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Entity Selection and Considerations for Conversion: Advantages and Disadvantages

Formation and Elections, Start-Up and Organization Costs, Tax Issues

TUESDAY, SEPTEMBER 28, 2021

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Today's faculty features:

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Entity Selection and Considerations for Conversion: Weighing Advantages and Disadvantages

Becker

Robert C. Brighton, Jr., Esq.
BECKER & POLIAKOFF, P.A.

What You Will Learn

As a business attorney, you are frequently asked what type of entity should be used for a particular transaction or purpose.

The answer depends on a variety of factors, both legal and practical.

In this course you will learn the key legal and practical considerations impacting on this choice, and what factors may cause a change in the type of entity selected initially including:

- How does your client's business or purpose influence the limited choice of an entity and influence a decision to change the entity?

- How does the number of parties involved in the entity affect the choice of entity?

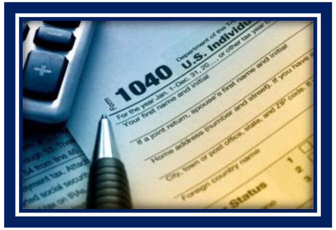
What You Will Learn (Con’t.)

- How do the types of assets owned or used in connection with the business or purpose affect the choice of entity?

- How does the need to engage in financing transactions impact on the choice of entity?

- How do tax considerations impact on the choice of entity?

- When is it advisable to employ a holding company structure, and use multiple entities (and perhaps different types of entities)?



I. An Overview of the Types of Business Organizations

A. Sole Proprietorships

i. Individuals conducting a business directly

1. No shield from personal liability

2. Taxed at personal rate

3. Advantages include simplicity and lower operating expenses related to the business organizations

I. An Overview of the Types of Business Organizations (Con't.)

B. General Partnerships

- i. Two or more individuals or entities conducting a business collectively

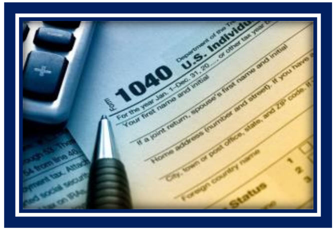
    1. What are the rules determining when a partnership is formed?

    2. No shield for individuals or entities for personal liability

    3. May be comprised of one or more of limited liability entities

    4. When is property partnership property?

    5. Taxed at partner's individual tax rate



I. An Overview of the Types of Business Organizations (Con't.)

6. Profits and losses allocated as agreed between/among the partners

7. Each partner has the right to make decisions on behalf of the partnership

   a. subject in some cases to a statement of partnership authority or a statement of denial

8. Partnership interests generally are not a security for securities law purposes

9. Used most often when each partner will participate fully in the operation of the partnership business

I. An Overview of the Types of Business Organizations (Con’t.)

10. Exists independent of any written document though one may be used to create certain contractual agreements between the partners

    a. Joint ventures are typically general partnerships

11. Effects of partnership disassociation

12. Often informal, but can be complex if the rights, responsibilities and interests of the partners are dissimilar.

I. An Overview of the Types of Business Organizations (Con’t.)

ii. Limited Liability Partnerships

a. May include professional limited liability partnerships among professionals, such as attorneys, architects, financial advisors, insurance agents and others

I. An Overview of the Types of Business Organizations (Con’t.)

C. Corporations

i. Corporations conducting a business as an entity have:

1. Flexible capital structure
2. Flexible management structure
3. Limited liability
4. Stock regarded as security for securities law purposes
5. Well defined jurisprudence, particularly in business friendly jurisdictions such as Delaware

I. An Overview of the Types of Business Organizations (Con’t.)

ii. Subchapter S corporations

1. Provide limited liability protection

   a. Can be structured as a limited liability company or partnership

2. Permit taxation at shareholder level

3. Limitations on capital structure and ownership

4. Do not permit dividend received deduction that would be available to corporations

5. Have some tax advances not available to limited liability companies or limited partnerships relating to local taxation

