

PART II: SELECTED CHOICE OF ENTITY CONSIDERATIONS

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In addition to the traditional entity selection issues (such as limitation of liability, transferability of ownership, and other issues), there are additional important, practical matters that should be considered when choosing a form of business entity. PART I of this article discussed taxation, exit strategy, and the jurisdiction of formation. This PART II discusses the issues of equity compensation, number of owners, and important other considerations.

1. Equity Compensation

Much has been made over the last several years of providing equity as a component in recruiting and retaining directors, advisors, executives, and employees, and in obtaining outside consulting and other services. While both corporations and limited liability companies are able to provide equity compensation (subject to certain securities law and other restrictions), C corporations are generally able to do so most effectively and efficiently.

a. General Considerations

Both corporations and limited liability companies have equity interests that may be issued by the entity as compensation. However, instituting a plan for a limited liability company or S corporation to issue equity compensation presents many challenges. First, because of the flexibility inherent in a limited liability company, the ownership and equity of a limited liability company may be structured in a variety of different ways. While this flexibility can be beneficial in customizing the ownership structure and control of the limited liability company, it may also make the issuance of equity compensation complicated, both from a legal and tax standpoint.

With respect to a S corporation, a S corporation may have only one class of stock. While options and other equity-based compensation does not necessarily create a “second class of stock” issue, if such equity has special rights, or is subject to special restrictions, it may be deemed to be a second class of stock. If this happens, then the entity’s S corporation status would be terminated. Therefore, though limited liability companies and S corporation may issue equity-based compensation, the C corporation is generally preferable for an entity that intends to utilize equity compensation.

b. Incentive Stock Options

In addition to these factors, it is very important to note that only a corporation may grant “incentive stock options”. An “incentive stock option” is a particular type of stock option defined under Section 422 of the Internal Revenue Code which receives beneficial tax treatment. This tax treatment can make them more attractive than other stock options (called “non-qualified” or “non-statutory” stock options) or other types of equity-based compensation.

In general, if the option is an “incentive stock option” the difference between the fair value of the shares at the time of exercise and the exercise price is not considered taxable income until the stock is then sold by the option holder. Thus, the taxable event is delayed. In addition, if the option holder holds the stock for a period of one (1) year or more, the difference between the price paid to acquire the stock upon exercise of the option and the fair value of the stock at the time of exercise is taxed at the favorable capital gains tax rate (and not at the ordinary income tax rate). In contrast, the recipient of a “non-qualified option” is taxed at the time of exercise of the option. Upon exercise of the option, the difference between the fair value of the stock purchased as a result of the exercise of the option and the exercise price (i.e., the price paid upon exercise to purchase the shares) is determined. This difference is treated as ordinary income of the stock option holder, taxable at the time of exercise.

Therefore, if the business plans to utilize equity as incentive compensation, then a C corporation is likely the most appropriate entity, and if the business intends to issue incentive stock options, then the company must be formed as a corporation.

c. The problem of the percentage

One final note: it is important to avoid referring to incentive compensation as a promise of a “percentage of the company”. Rather than committing that a grant of equity compensation (stock grant, option, or other arrangement) represents ownership of a certain percentage of the company, the company should refer to a fixed ownership interest, such as a certain number of shares of stock of a corporation or units of a limited liability company. For instance, the entrepreneur should avoid promising a certain percentage of the company, and instead should commit only to granting a certain number of shares of restricted stock or an option to purchase a certain number of shares.

The issue is that as of the date on which the entrepreneur commits to a certain stock grant or option grant, the shares represented by those grants will represent a certain percentage ownership in the company. The recipient of the shares or options may expect that those shares or options will always represent a certain, fixed percentage of the company’s ownership. However, as additional ownership interests are committed or issued over time, the percentage ownership of the company represented by that stock or option grant will be reduced (this is commonly referred to as “dilution”). While dilution is generally not a negative, it is often viewed that way by the stockholder or option holder. Instead, the stockholder or option holder should consider that although his or her

ownership percentage in the company is being reduced (dilution), he or she may own a smaller piece, but presumably of a more valuable company.

2. Number of Entity Owners

Another consideration is the number of owners of the company. As a practical matter, the corporate form may be more appropriate for an entity with only one owner or for an entity with several owners (as a general rule, more than 10 or so). While there is no legal restriction on the number of owners of a limited liability company, an abundance of owners becomes cumbersome. Conversely, a limited liability company with only one owner may present certain legal issues.

While all states have adopted limited liability company statutes, not all states permit single member (i.e., one owner) limited liability companies. In other words, in some states in order to form a limited liability company, the limited liability company must have at least two members. Although New Hampshire does permit single member limited liability companies, a single owner entity should consider an alternative form if the entity will do business in several states. The concern is that it is not clear how a single member limited liability company will be treated in a state that does not permit the formation of single member limited liability companies. In those states, a single member limited liability company may be treated as if it is a limited liability company validly created under the laws of that particular state. On the other hand, the existence of the limited liability company (with only one member) may be disregarded and the single member limited liability company may be treated as a sole proprietorship. In this case, the member of the single member limited liability company would lose the limited liability and other benefits of operating as a limited liability company. Therefore, if an entrepreneur is considering doing business in several states, the issue of whether a single member limited liability company is the proper business entity form should be considered in order to ensure that the single member limited liability company form is respected by states which do not permit the forming of a single member limited liability company under its laws.

Although the limited liability form of business entity may not be appropriate for entities with only one member that intend to do business in a variety of states, the limited liability company form may also not be appropriate for entities with more than a few owners. In general, entities that anticipate more than a few owners (through investments, grants of ownership interests to employees or others, or other methods) are generally better suited for the corporate form for a variety of reasons. First, the corporate form of entity generally allows for ownership interests to be more easily transferred from a legal and accounting standpoint. Second, the management structure and decision-making of a corporation is generally more centralized than that of a limited liability company (although a limited liability company may centralize its management in one or more managers). Overall, the limited liability company form becomes increasingly unwieldy the more owners there are. Therefore, despite the limitation on the number of shareholders of an S corporation, the corporate form is generally better suited for a large number of owners (i.e., stockholders).

3. Titles

The typical titles used for corporations and limited liability companies are different. While the authority of a corporation is wielded by directors and officers (such as President, Chief Executive Officer, Chief Financial Officer), limited liability companies are managed by the members (i.e., owners) and managers. If titles are important in running the business (for instance, the company's vendors expect to deal with the company's president, not a manager), then the corporate form may be more appropriate. That said, it is increasingly common for a limited liability company to provide for officers in much the same way as, and having powers very similar to those officer in, a corporation. Thus, a preference for certain officer titles is becoming a less significant consideration.

4. Conclusion

One of the most important decisions early-on in a business is to choose the appropriate form of entity. In an operating business, the corporate form and the limited liability company form are by far the most popular. Which form will be right for your company will depend on a variety of factors which require careful consideration by the entrepreneur and assistance from knowledgeable and experienced advisors.