Incorporating Your Startup: *Choice of Entity and Tax Considerations*

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What does it mean to incorporate?

- From a legal perspective:
  - The creation of an entity, separate and distinct from its owners, through the issuance of a charter by the Secretary of the Commonwealth.
  - Powers similar to an unincorporated business.
  - Duration of the entity, in most cases, is perpetual.

- As a practical matter:
  - There are required fees and formalities.
  - Capital is provided to the corporation for ownership interests (stock, membership interests, partnership interests, etc.) or debt.

Why incorporate?

- Limited Liability and Asset Protection
- Issuing “Founder Stock”
- Easier to Raise Capital
  - Sell stock or membership interests with identifiable rights.
- Easier to Sell/Perpetuity
  - With the assets and obligations of the business separated, it is easier to identify.
- Employment Considerations- Equity incentives
- Avoiding problems:
  - Discussions of who does what and who gets what might inadvertently form a “general partnership”
  - Ownership rights are unclear (the “Forgotten Founder” problem)

Which form of entity?

- Majority of startups will be formed as C corporations, S corporations or LLCs
- Key Considerations:
  – Liability protection
  – Tax treatment
  – Expected VC financing
  – Employee equity incentives
  – Exit scenarios

Tax "pass-through"

- S corporations and LLCs are pass through entities (not taxed at the entity level and instead the tax impacts of the business "pass through" to the owners, and distributions generally are not taxed)
- C Corporations are taxed at the corporate level, and then the owners are taxed again when there are distributions (dividends)
- This "double tax" on C corps only applies when distributions are made to the owners. Most startups reinvest any cash flow back into the business. If the eventual sale is structured as a stock purchase, then capital gains applies and there is no double tax. However, pass through entities can structure sales to be taxed as an asset transaction (without a double tax) that can have beneficial tax results for the buyer (thus leading to a higher purchase price).

Which form of entity?

	C Corp	S Corp	LLC
Limited Liability	★	★	★
Tax pass through		★	★
VC's can invest	★		
"Normal" stock options	★	★	
Potential for certain capital gains exclusions*	★		

Potential Tax Exclusion for Qualified Small Business Stock

- *At least until December 31, 2011, there are significant tax reasons why if you expect to end up a C corp you will be better off starting there in the first place (potential for excluding up to $10m of capital gains or 10x your basis, whichever is greater)
- Must meet criteria of Qualified Small Business Stock
  - Must be a C corp
  - Certain types of business will not qualify
  - Consult your tax advisor for full details
- Currently applies only to QSBS stock purchased after September 27, 2010 and on or before December 31, 2011 and held for more than five years (uncertain if Congress will extend it)

Which form of entity?

- The vast majority of startups that aspire to be venture funded should be set up as Delaware corporations initially (whether C or S)
- Which state?
  - Massachusetts (or other state where the company is located)
  - Delaware (or Nevada)
- Don’t over think it, but get it right the first time

What is involved?

- Reserve the name early in DE and MA (or other resident state)
- Certificate of Incorporation (DE)
- By-laws
- Initial consent of sole incorporator
- Initial consent of director(s)
- Stock certificates, receipt and ledger
- Qualification to do business in MA (or other resident state)
- S corporation election, if applicable
- Founder agreements, including restricted stock agreements

What is involved?

- Certificate of incorporation
  - Very simple at incorporation
  - Gets complicated when you get VC funding (preferred stock)
- Key questions:
  - What is the name of the company?
  - How many shares to authorize?
  - What is par value?
- Bylaws- Generally track the corporate statute

Founder Stock

- No legal definition of “founder” or “founder stock”
- Issued at incorporation or shortly thereafter when there is no tangible “value” to the company yet (important for tax reasons)
- Avoid “Forgotten Founder” problem-- Lots of litigation about promises made among founders
- Issue founder’s stock early, before there are disagreements and before you get angel or VC term sheets

Dividing the Pie

- Define group of “founders” to receive stock – keep it small and exclusive
- Consider past and future relative contributions of co-founders, and what feels “fair”
- Dividing equally is often sub-optimal (Apologies to King Solomon)
- “Sweat Equity” – incentivize founders by allocating enough equity for their sweat
- “Vesting” – incentivize founders by subjecting their equity to reverse vesting

Reverse Vesting

- 100% of the founders shares are issued day one, but the company has the right to repurchase at the price paid by the founder (usually nominal) if the founder leaves the company for any reason
- Restricted Stock Agreements
  - Typically, the repurchase right is with the company
  - In addition to vesting, restrictions on transfer
- Shares vest over time (usually over 4 years)
- Full or partial acceleration upon sale of the company and termination without cause
- Keep vesting schedule simple and linear
- Consider vesting for past activities
- Impose restrictions from day one
- Venture investors will require it anyway
- Critical tax consideration – 83(b) election!

83(b) election

- 83(b) election
  - Tax benefits
  - Consult your tax advisor
  - Strict deadline for filing: Within 30 days after the date of grant of the unvested equity interest; no procedure to extend
  - Proof of timely filing is important
  - All required information must be included on the election
  - Must be filed with correct IRS Service Center and included with personal tax return
  - Use professional help to prepare the form

Understand percentages

- Cannot divide more or less than 100%
- Don’t promise percentages, always speak in terms of shares and what that “currently” represents
- Avoid (inadvertently or overtly) giving antidilution protection to founders and employees
- Real percentages are based on “outstanding” shares–“authorized” shares are irrelevant for this purpose and can always be changed
- Understand the need for future option pool

Questions?

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