

INCORPORATING THE VENTURE BACKED LLC

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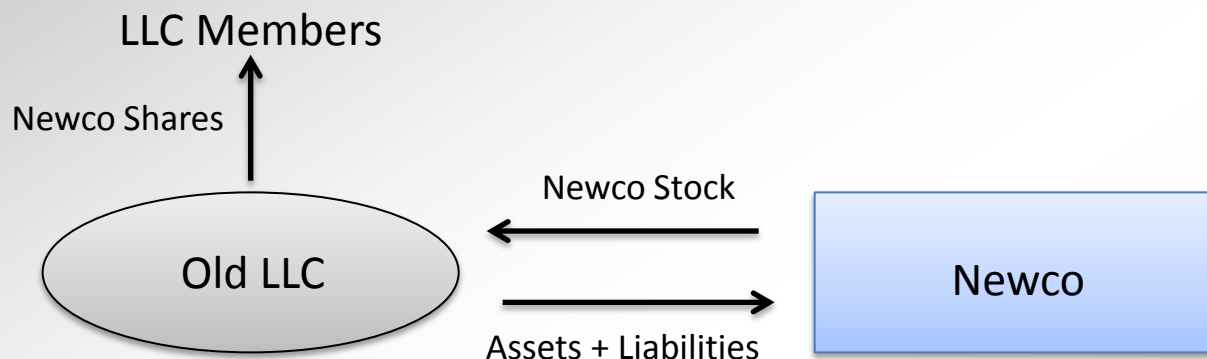
WHY INCORPORATE?

- Many benefits of corporate form now available through LLC
 - E.g., limited liability and different classes of stock
- However, corporations are still the preferred vehicle for raising capital
 - Venture capital investors more comfortable with corporate form
 - Potential IPO
 - Availability of Section 368 reorganization on exit
 - May need to wait two years after incorporating the LLC before attempting another reorganization
- Incentive Stock Options
- General increased liquidity
- Qualified Small Business Stock exemption
 - Issuance of stock in a C corporation on incorporation of an LLC may qualify as QSBS stock
 - Stock held in C Corp following termination of S Corp election does not qualify because stock was not issued in a qualifying corporation

METHODS OF INCORPORATION

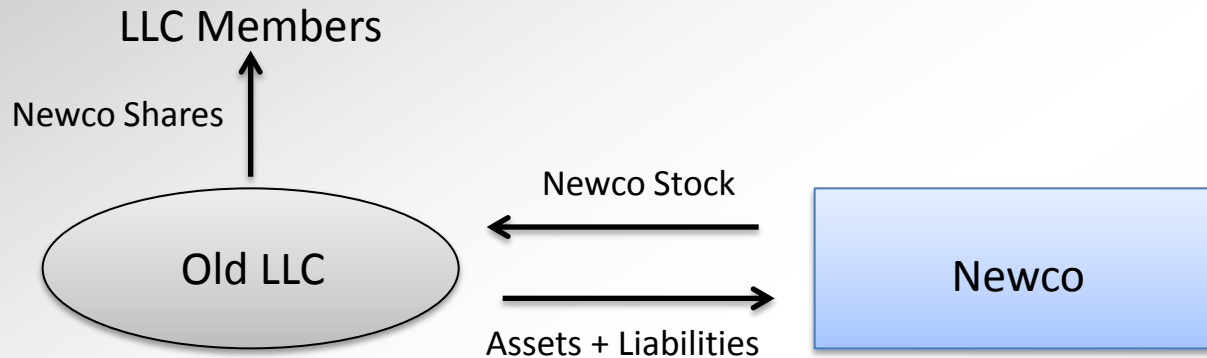
- The IRS has approved three methods of incorporation (Rev. Rul. 84-111)
 - (1) Assets Over
 - (2) Assets Up
 - (3) Interests Over

