Firm Overview

Miles & Stockbridge P.C. is a full-service law firm that represents businesses of various sizes, and has regional, national and international capabilities. Our team of more than 200 lawyers is widely recognized for its work in the manufacturing, distribution, finance/capital markets and real estate industries. We take pride in our forward-thinking approach and dedication to serving the best interests of our clients.
About the Presenter

Christopher A. Davis is a senior associate at the law firm Miles & Stockbridge P.C. He is a member of the Corporate & Securities Practice Group and Tax Practice Group and the Corporate Emerging Business Practice Area Team.

Christopher concentrates his practice in the area of representing companies of all sizes in all of their corporate business needs. He routinely represents business owners in the formation, sale or purchase of businesses, and investors in looking to invest in growth companies.

Christopher also counsels businesses and individuals in corporate, partnership, and international tax matters.

Chris Davis? – Who’s he?

DEEP RELATIONSHIPS, FORWARD THINKING, AND NOT JUST A LAWYER, A TEAM.
About the Presenter

Father          Tax Lawyer          Not Him

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Selecting Your Business Structure

TRUE OR FALSE?

Selecting the wrong entity is easy to fix so it doesn’t matter.
True & False

**TRUE:** It is easy to convert or change the business entity.

**FALSE:** It sometimes is very costly to do so and failure to have the right entity can mean loss of lots of money in legal fees and taxes.

There are 5 basic types of entities to select from.
**Selecting Your Business Structure**

1. Sole proprietorship
2. Corporations- Subchapter C and Subchapter S or close (Inc.)
3. Limited liability company (LLC)
4. General Partnership (LLP)
5. Limited partnership (LP, LLLP)

**Other business entity types**

- Trusts- Business Statutory Trusts or Real Estate Investment Trusts
- Other forms for non-profit organizations (non-stock)
- Benefit Corporation
- Benefit LLC
Tax Classification vs. State Law Classification

- Tax Classification
  - Sole Proprietorship/Disregarded Entity (NOT the same for liability purposes)
  - Partnership
  - S corporation
  - C corporation
  - Other (REIT, cooperative, etc.)
## Tax vs. State Law Classification

- **State Law Classification**
  - Limited liability company
  - Corporation
  - Partnership

- LLCs and Partnerships have broad flexibility
- Corporations can only be “C” or “S”

## True or False

I should form a corporation and have it be in Delaware.
True & False

IT DEPENDS! Delaware offers many advantages, but it isn’t for everyone.

- Benefits of Delaware domicile:
  - MAY help attract investors (primarily VCs). This trend is changing.
  - Well developed business courts, flexible corporate laws
  - Efficient and accommodating administrative structure (open till midnight!)
  - Privacy

True or False

I can avoid taxes if I organize or incorporate my company in a jurisdiction that doesn’t have income taxes.

FALSE: Income is generally taxed where it is earned, regardless of corporate domicile
True or False

A S Corporation is a separate kind of entity.

**FALSE:** Subchapter S is a tax election that either a corporation, partnership, or a LLC may elect to make.

So how do I decide?
Things to Consider

- Tax Treatment
- Flexibility
- Need for formalities, “hardwired” provisions
- Liability Risk
- What type of assets does it hold?

Overview of Major Types of Business Entity
Sole Proprietorship

- Requires no documentation to be formed - just commence business
- Receives the least complicated tax treatment
- All profits/losses of the business are passed through to individual owner for federal tax purposes
- Sole proprietor is personally liable for all debts, obligations and liabilities of the business.

***QUICK FIX*** A single member limited liability company can be formed quickly, easily, and inexpensively!

Corporations - Generally

- Limited liability
- Perpetual existence
- Centralized management
- There are two distinct types of corporations for income tax purposes; Subchapter C Corporation and Subchapter S Corporation.
- Very formal structure.
Formalities of Corporation

Corporations have certain business formalities which must be adhered to. These include:

- Annual filings
- The holding and recording of shareholder and board of director meetings
- Establishment of a board of directors
- Mandatory officers (President, Treasurer, Secretary)

Subchapter C Corporation

- “C corporation” is a tax classification only.
- Separate, distinct taxpaying entity.
- Pays federal income taxes on its income.
- Losses are not passed through to shareholders.
- Distributes appreciated property to its shareholders (either as a taxable dividend, in a stock redemption or liquidation).
Disadvantages of C Corporation

- The shareholders receiving the distributed property are also subject to tax.
- **DOUBLE TAXATION** - the effective federal tax rate on the “built in gain” of appreciated property owned by a C Corporation can be as high as 60%.
- Not generally used in the real estate area.

