Business Structure and Choice of Entity

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University of Rochester Ain Center for Entrepreneurship's Buzz Lab Boot Camp
March 2, 2019
Choice of Entity

- Introduction
- General Overview of Structures
- Taxation
  - Corporations
  - Pass-Through entities
- Other Considerations
- Compensation
- Governance
- Conclusion
General Overview of Structures
General Entity Considerations

Choice of Entity

– Considerations

• Management
  – Flexibility of governance

• Taxes

• Investment Capital

• Future plans/expectations

– *Potential Pitfall*: Failure to pick an entity
Default if One Owner: Sole Proprietorship

- **Sole Proprietorship**
  - Not a good choice for most businesses
  - BUT....Good baseline for discussion
    - Simplest form
    - You own the business, control its management, have the right to receive all profits
  - Taxation
    - All profits and losses are taxed directly to you on your individual tax return
Default if One Owner: Sole Proprietorship

- Advantages
  - Simple and inexpensive
  - Owner has full control of the business
  - One layer of tax

- Disadvantages
  - Unlimited personal liability (no legal separation between you and the business)
  - Virtually impossible to raise money
  - Only one owner by definition
  - No ability to provide equity as incentive compensation
Default if Multiple Owners: General Partnership

- General Partnership
  - An association of two or more people
  - Generally use a partnership agreement
    - Partners can agree to almost anything
      - Capital contributions
      - Requirements and ability to add new partners
      - Participation of partners in profits and losses
      - Decision making of partnership
      - Dissolution and winding up
Default if Multiple Owners: General Partnership

- Taxation
  - Pass-Through entity – profits and losses are taxed directly to partners
  - Partnership losses can be offset against income from other sources

- Advantages
  - No double taxation (contrast to corporation)
  - Flexible management structure

- Disadvantages
  - Each partner has unlimited liability for the debts and obligations of the partnership
  - Transfer of partnership interests difficult
  - Lack of hierarchy can create management and control issues
  - Inability to raise capital
Entity Considerations: Corporations

Corporation

- A separate legal entity, distinct from its owners and management
- Most common form of business entity
  - Owners are called shareholders
  - Shareholders elect a Board of Directors
  - The Board of Directors appoints officers to manage day to day operations
Shareholders are shielded from the liabilities of the Corporation (with certain exceptions in New York):

- Responsible officers personally liable for unpaid withholding taxes
- 10 largest shareholders liable for unpaid wages
- Piercing the corporate veil – “follow the formalities”

Governance

- Articles of Incorporation – filed with state
- Bylaws
- Shareholders’ agreement may be desirable
  - Identify the rights, duties and responsibilities of shareholders
  - Same types of issues as partnership agreements
Entity Considerations: Corporations

- **Advantages**
  - Limited liability for shareholders
  - Investors are used for investing in corporations
    - efficient form with which to raise capital
  - Multiple capital structures available
    - preferred stock, multiple classes, multiple rounds
  - Use of equity as compensation

- **Disadvantages**
  - Double taxation on corporate profits
  - Relatively complex governance system
Entity Considerations: Limited Liability Company

- **Limited Liability Company**
  - Hybrid between a partnership and a corporation
    - Anyone can be an owner; no maximum
    - Rights can be granted to some and not to others
    - Governed by an operating agreement – plenty of flexibility
      - Operating agreement used much like a partnership agreement
  - **Taxation**
    - Pass-Through
Entity Considerations: Limited Liability Company

– **Advantages**
  - Owners shielded from personal liability
    - Tax benefits of a partnership, liability protection of a corporation
  - Pass-Through taxation
  - No limitation on types of members

– **Disadvantages**
  - Exit strategy limitations
  - Incompatible form with some tax exempt investors
    - Some investors prefer corporations

– **Potential Pitfall**: failure to accurately articulate the desired rights and responsibilities of owners
Where to Incorporate/Organize?

Where should the entity be domiciled?

- New York
  - Cheaper
  - Less flexibility

- Delaware
  - Investor understanding
  - Legal certainty
  - Readily accepted by investors
  - No quirky statutes
  - Potential Pitfall: must qualify to do business in New York; additional cost

- Potential Pitfall: not incorporating soon enough
  - Lack of governance creates opportunity for owner/management disputes
Entity Taxation
Entity Taxation: Introduction

- Forms of Business Organizations for Tax Purposes
  - C Corporation (corporation, electing LLC, publicly traded partnership)
  - S Corporation (electing corporation, electing LLC)
  - Partnership (general, limited, LLC, PLLC)
  - Disregarded entity/sole proprietorship
C Corporations

- Historically, generally, used when other forms not available
  - Income of the corporation is taxed at the corporate level
  - Distributions from the corporation to its shareholders are taxed at the shareholder level as dividends or return of capital
  - “Double taxation”

- Generally speaking, C corporations are tax inefficient and typically not recommended from a tax perspective
  - However, there may be advantages to the C Corporation form in cases where cash is retained in the business and stock sale is expected
Partnerships (typically through LLC)

