Nutter McClennen & Fish LLP
Attorneys at Law

Choosing an Entity for Startups

Prepared by:

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Biography

- Nutter, McClennen & Fish, LLP - Partner; Director of Biz Dev, ECG
  - Top 10 Boston law firm
  - Represent clients in technology, hardware, software, mobile, medical devices, health IT, biotechnology, cleantech CPG, consumer electronics, sports & entertainment
- MassVentures – Director & Investment Committee Member
  - The Venture Arm of the Commonwealth: providing seed and early stage venture funding to high growth technology startups
- Angel Investor – Private investor in multiple technology and consumer products companies
- The Capital Network – Interim Chairman
  - Providing education, resources and community to high growth entrepreneurs and angel investors as they navigate the early stage capital process
- Tufts University; Professor of Entrepreneurial Leadership
  - Educating students in the art and science of leading ventures with limited resources.
- Previously: Co-Founder/VP Biz Dev MobileTek Corp.; Executive Chairman, Superb Productions
- UC Berkeley, B.A. (Go Bears!); UCLA School of Law, J.D.; Admitted to practice, CA and MA

Nutter's Emerging Companies Group

As a full service firm with a dedicated team of lawyers in the Emerging Companies Group, Nutter supports ventures across the innovation economy:

- Biomedical Devices
- Biotechnology
- Pharmaceuticals
- Life sciences
- Software
- Hardware
- Information Technology
- Cleantech
- Mobile
- Consumer Products
- Analytics
- New Media
- Robotics
- Food & Beverage

We provide entrepreneurs will the full spectrum of support that they need to build their businesses and realize their visions:

- Entity Formation
- Founders Agreements
- Financing Strategy and Key Introductions
- Angel & Venture Capital
- Debt Financing
- Private Equity
- Initial Public Offerings
- Private Placements
- Strategic Partnering
- Mergers & Acquisitions
- Employment support
- Equity Compensation
- Tax Strategy
- Litigation
- Licensing
- Distribution
- Manufacturing
- Supply Agreements
- Electronic Commerce
- Patent and Trademark Strategy & Prosecution

Key Issues in Choice of Entity Decision

- Limited Liability
- Control
- Cost
- Complexity
- Flexibility
- Tax Efficiency
- Investor Friendly

Types of Entities

- Corporation
  - C Corporation
  - Subchapter S Corporation
- Limited Liability Company
- Partnership
  - General Partnership
  - Limited Partnership
- Sole Proprietorship
- Social Enterprise Entities
  - Benefit Corporation
  - Low Profit Limited Liability Company (L3C)
  - B Corp

C CORPORATION

- A "C corporation" is a separate legal entity, providing limited liability protection to stockholders, officers and directors.

- C corporations are subject to double taxation, first at the corporate level, and then again, if and when shareholders receive dividends.
  - If the company is sold before it generates profits, stockholders will be taxed only once, and at favorable capital gains rates

- Clear delineation between equity interests (stockholders) and control (the Board).

- Formalities and filings must be observed to preserve limited liability protection.

- May be costlier to start than other business entities, although it depends.

- Flexibility is possible, but expensive. Investors often prefer the predictable nature.

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SUBCHAPTER S CORPORATION

- An "S corporation" is a corporation that has elected to be taxed as a pass-through entity.
- May not have more than 100 stockholders,
- Stockholders must be U.S. citizens or residents and be natural human beings (i.e., not corporations, partnerships etc.) and certain trusts and tax-exempt organizations.
- May only have 1 class of stock (i.e., may not have "common" and "preferred").
- Can convert to a C corporation, but there are usually tax consequences.
- S corporations are "pass through" entities: profits and losses flow through when realized and are recognized directly by shareholders who may be able to use losses to offset other income.
- Risk of phantom income tax gains, i.e., stockholders will owe tax on corporate income regardless of whether the corporation makes distributions to the stockholders.
- Most S corporation earnings are not subject to self-employment taxes; however, the IRS has challenged S corporations that do not pay reasonable salaries to shareholders-employees.

Limited Liability Company (LLC)

- Separate legal entity which is owned by its members and which may be either directly managed (“member managed”) or indirectly managed (“manager managed”)
- Provides limited liability protection for its members and managers.
- Like a partnership, LLCs are very flexible : Allow for varying classes of economic and voting rights, and no limits on the number or kind of members; may create profits interests that only provide an interest in the future increase in value, but not the existing value of the business
- Tax flexibility: Permitted to specially allocate income and losses among its members so long as those allocations have substantial economic effect.
- As a pass-through entity, members owe tax on the LLC’s income regardless of whether the LLC makes distributions – this is one reason fund-type investors do not like this structure.
- Disposition of an LLC interest can result in taxation at ordinary or capital gain income rates.
- Given the relatively young age of the LLC as an entity form, the body of law is less established, and therefore, less certain.
- Flexibility of LLCs means they are often more complex and more expensive to set up. Flexibility = complexity – another reason investors avoid LLCs.

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GENERAL PARTNERSHIP (GP)

- A general partnership may be formed intentionally or accidentally by two or more parties operating in concert, with or without a written agreement.

- Each partner is liable for all of the debts and obligations of the partnership as well as the acts of each other partner, i.e., no limited liability.

