

Business Entity Selection

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Common Corporate Mistakes Made By Entrepreneurs

- Creating a "cheap stock" tax problem by
 - Failing to incorporate early in the company's life (i.e., well before a funding event that sets the price of the stock) or
 - Failing to include all "founders" in the company until just before a funding event that sets the price of the stock
- Not creating a vesting schedule for founders' stock for a student startup (if all vests immediately, may create unfair reward to those who do not continue to support company)
- Failing to make 83(b) election on stock issued in return for services
- Failing to consider employees' or founders' obligations to other employers
- Failing to comply with securities laws as it raises capital
- Considering only the valuation as it negotiates an investment

Common Business Entities

- Sole Proprietorship
- General Partnership
- S Corporation
- C Corporation
- Limited Liability Company
- Single Member Limited Liability Company

Factors to Consider When Selecting an Appropriate Business Entity

- Liability—Limited vs. Personal
- Tax implications
- Complexity of formation and management
- Capital—Effect on ability to raise capital through angel investment, venture capital, or initial public offering (IPO)
- Credibility in the business world



Sole Proprietorship

- An individual (or husband and wife team) carrying on a business for profit
- Unlimited personal liability for owner
- Single level of income tax—all income and expense items reported on Schedule C of the owner's 1040
- Relatively simple to start
- If business not conducted under the name of the sole proprietor, assumed name publication needed
- Managed by the sole proprietor
- Any transfer of the business would be of the underlying assets as opposed to a transfer of shares in the business
- Capital needs—Addressed through loan to sole proprietor



General Partnership

- Two or more co-owners carrying on a business for profit
- Partners have *unlimited personal liability* for partnership debts
- Pass-through tax treatment (partnership files Form 1065 but all income and expense items pass through to individual partners on Schedule K-1)
- Relatively easy to start—Partnership agreement is typically entered into but is not legally required
- Managed by the partners or as described in the partnership agreement. **Problem:** Any partner can bind the partnership
- Ability to raise capital limited since most investors would prefer to invest in an entity offering limited liability
- LLC is almost always the better choice if partnership tax treatment is the goal



Limited Partnership

- Limited partnerships are partnerships with two types of partners: general partners and limited partners
- For the general partners, the law is the same as it is for the traditional general partnership
 - General partners exercise management and control
 - General partners can legally bind the partnership—and the other general partners—by their actions
 - General partners are subject to unlimited personal liability
- Limited partners, on the other hand, enjoy liability limited to the value of their registered investment
- Tradeoff is that limited partners can not exercise control in the partnership, although the law is changing/has changed on this issue
- Limited partnership are often used for:
 - Family limited partnerships (FLIPs) — an estate planning device
 - Private equity firms



S Corporation

- Limited liability for shareholders even if they participate in management
- Pass-through tax treatment under most circumstances, but not as complete as for the LLC
- Formation steps include: filing Articles of Incorporation with the Secretary of State, filing Sub S election with the IRS, adoption of bylaws, and, usually, adoption of a Shareholder (buy-sell) Agreement
- Limitations on the number and type of shareholders and limits on the ability to raise capital:
 - Limit of 100 shareholders
 - Only one class of stock is allowed so ability to give priority return of capital to investors is compromised
 - Differences in voting rights are allowed
 - Partnerships and corporations cannot be shareholders
 - Only US citizens and residents can be shareholders
- Is easier to convert S corp to C corp than it is LLC to C corp in the event that venture capital is sought



C Corporation

- Limited liability for shareholders even if they participate in mgmt
- Tax at both corporate and shareholder level. This double tax can be avoided to some extent by payment of reasonable salaries to shareholders in exchange for services actually rendered.
- Formation similar to S corporation except Sub S election not filed with IRS
- Typically required for publicly traded corporations, businesses that require venture capital, or if a broad based stock option program is utilized
- No limits on type or number of shareholders
- Different classes of stock allowed, for example, common stock and preferred stock, which enables different priority for return of capital
- If venture capital is being sought, incorporation should be in the state of Delaware



Limited Liability Company

- Combines limited liability provided by a corporation with pass through partnership tax treatment
- LLC files a partnership tax return (Form 1065) with all income and expenses being passed through to the LLC's individual owners on a K-1
- Formation steps include: filing articles of organization with the Secretary of State, contributing a suitable amount of capital, and adopting an operating agreement
- Can be managed by the members or, more often, by managers selected by the members. Can also elect officers.
- Self employment tax treatment may be less favorable than for S corporation
- Offers several advantages over the S corporation:
 - No limitation on the number of members
 - No limitation on who may invest (corporations, partnerships, and non-US residents can invest)
 - Treatment of gain on distribution of appreciated property more favorable
 - Different classes of ownership are allowed so there is the flexibility to provide for a priority return of capital to investors
- Often used to own commercial real estate



