CORPORATE FORMATION Q AND A (10/23)

The Q&A herein are excerpts from "Technology Commercialization Manual. Strategy, Tactics, and Economics for Business Success." (www.tclearningcenter.com). Notation after each heading reflects the (# of excerpts/total Q&A).

The Q&A are for information only. Seek legal or accounting advice for specific situations.
(Following is for information only. Seek legal or accounting advice for your specific situation)

1. How should I divide my shares?

a. I'd like to better understand how share works and how I divide them among investors, employees, and how much I should keep in reserve for the future? I believe I requested during incorporation an issue of 1,000,000 shares at $1.00 par value.

b. I am currently starting an Internet service business which is different from my incorporated business above. Should I include this entity as a DBA to the incorporation or create a separate INC or LLC?

Corporations are required to have at least one class of voting shares of stock. These shares represent the right to receive assets upon dissolution of the corporation. To conform with this requirement, most corporations authorize at lease one class of common stock with one vote per share. The attributes of the shares as well as the number that can be issued are set forth in the articles of incorporation.

Authorizing a large number of shares of stock has both advantages and disadvantages. The main advantage is the large number of shares that can be issued to potential shareholders of the corporation. There are more pieces of the pie to divide up amongst the owners. The negative is that many states charge base initial filing fees and annual taxes upon the number of shares that a corporation is authorized to issue. The more shares, the higher the fees. The number of shares of a corporation can always be changed by filing an amendment with the state.

When issuing shares, most jurisdictions provide that shares may be issued in return for any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed or other securities of the corporation. The board must determine the adequacy of the consideration for shares and so the values that are set must be reasonable. Thus, the board must decide how to issue the shares of stock.

The par value of a stock is simply the stated minimum value of a share stock and has no relationship to the actually value of the shares. Stock must be sold for at least this value or the owner of the stock can face liability. The actual value of the shares will be determined by book value or simply what someone is willing to pay for the stock.

A corporation can operate many different businesses and use many different names as DBAs. If this is down however, there is no separation between the businesses because no legal entities are formed. Thus, the assets of one the businesses could be used to pay the debts of the other businesses. If a new corporation is formed, the businesses would be separated, and, in most circumstances, the assets of one business (corporation) would not be used to satisfy the debts of the other corporation.

2. Is there an established process or standard formula for determining how much stock you would take (in lieu of a license fee) for a startup?

The standard value of technology for exclusive licensing is a 5% gross royalty plus a $30K origination fee, which needs to be adjusted upwards on downwards depending on many case factors.

As risk increases, so must reward. So... If there is no obligation for the company to pay dividends, and if the stock is non-liquid (at least until an IPO) then increase the equity. If there is

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no origination fee, then increase the equity some more. The end result is about a 20% stock position.

Take a rather pragmatic view. First, take equity as the up-front fee -- never instead of royalties. Start by deciding what up-front fee would be if it were in cash. For a pharmaceutical, one might ask for $200,000 up front. With a start-up, simply ask for equity and dilution protection that would value your share to be equal to or greater than that up-front target; e.g., 10% equity, not subject to dilution at any time the total stockholder's equity is less than $2 Million or, 5%, not subject to dilution if TSE > $4 Million.

Downside of this approach is that it ignores the time value of money, and also ignores the risk the stock is worthless. Upside is that it is easy to explain (even to entrepreneurs), and is quite palatable to venture capital investors.

Issue with statement below that "we all . . . agree that the standard value of technology for exclusive licensing is a 5% royalty plus a $30k origination fee which needs to be adjusted . ". depending on many case factors". Not as much issue with the 5% running royalty as a fairly popular benchmark for certain kinds of technologies (but certainly not most software, where 5% would be considered quite low, or many pharmaceuticals, where 5% would be considered too high), but who says that a benchmark upfront fee is $30k? Why not $10k, $50k, or $100k? For determining up-front fees, I think we are much safer starting with a blank piece of paper and trying to make an estimation of what to ask based on some realistic assessment of the technology.

