Choosing an Entity for Your Business: Tax Considerations

Presented to the DC Bar Pro Bono Center

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Amanda Reed
Topics We Will Cover*

- Tax Basics
- Drivers in Choosing an Entity
- The Magic of Check-the-Box Elections
- Which Entity Form is Right for Your Business?
- The Evolution of a Business: A Sketch

*This presentation is limited to businesses that do not operate outside the United States whose owners are U.S. Persons.
Tax Basics

- Corporate taxation vs. Pass-through taxation
  - Corporate taxation (business corporation aka a “C” corp.)
    - Profits – “Double taxation” of the corporation and its shareholders:
      - Corporation pays tax on its profits (taxable income).
      - If profits are distributed to owners as dividends they will also pay tax on the dividends.
      - A corporation may retain profits to meet needs of the business
        - Undistributed profits generally enhance the value of the business. If the business is later sold, it will be at a higher price based on this increase in value. Owners will pay tax on increased gain on the sale.
        - C corp. shareholders do not get a stock basis increase for retained earnings.
  - Losses:
    - Losses are locked up in the corporation and do not pass out to owners, but can be carried over to other years.
Tax Basics (cont’d)

2016 Corporate Tax Rates and 2016 Individual Tax Rates on Dividends*

<table>
<thead>
<tr>
<th>Taxable Income Over – To ($)</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-50,000</td>
<td>15%</td>
</tr>
<tr>
<td>50,000-75,000</td>
<td>25%</td>
</tr>
<tr>
<td>75,000-100,000</td>
<td>34%</td>
</tr>
<tr>
<td>100,000-335,000</td>
<td>39%</td>
</tr>
<tr>
<td>335,000-10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>10,000,000-15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>15,000,000-18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>18,333,333 +</td>
<td>35%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable Income Over – To ($)</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>Married/Joint</td>
</tr>
<tr>
<td>0-9,275</td>
<td>0-18,550</td>
</tr>
<tr>
<td>9,275-37,650</td>
<td>18,550-75,300</td>
</tr>
<tr>
<td>37,650-91,150</td>
<td>75,300-151,900</td>
</tr>
<tr>
<td>91,150-190,150</td>
<td>151,900-231,450</td>
</tr>
<tr>
<td>190,150-413,250</td>
<td>231,450-413,350</td>
</tr>
<tr>
<td>413,350-415,050</td>
<td>413,350-466,950</td>
</tr>
<tr>
<td>415,050 +</td>
<td>466,950+</td>
</tr>
</tbody>
</table>

*These rates do not include the 3.8% Obamacare tax applied to the investment income of high income taxpayers.
Corporate taxation vs. Pass-through taxation

- Pass-through taxation

  - For purposes of this presentation, we will use “taxed as a pass-through” or “pass-through taxation” to apply to:
    - Sole proprietorships,
    - Single owner entities treated as disregarded entities for income tax purposes, and
    - Entities with more than one owner treated as partnerships for income tax purposes.
Tax Basics (cont’d)

- Corporate taxation vs. Pass-through taxation
  - Pass-through taxation
    - Profits – one level of tax:
      - No tax on the entity itself. Profits pass through to the owners who report these profits on their personal federal income tax returns.
      - No additional tax to owners on distributions from the business.
      - Owners are taxed on profit whether or not it is distributed, which means you can be taxed on the entity’s profit even if you haven’t taken cash out of the business.
      - Tax basis in business increased by undistributed profit and reduced when distributions are made.
Tax Basics (cont’d)

- Corporate taxation vs. Pass-through taxation
  - Pass-through taxation
    - Losses:
      - Losses generated by the entity pass through to the owners and are reported on the owner’s tax return.
      - The owner may be able to use these losses to offset his/her income from other sources (including wages and investment income) if the owner is actively involved in the partnership’s business.
        - If the owner is not actively involved in the business (i.e. fails to meet tests for “material participation”), the owner may be able to use the loss but, in general only against income from the business or other business interests owned in pass-through entities in the current year or future years.
      - Losses also reduce the owner's tax basis in the business.
Corporate taxation vs. Pass-through taxation: An Illustration*

- Business earns an annual profit of $300,000 before owner’s salary.
- Owner takes a salary of $150,000.

