Tax Issues for Startups

By:Charles A. Wry Jr.
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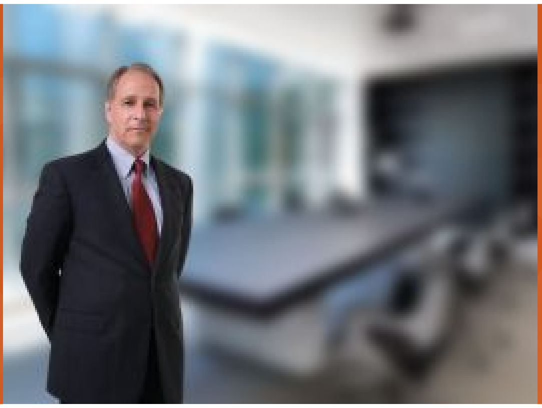

This article summarizes some of the more significant federal tax issues that founders may encounter in forming their companies, hiring and compensating employees and other service providers, and raising capital.

I. Choice of Entity.

The initial question founders typically face is the form of organization they should use for their company. For a company that will engage in a business, the choices are usually a C corporation, an S corporation or a limited liability company (or "LLC").[1]

A. Tax on earnings.

The type of entity chosen can significantly affect the rate at which the company's earnings will be taxed. If the company is a C corporation, it will be taxed on its earnings (without regard to character) at a rate of 21%, and its owners who are U.S. individuals will be taxed at rates of up to 20% on any earnings that the company distributes to them as dividends (resulting in an effective rate applicable to the distributed earnings as high as 36.8%).[2] If the company is an S corporation or LLC, on the other hand, it generally does not pay tax on its income.[3] Instead, its owners report and pay tax on their shares of its income at rates that depend on the character of the income (and without regard to the amounts of their distributions, which are not separately taxable to them to the extent representing income that they've reported). In that case, if the company's owners are individuals, the income is taxed at a maximum rate of (i) 20% if the income is long-term capital, (ii) 29.6% if the income is "qualified business income" fully eligible for a 20% deduction on account of the company's paying sufficient amounts of wages or having a sufficient amount of "qualified property," or (iii) 37% if the income is ordinary income and not "qualified business income" eligible for any deduction.[4] Thus, the effective rate applicable to the company's earnings will depend on the character of the earnings, who the company's owners will be, and the extent to which the company will distribute its earnings.

B. Losses.

A C corporation's loss for any year does not pass through to its owners. A C corporation can, however, carry a loss for any year forward indefinitely for use against future income (subject to various special rules, including a rule that limits a C corporation's ability to use its loss carryforwards following an "ownership change"). The loss of an S corporation or LLC for any year, on the other hand, passes through to its owners and may be used by the owners against other income they have subject to certain deductibility limitations.[5]

C. Choice of pass-through entity.

If pass-through taxation is desirable, the founders will have to choose between an S corporation and an LLC. While an S corporation may have some employment tax and exit transaction advantages over an LLC, an S corporation may not be available if the company will have multiple classes of equity interests (economically) or the company's owners will include corporations, partnerships or non-U.S. persons. Further, an LLC can be a better choice than an S corporation if, among other things, the company may borrow to fund operations or make distributions, make in-kind distributions, buy out owners from time to time or ultimately become a C corporation.

D. Sale of the company.

A sale of the company structured as a stock sale for tax purposes generally produces capital gains or losses, as the case may be (long-term for shares held more than a year), for the owners equal to the differences between the amounts they receive in the sale and their tax bases in their shares if the company is a C corporation or an S corporation.[6] If the company is an LLC, however, the character of the owners' gains or losses depends on the assets of the LLC and how the sale price is allocated among the assets. A sale of the company structured as an asset sale for tax purposes can produce gain taxable at both the company and owner levels if the company is a C corporation.[7] If the company is an S corporation or LLC, an asset sale generally produces gain or loss at only the owner level, but the character of the gain or loss will depend on the company's assets and how the sale price is allocated among the assets.[8] Points to note in terms of entity choice and exit planning include (i) that all or a portion of an owner's gain on the sale of stock in a C corporation can be excluded if the stock is "qualified small business stock" that has been held by the owner for more than five years (only C corporations can issue "qualified small business stock"),[9] (ii) that an owner's basis in his or her shares of stock in an S corporation or interest in an LLC will have been (A) increased by the income that has been allocated to him or her by the S corporation or LLC and (B) decreased by the losses that have been allocated, and by the distributions that have been made, to him or her by the S corporation or LLC, and (iii) that losses that have been allocated to an owner of an interest in an S corporation or LLC but that have been suspended due to a deductibility limitation retain their original character (as ordinary or capital) and may be freed up by an exit transaction (so that a lost investment in an S corporation or LLC may ultimately generate an ordinary rather than a capital loss).