ASSETS OVER



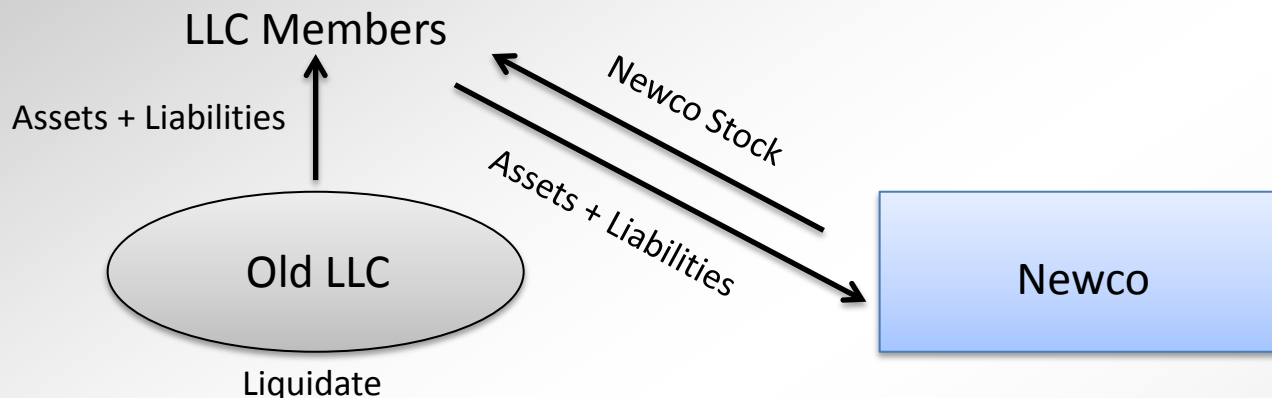
- Step One: Old LLC transfers all of its assets and liabilities to Newco in exchange for Newco stock
 - Assume transfer satisfies Section 351
 - Old LLC defers tax by taking a carryover basis and holding period in the stock (adjusted for liabilities assumed by Newco)
 - Newco takes a carryover basis, holding period, and cost recovery in the assets (adjusted for gain recognized by Old LLC)

ASSETS OVER



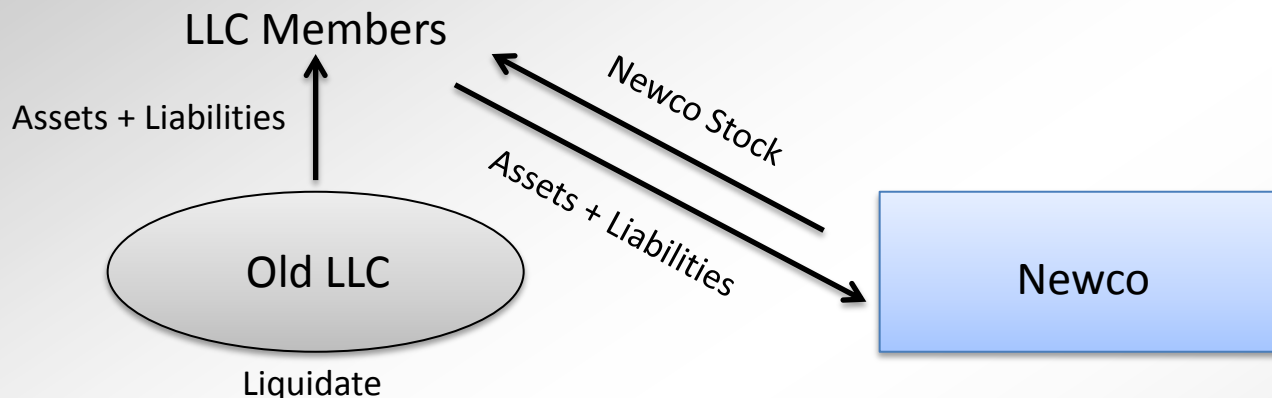
- Step Two: Old LLC distributes Newco stock to LLC Members in liquidation
 - LLC Members take a substituted basis in the stock equal to their basis in the membership interests (adjusted for liabilities assumed by Newco and any gain or loss recognized in the transaction) but will take a carryover holding period in the stock