### C Corp scenario without/with distribution of after-tax earnings

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Tax</th>
<th>Effective Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Income tax on $150,000 profit</td>
<td>$ 41,750</td>
<td>27.83%</td>
</tr>
<tr>
<td>2.</td>
<td>FICA on salary</td>
<td>$ 9,522</td>
<td>6.35%</td>
</tr>
<tr>
<td>3.</td>
<td>Deduction for FICA</td>
<td>($ 3,714)</td>
<td>2.48%</td>
</tr>
<tr>
<td></td>
<td>Corp. tax total (A)</td>
<td>$ 47,558</td>
<td>31.71%</td>
</tr>
<tr>
<td>4.</td>
<td>Owner tax on salary</td>
<td>$ 29,043</td>
<td>19.36%</td>
</tr>
<tr>
<td>5.</td>
<td>Owner FICA</td>
<td>$ 9,522</td>
<td>6.35%</td>
</tr>
<tr>
<td></td>
<td>Owner tax total (B)</td>
<td>$ 38,565</td>
<td>25.71%</td>
</tr>
<tr>
<td>6.</td>
<td>Tax on dividend of $102,442 to owner (C)</td>
<td>$ 15,366</td>
<td>15.00%</td>
</tr>
<tr>
<td></td>
<td><strong>Total two level tax (A + B + C)</strong></td>
<td><strong>$101,489</strong></td>
<td><strong>33.83%</strong></td>
</tr>
</tbody>
</table>

### Pass-through scenario

<table>
<thead>
<tr>
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<th>Description</th>
<th>Tax</th>
<th>Effective Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Tax on $300,000 profit</td>
<td>$ 74,529</td>
<td>24.84%</td>
</tr>
<tr>
<td>2.</td>
<td>Self-employment tax</td>
<td>$ 23,844</td>
<td>7.95%</td>
</tr>
<tr>
<td>3.</td>
<td>Benefit of self-employment deduction</td>
<td>($ 3,860)</td>
<td>1.29%</td>
</tr>
<tr>
<td></td>
<td><strong>Total tax</strong></td>
<td><strong>$ 94,513</strong></td>
<td><strong>31.50%</strong></td>
</tr>
</tbody>
</table>

*Assume that Owner is married filing a joint return; owner and spouse have no other income or deductions; state and local taxes are ignored.
# Tax Basics (cont’d)

## 2016 Individual Tax Rates on Gross Income

<table>
<thead>
<tr>
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<th>Married/Joint</th>
<th>Rate</th>
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<td>35%</td>
<td></td>
</tr>
<tr>
<td>415,050+</td>
<td>466,950+</td>
<td>39.6%</td>
<td></td>
</tr>
</tbody>
</table>
Tax Basics (cont’d)

Tax-exempt entities

- An enterprise can be tax-exempt if it meets certain substantive and procedural requirements such as being organized and operated solely for a charitable, religious, or educational purpose, and making required filings for recognition of tax-exempt status.

- Tax law places certain constraints on these entities, including:
  - All assets, including profits must remain held for tax-exempt purposes.
  - Hence, no distribution of profits to owners.
  - But, reasonable salaries can be paid to employees.

- In addition to being exempt from tax on its profits, certain tax-exempt entities may receive tax deductible contributions (generally referred to as “Section 501(c)(3)” organizations).

- Further discussion of tax-exempt entities is beyond the scope of this presentation. However, when an enterprise is being established it may be worthwhile to explore whether the enterprise should be set up and operated so as to qualify for tax-exempt status.
Drivers in Choosing a Form for Your Business

- “All in” income tax burden on profits and gain on sale
- Limited liability for owners
- Tax treatment of employee benefits for owner and non-owner employees
- Ability to raise capital
- Governance and control issues
- Ease and flexibility of being acquired by another entity or acquiring other entities
- Organization, compliance and maintenance costs
The Magic of “Check-the-Box” Elections

Before discussing available business entities, the flexibility afforded by the “check-the-box” rules is worthy of mention.

IRS Form 8832 allows you to elect the tax status of certain eligible entities to be treated as corporations or pass-throughs.

- Business corporations cannot elect pass-through status.
  - An exception applies to certain corporations that meet an array of requirements enabling them to elect status as an “S” corporation under Subchapter S of the tax code.
  - An “S” corporation has many of the basic attributes of a pass-through entity, but (for reasons discussed later) an S corporation is generally not the best choice for a newly-organized business.
The Magic of “Check-the-Box” Elections

- IRS Form 8832 (cont’d)
  - An LLC (limited liability company) or LP (limited partnership) with more than one owner is treated as a pass-through, i.e. a partnership for tax purposes. However, an LLC or LP can, initially or down-the-line, be “checked” into status as an entity taxed as a corporation if it files Form 8832.
  - Single owner LLC: if it does not “check-the-box” for corporate status an LLC becomes an entity disregarded as separate from its owner (tax results treated in the same manner as a sole proprietorship).
Which Entity Form is Right for Your Business?