I. An Overview of the Types of Business Organizations (Con’t.)

6. Q-subs

   a. A subsidiary 100% owned by S corporation treated as part of its parent

7. Not subject to limitations of 10% on charitable contributions

8. Requirements for profit distributions

iii. Not for profit corporations

1. Not to be confused with tax exempt entities, such as Section 501(3)(c) tax exempt entities

2. Separate regulatory requirements

3. Not available in all jurisdictions

4. Different management structures than for profit corporations

I. An Overview of the Types of Business Organizations (Con't.)

iv. Social purpose corporations and benefit corporations

1. Limitations on purpose and use of assets
2. Available in some, but not all jurisdictions
3. Also consider issues in states where qualified

I. An Overview of the Types of Business Organizations (Con’t.)

D. Limited Partnerships

i. Comprised of one or more general partners and at least one limited partner

ii. Provides limited liability to limited partners who do not actively participate in the business

iii. Pass through for tax purposes

iv. Flexible as to distribution rights

v. Contractual provisions generally set forth in a written agreement

vi. Default provisions provided by statute

vii. May be comprised of a mix of entities, such as corporations (both C-corps and S-corps) and limited liability companies

I. An Overview of the Types of Business Organizations (Con’t.)

E. Limited Liability Companies

i. Hybrid entities that combine the characteristics of corporations and partnerships

ii. Highly flexible as to management, distributions and allocations of profits and losses

ii. Generally evidenced by an operating agreement or limited liability company agreement which sets forth contractual rights and obligations of members

1. Member managed or manager managed

I. An Overview of the Types of Business Organizations (Con’t.)

2. Different membership classes, including voting only or pecuniary interest only classes

3. Can include restrictions on transfers or members interests

4. Ability to allocate profits and losses

5. Ability to disassociate from the limited liability company

6. Personal Representative for tax purposes

7. Can include tax advantaged investments

I. An Overview of the Types of Business Organizations (Con't.)

iv. Default provisions provided by statute

v. Series LLCs

1. Permit separate series for individual purposes within the same entity

2. Not permitted in all states, but permitted as foreign entities in some states where formation is not permitted (*e.g.*, Florida)

3. Issues regarding isolation of liabilities and assets in bankruptcies

I. An Overview of the Types of Business Organizations (Con’t.)

F. Trusts

i. Statutory business trusts

1. Generally used for estate planning or special purpose business transactions

2. Not a separate legal entity

a. Act through trustees for the benefit of beneficiaries

G. Joint Venture Entities

II. General Issues Applicable to Entities

A. Limited Liability

B. Management

i. Fiduciary Duties

* May be limited in some circumstances though subject to general obligation to have fair dealing

C. Allocations for Profits and Losses

D. Raising Capital

E. Restrictions on Transfers of Ownership Interests

II. General Issues Applicable to Entities

F. Taxation

i. Effect of Tax Cuts and Job Act/Future Obligations (including retroactive obligations)

G. Information Rights

i. Statutory and Contractual

H. Dispute Resolution Process

i. Arbitration

ii. Forced Sale (shotgun solution)

I. Dissolution and Winding Up

II. General Issues Applicable to Entities

J. Conversion, Merger & Sale of Assets

i. Effect of Conversion

a. Different on a state-by-state basis

ii. Effect of Merger

a. Subject to state law

iii. Approval Requirements

a. See above but generally required

III. Issues Applicable to Specific Situations

A. Estate Planning

B. Investment Funds

C. Foreign Investors/Property

D. Regulated Industries

   i. Financial Institutions

   ii. Real Estate

   iii. Utilities

III. Issues Applicable to Specific Situations

E. Professionals

I Doctors

ii. Attorneys

iii. Other Professionals

III. Issues Applicable to Specific Situations (Con't.)

F. Opportunity Zones

i. Qualified OZ Funds

ii. Restrictions on Redemptions and Transfers of Interest

iii. Restrictions on Investments

III. Issues Applicable to Specific Situations (Con't.)

A. Choice of State *e.g.* Delaware, Nevada or Other State

B. Issues Peculiar to LLCs

i. Manager vs. Member Managed

ii. Affiliate Transactions

C. Secured Financings

i. Use of Special Purpose entities

ii. Method for perfection

Thank You!