ASSETS UP



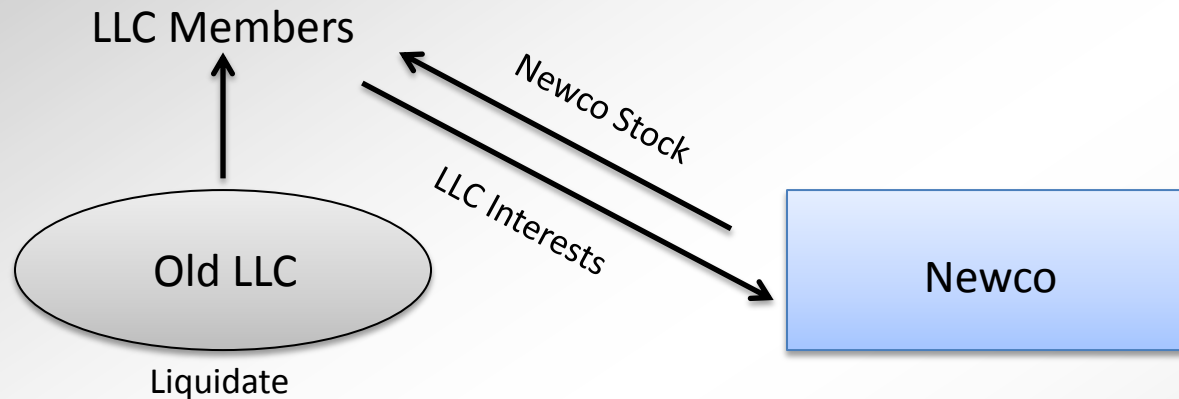
- Step One: Old LLC transfers all of its assets and liabilities to LLC Members in liquidation
 - LLC Members take a substituted basis in the assets equal to their basis in the membership interests (adjusted for any gain or loss recognized in the transaction) but will take carryover cost recovery and holding periods in the assets

ASSETS UP



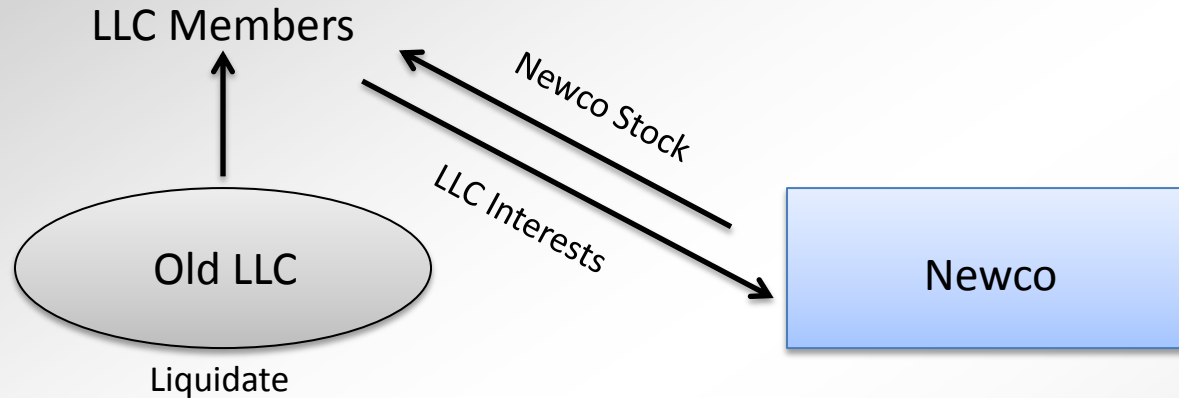
- Step Two: LLC Members contribute assets and liabilities of Old LLC to Newco in exchange for Newco Stock
 - Assume transfer satisfies Section 351
 - LLC Members take a carryover basis and holding period in the stock (adjusted for liabilities assumed by Newco and any gain or loss recognized in the transaction)
 - Newco takes substituted basis in the assets equal to the LLC Members' bases in their membership interests (adjusted for any gain or loss recognized in the transaction) but will take a carryover holding period and cost recovery in the assets