Appraising a technology is no different than appraising a piece of real estate or other business asset. In appraising residential and some commercial real estate, start with comparable sales ("comps") --known, closed deals. These are iron-clad facts off which you work. Take the house that you are appraising (the 'subject' property) and adjust it up or down in value. If it has a swimming pool, you adjust it up. If it has an extra or corner lot, you adjust it up again. If it is in a worse neighborhood, you adjust it down, etc. Our comps are much harder to get. We have fewer data points. So, we use what we got. 5% may be an average figure --again AVERAGE. It really doesn't matter.

Adjust for the industry, e.g. FDA approvals, development stage, cash flow, patent costs, etc. etc. 5% and $30K is not the end point. It is the starting point. A startup situation is riskier than licensing to an existing Fortune 500, so the equity compensation (potential payout) needs to be higher.

3. I am setting up a corporation and want to know the differences between C corp., S corp. and the new LLC as it affects future business, complications in filing returns, and write-offs - you want to be able to use losses if any against my personal taxes.

The types of entities that allow losses to be deducted against personal income are "pass through" tax entities. Income to the entity is not taxed. Instead the income is "passed through" to the individual shareholders or interest holders. S corporations and LLCs are both pass-through taxation entities.

Corporations that make the subchapter S election with the IRS and Limited Liability Companies (LLCs) do possess similarities: they offer their owners limited liability protection and are both pass-through tax entities. Pass-through taxation allows the income or loss generated by the business to be reflected on the personal income tax return of the owners. This special tax status eliminates any possibility of double taxation for S corporations and Limited Liability Companies.

However, that is where the similarities end. The ownership of an S corporation is restricted; however, a limited liability company does not possess these same restrictions. An LLC can have an unlimited number of members (owners) while a subchapter S corporation is restricted to no more than 75 shareholders. Non-US citizens can be members of an LLC while an S corporation may not have non-US citizens as shareholders.

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Also, S corporations cannot be owned by C corporations, other S corporations, many trusts, LLCs, or partnerships. Limited Liability Companies are not subject to these restrictions. LLCs are allowed to have subsidiaries without restriction. S corporations are not allowed to own eighty percent or more of another corporation's shares.

An LLC is more flexible in distributing profits than an S corporation. With an S corporation, the corporation can have only one class of stock and your percentage of ownership determines the percentage of pass-through income. On the other hand, an LLC can have many different classes of interest and the percentage of pass-through income is not tied to ownership percentage. The pass through percentage can be set by agreement of the members in the LLC's operating agreement.

S corporations are not without advantages. One person can form an S corporation, while in about 5 of the states at least two people are required to form an LLC.

A corporation's existence is perpetual. Conversely, an LLC typically has a limited life span. Most states require that an LLC list a dissolution date in its articles of organization and certain events such as the death or withdrawal of a member can cause the LLC to dissolve.

The stock of an S corporation is freely transferable while the interest (ownership) of LLC is not. This free transferability of interest means that the shareholders of S corporation are able to sell their interest without needing the approval of the other shareholders, while a member of an LLC would need the approval of the other members in order to sell his or her interest. Be sure to seek advise from a competent attorney or accountant.

4. How do I structure my LLC so it will be a partnership for federal income tax purposes?

1.Applicable Factors

a. The analysis of whether an LLC is a partnership or corporation is made by applying the Morrisey factors. The Morrisey factors were established by the U.S. Supreme Court in Morrisey v. Commissioner, 296 U.S. 344 (1935). These factors are now embodied in Treas. Reg. §301.7701-2.

b. The tax law uses the term "association" to refer to an organization whose characteristics requires it to be classified as a corporation for tax purposes. The basic analysis looks at six factors:

   1. associates,
   2. objective to carry on a business and divide the gains therefrom,
   3. limited liability,
   4. centralized management,
   5. continuity of life, and
   6. free transferability of interest.