Single Member Limited Liability Company

- Limited liability for owners makes it a better choice than a sole proprietorship unless cost of formation or maintenance is a controlling factor
- Disregarded entity from an income tax perspective
 - All income and expenses are reported on the sole member's tax return and no income tax return need be filed by the LLC
- Formation process similar to multiple-member LLC except that the operating agreement will likely be less complex
- In addition to circumstances where a sole proprietorship would be considered, a single member LLC is often used by a corporation or LLC to insulate the liability associated with a particular line of business
- Outside investment allowed only if converted to a multi-member LLC



LLC vs. Corporate Structure

LLC	Corporation
Members	Shareholders
Managers (optional)	Board of Directors
Officers (optional)	Officers



Bylaws and Shareholder Agreements for Corporation

- **Bylaws**
 - Procedures for shareholder and director meetings
 - Election and terms of directors, types officers and officer duties, and indemnification provisions for officers and directors
- **Shareholder Agreements**
 - Restrictions on the transfer of stock ownership (including upon death, disability, or cessation of employment)
 - Provisions for resolving deadlock among the shareholders
 - Method of establishing price of shares
 - Rights to purchase additional shares issued by the corporation (preemptive rights), rights to sell shares if other shares of the corporation are sold (co-sale rights), rights to cause a minority shareholder to sell its interest in the corporation when the majority votes to do so (drag along rights)
 - Ownership of intellectual property



LLC Operating Agreements

- Take the place of both the bylaws and shareholder/buy-sell agreement used for a corporation
- Address issues such as type of membership interests, who owns the membership interests, rights and duties of members, whether the LLC is member-managed or manager-managed, rights and duties of any officers, capital accounts, allocation of profits, transferability, and indemnification of managers, employees and agents



Piercing the Corporate Veil

- Limited liability associated with a corporation or an LLC can be lost if appropriate formalities are not followed:
 - Corporation or LLC should be appropriately capitalized upon setup
 - Annual meetings of shareholders and directors (or members and managers if an LLC) should be conducted and minutes of those meetings placed in the corporate or LLC book
 - Separate financial records and bank accounts should be maintained for corporation or LLC



Using Company Equity to Motivate and Retain Employees

- Incentive Stock Options
- Nonqualified Stock Options
- Restricted Stock
- Phantom Stock



Employment Agreements

- Nondisclosure of information/trade secrets
- Noncompetition
- Nonsolicitation of employees and customers
- Assignment of ownership of intellectual property to company (Illinois Employee Patent Act)
- Employee duties
- Compensation
- Term of agreement and ability of parties to terminate



Non-Profit Corporations and Tax-Exempt Organizations

The initial steps to forming an Illinois not for profit corporation are the filing articles of incorporation with the Illinois Secretary of State, electing officers and directors and adopting bylaws- however these steps do not confer the federal tax exemption that frequently accompanies non-profit status.

- Federal tax exemption is governed by Internal Revenue Code section 501(c) - an application must be made to the IRS in order to receive it
- Charitable organizations and chambers of commerce are both exempt from paying income tax under § 501(c).
- Contributions to (501(c)(3) charitable organizations are typically deductible to the donor as a charitable donation; contributions to chambers of commerce (501(c)(6)s) are not deductible as a charitable donation but dues are likely deductible as a business expense



Non-Profit Corporations and Tax-Exempt Organizations

501(c)(3) — Charitable Organization



- Exempt from federal income tax
- Contributions are tax deductible to the donor

501(c)(6) — Business League or Chamber of Commerce



- Exempt from federal income tax
- Contributions are *not* tax deductible to the donor as charitable contribution; but may be deductible as a business expense by a business

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Non-Profit Corporations and Tax-Exempt Organizations



- The HDF Group
 - Located in Research Park at University of Illinois
 - Organized as a 501(c)(3) not-for-profit corporation
 - That is, it enjoys the advantages of both tax exemption and tax deductible contributions
 - Its charitable mission is “to ensure the sustainable development of HDF technologies and the ongoing accessibility of HDF-stored data.”
 - “Most of The HDF Group products and services will be available to all persons for free.”
 - Source: company website
 - This demonstrates that the 501(c)(3) not-for-profit form is hardly limited to conventional charitable causes

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Non-Profit Corporations and Tax-Exempt Organizations

- Additionally, Illinois law provides the following exemptions from state taxes:
 - **State income tax – tracks federal**
 - Tax will be due at both the state and federal level on income earned from the incidental conduct of business not related to the exempt purpose (unrelated business income)
 - **Sales tax exemption – different standard and test**
 - **Property tax – different standard and test**
- Illinois (as well as other states) requires that certain charitable organizations register with the Attorney General and to file an annual report with that office

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Low-Profit Limited Liability Companies: L3Cs

- **A new form created to:**
 - “bridge the gap between non-profit and for-profit investing
 - by providing a structure that facilitates investments in socially beneficial, for-profit ventures
 - while simplifying compliance with IRS rules for program related investments.”
- **Most private charitable foundations are required to distribute at least 5% of their average net assets annually to recipients that further the stated charitable purpose of the foundation.**
- **Often this is in the form of grants.**
 - But there is an alternative: the program related investment (PRI)
 - Ordinarily, investing activity would not go toward satisfying the minimum distribution requirement. PRIs, however, can.
- **Program-related investments leverage foundation assets.**
 - Instead of grants, which don't come back through the door, PRIs (which take the form of loans, financing guarantees, and other investment forms) are made with the anticipation of return of capital.