E. Investor sensitivities.

Investors may not view the "pass-through" taxation characteristic of S corporations and LLCs as a good thing. Although governing documents may provide for periodic distributions to the owners to cover their tax liabilities, investors may nevertheless be concerned about having to report their shares of the company's income without regard to the distributions they receive.[10] Further, tax-exempt and non-U.S. investors are subject to U.S. tax reporting and payment obligations with respect to pass-through operating income that generally do not apply to their dividends on, and their gains from sales of, stock in C corporations.[11]

II. Forming the Company.

While founders can usually form their companies without adverse tax consequences, tax issues can arise if founders receive more than equity of their companies or receive valuable equity for services provided or to be provided by them to their companies.

A. Equity for property.

A founder can generally contribute property to the company in exchange for equity without having to report income, although, if the company is a corporation (C or S), the founder must, as of the time immediately after the contribution, either (i) "control" the corporation or (ii) be part of a group of persons who contemporaneously transfer money or property to the corporation for stock and who "control" the corporation.[12] A founder can be taxable on a contribution of property to the company, however, if the founder receives cash or property other than equity from the company as part of the contribution.

A founder can also be taxable on a contribution of property if the company assumes a liability of the founder in connection with the contribution. The rules regarding the reporting of income by a founder upon contributing property subject to a liability can be complicated, but if the company is a corporation, the founder can be required to report income to the extent the assumed liability exceeds the founder's adjusted tax basis in the contributed property.

B. Equity for services.

If any portion of the equity received by a founder is for services, the value of the equity received by the founder for services is taxable to the founder as compensation income.[13] This issue may be particularly difficult to avoid if the founders have waited to form their company until they've arranged for investments in the company by one or more investors (or if the founders receive the same amounts of equity but contribute different amounts of cash or other property). For example, suppose that a founder forms a corporation and, upon the formation of the corporation, receives 80 shares of the corporation's stock, and that contemporaneously with the formation of the corporation, an investor purchases 20 shares of stock in the corporation for $200,000. The price contemporaneously paid by the investor may imply a value of the founder's shares of $800,000 (or even more if the founder's shares have some sort of control premium).[14] To the extent the shares received by the founder are for services provided or to be provided by the founder rather than for property contributed by the founder, the value of the shares received for services is taxable compensation income to the founder.

III. Compensating Service Providers.

Compensating employees and other service providers, whether with cash or equity awards, can raise a number of tax issues.

A. Classification, withholding and employment/self-employment tax.

Companies are generally required to withhold income and employment tax from, and pay employment tax with respect to, compensation paid to their employees. Companies do not, however, have to withhold from, or pay employment tax with respect to, compensation paid to independent contractors.[15] The lack of withholding and employment tax obligations around compensation to independent contractors can tempt companies to treat service providers as independent contractors. Whether a service provider is an employee or independent contractor for tax purposes is determined based on the extent to which the company controls the service provider's work and certain other factors. That a service provider works part-time, works from home or also works for others will not necessarily prevent the service provider from being an employee. Because employee classification issues can present significant stumbling blocks in investment or sale transactions, and because officers and other company representatives can be held personally liable if the company fails to satisfy its obligations to withhold and pay over taxes, companies are best to err on the side of conservatism in classifying service providers.