- Sole Proprietorship
- General Partnership
- Limited Partnership
- Limited Liability Company
- Corporation
- S Corporation
Which Entity Form is Right for Your Business?

- **Sole Proprietorship**
  - Unincorporated business owned and run by one individual with no legal distinction between the business and the owner.
    - Owner is entitled to all profits and is responsible for the debts, losses, and liabilities of the business unless otherwise modified by contract (e.g., non-recourse debt).
    - This status applies to a business if there is a sole owner and no action is taken to form an entity.
    - A sole proprietorship may exist even if the business is conducted under a trade name.
Which Entity Form is Right for Your Business?

- **Sole Proprietorship**
  - The business is not taxed separately from its owner. Generally, the owner reports business income on Schedule C, and sometimes other related schedules, to the owner’s IRS Form 1040 Income Tax return.
    - The owner is taxed on profits of the business whether or not the profits remain in the business (e.g. in a bank account for the business), but the owner can help himself or herself to cash in the business without an extra tax at any time.
  - **Advantages:**
    - Generally low cost to set up and maintain. Some owners choose to register a trade name to create a commercial identity for the business.
    - All of the tax advantages of pass-through status. (See slides 5-8)
Which Form is Right for You? (cont’d.)

- Sole Proprietorship
  - Disadvantages:
    - Unlimited personal liability
      - Sole owners often put their business into an LLC, which is disregarded under the “check-the-box” rules and ends up being taxed exactly the way a sole proprietorship is taxed but with the advantage of limited liability.
      - It is generally not a good idea to operate a business that may result in unacceptable or unforeseen exposure for contract and tort liability without putting the business into an LLC.
        - To protect the owner, limited liability formalities need to be maintained.
        - In the case of tort liabilities for harm caused to others, the organizational “veil” may be pierced and the owner may have liability.
        - Liability insurance is often prudent even when a limited liability vehicle is used.
Which Entity Form is Right for Your Business? (cont’d.)

- General Partnership
  - Business with more than one owner, called partners.
    - Partners in a general partnership are personally liable for all business liabilities (jointly and severally) and can be sued individually for the actions of another partner.
      - By agreement or under common law, a partner who is “tagged” for a liability to 3rd parties may have a right of contribution from other partners.
    - Partners contribute capital (money or property including know-how) or “sweat equity” (services) to the partnership in return for a share of profits and losses in agreed percentages or other sharing arrangements.
    - Any partner can bind the business with his or her actions. You can try to create governance rules to avoid this, but they tend not to be effective against 3rd parties.
Which Entity Form is Right for Your Business? (cont’d.)

- General Partnership
  - Tax: pass-through entity (see slides 5-8)
    - Partnership files a Form 1065 annual partnership return and issues K-1 information returns to each partner showing their share of partnership losses, gains, and other tax attributes.
  - Advantages:
    - Business structure is easier to form and maintain than a corporation, LLC or limited partnership, and relatively inexpensive to maintain.
    - No need for a legal filing; a partnership can exist through an oral agreement.
      - However, there are hazards of misunderstanding and disputes if partnership details are not reduced to writing.
Which Entity Form is Right for Your Business? (cont’d.)

- General Partnership
  - Advantages (cont’d):
    - Flexible on the economics, which includes priorities of payment (certain partners get money up front before other partners begin to share profits), but this comes at the price of needing a written partnership agreement, which can get complicated – see Disadvantages below).
    - Sharing financial commitment can mean that all partners are invested in the entity’s success.
    - All of the tax advantages of a pass-through.
  - Disadvantages:
    - Joint and several liability.
    - Each partner can bind the business.
    - Partnership agreements, in general and including general partnerships, can be quite complicated and even simple partnerships tend to end up with fairly elaborate agreements that require certain legal skill to create. This is generally a disadvantage of any multi-owner pass-through.
Which Entity Form is Right for Your Business? (cont’d.)

