

Choosing Your Corporate Entity: C-Corps, Nonprofits, and Hybrid Entities
Prepared for Philadelphia VIP by Rana Ozer, esq.

1. What are some potential corporate structures?

There are numerous forms of business entities. The ones that are most commonly used by entrepreneurs are sole proprietorships, limited liability companies (LLC), general partnerships, limited partnerships, C-corporations, non-profit corporations and hybrid for-profit and non-profit entities.

Here, we will only explain C-Corporations, non-profit corporations and hybrid entities as we believe hybrid entities are starting to become popular among entrepreneurs due to their advantages that are explained below.

2. What could be some considerations when structuring your entity?

Potentially, there are various factors that go into the decision-making process when choosing an entity structure:

- a. The complexity of formation of the entity and the complexity of keeping the entity compliant with the laws: As liability of the owners differ from entity to entity, whether you choose to have limited liability as the owner against customers and third parties or let the creditors have access to your personal assets is another consideration.
- b. The ability to attract funding and capital: You need to ensure that the entity structure matches funding and outreach needs. Some means of gaining capital are receiving donations, securing investments and obtaining grants.
- c. Business management preferences: Depending on whether you intend for all owners to have a say in business operations or not your decision may be impacted.
- d. Taxation: Each entity structure may be subject to a very different method of taxation. These differences could lay in the nature of the tax, amount of recognized income or loss, and deductibility of expenses.

3. What are the advantages and disadvantages of C-Corporations?

Advantages of incorporating as a C-Corporation are the ability to receive any type of funding; such as donation, investment or a grant and the possibility of having an unlimited revenue generation.

Disadvantages would be the requirement to pay the one-time filing fee (for example \$89 in Delaware - assuming you incorporate in Delaware due to various reasons such as Delaware keeping its corporate taxes as low as possible in order to remain competitive with other states, the quality of Delaware courts and judges in corporate matters and its modern corporation statute). Other annual spending includes franchise tax and report filing which cost around \$200. Apart from these, C-Corporations must pay corporate tax each year and they cannot allow for tax deduction by donors.

4. What is a B-Corporation Certification and what are its advantages?

B-Corporation is not an entity choice, it is rather a certification provided to entities. B-Corporation certification is a social and environmental performance certification for for-profit entities such as C-Corporations provided by a third party non-profit organization. You can only apply for a B-Corporation certification after you incorporate as a C-Corporation. Benefit Corporations are different from certified B-Corps. Receiving a B-Corporation certification does not make the company a Benefit corporation. Benefit corporations are corporations in the traditional sense but they are legally empowered to pursue positive stakeholder impact alongside profit unlike C-Corporations which are required to pursue the maximum profit generation.

Even though there aren't any legal tangible advantages to registering as a B-Corporation, when a corporation gets a B-Corp certification, it becomes encouraged to be socially responsible, it may attract like-minded people in terms of talent finding, and due to the access it brings to B-Corporation community data, the company may be able to cost-save in the future by learning the most cost-effective means to be sustainable.

5. What are non-profit corporations?

Non-profit corporations are just another form of entity structures that are formed under state law. Non-profit incorporation usually involves these steps:

- Choosing a business name that is legally available in your state and filing for an Employment Verification Number (EIN),
- Preparing and filing your articles of incorporation with your state's corporate filing office and paying a filing fee,
- Creating bylaws that will explain how the corporation will operate,
- Appointing initial board of directors,
- Holding the first board of directors meeting.

6. What is a 501(c)(3) status?

501(c)(3) is an Internal Revenue Service approved federal tax-exempt status for non-profit corporations and some other satisfying entity structures. When IRS approves your organization's 501(c)(3) status, it defines the corporate entity as tax-exempt. Exempt purposes set forth in section 501(c)(3) of the Internal Revenue Code are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. The term charitable is used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.

7. What are the advantages and disadvantages of non-profit corporations with 501(c)(3) status?

Advantages to incorporating as a non-profit with 501(c)(3) status is that you can receive donations and grants without any limitations as funding, you can allow your donors to get tax deductions from their donations, you get to be tax-exempt (but only for your activities pursuant to exempt purposes) and the possibility for your organization to have a legal structure that is aligned with your social impact vision, in cases where you have such a vision.

Disadvantages would be the inability to receive investments as a method of funding, the requirement to pay the one-time IRS user fee of \$275, limitations on revenue generation due to the exempt-purposes defined by the code and the possibility of status revocation if substantial part of the corporation's activities arise from non-exempt purposes which would mean that tax liability for those activities would apply as well.