Advantages of C Corporation

- Required for most public companies
- Attractive for foreign and tax exempt investors
- Established financing model for VCs and early stage funders (seed)
**Subchapter S Corporation**

- “S corporation” is a **tax classification only**.
- A S corporation is formed as a regular corporation (or LLC!) under state law, but makes a specific election under the Internal Revenue Code
  - Once the election is made, the S Corporation must monitor its activities to avoid loss of this special tax status
- **Only one level of taxation.**

**Rules for S Corporations**

- Stock may only be owned by **US individuals**, certain qualified trusts and certain tax exempt entities
- May only have one class of stock and debt- **Preferred not allowed; convertible debt is problematic**
- May have different voting rights
- Limited to 100 stockholders
- “Straight Debt” Safe Harbor
Disadvantages of Subchapter S

- Must make estimated tax payments
- Possibility of “phantom income”
- Less flexibility on who can become stockholder
- No LLC profits interests
- Not for real estate deals (non-recourse financing issue)

Advantages of S Corporations

- Certain distributions may be made without a second level of tax
- Medicare/Obamacare tax savings
- Members can receive W-2 payments
- ONE LEVEL OF TAX
Limited Liability Company (LLC)

- Limited liability for members
- An operating agreement governs the affairs
- Can be taxed as disregarded entity (one member); partnership (two or more members); or C or S corporation (any number of members).
- Flexible governance, management, operations
- “Relatively” new (since 1977)

Limited Liability Company (LLC) cont.

- Flexible in management
  - Member managed
  - Manager managed
  - Board of Directors
- Generally easy to convert to another form of entity as business grows
- Maryland’s Conversion Statute (effective Oct. 2013)
Limited Liability Company (LLC) cont.

- **Flexible in how ownership is structured**
  - Can have different classes of ownership
  - Can allocate profits, losses & cash flow

- **Flexible in how it is taxed**
  - Disregarded entity (single member LLC)
  - Partnership
  - Subchapter S
  - Subchapter C

Advantages of LLC

- Flexibility (both tax and governance)
- Limited Liability
- Less formal
- But...no W-2s to members
LLCs are increasingly the most commonly recommended entity for start ups.

Why an LLC?

- Form now, elect tax status later
- Ease of set up (cheaper, less documents!)
- LLC profits interests can be issued tax free to service providers and employees
- LLCs are not just for small companies
  - Koch Industries
  - Mars
  - Kaiser Permanente
  - Chrysler
Why? – Less Documents!

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Limited Liability Company</th>
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<tbody>
<tr>
<td>• Articles of Incorporation</td>
<td>• Articles of Organization</td>
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<tr>
<td>• Bylaws</td>
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<td>• Organization Minutes</td>
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<tr>
<td>• Employment Agreement</td>
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<td>• Annual Minutes</td>
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Ok, so what’s the **bottom line**?

DEEP RELATIONSHIPS, FORWARD THINKING, AND NOT JUST A LAWYER, A TEAM.
Ok, so what’s the bottom line?

- You should consider a corporation taxed as a **C corporation** if:
  - You are a service business;
  - You anticipate attracting foreign or tax-exempt investors;
  - You anticipate attracting venture capital funding; and filing for an IPO.

Ok, so what’s the bottom line?

- You should consider a corporation taxed as an **S corporation** if:
  - You are service business;
  - The shareholders desire to receive W-2 compensation;
  - You do not anticipate any entity investors, foreign shareholders, or issuance of any type of equity interest with special features such as a preferred return or preferential rights; or
  - You do not want to issue tax free equity to employees
Ok, so what’s the **bottom line**?

