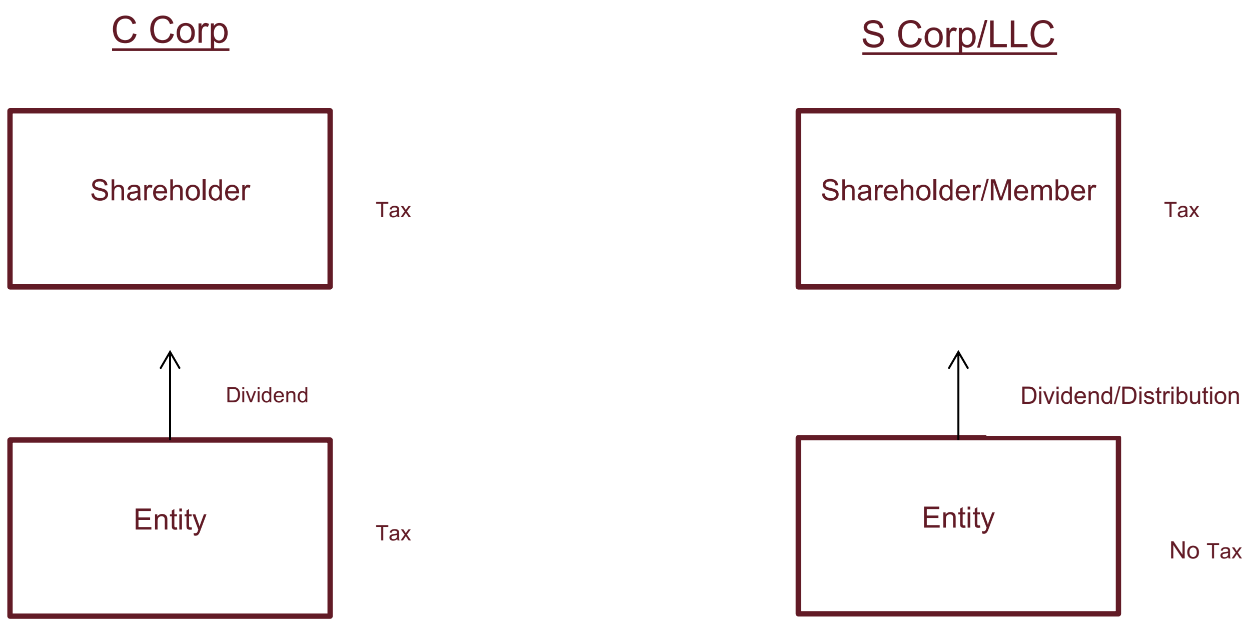
Corporate Formalities

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

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

	C Corp	S Corp/LLC
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/Proposed to be **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

Choice of Entity

	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

- For-profit entity that is "intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner".
- Affirmative duties on directors to consider different stakeholders.
- Adopted in 38 States
- Taxation: May be Taxed as a C Corporation, Partnership or as an S Corporation

Benefit corporation

Advantages

- Great Marketing Tool
- Strong Commitment to Social Purpose
- Legal Protection for Directors
- Flexibility for the Board in Case of Sale of the Company

Disadvantages

- Investor Hesitancy / Raising Funds
- Legal Uncertainty/No Legal Precedents
- Additional Reporting and Disclosure Requirements
- No Tax Incentives

B Corp Certification

- Third Party Certification
- Not a Legal Entity
- Laundry List of Requirements
  - Purpose
  - Amendment of Certificate of Incorporation
  - Annual Reporting Requirements
  - Other Burdens

B Corp Certification

Advantages

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

Disadvantages

- No Tax Incentives
- Burden; Stringent Requirements

Nonprofit Corporations

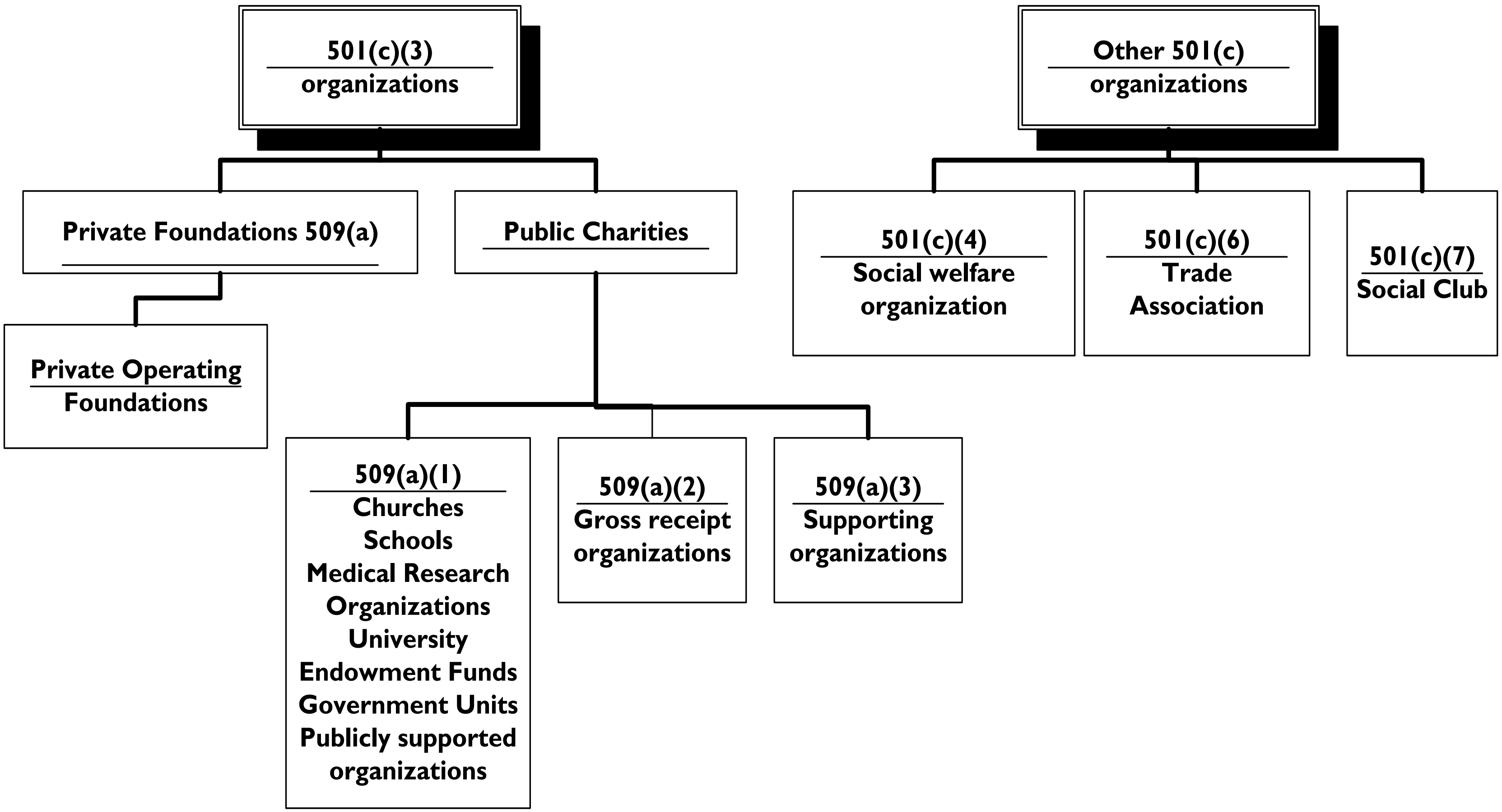
Advantages

- 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!!!

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

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