   The first two factors are generally disregarded because they are present in both a corporation and a partnership. The final four factors are analyzed to determine whether there are more corporate than non-corporate characteristics. Because the test is whether there are more corporate than non-corporate characteristics, an entity with three or more of the corporate characteristics will be deemed to be a corporation. However, if an entity has two or fewer of the corporate characteristics, it will be classified as a partnership for federal income tax purposes.

c. The following discussion analyzes each of the primary factors:

   1. Associates (necessity of two or more). This factor is generally ignored because associates are common both in a partnership and a corporation. However, this factor is a problem in some cases. Some states' LLC statutes permit the formation of a single member LLC. The use of a single member LLC can raise some serious tax concerns. While one can argue that a single member LLC should be taxed as a sole proprietorship, the IRS has not yet conceded this point. The IRS position is that a single member LLC is a corporation for tax purposes because

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the LLC does not have associates and because of the effect on the other factors of having only one member.

2. Objective to carry on a business and divide the gains therefrom. This factor is present in both partnerships and corporations so it is generally ignored.
3. Limited liability. An organization has the corporate characteristic of limited liability if, under local law, there is no member who is personally liable for the debts of, or claims against, the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim. Under the terms of the LLC statutes, a member is not liable for the debts of an LLC merely as the result of being a member or manager. Therefore, an LLC will have the corporate characteristic of limited liability.
4. Centralized management. An organization has centralized management if any person (or any group of persons which does not include all of the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Thus, persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation.
   Under most state statutes, an LLC is permitted, if it so chooses, to be operated by its members. However, the company may be operated by managers who are appointed under the terms of the Operating Agreement. Therefore, an LLC may or may not have centralized management. If an LLC has managers, the LLC will likely have centralized management. If the LLC does not have managers (i.e. it is member-managed), it will not likely have centralized management.
5. Continuity of life. An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. An agreement by which an organization is established may provide the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life under local law if the death or withdrawal of any member causes dissolution of the organization.
   Continuity of life is one of the key areas around which the LLC has been structured in order to provide partnership tax treatment. Most state statutes have essentially adopted the events of dissolution described in the Treasury Regulations as the events which will cause an LLC to dissolve. When any of these events occur, there is a technical dissolution of the LLC. A technical dissolution does not mean the entity must be wound up or its affairs terminated. The members may include a provision in the LLC's formation documents which permit the remaining members to continue the operation of the LLC by agreement. Under the currently prevailing tax authorities, an agreement which requires approval of at least a majority in interest of the members of the LLC to continue the business of the LLC should not cause an LLC to have continuity of life.
6. Free transferability of interest. An organization has the corporate characteristic of free transferability of interest if each of its members or those members owning substantially all of the interest in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of

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substitution to exist in the corporate sense, the member must be able, without the consent of the other members, to confer upon his substitute all the attributes of his interest in the organization. Thus, the characteristic of free transferability of interest does not exist in the case in which each member can, without the consent of other members, assign all his rights to share in profits but cannot sell or assign his rights to participate in the management of the organization. Most LLC statutes are structured to avoid free transferability of interest. Some state statutes specifically prohibit a transferee from succeeding to any rights to participate in management of an LLC unless the admission of such transferee to the partnership is approved by all the members. Other state statutes permit the operating agreement for the LLC to control the conditions for the admissions of a transferee to membership. In these states the draftsman needs to be careful to assure that he requires sufficient approval to avoid the characteristic of free transferability of interest.

7. Other factors. In addition to the factors described above, the IRS may consider additional factors to determine whether an entity is more like a partnership or more like a corporation. Although the IRS has made several comments in this regard, the IRS has not identified what other factors it might consider.

d. In summary, the analysis of whether an entity is a partnership or a corporation for tax purposes revolves around four primary factors. These factors are (1) limited liability, (2) centralized management, (3) continuity of life and (4) free transferability of interest. As described above, limited liability almost always exists in an LLC. Centralized management may or may not exist. However, if it does exist, that is only the second corporate factor. The key factors are continuity of life and free transferability of interest. If these factors are not present, the entity should be a partnership for tax purposes. A carefully structured LLC can avoid the existence of continuity of life and free transferability of interest and, therefore, should be capable of classification as a partnership for tax purposes.

