Harter Secrest & Emery LLP

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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

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Overview

- 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

Entity Considerations: Corporations

- 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

Entity Taxation: Introduction

- 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

Entity Taxation: Introduction

- 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

Entity Taxation: Introduction

- 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

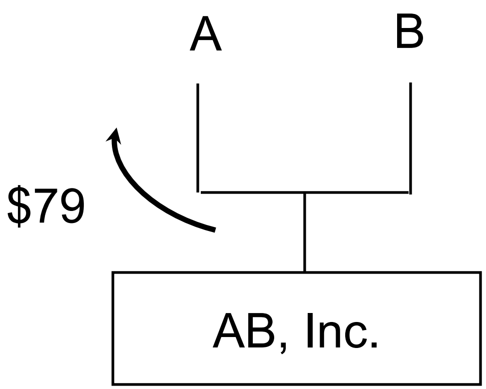
- S Corporations
  - Generally similar to partnership: pass-through taxation
  - Not as flexible as partnership
  - Possible payroll tax benefits
  - New pass-through deduction (§199A) provides material benefits, but is subject to material limitations
    - Deduction cannot be obtained for compensation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

C Corporations

- 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



→ $18.8 tax (shareholder level)

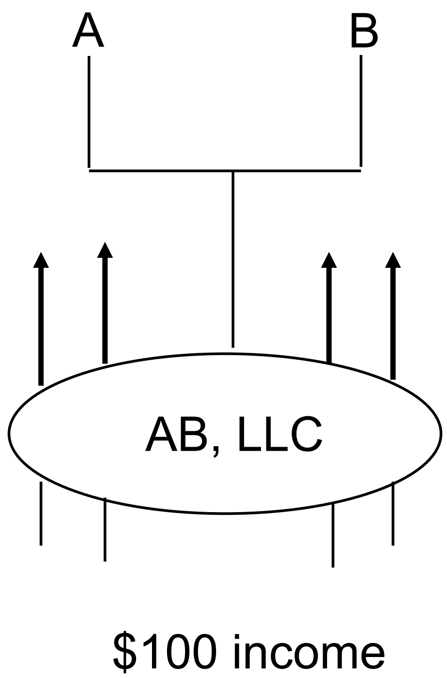
$100 income → $21 tax (corporate level)

Total tax: **$39.8**

Simplification. Federal income tax and NIIT only.

Pass-Through: Simple Illustration

- Partnership / S Corporation



$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.

Comparison

- Notwithstanding the decreased corporate rate, pass-through entities still produce lower tax burden, especially if the pass-through deduction is available.

	C Corp	Pass-Through†
Taxable Income	$1,000	$1,000.00
Corporate Tax	$210.00	N/A
After Corporate Tax	$790.00	$1,000.00
Shareholder Tax*	$188.00	$296.00
After Shareholder Tax	$602.00	$704.00
Total Tax	$398.00	$296.00
Tax Percentage	39.80%	29.60%

10.2% differential

* 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.

	C Corp	Pass-Through†
Beginning balance	$1,000	$1,000.00
Corporate Tax	$210.00	$0.00
After Corporate Tax	$790.00	$1,000.00
Shareholder Tax*	$188.00	$0.00
After Shareholder Tax	$602.00	$370.00
Total Tax	$398.00	$630.00
Tax Percentage	39.80%	37%

2.8% differential

* Assumes 37% marginal tax rate for Pass-Through (active business) and 23.8% for dividends
† Assumes **no** income is qualified business income and is eligible for deduction
For simplicity, ignores state tax implications and non-income taxes (other than NIIT).

Comparison

- If no income is taken out, the C corporation is the clear winner on a current basis.

	C Corp	Pass-Through†
Beginning balance	$1,000.00	$1,000.00
Corporate Tax	$210.00	N/A
After Corporate Tax	$790.00	$1,000.00
Shareholder Tax*	$0.00	$296.00
After Shareholder Tax	$0.00	$704.00
Total Tax	$210.00	$296.00
Tax Percentage	21.00%	29.60%

8.6% differential

* Assumes 37% marginal tax rate for Pass-Through 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).

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Exit Events

- Character of Gain

	C Corporation	S Corporation	Partnership
Stock	Capital	Capital	Capital or ordinary
Asset	Ordinary (Plus tax on dividends)	Capital or ordinary	Capital or ordinary

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 Information

- 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

Protecting Information

- 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

Compensation

- What are payroll taxes imposed on?

C Corporation	S Corporation	Partnership
Reasonable compensation	Reasonable compensation	GPs/Active LLC Members: distributive share of trade or business income LPs: N/A Passive LLC Members: Law evolving

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

Recruiting and Retaining Personnel

- 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

Governance and Administration

- 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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