- Limited Partnership
  - A partnership with at least one general partner and one or more limited partners.
    - Limited partners enjoy limited liability, but they cannot be involved in the business.
    - General partner(s) control and run the business but end up with unlimited liabilities.
    - Limited partnership status generally requires a state law filing and provisions in a written partnership agreement that spell out the status and role of the general partner(s) and the limited partner(s).
  - Taxed like a general partnership with attributes of being a multi-owner pass-through. (See slides 5-8)
Which Entity Form is Right for Your Business? (cont’d)

- Limited Liability Company (LLC)
  - Hybrid business entity that provides the limited liability features of a corporation with pass-through tax treatment and very flexible operational and governance features.
    - Owners are called “members”.
    - Depending on your state, members may be a single individual, or two or more individuals, corporations, or other LLCs.
    - All owners have limited liability.
    - Freedom to determine who is involved in the business and how governance structure works, e.g., who makes decisions.
    - LLC can be used to create limited liability for a sole proprietorship. Under the “check-the-box” rules the LLC can be disregarded for income tax purposes.
    - In some cases there will be state-level taxes imposed on the LLC as an entity.
Which Entity Form is Right for Your Business? (cont’d.)

- LLC
  - Tax: LLC is a pass-through entity with tax attributes of a partnership, or sole proprietorship if there is only one owner. (See slides 5-8)
  - Advantages:
    - Limited liability for members.
    - Flexibility in economics (the various members’ economic interests) and governance (e.g. managing member(s) call the shots).
    - Pass-through taxation unless and until the owners decide to “check” the LLC into corporate status for tax purposes.
Which Entity Form is Right for Your Business? (cont’d.)

- LLC
  - Disadvantages:
    - State filing as an LLC required.
    - Limited liability depends on ongoing maintenance of formalities.
    - LLC agreement (often called an “operating agreement”) can be complex depending on the economics and governance arrangements desired by the owners.
    - May be subject to state or local entity tax.
Which Form is Right for You? (cont’d.)

- **Corporation**
  - An independent legal entity that is owned by shareholders. Shareholders purchase stock of the corporation with money or other assets and the corporation uses this money for operational purposes.
  - The corporation is a legal “person” and is held legally liable for its actions, debts, and taxes.
  - Under “check-the-box” rules, a business corporation is, per se, a corporation and sometimes referred to as a “C corp.” because it is governed by the Subchapter C rules of the tax code.
    - If eligible, a corporation can elect to be an “S Corp.” (see below) that is treated as a modified form of a pass-through.
    - C corps. Are like “lobster traps”. Relatively easy to get into but potentially difficult (i.e. expensive) to get out of.
      - To get out of the corporate form, you must complete a liquidation of the entity, which is a taxable event. The corporation and the owners will be taxed on any appreciation of the business assets or business as a whole.
Which Entity Form is Right for Your Business? (cont’d.)

- **Corporation**
  - Be careful what you wish for!
    - If you are in pass-through form, you can, generally, get into the corporate form pretty easily without tax difficulties, but if the business starts in corporate form it may be costly to become a pass-through business.
  - Tax: Separate taxpaying entity (see slides 3-4)
  - Advantages:
    - Limited liability of shareholders.
    - Documentation and governance can be more straightforward than partnership agreements and LLC operating agreements.
    - Ability to raise capital more easily through the sale of its stock to shareholders.
    - Corporate tax rates are usually lower than personal income tax rates for high income individuals.
Which Entity Form is Right for Your Business? (cont’d.)

- Corporation
  - Advantages (cont’d):
    - Owners of a corporation only pay tax on dividends received from the corporation, as well as salaries and bonuses, to the extent they are also employed by the corporation. (Corporation pays the employer’s share of employment, social security, and Obamacare taxes).
    - Partners who are active in the business are subject to self-employment tax. They pay, in effect, both halves of social security and Obamacare taxes.
  - Good entity choice if you are operating in higher capital industries where you want to attract capital from investors or the public.
  - Easier to attract investment from non-U.S. persons and tax-exempt organizations.
  - Corporations with lower levels of profits are taxed at lower rates and dividends with lower tax rates to recipients also help to ease the pain of double taxation in the corporate form (see slide 4).
Which Entity Form is Right for Your Business? (cont’d.)

- Corporation
  - Advantages (cont’d):
    - Corporations are also able to be acquired in exchange for stock in another corporation on a tax-free basis.
      - A tax-free acquisition by a business in pass-through form is sometimes available but the opportunities for doing so tend to be much more restrictive than the rules governing corporate stock swaps.
  - Disadvantages:
    - Double taxation.
    - The incorporation process can more involved than the process to start and maintain other entities.
    - Tends not to be as flexible as a partnership or LLC when complex economic arrangements are desired.
Which Entity Form is Right for Your Business? (cont’d.)