- Historically, the preferred vehicle unless C Corporation required
- Pass-Through taxation
  - Income of the partnership is taxed once at the owner level
  - Distributions corresponding to income typically tax-free
- Very flexible
- Flexibility comes at the cost of complexity
- New Pass-Through deduction (§199A) provides material benefits, but is subject to material limitations
S Corporations: Restrictions on Capital Structure

- Single class of stock
  - No preferred stock
  - No special allocations
- Restrictions on shareholders
  - Types (no foreign or corporate shareholders)
  - Number (100 shareholder limitation)
S Corporations

- Generally similar to partnership: pass-through taxation
- Not as flexible as partnership
- Possible payroll tax benefits
- New pass-through deduction (§199A) provides material benefits, but is subject to material limitations
  - Deduction cannot be obtained for compensation paid to shareholder
C Corporations

- The corporate rate is cut to 21% and the corporate AMT is abolished
- New rate places US closer to OECD average of 23.75%
- Old US combined rate of 38.9% was the highest among OECD nations
- Rate change is permanent (but change of law risk)
- Unlike individual AMT, corporate AMT is repealed
- Numerous changes to tax base accompany rate reduction
C Corporations

Corporations

AB, Inc.

$100 income

$18.8 tax (shareholder level)

$21 tax (corporate level)

Total tax: $39.8

Simplification. Federal income tax and NIIT only.
Pass-Through: Simple Illustration

- Partnership / S Corporation

$100 income

$37 current tax — shareholder level
Reduced to $29.6 if §199A applies
No tax on distribution
Reasonable compensation (not subject to §199A) must be paid by S corporation

Simplification. Federal income tax only. Assumes no NIIT.
Pass-Through: Overview

- **General** - Provides for a 20% deduction for noncorporate owners for qualified business income from a partnership (including LLC), S corporation, or sole proprietorship.
  - Also includes an S corporation, partnership, or trust that owns an interest in a pass-through entity (future regulations to provide guidance on deduction for tiered entities).

- **Qualified business income** - Qualified business income is generally defined as all trade or business income other than wage-like and investment-related income.

- **Effective Date** - Effective for tax years beginning after Dec. 31, 2017 (can claim deduction on 2018 return).

- **Expiration** - Sunset on 1/1/2026.

- **Threshold** - $157,500 or $315,000 for joint returns (adjusted annually for inflation).
Pass-Through: Special Rules

- Availability of deduction is limited to the greater of:
  - 50% of the allocable share of W-2 wages paid with respect to the qualifying trade or business; or
  - 25% of the W-2 wages with respect to the qualifying trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

- Limitation does not apply to individuals with taxable income less than $157,500/$315,000 (adjusted for inflation). It then phases in over the next $50,000/$100,000.
Pass-Through: Special Rules

Example:

- Peter and Paul are owners of Peter Piper’s Pepper Pickling, a Partnership.
- Pass-Through income was $1,000,000, 50% to each Pickling Partner.
- Total W-2 wages for pickling employees are $400,000, 50% allocable to each Pickling Partner.
- Because 20% of $500,000 ($100,000) exceeds $200,000 (allocable share of wages), the deduction is available.
- Because the wages substantiate the deduction, it is not necessary to analyze the unadjusted basis of equipment (the pepper pots).
- Conclusion: Our President’s particular preference for pass-throughs, produces a $100,000 pass-through deduction for each Pickling Partner.
Pass-Through: Special Rules

- Income from Certain Service Businesses
  - 20% deduction is not available for income from health, law, consulting, financial/investment businesses or any trade or business, “where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.”
  - Exception: Income below $157,500/$315,00, with phase out over the next $50,000/$100,000.
Notwithstanding the decreased corporate rate, pass-through entities still produce lower tax burden, especially if the pass-through deduction is available.

<table>
<thead>
<tr>
<th></th>
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<th>Pass-Through†</th>
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<tbody>
<tr>
<td>Taxable Income</td>
<td>$1,000</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>Corporate Tax</td>
<td>$210.00</td>
<td>N/A</td>
</tr>
<tr>
<td>After Corporate Tax</td>
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<td>Total Tax</td>
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<td>Tax Percentage</td>
<td>39.80%</td>
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* Assumes 37% marginal tax rate for Pass-Through (active business) and 23.8% for dividends
† Assumes all income is qualified business income and is eligible for deduction
For simplicity, ignores state tax implications and non-income taxes (other than NIIT).
Comparison

- But this gap narrows if the Pass-Through deduction is not available.

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2.8% differential

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For simplicity, ignores state tax implications and non-income taxes (other than NIIT).
If no income is taken out, the C corporation is the clear winner on a current basis.