- You should form an LLC tax as a **disregarded entity or partnership** if:
  - You only have a single member;
  - You own real estate;
  - You will incur significant financing that is unsecured debt;
  - You anticipate attracting new investors and or issuing equity to employees, service providers, etc.;
  - You don’t mind paying estimating taxes; or
  - **IF YOU JUST DON’T KNOW!**

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**Fringe & Other Benefits**

- An owner-employee of a C corporation can receive various fringe benefits such as life insurance, health insurance, medical benefits, and death benefits on a tax-free basis. In contrast, a partner, member of an LLC and a 2% owner of an S corporation who are also employees are not entitled to receive these fringes on a tax free basis.
Self Employment Tax Savings

All trade or business income of a partnership is considered self-employment income to the partners and is subject to self-employment tax. For S-corporations, only the salary paid to the stockholder-employee is subject to employment tax. Any other income is not subject to employment tax. This often results in employment tax savings for the owners of an S-corporation. Under Obama’s new healthcare legislation, the Medicare tax will increase by 0.9%, and will be expanded to include investment income. These tax increases would be applicable to married couples earning more than $250,000. In most cases, the self-employment tax savings average between 2-3% of gross profit for businesses with more than $500,000 per year of profit. The more profitable a business is, the greater the self-employment tax savings.

What about Partnerships and Other Forms of Entity?
Partnerships

- Similar to LLCs
- Historic
- No real benefit over LLC
- Used in investment funds
- State tax savings (Pennsylvania)

Benefit Corporation or Benefit LLCs

- A corporation or LLC that also wants to support a general public benefit
  - Material positive impact on society or the environment
  - This can be general or specific
- Must clearly indicate the public benefit purpose in the formation documents
- Additional annual reporting requirements
Creating and Registering Your Name and Entity

- Select your name and make sure it is available and not subject to any trademarks
- If necessary, you may reserve your entity name and any trade names for up to 30 days
- If you plan to operate or do business under another name, you must register a trade name
- Google your proposed name- make sure it isn’t being used
- Reserve your URL and similar URLs
Obtaining Tax Identification Numbers and Information

After you have selected the appropriate entity, you should file (if necessary) the appropriate documents with SDAT.

- Certain entities have annual filing requirements with SDAT.
- If you need to amend, supplement, modify or correct, any filings with SDAT, this may also be done, but often has an additional fee associated with it.
- If you elect to file your business entity in other states, the filings are frequently made to the Secretary of State or similar entity.
Obtain Personal Property Tax Information

- In MD, businesses must pay an annual tax based on the value of their personal property (furniture, fixtures, machinery, equipment, etc.).
- SDAT automatically registers corporations, LLCs, LPs, and LLPs, for this tax when these legal entities are formed. All other business entities (sole proprietorships and general partnerships) that own or lease personal property are required to register.

Obtain Federal Tax Identification Numbers

- Apply for your Federal Employer Identification Number of EIN for federal tax returns (apply online)
- May need an EIN for banking purposes
- Certain entities must also file additional forms for special tax treatment status
  - S Corporations- File Form 2553
State Tax Information

- MD- file the Combined Registration Application which registers your business for state, county, and local taxes
- DC- you must also file a Combined Business Tax Registration and in most cases a Basic Business License (BBL).
- VA- file the Registration Form R-1.

Registering Your Business in Other jurisdictions

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True or False

Once you form your company and get your tax ID number, you don’t need to worry about it again.

FALSE!!

Annual Reports; Foreign Registration

- You need to be mindful that you are often required to file annual reports to keep your entity status
- If you conduct or do business in jurisdictions other than where you formed your company, you need to register or “qualify” to do business in that jurisdiction.
Penalties

- Vary by state
- May be prevented from bringing or maintaining an action in the courts of that state.
  - Can defend claims, just may be prevented from filing claims or counterclaims
- Monetary penalties
- Some states have personal liability (CA)
- Subsequent qualification may or may not remedy

License Requirements/Other Restrictions
Check County and Local Zoning Requirements

- Be sure that your location is properly zoned for your business activity.
- Other factors to consider are restrictions on business signs and availability of parking at your location.
- If you are planning to operate your business at home, you will need to consider whether your community or county restrict home-based businesses.
- To obtain more information on local zoning and building requirements, contact the planning and zoning department in the county in which your business will be located.