Entrepreneurs, Investors and Dynasties - finding the right corporate vehicle

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To appreciate fully the use of special purpose corporate vehicles, a sophisticated business planner must understand that a company's needs and dynamics change over time. Although the structure of the company may have been sufficient at its inception, the form may need to be changed as the company matures and evolves.

The purpose of this article is to shed some light on recent legislative initiatives that permit business entities to de-register as one form of legal entity and re-register as a new form of legal entity. In many jurisdictions, this concept is referred to as "conversion" and it is widely adopted in the US by various states. Internationally, this concept is recognised (in varying degrees) by countries such as Australia, India and Canada.

For the reader's better understanding, set forth below is substantially the text of the language contained in the statutes of Delaware and Liberia that permit the de-registration of an entity within each jurisdiction and its re-registration as a different form of entity.

In Delaware, Section 265 of the General Corporation Law (GCL) governs the conversion of other forms of entity into a Delaware corporation. Under the statute, "other entities" is defined as any limited liability company, statutory trust, unincorporated business including a partnership, or a foreign corporation. The process of carrying out the conversion is as simple as filing a certificate of conversion and a certificate of incorporation with Delaware's Secretary of State. Under the statute, the conversion of the original entity into a Delaware corporation will not affect any of the obligations or liabilities that the original entity may have incurred prior to its conversion. Also, by operation of law, all of the assets and liabilities of the original entity will be automatically vested in the new entity. The statute further provides that the act of converting an original entity into a corporation will not constitute a dissolution of the original entity and it will not require the original entity to "wind up its affairs or pay its liabilities and distribute its assets, and the conversion shall not be deemed to constitute a dissolution of such other entity and shall constitute a continuation of the existence of the converting other entity in the form of a corporation of [Delaware]".

Section 266 of Delaware's GCL governs the conversion of a Delaware corporation into another entity. In effect, this section allows the conversion of a Delaware corporation into a Delaware limited liability company (LLC), a Delaware limited partnership or a Delaware business trust. In order to induce the conversion, a corporate resolution must be passed by the directors of the Delaware corporation authorising the conversion. In addition, all remaining shareholders must approve the conversion and a certificate of conversion must be filed with Delaware's Secretary of State. According to the law, the conversion of a corporation to another entity will not affect any of the obligations or liabilities that the original entity may have incurred before its conversion.

Similar to Delaware law, various provisions of the Liberian Business

Corporation Act (BCA) address the concept of conversion from one form of business entity into another. Section 10.14 of the BCA provides for the de-registration of a Liberian corporation and its re-registration as another form of Liberian entity, Section 14.2.14 governs the re-registration of a legal entity existing under the laws of Liberia to re-register as a Liberian limited liability company, and Section 14.2.15 allows the cancellation of a Liberian limited liability company upon re-registration as another form of Liberian entity. Provisions comparable to Sections 14.2.14 and 14.2.15 of the BCA are incorporated in the Liberian laws related to limited partnership and foundations.

Prior to the legal concept of "conversion", practitioners would have had to either: (a) form a new entity and merge the old entity into the new one; or (b) dissolve the original entity, distribute the assets to the equity holders and then have the equity holders contribute the assets into a new entity. Other than time consuming, these practices can be costly and can trigger unnecessary tax consequences. In many cases, conversion will yield the same result (changing one type of entity into a new type of entity) in a more efficient manner.

Perhaps it is easier to grasp the use of conversion by way of example.

In the first illustration, two entrepreneurs decide that, in order to limit their liability in a proposed investment, it would be best for each to contribute capital by purchasing shares in a standard special purpose International Business Company (IBC). Over the course of time, the entrepreneurs realise that additional capital is needed to fund the new corporation's expansion. They are introduced by their financial advisor to three investors. While the three investors are content to leave full management and operation in the hands of the two entrepreneurs, they do not want the tax revenue agency to reap the reward of corporate taxation at the entity level and subsequently personal income taxation from the three investors.

Assuming the IBC was formed within a jurisdiction that allows for entity conversion, the two entrepreneurs can transfer the assets and liabilities of their special purpose company to a pass-through tax vehicle by conversion of their IBC into an LLC. The entrepreneurs will assume responsibility as co-managing members with the investors participating as investment members. Hence, the advantages of an LLC will be realised, which in general include: members' protection from being personally liable for the debts and obligations of the LLC; single layer of taxation; simplicity and operational flexibility; and reduced requirements for record keeping.

In our second example, another entrepreneur decides that to limit his liability in a proposed investment, it would be best to contribute capital by purchasing shares in a standard special purpose IBC. After a few very prosperous years, this special purpose IBC grows into an extremely valuable holding company of the entrepreneur's family wealth. In this case, the shareholder would like to donate certain assets to his heirs. However, he would like to maintain the wealth generating potential of the company while distancing himself from its assets and the tax revenue agency's long reach. In this case, the entrepreneur's corporation was also formed in a jurisdiction that permits conversion. Therefore in this situation, a conversion of his special purpose IBC into a foundation seems to be the most sensible option. The de-registration of the corporation and its subsequent re-registration as a foundation will allow the donor to become a beneficiary of the foundation while participating on the foundation's supervisory board. However, once the conversion is completed, he will be able to avoid inclusion the foundation's assets in his personal taxable estate since it is the foundation that will own the assets.

Furthermore, following the conversion, the donor will realise the following additional advantages: the foundation will be managed by independent officers (usually professional administrators), guided by a Supervisory Board (or Council) and the foundation's officers will determine distribution of income and capital in accordance with the Founder's instructions, which can change over time. Moreover, in many jurisdictions there will be limited public filing requirements and no disclosure of the founder or the beneficiaries.

The clear advantage of the conversion is that the foundation will distance the assets from otherwise taxable events. In addition, the creation of the foundation structure avoids problems that could be incurred by the creation of a trust structure. With this structure, the foundation rather than trustees are the legal owners of the property.

It is important to note that in both examples above, the interested parties were incorporated in a jurisdiction that permitted conversion, such as Delaware or Liberia. However, if they were outside such a jurisdiction, the parties would have to review closely the corporate statutes of their jurisdiction. If the statutes allowed for re-domiciliation, the entrepreneurs might consider moving (re-domiciling) their companies to a favourable jurisdiction and thereafter arranging for conversion.

The mass conversion of Canadian income trusts into corporations is a recent example of the benefits of conversion statutes. On 31 October 2006, the Canadian Department of Finance announced the Specified Investment Flow-Through rules (SIFT rules). The new SIFT rules changed the way in which publicly traded income fund trusts were to be taxed, which was similar to corporate taxation. On 14 July 2008, the SIFT rules were further amended to allow for the conversion of a SIFT trust into a corporation on a tax deferred basis if the conversion completed prior to 2012.

The corporate world responded swiftly to these new regulations and a significant number of income fund trusts took advantage of the new regulations; many trusts have either converted into corporations or have announced their intention to convert. Some of the advantages of the conversion that Canadian companies have cited are: the effective and efficient method to convert from a trust into a corporation under Canadian legislation; the benefit of lower income tax rates on dividends paid by unit holders after the conversion; the improved access to capital markets in Canada by utilisation of a corporate form (rather than a trust form); and the elimination of normal growth restrictions imposed by the SIFT rules.

From the above fictional and non-fictional illustrations, it is easy to appreciate the advantages of concrete rules for conversion. As a note of caution, it is worth reiterating that conversion from one type of entity into another could have tax implications. While these implications are beyond the scope of this article, with advice and guidance of financial professionals, conversion clearly offers an intriguing option to change corporate structure as a company evolves and matures.