

# Choice of Entity

OTBC

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## Highlights

- ▶ **Choose the legal/tax entity**  
LLC/corporation
- ▶ **Determine your capital structure**  
Founders' ownership, equity compensation, outside investment
- ▶ **Corporate governance**  
Board of directors/LLC managers

## **The Silicon Valley Model**

- C corporation is prevailing Silicon Valley model
- Limited liability company (LLC) generally provides tax advantages to owners
- Angel and VC investors may disfavor LLCs

## **Factors Involved in Choice of Legal/Tax Entity**

- Liability protection
- Income tax treatment
- Social Security/Medicare tax treatment/ fringe benefits (cafeteria plans, benefit plans, etc.)
- Ownership restrictions
- Equity compensation
- Ability to convert to another form of entity
- Attractiveness to potential investors

## **Liability Protection**

- Inside out
- Outside in
- Limited liability:
  - Corporations
  - LLCs
  - Others
- Unlimited liability:
  - Sole proprietor
  - General partnership

## **Income Tax Treatment**

- LLC treated as a disregarded entity (single member)
- LLC treated as a partnership (multiple members)
- S corporation
- C corporation

## **Corporations Are Like Lobster Traps**

- Property can be contributed tax free (subject to the 80% control and investment company limitations)  
**BUT**
- Property cannot be distributed without triggering a corporate level tax
- **REMINDER:** this lobster trap metaphor applies to S corporations as well as C corporations

## **Social Security, Medicare Tax, Fringe Benefits**

- Social Security capped at first \$102,000 (2009) at 6.2%
- Medicare uncapped at 1.45%
- Self-employed individuals pay both employer/employee portion
- S corporation/LLC benefits limited

## **Ownership Restrictions**

- **S corporations:**
  - Limited to 100 shareholders, no foreign or corporate owners, no partnership owners
- **LLCs/C corporations:**
  - No ownership limitations

## **Equity Compensation**

- In a C corporation, stock options, restricted stock, or phantom equity
- In LLC, profits-only interest, equity options, or phantom equity
- FMV issues

## **Ability to Convert to Another Form of Entity Without Adverse Tax Results**

- Conversion of S corporation to C corporation
  - Easy, but difficult to go back
- Conversion of C corporation to S corporation
  - Easy, but hidden tax trap
- Conversion of any corporation (C or S) to LLC
  - Probably taxable
- Conversion of LLC to corporation
  - Easy, generally tax-free

## **Summary of LLC Tax Advantages**

- While operating:
  - Pass-through desirable tax losses to investors
  - Single level of tax on any operating profits
- If acquired for cash, single level of tax on sale of assets

## **Attractiveness to Investors**

- Tax-exempt VC investors
- C corporation necessary for tax-free merger or IPO
- Conversion timing can be tricky
- Investor familiarity with corporate governance and control rights

## **Determining Your Capital Structure**

- Determine founders' equity
- Consider option pool or other equity compensation
- Start thinking about what you will offer outside investors

## **Founders' Equity**

- In a C corporation, founders own common stock
- In an LLC, founders own membership interests
- Document share amounts or membership percentages early
- Later adjustments, at a higher valuation, are difficult
- Tricky when property or cash and others receive equity for services

## **Outside Investments**

- Debt-equity continuum, from traditional secured debt to common stock
  - Reflects risk- reward tradeoff
- Convertible debt and participating preferred are in the middle
- Flexibility in creating equivalent LLC membership interests

## **Corporate Governance**

- **Corporations:**
  - Day to day operations managed by officers
    - Only president and secretary required
  - Under the direction of the board of directors
  - Articles, bylaws, statute, and caselaw

## **Corporate Governance**

- **LLCs:**
  - Managed by either members (if member- managed) or managers
    - Appropriate for start-up company
  - Can create board and officers in operating agreement, but duties not defined by statute
  - Generally, more flexibility in operating agreement, with less statutory and case law guidance

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