- Corporation
  - Qualified Small Business Stock (QSBS)
    - Shareholders that sell QSBS can exclude a portion of the gain on the sale from their federal income if they have held the QSBS for at least 5 years when it is sold.
    - The remaining gain is taxed at applicable capital gains rates. (See slide 4)
  - QSBS is defined as:
    - Stock in a domestic C corp. that does not have more than $50M in assets as of the date the stock was issued and immediately after the issuance.
    - Stock must be acquired at its original issue (not from a secondary market).
    - The C corp.’s assets must be used in the active conduct of a “qualified business”.

April 4, 2016 Taxation for Businesses
Which Entity Form is Right for Your Business? (cont’d.)

- **S Corporations**
  - A corporation that elects S corp. status from the beginning of its existence is treated in many ways as a pass-through.
  - **Tax:** Profits and losses flow through to shareholders whether or not distributed.
  - **Advantages:**
    - Distributions of cash generally are not taxed.
    - Basis adjustments to shares for undistributed profits and losses are similar to the pass-through rules.
Which Entity Form is Right for Your Business? (cont’d.)

- S Corporations
  - Disadvantages:
    - Restrictions on eligibility to make and maintain S corp. status:
      - Only allowed to have common stock, which can be voting and non-voting, but preferred stock or other classes of shares are not allowed.
      - Ownership is generally restricted to U.S. individuals, estates and certain types of trusts.
      - All too easy to lose S corp. eligibility through “foot fault” violations of the rules.
    - While partnerships are usually able to distribute assets “in kind” without triggering tax to owners, if an S corp. does so, the owners will generally be taxed on the assets’ appreciation.
S Corporations

- Disadvantages (cont’d):
  - A “C corp.” that has been in existence and has undistributed profits which elects S corp. status is subject to further adverse and technical rules, which could also apply to an S corp. that acquires a C corp. by merger.
  - Because the advantages of pass-through tax status, limited liability and economic flexibility can be obtained using an LLC, it is generally not advisable to use an S corp. when other pass-through entity forms are available.
A Brief Word on Employee Benefits

- Owners who provide substantial services to a corporation are generally considered employees for tax purposes, while owners who work for a pass-through generally are not.

- Thus, C corps. may present certain benefits generally not available to pass-through owners.
  - Employer-provided health insurance is a deductible expense to the corporation and also not taxable to employees.
  - Similarly, an employer can provide up to $50,000 of group term life insurance, as well as all other tax-deductible fringe benefits, to employees tax-free.
  - Owners of pass-throughs generally cannot receive health benefits and many other fringe benefits (e.g., employer contributions to HSAs and FSAs, group term life insurance, transportation benefits) on a tax-free basis.
A pass-through owner is generally subject to self-employment tax, whereas a corporate employee is generally liable for only one-half of the parallel social security and Medicare taxes – the other half is paid by the employer as a deductible expense.

Pass-throughs that are partnerships for tax purposes provide certain tax-favored opportunities for service providers to obtain equity interests (so-called profits interests) that are generally not available to corporate employees.

- Whereas a typical equity incentive arrangement for corporate employees involving stock options will result in ordinary income treatment, profits interests receive capital gains treatment.
- The profits interest alleged “loophole” has been under attack for years but remains in the law to date.
The Evolution of a Business: A Sketch

- Margot starts her consulting business as a sole proprietorship. She may choose to put the business into an LLC to protect herself from contract and, in some cases, from tort liability.

- As Margot’s business grows and expands its services, she approaches other individuals to join her. They may invest capital and provide services to the consulting business in exchange for equity. The consulting business then becomes a multi-owner pass-through LLC.
  - Remember: Pass-through entities can generate losses, which can be used to offset other income of Margot and the other owners.

- Eventually, the business and its capital requirements become so large that Margot and the other owners decide to shift into the corporate form so they can recruit capital in a private placement of securities from a limited number of investors who are not active in the consulting business.

- After the business grows larger and more successful, Margot, the founder, and the other owners decide to go public or be acquired by a larger company in a tax-free transaction and “live the American dream.”
For further information, visit our website at dechert.com.

Dechert practices as a limited liability partnership or limited liability company other than in Dublin and Hong Kong.