INTERESTS OVER



- Step One: LLC Members transfer their Old LLC interests to Newco in exchange for Newco Stock
 - Assume transfer satisfies Section 351
 - LLC Members take a substituted basis in the Newco Stock equal to their basis in the membership interests (adjusted for any gain or loss recognized in the transaction and liabilities assumed by Newco) and will tack the holding periods of their membership interests to the holding period in Newco Stock

INTERESTS OVER



- Step Two: Old LLC liquidates, but treated as asset transfer to Newco
 - Newco takes a carryover basis, holding period, and cost recovery in the assets (adjusted for gain recognized by LLC Members)

COMPARISON OF TAX CONCERNS

Alternative	Tax Concern							
	Corporate Basis	Corporate Holding Period	Stock Basis	Stock Holding Period	Section 751/752 Gain	Mixing Bowl & Disguised Sale Rules	704(c) Gain	Other Member Gain
#1 Assets-Over	Equal to LLC's Basis	Equal to LLC's Period	Equal to Member Outside Basis (less liabilities)	Equal to LLC's Holding Period for Capital Assets	n/a	On liquidation of LLC	On liquidation of LLC	Excess liability assumption
#2 Assets-Up	Equal to Member Outside Basis	Equal to LLC's Period	Equal to Member Outside Basis	Equal to LLC's Period Holding Period for Capital Assets	N/a if proportionate distribution	On liquidation of LLC	On liquidation of LLC	Cash distribution or excess liability assumption
#3 Interests-Over	Equal to LLC's Basis	Equal to LLC's Period	Equal to Member Outside Basis	Equal to Member Outside Period	n/a	n/a	No Concerns	Excess liability assumption

SECTION 351

- Section 351 provides nonrecognition treatment for exchanges of property by “one or more persons” to a corporation in exchange for stock provided that such persons are in control of the corporation immediately after the exchange
- Control is defined by reference to Section 368(c) which states “the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation”
- Tax-free treatment under Code Section 351 will only apply to the LLC’s/Members’ transfer of assets to the extent such assets consist of “property” within the meaning ascribed to that term by Section 351
 - Generally, hard assets, intellectual property, contracts, accounts receivable, money, secured transferee debt, and other items do qualify as property.
 - Services generally are not considered to be property
 - Capital interests are property for Section 351, but treatment of profits interests is uncertain

DEBT ISSUES

Negative capital accounts:

- Debt in excess of basis
- There may be a taxable gain where liabilities assumed exceed basis
- Partners could consider assuming some of the debt or contributing additional capital

DEBT ISSUES

Debt Shifting:

- Applicable to “Assets Over” incorporations
- Transfer of liabilities from the LLC to the corporation is a deemed distribution by the LLC to its members, reducing the members bases in their LLC interests
 - May result in taxable gain if there is boot i.e., total liabilities exceed total basis

DEBT ISSUES

“No Net Value” rules:

- Prop. Treas. Reg. 1.351-1
- Transferor must surrender net value and receive net value for a contribution to qualify for nonrecognition under Section 351
- FMV of the assets transferred must exceed the amount of any liabilities of the transferor assumed/satisfied by the transferee
- The Proposed Regulations do not consider the tax consequences of a transaction if it is determined that Section 351 does not apply

COMPENSATORY ISSUES

Options:

- What happens on cancellation of unit options and subsequent replacement with stock options?
 - No gain or loss recognized on exchange of partnership option for stock option in new corporation (Private Letter Ruling 9801016)
 - Note ISO and 409A Requirement that option be granted at FMV
 - Contrast exchange of partnership options for corporate options
- Contribution of options for stock under Section 351
 - An option may constitute property for 351 purposes

COMPENSATORY ISSUES

Profits Interests:

- Grant of vested profits interests – generally not taxable as long as conditions of Rev. Proc. 93-27 satisfied:
 - Received in position as member or in anticipation of becoming a member
 - Income is not related to a substantially certain and predictable stream of income from LLC's assets
 - Recipient does not dispose of interest within two years of receipt
 - Unclear what happens to profits interest if surrendered on incorporation before two year holding period is satisfied

COMPENSATORY ISSUES

Profits Interests:

- Grant of unvested profits interests – generally nontaxable as long as conditions of Rev. Proc. 2001-43 satisfied:
 - Must be a real member
 - Neither party may take a deduction
 - Conditions of Rev. Proc. 93-27 satisfied
- Notice 2005-43 – Includes proposed regulations which, when final, will require a Section 83(b) election on receipt of unvested profits interest

COMPENSATORY ISSUES

Profits Interests:

- What happens on incorporation?
 - Vested profits interest
 - Contribute for stock under Section 351
 - Not entirely clear if profits interest is “property” for purposes of Section 351
 - Exchange for preferred stock
 - Preferred stock can be issued under Section 351 as long as it is not “non-qualified preferred stock” which is generally stock with a redemption right or requirement or stock with a dividend linked to interest rates of commodity prices
 - Does exchange of a profits interest constitute a disposal for purposes of the two year rule?
 - Under the three recognized incorporation methods, there is usually a carryover of holding periods so that could apply to the two year rule as well although the law is unclear

COMPENSATORY ISSUES

Profits Interests:

- What happens on incorporation?
 - Unvested profits interest
 - Exchange for option
 - May be the same result as the option for option exchange under PLR 9801016
 - If so, then probably not a taxable event

COMPENSATORY ISSUES

Compensation:

- Managers become employees
 - Guaranteed payments become salaries
- Employment taxes: withholding vs. quarterly estimated tax payments and self-employment tax
- Timing: K-1 vs. wages when received
- Character: pass through vs. always ordinary income

SECTION 409A

- Issue: Does Section 409A apply on the conversion of LLC options to corporate stock options?
- General application of Section 409A to partnerships (and LLCs) is not clear in the legislation and is currently governed by Notice 2005-1
 - Grants of a partnership interest in exchange for the performance of services are to be treated under the same principles governing the issuance of stock
 - Capital interests are not subject to Section 409A
 - Profits interests are not subject to Section 409A provided the recipient does not have to include the interest as income
- On conversion
 - Rules are not clear, but if the analogy to the corporate stock rules is extended to partnership incorporation then the assumption or substitution of options is permitted where it is by reason of a corporate transaction (i.e., merger, consolidation, acquisition of property, reorganization, or liquidation)

NON-COMPENSATORY ISSUES

- Cancellation of indebtedness income
 - Example: debt with an issue price (stated principal amount) of \$1,000 exchanged for stock or debt worth \$900; COD of \$100
 - Example: creditor transfers LLC debt to new corporation prior to merger with LLC; capital gain?
- Transfer of warrants
 - No clear law, but PLR 9801016 could apply to warrants as well as options
 - Final Treasury Regulations 1.704-1 issued in 2013, however the Treasury refused to comment on the impact of partnership mergers, divisions, and terminations on outstanding noncompensatory options, believing it to be outside the scope of the regulations

CAPITAL ACCOUNTS

- Properly maintained capital accounts ensure that tax allocations have economic effect
- Capital accounts must be:
 - (a) increased for the value of property and cash contributed to the partnership;
 - (b) decreased for the value of cash and property distributed; and
 - (c) increased (or decreased) for allocations of income (or loss)
- Liquidation proceeds distributed in accordance with final capital account balances

BOOK UPS ON LIQUIDATION

- LLC operating agreement may provide for a revaluation of property (inc. goodwill) to be reflected in the capital accounts on the occurrence of certain events
 - E.g., a contribution of property to the partnership or a distribution of property from the partnership (Treas. Reg. 1.704(b)(2)(iv)(f))
- Example:
 - Founder has \$0 capital account balance
 - Investor 1 acquires 33% share in year two when LLC is worth \$100
 - Investor 2 acquires 25% share in year five when LLC is worth \$600

