

Strategically Boosting Exit Value: The Power of Proper eCommerce Entity Formation



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Why is Entity Selection So Important?

My passion is helping eCommerce sellers grow from inception to exit. Unless taxes, company M&A marketability, and/or hitting a dead end on, e.g., a partnership lock, are not a concern, picking between a corporation and a limited liability company is a huge consideration for most of my successful eCommerce clients.

Entities are formed for three specific reasons: to avoid liability, to minimize taxes, and to create an attractive vehicle to invest in, grow and sell. "Business Law for Dummies," or really any business book, lists the various entities one can form. A company can fly without the filing of any legal paperwork (not recommended) or choose from three popular legal entities: LLCs, S-Corporations, and C-Corporations. And there are 50 states, 10 Canadian provinces, and many offshore locations an eCommerce entrepreneur can form in. This makes the question of what legal entity to form, and where to form it a fairly complicated question.

Add to this the complexity of the eCommerce industry. eCommerce sellers sell interstate or even internationally so liability and tax issues can be complex. An eCommerce seller generally needs money to grow inventory and SKUs which means that the entity may need an investor or financier who is going to care about what entity is formed.

And then when it comes time to exit, the choice of entity really matters as buyers of eCommerce businesses tend to be sophisticated and may walk if the entity is not to their liking

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The Entities

A) Limited Liability Companies ("LLC")

LLCs didn't really exist until the 1980s. The IRS does not recognize an LLC, and it is essentially a creature of contract. The taxes are pushed through to each owner's individual tax return because there is no official entity for the IRS to recognize. Here are some examples that demonstrate how simple the LLC structure can be and how complicated it can get relatively quickly.

i. Example 1: Single Member LLC

I decided to start Steve's Sausage Holders, LLC. I filed a Certificate of Organization as a Nebraska single-member LLC. I am the sole member (the person who will be allocated the profit). I can also be the manager (the person(s) who manages the LLC, or I don't have to declare a manager. I established my Seller Central account, listed my Steve Sausage Holder stick, and got an ASIN, and I was ready to sell.

The profits/losses carry over to my personal tax return. If someone gets poked by the sausage stick because it was, e.g., negligently too sharp, the LLC provides a shell of indemnity, so they cannot generally sue me personally. Finally, if I decide to sell Steve's Sausage Holders, LLC the profit (or loss) would carry to my personal income tax form, so it doesn't get confusing.

ii. Example 2: Multi-Member LLC

My friend Jon and I form S&J's Sausage Sticks, LLC to commercialize a new set of sausage-holding products to sell in numerous channels, including our own Shopify Store and into retail. Jon put in \$1,000, and I put in \$99,000 (but I need Jon's expertise as a product designer, so it seems fair to me at the time we are forming). We issue "units" (I look at units like a pizza, there is one pizza but an infinite way to cut the pizza up). Each slice is a "unit". It is not the same as a share because shares have statutory rights that units don't). We issue 10,000 units (5,000 to me and 5,000 to Jon).

We should (but usually don't in adequate detail) contemplate:

- Who is going to manage the LLC?
- Who is going to be a member?
- Can we add new members and how is that going to work?
- How will the units be distributed?
- Can a member be diluted?
- What happens if a member stops working?
- What happens if we need to raise cash or one of us puts in additional cash?
- What happens if the LLC outgrows Jon's skills?
- Who is going to account and how are we going to account?
- What happens if we disagree on decisions?
- What happens if an investor doesn't like the LLC entity and wants to convert it?
- What happens if Jon or I die or are disabled?
- What are the instructions for the accountant/How are we going to split the profits/losses?
- What happens if we want to give a working employee equity?

If we did take the time to think out, our answers would be memorialized in an "operating agreement" which is a contract (typically between 30 to over 100 pages). Having no operating agreement or an operating agreement that is cut and pasted from a standard template is a litigator's dream.

iii. LLCs Can Be a Dream for Some and a Nightmare for Others

In summary, LLCs can start out super simple (and cheap) and really get complicated (and expensive. Entrepreneurs generally like LLCs because taxed as a flow-through (we make \$100/each person is taxed for \$50), and the members do not pay corporate taxes.

But it can also be a nightmare. For example, in S&J's, I begin to feel like Jon is now dead weight, but he owns 50% of the S&J's; now, what do I do? Can I dilute him? Does the Operating Agreement spell out?

Whether the LLC is the right strategy for you takes some discussion and contemplation because while forming one might cost little money, the complexity of the business relationship(s) may drive up the cost, limit the efficacy, and really hamstring your business later on.

B) Corporations

Investors and acquirers like Corporations because they both understand and like the corporate chessboard much better than the LLC chessboard.

