Structuring Start-Ups

October 27, 2022
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

Shareholders

Corporation

Managed by Directors/Officers

Members

Limited Liability Company

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
Tax – Why you should care!

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

**C Corp**
- Shareholder
- Entity
- Tax
- Dividend
- Tax

**S Corp/LLC**
- Shareholder/Member
- Entity
- Tax
- Dividend/Distribution
- No Tax
### Example of Double Tax on Sale of Assets

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>S Corp/LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Corporate Tax</td>
<td>$ 21</td>
<td>$ 0</td>
</tr>
<tr>
<td>After-Tax Entity Income</td>
<td>$ 79</td>
<td>$100</td>
</tr>
<tr>
<td>Individual Tax - capital gain</td>
<td>$ 16</td>
<td>$ 20</td>
</tr>
<tr>
<td>Individual After-Tax Cash</td>
<td>$ 63</td>
<td>$ 80</td>
</tr>
</tbody>
</table>

**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
## Choice of Entity Considerations

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

• Not a Legal Entity
• Third Party Certification, similar to Fair Trade or LEED certification
• 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
- 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
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)
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)

<table>
<thead>
<tr>
<th></th>
<th>Weight</th>
<th>Founder 1</th>
<th>Founder 2</th>
<th>Founder 3</th>
<th>Founder 4</th>
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<tbody>
<tr>
<td>Idea</td>
<td>7</td>
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<td>3</td>
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<tr>
<td>Business Plan</td>
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<tr>
<td>Domain Expertise</td>
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<td>6</td>
<td>4</td>
<td>6</td>
<td>4</td>
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<tr>
<td>Commitment &amp; Risk</td>
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<td>0</td>
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<tr>
<td>Responsibilities Going Forward</td>
<td>6</td>
<td>0</td>
<td>6</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
## Demmler Founder Pie Chart (Example)

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<th>Founder 3</th>
<th>Founder 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Idea</td>
<td>70</td>
<td>21</td>
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<tr>
<td>Business Plan</td>
<td>6</td>
<td>16</td>
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<tr>
<td>Domain Expertise</td>
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<tr>
<td>Commitment &amp; Risk</td>
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<tr>
<td>Responsibilities</td>
<td>0</td>
<td>36</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

| 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