For questions, please feel free to contact me:

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Entity Selection and Considerations for Conversion: Advantages and Disadvantages

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Strategic Considerations Around Management, Taxation and Conversion

- How do entity selection factors and management considerations interact?
  - Legal distinctions; jurisdiction
  - Equity compensation
  - Capital-raising strategy – will VCs or institutional equity be involved?
  - Tax considerations are also intertwined with management factors (equity comp, 1202)
  - Ethical considerations for counsel

The Right Entity – 5 Easy Questions

1. How many founders?

Factor	No	Yes
More than one founder?	Less risk in using LLC as an initial option; disregarded entity; can use Schedule C to report results	LLCs can be complicated b/c they are partnerships: tax accounting, capital accounting

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The Right Entity – 5 Easy Questions

2. When will we make money?

Factor	No	Yes
Will the company experience losses at first, followed by expected profits?	If company will be cash-flow positive from the beginning of operations, then an LLC can be tax-efficient	A corporation (C-corp.) can use losses, subject to certain limitations on a change of control

The Right Entity – 5 Easy Questions

3. What should we do with the money?

Factor	No	Yes
Distribute profits to founders, instead of using them to grow?	C-corporation can use dollars inside the taxpayer entity IRC 1202 treatment available if QSBS requirements are met	LLCs provide single-level tax on distributions (licensing entity)

The Right Entity – 5 Easy Questions

4. Do we want to issue options?

Factor	No	Yes
Will the company use equity to attract and retain senior management?	If the partners will essentially deal in the capital they contributed upon entry, then an LLC will work fine	Corporate options are very simple; LLC profits interests are more complicated: tax accounting, booking up capital accounts

The Right Entity – 5 Easy Questions

5. Who Will Be Our Investors?

Factor	No	Yes
Will the company seek to attract institutional investment (VCs)?	Angel and individual investors, and some strategics, can use losses. Also see Questions (2) and (3) regarding profits	Most VCs will not accept pass-through treatment; VC documentation (from Series Seed to NVCA models) are built for corporate form

Entity Selection –Recap

LLC	**C-Corp.**
-Single-member or few fixed partners - don’t intend to lose money initially - won’t use equity to attract and retain management - won’t seek institutional equity -intend to distribute profits	-Team of founders with different contributions and attributes - intend to use equity to grow the team - expect initial losses and want to carry them forward - intend to seek VC funding - use profits to grow the company to an exit

General Considerations

- For most high-growth angel or VC-backed businesses, a Delaware corporation will be the preferred entity
  - Preferred by institutional investors with tax-exempt LPs
  - Subchapter S corporations less and less common because of requirements (< 100 US natural persons, single class of stock)
- For PE-backed companies, LLCs may be preferred
  - Recaps of profitable businesses
  - LBOs, MBOs
- Frequently, companies that do not need Delaware corporation status can be formed as LLCs; thus “local law” corps are less common

Sources of Applicable Law -- Corporation

- Delaware General Corporation Law
  - Formation and governance
  - Board responsibilities
  - Stockholder rights
- Delaware Chancery Court and Delaware Supreme Court
- Fiduciary duties
- “Business judgment” rule
- Uniform Commercial Code; federal and state securities laws; state and local laws

Sources of Applicable Law -- LLCs

- Delaware Limited Liability Law (6 Del. C. §§ 18-101, et seq)
  - LLC Act provides skeleton requirements, leaves a lot of flexibility to the LLC operating agreement
  - LLC can be “member-managed (think partnership) or “manager-managed” (think corporation)
  - Some LLCs are formed as close
- Chancery Court and Supreme Court decisional database is growing
- UCC and other local laws are similar
- Management and tax considerations should be considered strategically

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Typical Management Features of Corporation

- Independent legal person with indefinite life
- limited liability for investors
- free transferability of share interests
- centralized management
- Stockholder exercise the electoral franchise; directors control management and operation of the corporation (§ 141(a)) (a "republic, not a democracy

Typical Features of an LLC

- Equity is owned by members
- An LLC can be “member-managed” (think partnership) or “manger-managed” (think corporation)
- Typically, an LLC is taxed as a partnership
- limited liability for investors
- free transferability of share interests

Management Questions

– Who owns the entity?
– What management resources are needed?
  • Tech
  • Growth/operations
  • financial
– Can the owners run the company? Or will the owners need to hire outside resources?