8. How do you obtain 501(c)(3) status?

There are a few steps when seeking 501(c)(3) status. Even though some of these steps are already covered for incorporating in general, some others are required specifically for the tax-exempt status. First of all, you need to assemble a board of directors. Board of directors is the governing body of the non-profit organization thus it plays a very important role. Typically, board is more about governance rather than management, which consists of day to day operations. Board members may overlap with the people involved in management/officers in the non-profit organization. Even if the IRS does not require a separation within board members and officers, it is usually suggested to have a board separate from the officers of the non-profit corporation from a corporate governance perspective; in order to create an efficient oversight mechanism. In Delaware, a minimum of one board member is required for non-profits. There is no residency requirement for the board members. Drafting bylaws and seeking their adoption by the board is the second step. Then, the third step is to draft the conflict of interest policy. Conflict of interest policy is drafted in order to prevent the board members benefitting from board policies; either financially or personally. Afterwards, you need to provide the organizing document and financial statements to the IRS, as well as a complete IRS Form 1023. IRS Form 1023 has a \$600 fee and needs to be filed with the IRS by mailing it to them. The form is 28 pages long and it requires some attachments such as the articles of incorporation, bylaws, financial statements, conflict of interest policy. There is a shorter version of the Form 1023, titled Form 1023-EZ. Form 1023-EZ is 3 pages long, requires a \$275 fee, is submitted online and the response from the IRS typically comes within less than 30 days. It also does not require any attachments to be filed with it. However, the fact that it does not require attachments to be filed does not mean that those attachments shouldn't be ready for a potential future audit. The moment you file a Form 1023-EZ with the IRS, you need to have the attachments for Form-1023 ready as the applicant is still certifying, under penalty of perjury, that these documents are ready and available if the IRS requests them. Lastly, the final step, as you

can imagine, is staying compliant; which means keeping good records, tracking the minutes of meetings, etc.

9. What is a hybrid structured entity?

A hybrid structure is a combination of for-profit and non-profit corporations. A hybrid structured corporation can either be in the form of a parent-subsidiary or as two separate but related entities connected by a contract.

10. What are parent-subsidiary hybrid entities?

In such structure, both parent and the subsidiary can be either for-profit corporation or the non-profit corporation. The goal is for the organization to be tax-exempt when engaging in the purposes that are in accordance with the tax-exemption but still remain able to engage in non-tax-exempt purposes and not lose the tax-exempt status.

There are various factors to take into consideration when deciding on which form of hybrid structure to choose. In the parent-subsidiary structure, if the for-profit corporation is the parent and the non-profit corporation is the subsidiary, in cases where for-profit corporation is held liable for something, not only it will be subject to 'piercing the corporate veil', but also the non-profit corporation. Piercing the corporate veil is a legal terminology meaning the liability of the company will ultimately result in personal liability. The reasons for why the for-profit corporation could be held liable are disregarding corporate formalities, using corporate form for improper or personal purposes, engaging in fraud, and inadequate capitalization. On the other hand, one advantage of such structure is the potential ability to maintain more control over the subsidiary than the control you would maintain in the second entity in the separate entities structure. However, in the parent-subsidiary structure the parent also has the duty to oversee subsidiary and its board. Even though it is not required, it is highly suggested that the parent and the subsidiary have separate board. Of course, some directors could always be common in both boards. Even if there is substantial overlap, the subsidiary's tax-exemption will not be jeopardized.

11. What are separate-but-related hybrid entities?

In such structure, the for-profit corporation and the non-profit corporation are only contractually connected, therefore they do not cause liability for each other.

Even though there are no solid rules, it is suggested that the boards of the entities be substantially different or at least not fully identical in order not to defeat the purpose of creating two entities. Otherwise, they may be regarded as the same entity for tax and liability purposes.

12. What are the advantages and disadvantages of hybrid structured entities?

Some advantages of hybrid entities are that they can receive any type of funding, they are unlimited in their revenue generation, they can allow for tax deduction by their donors and they pay corporate tax only for some of their activities.

On the other hand, some disadvantages are that they have tricky organizational structures and they need to pay corporate tax on for-profit activities. Some aspects of the tricky organizational structure are the resource sharing between entities, the requirement of adequate separation between the entities and a complicated governance due to two separate boards.