- Under a partnership agreement, each partner contributes money, property, labor, or special skills and each partner shares in the profits and losses from the business.

- Having all partners equal in power and responsibility can cause problems unless proper guidelines are set out.

- General partnerships are pass-through entities: profits and losses flow through the business to the partners, all of whom are taxed on their income tax returns.

LIMITED PARTNERSHIP (LP)

- A separate legal entity formed by filing with a state, that requires at least one general partner and at least one limited partner.
- The general partner(s) take charge --deal with the daily operations and responsibilities and don't need to consult the limited partners for most business decisions.
- A general partner is liable for all of the debts, obligations and liabilities of the partnership.
- A limited partner's liability for the partnership's debts and obligations is limited to the amount of money or property that the partner contributed to the partnership.
- A limited partnership is a great way to offer investors the opportunity to benefit from the profits and losses of your business without getting them actually involved in the business.
- Limited partnerships are pass-through entities: profits and losses flow through to the partners, regardless of whether distributions are made.
- Creating a limited partnership requires less paperwork than forming a corporation.

SOLE PROPRIETORSHIP

- A sole proprietorship is not a separate legal entity.
- A sole proprietor has complete control and decision-making power over the business.
- No entity level tax.
- The sole proprietor of the business can be held personally liable for the debts and obligations of the business. Additionally, this risk extends to any liabilities incurred as a result of acts committed by employees of the sole proprietorship.
- All responsibilities and business decisions fall on the shoulders of the sole proprietor.
- Investors cannot invest in sole proprietorships.

BENEFIT CORPORATION

- Benefit corporations are corporations formed to further specific public benefits <u>and</u> shareholder profit.
- Directors of a benefit corporation are expected to consider stakeholders beyond shareholders, including employees, the environment and the community.
- Higher standards of transparency and reporting at the state level than traditional corporations.
- Does not affect a corporation's tax status—may still elect to be taxed as a C corporation or a S corporation.
- 11 states have adopted benefit corporation statues; states without such laws may not recognize benefit corporations for purposes of interstate business, permits and insurance.
- Benefit corporations are formed to hold boards and managers accountable to higher standards of corporate purpose, accountability and transparency.

LOW PROFIT LIMITED LIABILITY COMPANY (L3C)

- Similar to limited liability companies; except that they include having a positive social impact as one of their purposes.

- Designed to take advantage of Program Related Investments (PRIs) by private foundations and might allow a venture to tap into new sources of capital.

- There is no federal tax benefit to forming an L3C as opposed to an LLC.

- Limited liability in the same manner as a standard LLC.

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B CORP

- B corporations, sometimes called "B Corps," are corporations that elect to be certified by an independent third-party organization as committing to and serving a public benefit; but, as a matter of state law they are simply corporations.
- Certified B Corporations meet rigorous, independent social and environmental performance standards.
- B Corporations do not have a special tax status.
- A corporation may become a B Corporation by providing in its governing documents that it will further a public benefit and by seeking certification.
- B corporation requirements may create a conflict between existing state law and the obligations outlined in the corporation's governing documents.

COMPARISON of ENTITY FORMS

	C CORP	S CORP	LLC	LP	GP	SOLE PROPRIETOR -SHIP	BENEFIT CORP	L3C
MONEY	Easier to raise capital through public offering of stock Income taxed at corporate level, and to shareholders upon dividend distributions	Corporate income and losses flow through to shareholders, but not again at shareholder level	Company income and losses flow through to members, but not again at member level	Income and losses flow through to partners, but not again at partner level	Income and losses flow through to partners, but not again at partner level	Income and losses are reported by sole proprietor as own tax items	Can elect to be taxed as C Corp or S Corp	Same as LLC Designed to take advantage of PRIs
CONTROL	Board of Directors; Shareholders retain control not delegated to board or officers	Board of Directors; Shareholders retain control not delegated to board or officers	Option between manager or members managing daily matters	General partner makes most day-to-day decisions	Power shared equally by all partners	A sole proprietor has complete control and decision-making power	**Third-party outside organization retains control over certification**	State Attorney General may have authority to enforce charitable purposes

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COMPARISON of ENTITY FORMS (cont.)

	C CORP	S CORP	LLC	LP	GP	SOLE PROPRIETOR-SHIP	BENEFIT CORP	L3C
LIABILITY	Limited liability for shareholders	Limited liability for shareholders	Limited liability for members	Limited liability for limited partners Unlimited liability for general partners	Personal liability for all the business's obligations, debts and acts of every other partner	Sole proprietor personally liable for the debts and obligations of the business	Limited liability for shareholders	Limited liability for members
START-UP COST & FLEXIBILITY	Higher start-up costs Future investors more likely to want C corp	Higher start-up costs One class of membership Conversion (with significant tax costs) to a C corp if a public stock offering becomes desirable	Lower start-up costs Highly flexible Allows for varying classes of membership Ability to grant profit interests	Lower start-up costs Highly flexible	Lower start-up costs	No entity start-up costs Sale or transfer can take place at the discretion of the sole proprietor	Existing corporation may amend articles of organization May need 2/3 shareholder vote to eliminate public benefit purpose	Like LLCs

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Questions?

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