2. IRS Rulings

a. Rev. Rul. 88-76. In Rev. Rul. 88-76 the IRS finally conceded that it would recognize a Wyoming LLC as a partnership for tax purposes.

b. Private Letter Rulings. Following the release of Rev. Rul. 88-76, there was a slow trickle of private letter rulings on the tax classification of LLCs.

c. New Published Rulings. In January of 1993, there were several published rulings issued by the IRS which classified LLCs formed under various state statutes as partnerships for federal income tax purposes. Several additional published rulings have been added since then. These rulings have established a clear intent on the behalf of the IRS that LLCs will be classified as partnerships for tax purposes. It is important to note that these rulings applied to specific LLC statutes and specific provisions included in the LLC formation documents. An improperly structured LLC can be taxed as a corporation. A drafter of LLC formation documents needs to use caution in forming an LLC.

d. New Revenue Procedure. The IRS has recently issued Rev. Proc. 95-10 which describes the factors that are required to be present before a ruling will be issued that an LLC is classified as a partnership.

e. Notice 95-14. The IRS has recently issued Notice 95-14. This notice announces that the IRS is considering making the partnership versus corporate income tax classification elective. If adopted, LLCs could become much less complex.

3. Other Tax Considerations

a. There are a number of other important tax considerations in deciding to operate as an LLC. Tax practitioners are generally taking the position that the word "limited liability company" is inserted for the word "partnership" and the word "member" is inserted for

the word "partner" in all provisions of the Internal Revenue Code. However, there is no clear authority for such a position.

b. The lack of clarity on this point has raised a number of collateral tax issues. One example is whether the LLC may use the cash method of accounting. This question has been examined in a private letter ruling which went through a convoluted analysis of whether the LLC was a "tax shelter" as defined in certain provisions of the Internal Revenue Code. Another issue which has raised questions is whether income from an LLC should be treated as self-employment income. New Proposed Regulations have been issued to address these issues. A review of these issues and other tax considerations is beyond the scope of this outline. For a detailed discussion of these issues see Thomas and Morgan on Limited Liability Companies, by James C. Thomas III and John C. Morgan (Harcourt Brace Professional Publishing 1995).

4. State Tax Considerations

Since federal taxes are generally much higher than state taxes, the state tax considerations are often overlooked. State taxes can be significant and should not be ignored.

Each state is different. Some states tax income of LLCs at the entity level even though the LLC is a partnership for federal income tax purposes. For example, Florida imposes an income tax on an LLC and Texas has a franchise tax on LLCs.

5. I am looking to begin an Internet-based home furnishing business. What incorporation status and business structure best fits e-business? Are there special legal considerations for a business that is entirely web-based?

No one entity is perfect for every business venture; there are a number of different factors that favor one entity over another. In dealing with a technology or internet start-up business, however, two very important factors in deciding which form of entity to choose are (a) your expectation of the most likely exit strategy, if any, and when; and (b) your expected financing needs, particularly venture capital financing. By exit strategy, I mean your plan, if any, to sell the business, how, and when. Companies that don't anticipate going public or will not need much, if any, venture capital financing, may be best suited with a limited liability company (LLC). You should work closely with an attorney to decide which entity is most appropriate for your business.

6. You just formed a new corporation, and now need to put together the bylaws. Where can you get a sample copy of simple corporate bylaws as examples to structure yours?

There are several Internet sites that offer legal forms. You should be able to download a sample form off one of these sites. One such site is Business Filings Incorporated, https://www.bizfilings.com that offers a corporate forms disk for $35. The corporate forms disk has been designed to make complying with corporate formalities easy. It contains all of the necessary forms to properly hold every type of corporate meeting including: organizational directors' meeting, annual directors' meeting, special meeting of directors and annual shareholders' meeting. The forms disk also contains bylaws and resolutions. All forms included on the disk can be used as are or with minor changes or additions.

An informational booklet is included that explains how and when to hold corporate meetings. The booklet also contains an index of all of the forms included on the disk.