B. Members of LLCs.

An LLC is not required to withhold income or employment tax from, or pay employment tax with respect to, service providers who also hold equity interests in the LLC. Instead, the service-providing members of an LLC are responsible for paying their own income tax and, in addition, are also subject to self-employment tax, on their income from the LLC (including on their fixed compensation payments, which are referred to as "guaranteed payments").[16]

C. Equity awards.

Startups often use equity incentives to compensate and motivate their service providers. In the corporate context, equity incentives are usually structured either as (i) option grants, where the recipient receives the right to purchase, during the recipient's employment and for a short period of time thereafter, a specified number of shares of the company at a specified price to the extent the recipient has "vested" in the option, or (ii) restricted stock awards, where the recipient acquires the stock up front subject to the right of the company to repurchase any shares as to which the recipient has not "vested" as of the termination of his or her employment at a price equal to the lesser of the amount paid by the recipient for the shares or the fair market value of the shares as of the termination of the recipient's employment. In the LLC context, equity incentives are usually structured as "profits interests." The tax laws figure heavily into structuring equity incentives, with the objectives of the recipients generally being to defer having to pay tax with respect to their awards for as long as possible and to maximize the amount of their income with respect to their awards that is long-term capital gain rather than ordinary compensation income. Unfortunately, the objectives can be difficult to achieve.

D. Deferred compensation.

A very punitive tax rule can subject service providers who earn income in one year that is payable in a subsequent year to regular tax and a 20% penalty on the income in the year in which it is earned unless the deferral arrangement qualifies for an exemption. The rule can apply to, among other things, an option granted with an exercise price that is less than the fair market value of the underlying equity at the time of the award, with the appreciation in the value of the underlying equity being taxed under the rule upon and after the vesting of the option. In any event, deferred compensation (including "phantom equity") arrangements need to be structured to avoid this rule.

E. "Change in control" payments.

If the company is a C corporation, certain types of payments to service providers that are contingent upon a change in the control of the company can be non-deductible by the company and subject to a 20% excise tax to the recipient. Care needs to be taken in structuring compensation arrangements triggered by a change in control.

IV. Taking on Investors.

An investor financing can require tax planning if, among other things, the investors want the company to change its form of organization or one or more of the existing owners will sell equity in connection with the financing. A financing can also establish a value for the company's equity that needs to be taken into account when the company makes equity awards. Finally, the terms of the securities issued by the company in a financing can raise tax issues for the company and the investors.

A. Change in form of organization.

With a few exceptions, an S corporation or LLC can become a C corporation (and an LLC can become an S corporation) for tax purposes without much trouble, at least from a tax standpoint.[17] If the company has been formed as a C corporation or S corporation, however, the company may not be converted to an LLC without the company being treated as having sold its assets for their fair market value and distributed the net proceeds of the sale to its owners. In that case, if the investors want to invest in an LLC, the company and the investors will have to form the LLC (with the company contributing its assets and liabilities, and the investors contributing their investment amounts, to the LLC for equity of the LLC), and the company will have to remain in existence as the holder of the equity of the LLC it received for its assets.

B. Sales by existing owners.

Existing owners who sell equity in the financing can of course be taxable on their gains from their sales.[18] The amount received by an existing owner who sells equity back to the company in the financing can be treated as a dividend, however (so that the existing owner can not use his or her basis in the shares sold back to the company to offset the proceeds of the sale), if the company is a C corporation and the sale back to the company does not cause a significant enough reduction in the existing owner's percentage interest in the company. A redemption by a C corporation within a certain period of time before or after a stock issuance can also prevent the issued stock from being "qualified small business stock."

C. Value data point.

The value of the equity underlying an equity award has to be taken into account in establishing the terms and tax consequences of the award. The valuation established for the company in connection with a financing can be a data point to consider in valuing equity subject to awards for some period of time after the financing. If the equity issued in the financing was preferred equity and the equity underlying an award is common equity, however, the common equity can generally be valued at a significant discount to the preferred equity.

D. Financing terms.

Tried and true preferred equity terms generally do not raise significant tax issues for the company or the purchasers of the equity. Terms can raise tax issues, however, if, for example, the issued securities purport to be debt but have equity-like features.[19]

If you would like to discuss tax issues related to startups, please contact **Chip Wry**, **Dave Czarnecki** or **Joe Hunt**.

Footnotes.

1. In this article, it is assumed that an LLC is a partnership for tax purposes. The following summary is by no means an exhaustive comparison of the tax characteristics of C corporations, S corporations and LLCs.

