
Choosing the Best Entity for Your Client's Business

Presented by Peter Mirakian III
Partner, Spencer Fane Britt & Browne
LLP

Introduction

- Welcome
 - Objectives
 - Analyze entity choice options
 - In a variety of client fact patterns
 - Consider tax, securities, governance issues
 - Drafting points in Operating Agreements, Stock Restriction Agreements, etc.
 - State law and limitation of liability
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Instructor's Background

- Spencer Fane is a 130-lawyer, full-service firm with offices in Kansas City and St. Louis, MO; Overland Park, KS; and Omaha, NE
 - I represent closely held and public companies in the areas of securities, mergers & acquisitions, tax, and corporate governance
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Willy and Wanda, Window Washers

- Willy and Wanda want to start a window-washing business
 - 50/50 ownership
 - Each contributes \$5,000 to buy supplies
 - Each will work full-time in the business
 - Want to split everything 50/50
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Willy and Wanda, Window Washers

- Possibilities
 - General partnership
 - Corporation
 - Limited liability company
 - Liability Limitations
 - Partnership—unlimited
 - Corporation/LLC—limited
 - Insurance
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Willy and Wanda, Window Washers

■ Liability Issues

- ❑ No entity eliminates personal liability for personal actions
 - ❑ Corporation = LLC
 - ❑ See Section 25 of the Model Business Corporation Act:
 - A holder of or subscriber to shares of a corporation shall be under no obligation to the corporation or its creditors with respect to such shares other than the obligation to pay to the corporation the full consideration for which such shares were issued or are to be issued.
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Willy and Wanda, Window Washers

■ Veil Piercing

- Governance requirements
 - Commingling assets
 - Alter Ego
 - Applies to LLCs, too
 - See, e.g., *Hollowell v. Orleans Regional Hospital, LLC*, No. Civ. A9504029 (E.D. La. May 29, 1998), *aff'd* 217 F.3d 379 (5th Cir. 2000)
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Willy and Wanda, Window Washers

- Tax Distinctions
 - One layer versus two
 - Employment tax
 - Flexibility down the road



Willy and Wanda, Window Washers

■ Corporate Income Tax

- ❑ Money earned by corporation is taxed at the entity level
- ❑ Dividends to shareholders are taxed to the shareholders
- ❑ Dividends are currently taxed at 15%, so the issue is less pronounced than it may become

■ Partnership Income Tax

- ❑ Money earned by partnership is allocated to the partners
- ❑ Allocable income is taxed only at the partner level, not at the partnership level
- ❑ Allocations increase partners' basis, so distributions are typically not taxed

Willy and Wanda, Window Washers

- S Corporation
 - Subchapter S of the Internal Revenue Code
 - Corporation taxed as a pass-through entity
 - Requirements (IRC § 1361)
 - 100 shareholder limit
 - All shareholders must be individuals, estates, certain trusts, banks, and certain exempt organizations
 - All shareholders must be US residents
 - Only one class of stock
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Willy and Wanda, Window Washers

- One Class of Stock (§ 1361(b)(1)(D))
 - May have voting and non-voting common
 - Distribution and liquidation rights must be identical for all shares
 - May not have preferred shares
 - “Straight” debt is OK (§ 1361(c)(5))
 - Not convertible
 - Interest rate not contingent on profits
 - Creditor is bank, individual, estate, certain trusts
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Willy and Wanda, Window Washers

- Flexibility Concerns with S Corporation
 - Ownership limitations may hamper later decisions to raise money or bring in a corporate shareholder
 - S corporation does not escape repeal of the *General Utilities* doctrine
 - If corporation distributes property worth more than its basis, § 311(b) treats the distribution as a sale by the corporation for fair market value followed by a distribution
 - Thus, corporate-level taxable income flows through to S shareholders
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Willy and Wanda, Window Washers

- More Flexibility Concerns
 - Built-in gain at time of S election
 - S may have C sub
 - S may have 100%-owned qualified subchapter S subsidiary
 - S may not otherwise be a shareholder in an S
 - Single class of stock and limits on number of shareholders may restrict benefit plan options
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Willy and Wanda, Window Washers

■ Corporate Employment Tax

- Employment tax applies to wages
- Not to dividends
- True for S and C corporations
- Must pay a reasonable wage

■ Partnership Self-employment Tax

- All allocations to general partners are subject to self-employment tax
 - Allocations to limited partners are not
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Willy and Wanda, Window Washers

- **LLCs and Self-Employment Tax**
 - Is an LLC member more like a limited partner or a general partner?
 - Proposed Regs. § 1.1402(a)-2(h). Treat member as limited partner unless:
 - Personal liability for LLC obligations by reason of membership (not by guarantees)
 - Authority to contract on behalf of LLC
 - Participates in business more than 500 hours in tax year
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Willy and Wanda, Window Washers