7. I plan to incorporating my business in California. What do you estimate it will cost and what type of corporation is best?

A1: Incorporating is fairly straightforward. The papers can be filed by an individual entrepreneur. But there are usually considerations regarding what type of corporation is best and how much stock to initially authorize. If there is a plan to have offices in other states the amount of authorized shares, not issued shares, can mean a substantial tax on the corporation for doing business within that state. However, it is possible to authorize enough shares so there is no need

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to get stockholder approval to authorize new stock as the company grows. Issuing new shares can then be done solely with board approval.

Incorporation in California cost is about $115, so the cost is not that much. A C corporation is the simplest, most straightforward form of organization. It provides the flexibility to do many things that would be much more difficult if the company was an S or LLC. This is especially true if there is intent to do a private offering. S types are limited by the number of total shareholders and LLC shares issued to each member are valued at par and taxable to each member of the LLC.

A2: A difference of opinion also exists when comparing C and LLC companies. LLC's are highly flexible, and are now the most common form of initial legal format used in most states for startup businesses. They have pass through of profits and losses to shareholders which in many cases is very appealing to the investors because they get early advantage of the startup tax losses rather than having to wait some years to offset against potential profits.

They are governed by their operating agreement which can be tailored to the negotiated needs of the founders and the angel investors. They are now available in all states. In Wisconsin, they expect to modify them soon for easier "rollover" into corporations which will help startups around the corner. Such a rollover can be accommodated currently, but from a tax accounting standpoint they are not as easy as they should be, and will be in Wisconsin. Due to the prominence of LLCs it is likely that they are easy to "rollover" in all states.

Be careful of listening to an attorney who does not give a fair and reasonable review of LLCs. For one's particular situation another format may be better, but attorney's have been having a field day with LLCs for the last half dozen years. One example of their simplicity relative to corporations, is reporting. Reporting, as are most components, is a function of what the owners define it will be in the operating agreement versus corporate reporting which is specified by law and far more detailed, typically. Remember, if the owners fail to follow the corporate reporting requirements, they may be piercing their own veil.

A3: There are a lot of pluses for LLCs, particularly the flexibility it gives the owners regarding the reporting of profits and losses, and the resulting tax implications.

However, because of the flexibility, they can be difficult to structure properly, especially making sure the capital accounts balance (that is, stay consistent with the investors intentions) after allocation of profits and losses. Good attorneys and good accountants are needed to avoid later regrets. Flexibility, complexity and legal costs tend to go together. Administration of an LLC can be trivial or a disaster, depending on how it is set up.

The bottom line for universities is: if flexibility is not needed, don't push for it. Simpler can be better. If outside investors want it, fine, but get them to pay for the legal and financial advice. It won't be cheap. And, don't forget to get advice.

A4: LLCs give flexibility to owners, but university license deals involving equity in LLCs are not easy to be structured properly for several reasons:

1. *Regulatory/policy issues.* LLCs are classified for federal income tax purposes as partnerships. Therefore, income earned from active businesses conducted by LLCs is taxable to the university as UBTI ("Unrelated Business Taxable Income"). Tax-exempt universities are usually allowed to only have a small percentage of UBTI. Please make sure that your university allows you to take equity in LLCs before you structure equity deals with LLCs. Exempt organizations generally would have UBTI when the LLCs earn the income, not the LLCs distribute the income to the exempt organizations. It is irrelevant that the exempt organizations may not take any active role in the LLCs' business.
2. *Special skills are needed to structure equity deals with LLCs.* There are alternatives for exempt organizations to get around UBTI. However, technology managers need to thoroughly understand financial instruments other than equity and be familiar with tax/business laws. For example, to avoid having equity in LLCs, an exempt organization

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could receive warrants from the LLC. Receipt of the warrants should not be a taxable event to the organization if the LLC's income is not allocated to the warrant holder. The organization could exercise the warrants when the LLC is converted to a C corporation because the LLC-to-C conversion can usually be designed as a tax-free transaction. Thereafter, the dividends from the C corporation would not be UBTI.