Management – Equity Compensation

- Equity interests are much easier to grant for a corporation
  - Adopt plan, issue options
  - Tax and accounting rules are very well understood by practicioners and participants alike
  - However, this is not the case for LLCs

Management – Equity Compensation

– Corporation option plans

- ISOs and NSO, depending on employment status and IRS regulations
- Employees can receive “incentive stock options
- Non-employees (consultants, directors) can receive
  non-statutory options”

Management – Equity Compensation

– ISOs

- Not taxed upon grant
- Not taxed upon exercise (subject to compliance with restrictions)
- Taxed upon disposition (gains or ordinary income)
- Holding period: 1 year from exercise, 2 years from grant
- Subject to limitations and rules (limit on value of grant, special rules for 10% holders)
- ISOs are highly favored by employees – even though it is difficult in practice to achieve the intended tax benefits

Management – Equity Compensation

– NSOs

- Simply, a contract to buy shares at a later date
- Not taxed upon grant
- Taxed upon exercise: ordinary income om the “spread” between the exercise price and FMV of the shares on the date of exercise
- After exercise, the holder holds a capital instrument subject to short- or long-term capital gains tax upon disposition

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Management Questions

- LLC Equity Interest
  - Not simple
  - LLCs issue "profits interests"
  - Not taxable upon grant
  - However, profits interests:
    - require <u>expert, coordinated</u> tax and accounting resources
    - require employees to obtain tax advice
    - Change the tax reporting for profits interests holders (K-1 instead of W-2)
    - in general, can be complicated and produce unexpected/undesirable outcome

Management – Equity Compensation

- LLC equity alternatives
  - Option to purchase LLC membership interest
    - Still requires tax and accounting expertise
  - Phantom equity/cash awards based on enterprise value
    - simple and effective

Management – Equity Compensation

– Equity Incentives – Conclusions

- It is much, much easier to issue equity in a corporation
- Strategic considerations

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Conversion

- An entity can obtain a Delaware corporate franchise without creating a new entity and effecting a merger with the new entity.
- Most entities (LLCs, trusts, business trusts, REITs, general and limited partnerships), or a foreign corporation, may convert to a corporation (§265); and vice-versa (§266).
- Stockholder approval required;
- EIN number and other tax questions

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Conversion Recipe -- DE LLC to DE Corporation

- LLC adopts “plan of conversion”
  - Numbers of shares of new corp. for each member, etc.
  - Name directors and officers of the corporation
- LLC members or managers approve
- Corporation executes initial consent of incorporator
- LLC files certificate of conversion
- Corp. files certificate or incorporation
- Corp. executes all customary startup documentation: bylaws, initial authorizations

Effects of Conversion

- State law
  - The same entity continues its existence
  - Leases, employment relationships, contracts, IP ownership continue in effect
  - Under state law, the entity has essentially swapped out one form of state-recognized legal existence for another
  - For federal tax purposes it is a bit more substantial

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Conversion -- Notes

- Tax considerations
  - termination of partnership; final partnership return
    - LLC provides K-1 to partners; corporation files its own Form 1120
  - New EIN may be required
  - Beware the "double taxation" hype
    - Conventional wisdom (and Google) tell us that "double taxation" is a fate too horrible to contemplate
    - This issue is very real for, e.g., selling a manufacturing company
    - However, for tech companies, not as much
- Why convert?
  - Investor requirements
  - Business pivot introduces new realities, need to use equity compensation, etc. (see "Manage,": above)
  - I.R.C. 1202 (potentially higher basis, but clock starts running only upon conversion)

Note on Ethical Considerations

- Now that you know how to advise your client as to entity choice: who are what is/are your client(s)?
- Review your jurisdiction's ethical rules and interpretations on the representations of entities
- The existence of the attorney-client relationship is generally in the reasonable belief of the putative client
- This analysis is always tricky in the startup space, and with respect to closely-held corporations, but can be even more complex in the context of, e.g., a member-managed LLC
- Even if your engagement letter carefully states that you represent only the entity, and not any individual, (i) you may be held to owe a fiduciary duty to minority members (e.g., Massachusetts law) or (ii) the founder of the LLC may be seen as a current or former member, especially if you have a relationship with the founder.

Questions/Comments?

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