- Governance distinctions
 - Corporation requires board, officers, annual shareholder and board meetings
 - LLC can be organized less formally or can adopt a corporation-like board/officer structure
 - S corporations have additional structural issues
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Willy and Wanda, Window Washers

- 50/50 control concerns
 - How to break an irreconcilable tie in shareholder and board voting?
 - Could add a third board member
 - Could rely on statutory dissolution provision (applies to both corporation and LLC?)
 - Could use Stock Restriction Agreement or Operating Agreement to provide for “Texas shootout”
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Willy and Wanda, Window Washers

■ Assessing the options

□ C corporation

- Two layers of tax may be a problem, but maybe not if everything is paid out in salary and bonuses
 - Unlikely to own appreciating property, so ability to distribute property without immediate gain may not be an advantage for LLC/partnership
 - If all profits are paid out in salary and bonus, employment tax is equivalent to LLC
 - Greater organizational flexibility than S corporation
 - May not always be reasonable to bonus out all profits
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Willy and Wanda, Window Washers

- Assessing the options
 - S corporation
 - S limitations don't seem likely to come into play
 - Employment tax treatment better than LLC or C corporation (can pay dividends without incurring second layer of tax)
 - Unlikely to own appreciating property, so ability to distribute property without immediate gain may not be an advantage for LLC/partnership
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Willy and Wanda, Window Washers

■ Assessing the Options

□ LLC

- Single layer of tax assured; no need to scramble to pay out all profits as wages
 - Employment tax treatment less favorable than S corp
 - Unlikely in service business, but flexibility to make distributions, take on financing, etc. beats S corp
 - Less formal organization required
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Willy and Wanda, Window Washers

- Assessing the Options
 - General Partnership
 - Much simpler organizationally
 - Tax treatment mirrors LLC
 - Using insurance, partners can minimize risk of tort liability
 - Nevertheless, liability situation favors LLC or corporation
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Willy and Wanda, Window Washers

- S corporation is probably best for this type of small service company



Tech Toys, Inc. Joint Venture

- Tech Toys, Inc. is listed on NASDAQ
 - Leading edge manufacturer of high-tech toys
 - Plans a joint venture with Macrosift, Inc. to design a new line of road-racing, remote-controlled cars with sensors and artificial intelligence to avoid oncoming, full-sized traffic
 - Macrosift will provide the software technology
 - Tech Toys will provide the rest
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Tech Toys, Inc. Joint Venture

- Your client fears that the children may not be as smart or agile as the car, so tort liability is a real concern
 - What sort of entity should they use for their joint venture?
 - Tech Toys will own 51%; Macrosift, 49%
 - Each licenses technology to venture; any IP developed by venture needs to be dealt with
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Tech Toys, Inc. Joint Venture

- Could simply proceed as a joint venture
 - Essentially a general partnership, but limited purpose also limits scope of authority of venturers to bind one another
 - Activities outside the scope of the venture would not impose liability on the other venturer
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Tech Toys, Inc. Joint Venture

- Can't use an S corporation because C corporations aren't eligible shareholders
 - Selection should be LLC or C corporation
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Tech Toys, Inc. Joint Venture

- C corporation

- Two layers of tax, but deduct 80% of dividends from 20%-owned subs
- No deduction of losses

- LLC

- One layer of tax
 - Deduct losses up to basis plus share of debt
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Tech Toys, Inc. Joint Venture

- Governance, Profits, Equity
 - LLC offers flexibility to divide voting, profits, and capital interests of units
 - With an LLC, Tech Toys can contribute 80% of the capital in exchange for 51% voting rights, an initial 80% capital account, a 51% profits interest, and preferred distributions until capital accounts reach 51/49
 - If use corporation, 51/49 share split necessarily applies to voting, profits, and capital
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Tech Toys, Inc. Joint Venture

- But a corporation can mimic the LLC
 - Rather than contributing 80% of the capital, Tech Toys could contribute 51% and make a loan for the remainder
 - Repayment of the loan would be essentially equivalent to the LLC's preferred distributions
 - To make the loan appear as debt and not equity, it should not be payable based on the profits of the corporation, so it will differ somewhat from the LLC model
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Tech Toys, Inc. Joint Venture

- Both venturers operate as corporations, so it's likely that even with an LLC, they'll choose to adopt a board-and-officers model
 - Either LLC or C corporation provides the desired limited liability
 - Either provides sufficient flexibility to handle the licenses of intellectual property
 - LLC is likely the best choice here
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Gates & Buffett Investments

- Two young entrepreneurs come to your office with a plan to form a company to develop software that will predict stock market swings
 - They need to raise \$500,000 initially
 - They will share management, but they don't have any money to put into the venture
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Gates & Buffett Investments