3. *Economics of UBTI.* An exempt organization may be willing to incur UBTI if the after-tax economic return is high enough and its tax-exempt status is not endangered. An example follows.

Assumption:

-An exempt organization has a 5% equity in a business. The business earns $1M of net income, and gives the exempt organization a $50K share. The exempt organization's UBTI tax rate is 34%.

-A C Corporation paying tax on its income at the rate of 34% and paying the exempt organization a dividend out of after-tax income ($660k)

-An LLC paying no income tax and distributing the full $1M to the LLC members. The exempt organization gets $50K (5% ownership).

Consequences:

- The C Corporation pays $340K to the IRS and issues $660K as dividends. The exempt organization gets $33K and pays no tax. Thus, the exempt organization having no UBTI receives $33K after tax.

- The LLC distributes everything to its members and the exempt organization gets $50K. The exempt organization owes IRS $17K at the tax rate of 34% and will be left with $33K. Thus, the exempt organization receives $33K after tax. Economically, there is no difference between holding equity in the C and in the LLC in this scenario.

However, if the $1M business income consisted of income that would NOT be considered UBTI (such as interest income), the exempt organization could be better off holding equity in the LLC than in the C. For example, if the $1M consists 10% of interest income, the exempt organization would receive the same amount ($33K) after tax if it holds 5% in the C because the C pays tax on interest income. However, the exempt organization would be left with $34.7K after tax if i holds 5% in the LLC because interest income would be tax-exempt. The math reads as follows:

- Income distributed to LLC members: $1M
- The exempt organization's share: $50K
- The amount subject to UBTI: $50k-$50k x 10% =$45K
- Tax paid: $45K x 34%=$15.3K
- The exempt organization's net worth of the 5% equity in the LLC: $50K-$15.3K=$34.7K

In summary, LLC deals are more complicated than people think, but an exempt organization could be better off economically if the technology transfer (TT) office's performance is measured by economic return on TT deals. Please be aware that the above examples are simplified hypotheticals. There are more facts that need to be considered to determine whether you would like to have an LLC deal or a C deal. Generally speaking, TT people prefer to have a C deal for two reasons: a) limited skill sets in TT offices; b) most successful LLCs convert to C corporations eventually.

8. Where did LLCs originate?

LLCs have their roots in the "partnership association" of 1874 and 1881 in Pennsylvania, Michigan, New Jersey, and Ohio. Although the partnership association did not survive as a viable business entity because too many restrictions on its structure hindered it, not so with LLCs.

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Today, Germany's GMbH and the "limitada" entity in Latin American countries are variations of the LLCs existing worldwide.

9. When were the first LLCs formed?

When Wyoming passed its LLC Act in 1977, the first LLC statute was enacted. But between 1977 and 1988, states were slow to adopt LLC legislation. In those early years, LLCs were not popular mainly because business persons were uncertain about how the Internal Revenue Service (IRS) would treat the LLC's tax status. In 1980, the IRS issued proposed regulations that would have denied taxation as a partnership to LLCs because their members lacked personal liability. The originally proposed regulation was subsequently withdrawn, and after several years of consideration, the IRS enacted Revenue Ruling 88-76, which set forth the regulations under which an LLC could be taxed as a partnership rather than a corporation.

In the meantime, Florida became the second state to adopt an LLC statute, and it designed its statute to allow greater flexibility than Wyoming's statute. After Revenue Ruling 88-65 was enacted, Colorado, Kansas, Virginia, Utah, and Texas enacted LLC statutes. To date, 47 states and the District of Columbia have enacted LLC legislation. The remaining states are either in the process of drafting LLC legislation or are considering it. The American Bar Association has drafted a proposed Uniform LLC Act that is now being ratified by the states.

10. Why did LLCs originate?

The original Wyoming statute was written specifically for an oil company that required a special form of ownership interest similar to the Latin American limitada. Both require management by an administrator, limited liability, and a minimum 20-year life continuity.

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