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8.6% differential

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## Character of Gain

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<th>S Corporation</th>
<th>Partnership</th>
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<tr>
<td>Stock</td>
<td>Capital</td>
<td>Capital</td>
<td>Capital or ordinary</td>
</tr>
<tr>
<td>Asset</td>
<td>Ordinary (Plus tax on dividends)</td>
<td>Capital or ordinary</td>
<td>Capital or ordinary</td>
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</tbody>
</table>
Exit Events: C Corporation

- C Corporation
  - Two layers of tax on asset sale
  - No corporate capital gain rate
  - No asset basis step up for buyer on stock sale
  - Reduced rates on sale of qualified small business stock
  - Deferral/elimination of tax for opportunity zones
  - Ordinary loss for failed small business corporation
  - Can participate in reorganizations
  - Availability of IRC 338/336
Exit Events: S Corporation

- **S Corporation**
  - Single layer of tax (including on asset sale)
  - Capital gain rates apply on stock sale (no “hot assets” rule)
  - Basis stepped up for income inclusions
  - Ordinary loss for failed small business corporation
  - Can participate in reorganizations
Exit Events: Partnership

- Partnership
  - Single layer of tax (including on asset sale)
  - Ordinary income on sale of partnership interest to extent of hot assets
  - Basis stepped up for income inclusions
Other Considerations
Funding the Entity

Raising Capital

– Debt:

• Debt must be repaid…
• Debt holders’ upside typically limited to interest payments
• Some debt has preference over other debt
• Senior/Subordinated
• Sources – bank, venture capital, family and friends
• Potential Pitfall: Personal guarantees – regardless of type of entity
• Potential Pitfall: More difficult to obtain conventional bank financing with current market conditions
Funding the Entity

– Equity – sales of securities
  • What is a security?
  • Company typically has no obligation to repay or redeem equity
  • Equity holders have unlimited potential upside
  • Participation in management
    – Common shares get to vote for directors
    – Management role of professional investors
  • Sources:
    – Venture capital
    – “Country club” financing
  • Potential Pitfall: Complex regulatory framework
Protecting Intellectual Property

- Pre and post entity formation protection
  - A company’s worth is often based largely on its intellectual property
- Patents: an exclusive right to use an invention for a specified period of time
  - Advantage
    - The holder has a monopoly; others are prevented from using the invention
  - Disadvantages
    - Public
    - Work arounds
  - In order to obtain a patent, a filing is made with the U.S. Patent and Trademark Office, which must approve the application
    - Potential Pitfall: Failure to make timely filings can invalidate your protections
Protecting Information

- Trademark: a protected right to use a name, brand, packaging, or other device intended to identify a project, service or business
  - Name of new business – infringing on others?
- Copyright: ownership of an original work of authorship
- Proprietary information and trade secrets

**Potential Pitfall: “what’s yours is mine”**

- Often your employer has pre-existing ownership rights in ideas that you develop as part of your employment
Non-Disclosure Agreements

- Use in connection with:
  - Any situation where your unique technology, processes, products etc. will be shared with others
    - contractors
    - suppliers
    - potential financing sources
    - joint ventures

- Essential to protecting intellectual property

- Potential Pitfall: know what you sign
  - NDA’s often contain more than just “boilerplate”
  - Not all “boilerplate” is standard or applicable to your situation
Compensation
Compensation

- **Payroll Taxes**
  - Social Security (first $128K): 12.4%
  - Medicare: 2.9%
  - Medicare surtax 0.9%

- **Unearned Income Medicare Contribution Tax**

- **Unreasonable compensation issues**
What are payroll taxes imposed on?

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<td>Reasonable compensation</td>
<td>Reasonable compensation</td>
<td>GPs/Active LLC Members: distributive</td>
</tr>
<tr>
<td></td>
<td></td>
<td>share of trade or business income</td>
</tr>
<tr>
<td></td>
<td></td>
<td>LPs: N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Passive LLC Members: Law evolving</td>
</tr>
</tbody>
</table>
Recruiting and Retaining Personnel

- Incentivized Compensation
  - Cash
  - Equity
    - Actual or potential “phantom” ownership interest in the enterprise
    - Conserves cash
    - Aligns interests with founders
    - Most common types:
      - Stock options
      - Restricted stock
  - Potential Pitfall: 409A Compliance
Section 409A regulates the payment of “nonqualified deferred compensation”: any compensation that is earned in one taxable year and payable in a subsequent taxable year

- Employment agreements, bonus arrangements and equity compensation may be subject to Section 409A
- Section 409A is very complex and substantial tax penalties are imposed for failures to comply

Incentive compensation can be structured to be exempt from Section 409A or to comply with Section 409A
Governance
Shareholder Agreements

- Govern the relationship between owners
  - Voluntarily leaving the company
  - Termination
  - Death
  - Disability
- Redemption or “liquidity” events
  - Provide opportunities for shareholder’s to receive cash in exchange for their ownership interest
- Sales to third parties
  - Protecting the closely held nature of ownership
- Help reduce likelihood and cost of “Corporate Divorce”
Governance and Administration

Recordkeeping

- Critical for
  - Obtaining future financing
  - Legal and regulatory compliance
  - Transition planning and future sales of the business require accurate records

- Create and implement processes and procedures from the outset
  - Good records help prevent problems before they occur
Conclusion
Conclusion

- What Entity to Choose
  - Tax and non-tax considerations
  - Every deal is different
  - Changes over business lifecycle
Please feel free to contact me with any additional questions or to discuss the content of this presentation further:

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