■ Time Horizons

- In the short term, this looks like a good situation for an LLC
 - Over the long run, a corporation may work better
 - Could begin as LLC, then change to C corporation
 - Going from LLC to corporation requires approval of managers and, possibly, members, but it doesn't raise insurmountable tax problems
 - Going from corporation to LLC gives rise to tax upon distribution of corporate assets
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Gates & Buffett Investments

- Short-term analysis
 - LLC allows Gates and Buffett to run the company on a fairly informal basis
 - Can issue non-voting units but require member approval of significant actions
 - In its early stages, the company could operate like a limited partnership—investors have all the equity but don't participate in management; managers have virtually no equity but make all decisions
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Gates & Buffett Investments

■ Securities issues

- ❑ LLC interests may not be securities if all members participate in management
 - ❑ LLC interests are clearly securities in the hands of non-participating investors
 - ❑ Federal Rule 504 covers initial \$500,000 offering
 - ❑ Must attend to state exemptions
 - ❑ No private placement memorandum required by Rule 504
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Gates & Buffett Investments

- More securities considerations
 - Even if no PPM, investors should receive copies of operating agreement, pro forma financials, and such other documents as may be material
 - LLC's liability shield does not protect managers from their own participation in any fraudulent statements or omissions
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Gates & Buffett Investments

- Long-term view
 - If this company succeeds, it may need significant future capital infusions
 - If the company eventually goes public, a corporation would be simpler to take public
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Gates & Buffett Investments

- Equity Compensation
 - Unrestricted stock/LLC interest
 - Nonvoting stock/LLC interest
 - Restricted stock
 - Nontransferable
 - Subject to risk of forfeiture
 - Defer tax until vested
 - Stock options
 - Contractual right to participate in profits (i.e., performance bonus)
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Gates & Buffett Investments

- Phantom stock
 - Right to receive value of notional share of stock upon vesting
 - Taxed upon vesting
 - Stock appreciation right
 - Right to receive increase in value of notional share from date of grant to date of exercise
 - Not taxed upon vesting, but upon exercise
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Gates & Buffett Investments

■ Securities Exemption

- Private company

- Rule 701

- Written plan

- By issuer, parents, or majority-owned subs of issuer or parents for employees, directors, partners, officers, consultants, advisors

- Maximum sales in 12 months can't exceed greater of:

- \$1 million

- 15% total assets of issuer at last balance sheet date

- 15% of class outstanding at last balance sheet date

Gates & Buffett Investments

- Rule 701 (continued)
 - Information required
 - Copy of plan or contract
 - Significant securities and (if applicable) ERISA information if sales price exceeds \$5 million in 12 months
 - No integration with other offerings
 - Restricted securities under Rule 144
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Athos, Porthos & Aramis Co.

- Three inseparable friends want to form a company to sell fencing supplies online and to run a fencing school in their native Paris, Kentucky
 - Athos brings money, Porthos brings some money and fencing instruction skills, Aramis brings managerial skills
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Athos, Porthos & Aramis Co.

- The sales business will distribute fencing supplies for one or more manufacturers
 - It will not operate in conjunction with the fencing school
 - To keep the two entities separate for liability purposes, it could make sense to form two entities, each owned by the three participants, or three, with a holding company above the two operating companies
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Athos, Porthos & Aramis Co.

- Holding company structure works with an S corporation holding company and two Qualified Subchapter S Subsidiaries
 - Each must be 100% owned by the parent S corporation
 - In that case, the subs are disregarded for tax purposes
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Athos, Porthos & Aramis Co.

- Nevertheless, the disproportionate contributions favor an LLC
 - Athos would receive a full capital interest
 - Porthos would receive a capital interest to the extent of his cash contribution
 - Porthos and Aramis would receive profits interests to bring their profit rights up to 1/3 each
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Athos, Porthos & Aramis Co.

■ Profits interest

- Rev. Proc. 93-27
 - If a partner contributes services in exchange for a capital interest, the value of the capital interest constitutes taxable compensation income
 - If the partner does not receive an interest in the LLC's equity, but only receives a right to participate in future profits, the compensation problem is avoided
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Athos, Porthos & Aramis Co.

■ Transfer Restrictions

□ Rights of first refusal

- Members
- Company

□ Death

- Leave to heirs?
- Company option to buy?
- Company required to buy?

□ Involuntary transfer

- Bankruptcy, divorce, dissolution of corporate member
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Athos, Porthos & Aramis Co.

■ Determining Value

- Agreed Value
 - Appraised Value
 - Formula
 - EBITDA multiple?
 - Multiple determined by similar public companies?
 - Book value multiple?
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Conclusion

- Every situation requires a fresh analysis
 - The options are virtually endless
 - Questions?
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Thank You

- Spencer Fane Britt & Browne LLP and NBI appreciate the opportunity to bring you this seminar presentation
 - If you have follow-up questions, you can e-mail me at pmirakian@spencerfane.com
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