A corporation is its own entity. There are shareholders, and there is a board (in many states, this can be one person). The board makes a significant majority of the decisions, and their governance rules are contained in the "bylaws." The shareholders have certain statutory rights that the board cannot override. There can be numerous classes of shares (management shares,

investment shares), and each can have its own rights and distribution priorities (often referred to as a "waterfall"). In summary, the Board makes all key decisions about the Company (like when it makes distributions, hiring, firing, etc.) and figuring out who is on the board art in and of itself to avoid a Board Room Brawl. In summary, the corporate structure is tried, true, and tested, which makes it cost-efficient to memorialize the board by-laws and run the company.

There are two types of corporations, the "C-Corporation" and the "S-Corporation".

i. The C-Corporation

Investors/acquirers generally like and are used to a C-Corporation. Almost all the publicly traded stock is a C-Corporation, and as explained below, they may not be able to invest in an S-Corporation.

The issue with a C-Corporation is double taxation. Say Steve's Sausage Stick Corp. ("Steve's) profits/EBITDA are \$100,000. The corporation will be taxed at the corporate tax rate (21% plus state tax rates) and then each distribution is taxed at individual income tax rates. If I own 50% of Steve's with Jon (see LLC example above) and my blended personal tax rate is 33%, I am going to end up paying (21% Federal + 4% Colorado = 25% = \$75,000. $\$75,000/2 = \$37,500$ (My Distribution). $\$37,500 * .66 = \$24,750$ (Net Distribution).

With the LLC or S-Corp (see below) all things being equal it would be $\$100,000/2 = \$50,000$ (My Distribution). $\$50,000 * .66 = \$33,000$ (Net Distribution).

So the C-Corporation would cost me \$5,500 more in taxes than if an LLC. So if Steve's were just form an entity for tax purposes, I guess it would pick the LLC.

But if Steve were thinking about how to govern the company and didn't want to pay for, e.g., a 50-page operating agreement to spell out governance and distributions, the corporate structure is a much better bet. I certainly know in my work that investors and acquirers really like C-Corporations and do not like LLCs for that very reason.

ii. S-Corporation

An S-corporation functions like a corporation but can be taxed like an LLC. The issue is that an S-corporation's shareholders have to be natural persons (as opposed to a corporation or LLC acting as a pool of individuals) and must also be US nationals.

This becomes an issue because oftentimes, when capital is raised, investors may not be individuals and may not even be American, making the S-Corp election impossible. And what happens if Steve's elected an S-Corporation not knowing it needs to raise money? Steve would be really hoping that the investor

found is an American individual investor, or it is going to have issues. (Revoking an S-Corporation status is possible but involves a relatively complicated tax analysis to conform to IRS regulations).

Which Entity Is Right for Your Organization?

Again, which entity you, the eCommerce entrepreneur, choose does not just involve tax considerations. I can tell you that most acquirers and investors will think twice before buying an eCommerce business that is not a C-Corp, regardless of tax consequences. However, paying extra taxes is no fun and maybe like flushing money down the toilet.

In summary, you are not going to know the right move until you balance the three factors: a) taxation, b) business plan, and c) attractiveness of the structure to others. That is what we do as business counsel: understand your business and weigh these relatively qualitative and intangible factors to come up with a focused and justifiable solution.

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Here are some of my mantras/opinions in this analysis:

The easiest now may equal a nightmare later.

Planning is everything.

Flowthrough entities (like an LLC) work when the equity holder's personal tax situation benefits from the flowthrough. This doesn't work for everyone and every situation.

The easiest is not necessarily the best fit.

Corporations and LLCs generally provide indemnity from personal liability, so it is not a major consideration in entity choice.

Venture capitalists and many other acquirers are either not accustomed to the LLC format or are averse to it.

No decision is set in stone. However, changing things around is exceedingly time-consuming (and requires CPA and legal help).

No one likes paying attorneys. Make sure that your attorney understands your industry, your business, and your personal goals so they can get the job done efficiently and to your liking. I would be a terrible attorney to do this for biotechnology. But I do know eCommerce.

About the Author

After years of corporate counsel experience with a Fortune 100 company, Steven Weigler built and managed a startup where he was able to create and institute a protective intellectual property strategy, commercialize the resulting products and protect the intellectual property, build and manage a sales, marketing and operations team under a "lean startup" budget, and secure both angel and A round financing, and finally negotiated an exit.

Steven's combination of legal, entrepreneurial, governmental and corporate experience gives him a unique, focused perspective on what entrepreneurs who are starting up or emerging their businesses need but rarely have: a) someone who zealously protects their interest and b) someone who has the empathy to understand each entrepreneur's vision and motivation as well as their business plan. Steven has a passion of e-commerce and advises many clients on all aspects of the industry.

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EmergECounsel strategizes with a worldwide clientele in the focus areas of protection of intellectual property and business assets for eCommerce business. Our TotalTM® provides trademark guidance, search, appeals of office actions and denials, and trademark monitoring at flat and affordable rates. In addition, EmergECounsel has an extensive network of professionals who provide co-counsel and services for businesses of all sizes.

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