Low-Profit Limited Liability Companies: L3Cs

- **PRIs have three requirements**
 - The primary purpose is to accomplish one or more of the foundation's exempt purposes
 - Production of income or appreciation of property is not a significant purpose
 - Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose
- **How does an L3C facilitate receipt of PRI funds?**
 - By adopting the L3C form, with its accompanying requirement to document explicitly its charitable purpose and related restriction, the L3C signals its eligibility to receive such funds
 - In the alternative, foundations would have to go through a due diligence process—perhaps even going so far as getting a Private Letter Ruling from the IRS—before making the investment



Low-Profit Limited Liability Companies: L3Cs

- **Although it has generated some excitement among practitioners of non-profit organization law, others are skeptical that it will be a “magic bullet”**
 - In particular, the L3C form, while it makes it easier to meet IRS technical requirements in one fell swoop, does not add any substantive rights or authority.
 - That is, everything that can be done with the L3C could already be done (and was already being done) with the more traditional forms of organization—albeit with greater administrative burdens for the parties



Business Financing



General Concepts

- Risk vs. return
- Equity (e.g., stock ownership) vs. debt (e.g., a loan)
- “Smart” money vs. “dumb” money
- “Free” money
- Dilution
 - Substantial outside equity investment at early stage of company will cause loss of control whereas same dollar investment when company is more mature and more valuable might not
 - Small piece of big pie worth more than 100% of marginal company



Business Plan

- Written business plan required by most financing sources
- Even if outside funds are not being obtained, or if a friend or relative is providing the funds, a written business plan is a good idea



Sections of the Business Plan

- Executive Summary
- Description of Business
- Marketing
- Financial Plan/Statements
- Management Team



Business Plan—Sources of Assistance

- Attorneys and accountants
- SCORE
- SBDC



Sources of Funding

- Personal funds
- Friends and family
- Champaign County Regional Planning Commission
- Banks (SBA)
- Loan brokers
- Bootstrap (company profits)
- Government and foundation grants
- Joint development agreements
- Angel investors
- Venture capital
- Bonds
- Initial public offering (IPO)



Personal Funds

- People who are considering loaning you money or otherwise investing in your business are more likely to do so if they see that you are also investing some of your own funds



Friends and Family

- Run the risk of losing a friend or straining family relationships if there is difficulty with repayment
- Best reserved only for situations where the friend or family member can afford to lose the money



Banks

- Asset based lenders
- Risk averse, but the cost of borrowing is less
- Require good credit record
- Will want to see a written business plan
- Typically want 20% financed by you
- SBA loans through banks can allow bank to take on more risk



Champaign County Regional Planning Commission

- Provides debt and equity financing to qualifying small businesses in Champaign County
- Preference towards capital-intensive and/or technology-oriented businesses
- Must create a specific number of full time jobs
- Can't constitute more than 50% of the total project investment
- Work with a local bank as well



Bootstrap

- Use company profits to grow the business
 - Revenues from sale of product
 - Revenues from consulting used to support product development
 - The “old fashioned” way
 - Not possible for some businesses



Grants

- Available only under very limited circumstances
- Typically not available for retail, restaurants, etc.
- “Free” money but not “easy” money
- Don't have to repay
- Typically retain ownership of intellectual property, subject to certain conditions, particularly in government grants
- Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) Programs through US government agencies (www.sbirworld.com)



Joint Development Agreements

- Big company interested in small company's technology will "give" small company money and resources to refine product
- May lead to eventual license of IP to a big company
- Be careful with respect to ownership of IP generated under the JDA
- Nondisclosure agreements needed
- Risks associated with dealing with big company include superior litigation resources available to big company in event of dispute



Angel Investors

- Angel investors are typically high net worth persons or an entity owned by these individuals
- Three types
 1. Passive
 2. Ones that add value to company through expertise or contacts
 3. The kind that think they add value but really don't!



Venture Capital

- Only available for certain types of businesses (for example, commercializing a technology)
- Can accelerate the growth of the company through contacts and management expertise added by the VC



Stages of a Venture Capital Transaction

- Courting process
- Letter of intent
- Term sheet
- Due diligence
- Final agreements
- Ongoing input from VC
- Assistance with location of follow on rounds
- Exit



Bonds

- Debt whereby the issuing company or governmental body promises to pay the bondholders a specific amount of interest for specific amount of time and to repay principal on expiration date
- Can offer a very favorable interest rate and no loss of equity
- Typically feasible only for substantial amounts of capital



Initial Public Offering

- Very few companies actually go public
- Most exit through sale to another company or just operate and then wind down
- Very expensive
- Very difficult to go public in current market and economy



Attorney Roles

- Advisor—Assist in identifying appropriate funding sources and preparing a credible presentation to financing sources
- Referral source—To venture capital firms, bankers, and private investors
- Assist by reviewing and negotiating terms of the financing and by making sure you understand what you are signing



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