2. An individual owner's dividend income can be subject to an additional 3.8% tax if the owner has "modified adjusted gross income" exceeding a certain threshold ($200,000 or, if the owner is married filing jointly, $250,000). The additional 3.8% tax can increase the effective rate applicable to distributed earnings of a C corporation to as high as 39.8%.

3. An S corporation can be subject to tax if it has retained earnings or assets from when it was a C corporation (or if it has assets it acquired from a C corporation in a non-taxable transaction).

4. An individual owner's share of the income of an S corporation or LLC can be subject to an additional 3.8% tax, however, if the owner has "modified adjusted gross income" exceeding a certain threshold ($200,000 or, if the owner is married filing jointly, $250,000) and the company is a passive activity for the owner. The additional 3.8% tax increases the effective rate applicable to the earnings of an S corporation or LLC.

5. Among other potential limitations, an individual owner may not use his or her share of a loss for any year to the extent the loss exceeds (i) his or her adjusted basis in his or her interest in the company, (ii) his or her amount "at risk" with respect to the company, (iii) his or her income from other passive activities if the company is a "passive activity" for him or her, or (iv) his or her capital gains plus a small amount of ordinary income if the loss is a capital loss. In addition, non-corporate taxpayers are no longer allowed to deduct their "excess business losses" for any year (and instead are required to carry their excess business losses for any year forward as net operating losses). A taxpayer's "excess business loss" for any year is the excess of (a) the taxpayer's aggregate deductions for the year from trades or businesses of the taxpayer over (b)

the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses plus (2) $250,000 ($500,000 in the case of a taxpayer filing a joint return).

6. Individuals may report up to $50,000 ($100,000 in the case of a husband and wife filing a joint return) of their losses for any year from sales or exchanges of "section 1244 stock" as ordinary losses. "Section 1244 stock" is stock issued for money or other property by a "small business corporation" (the corporation may not have received more than $1,000,000 in money or other property for stock) that satisfies an active gross receipts test.

7. Purchasers often prefer to purchase assets rather than stock so that they can "write up" the tax bases of the target company's assets and better avoid unassumed liabilities of the target company.

8. The analysis described in I.a. also applies to income and gains on asset sales. To the extent the gain from an asset sale is long-term capital gain, the company's being an S corporation or LLC may produce a lower effective rate on the gain from the sale than would apply if the company were a C corporation because of the double-taxation of the distributed earnings of a C corporation and the absence of any long-term capital gain preferential rate for C corporations.

9. For qualified small business stock acquired after September 27, 2010 (and held for more than five years), the percentage of the gain that may be excluded is 100%. The aggregate amount that may be excluded by any taxpayer on sales of the stock of any issuer is in any event subject to a cap, however, equal to the greater of (i) $10 million ($5 million for a married individual filing a separate return) or (ii) ten times the taxpayer's adjusted tax basis in the stock. Only C corporations can issue qualified small business stock.

10. An owner of an interest in an S corporation or LLC can also be required to file returns in the jurisdictions in which the S corporation or LLC has a tax nexus.

11. The sensitivity of tax-exempt and non-U.S. investors to pass-through operating income is a primary reason why venture capital funds, which often themselves have tax-exempt and non-U.S. investors, prefer to invest in C corporations.

12. "Control" is defined as the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.

13. If the founder's equity is subject to vesting, the founder's income can under certain circumstances be postponed until the founder vests in the equity, but the founder's income in that case is based on the value of the equity when the founder vests.

14. Of course, the value of the founder's shares might be significantly less than $800,000 if the founder's shares are common stock and the shares issued to the investor are preferred stock.

15. Independent contractors are responsible for paying their own income tax and, in addition, are also subject to self-employment tax on their compensation.

16. This regime can be problematic for service providers who are used to being W-2 employees.

17. Converting an LLC with debt to a corporation can trigger gain if the debt exceeds the partnership's adjusted basis in its assets.

18. Existing owners of an LLC can be deemed to receive distributions from the LLC in connection with a financing if their shares of debt of the LLC are reduced as a result of the financing.

19. Investor financings of LLCs can also cause accounting complexities, as unrealized gain or loss with respect to the LLC's assets at the time of a financing generally gets "booked" to the capital accounts of the existing owners, causing disparities between the existing owners' capital account balances and adjusted tax bases that get closed under some fairly complicated rules.