BOOK UPS ON LIQUIDATION

Founder		Investor 1		Investor 2		Description
Capital account	Outside basis	Capital account	Outside basis	Capital account	Outside basis	
\$0	\$0					Starting value
\$100						Year 2 book up
		\$50	\$50			1 st Investment
\$300		\$150				Year 5 book up
				\$200	\$200	2 nd Investment
\$400	\$0	\$200	\$50	\$200	\$200	

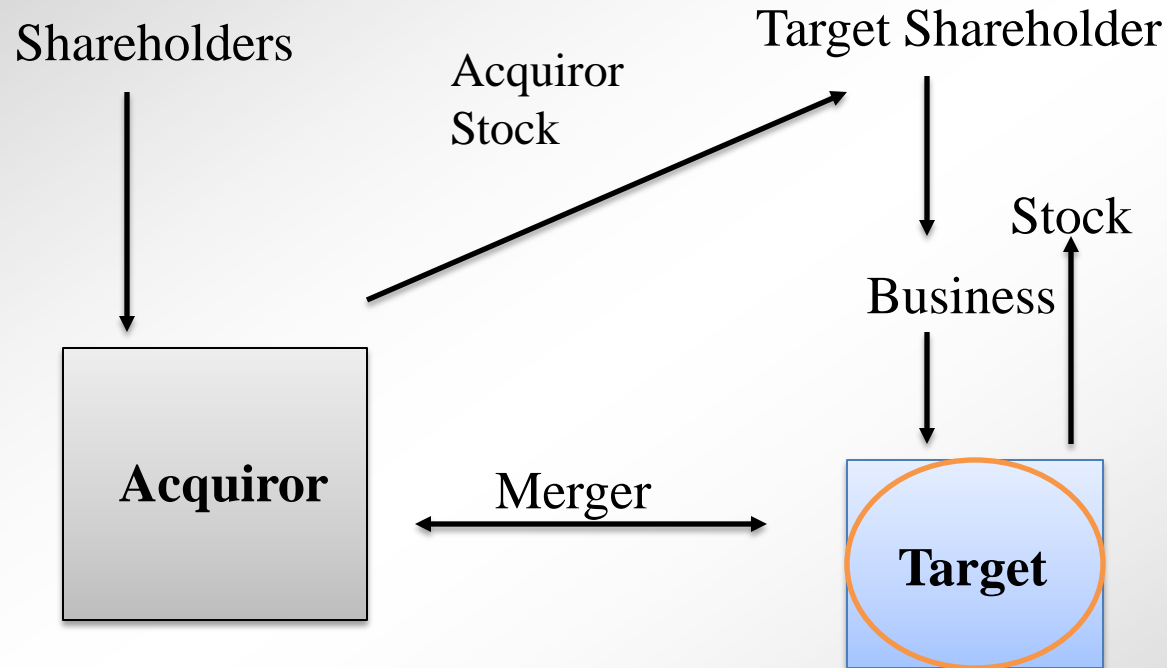
S CORPORATION

- S corporation cannot have partnership shareholder
- Transitory ownership OK. PLRs 9421022, 9010042, 8948015, 8934020, 8926016, 8922004

QUALIFIED SMALL BUSINESS STOCK

- Section 1202 QSBS qualifies for reduced rate of tax on sale and qualifies for rollover treatment
- QSBS must be issued directly to an individual for services or property
- Stock issued on incorporation of partnership can be QSBS, but the portion of the gain eligible for QSBS treatment is limited to appreciation that occurs after incorporation

BUSTED 351



Rev. Rul. 54-96; 70-140; 70-225
Weikel v. CIR, 50 T.C.M. 432 (1986)

Step 1: Convert Target to Corporation
Step 2: Merge Target into Acquiror



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