CROWDFUNDING INVESTING TAX CONSIDERATIONS

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Who Will Issue the Security?

- Is there an existing business that is raising capital, or is the funding sought for a new business?
- If an existing business, should this same entity be used to raise the money and operate the business or should a new entity be created?
- Where a new entity is being created, what type of entity best suits the client's business needs and tax expectations?

Raising Capital through Existing Entity

- If business exigencies point towards raising capital through an already existing entity, think about how the new investors will fit into the entity's capital structure. A new class of stock? A new type of security?
- Should the new investors get debt or equity? Issuing debt won't dilute existing holders, but will create a repayment obligation and obligate the issuer to pay interest (which will be deductible).
- Is a recapitalization necessary to implement a new financial structure for the entity? This can generally be done on a tax-free basis.

Choice of Entity

- Corporation
- S corporation
- Partnership
- LLP or LP
- LLC taxed as partnership
- LLC taxed as S corporation
- LLC taxed as corporation

* An LLC owned by a single member would be disregarded as separate from its owner. This type of LLC and the sole proprietorship (no entity apart from the individual business owner) are not the focus of this presentation.

Corporation

Corporations taxable under subchapter C of the Internal Revenue Code (sometimes called “C corporations”, as distinguished from “S Corporations” taxable under Subchapter S of the Code) are subject to what is referred to as a “two tier” regime of taxation.

- First they taxed on their profits at the corporate level at corporate tax rates (currently ranging from 15 – 35%).
- Remaining amounts paid out to shareholders in the form of dividends are taxable to the recipients are applicable rates applicable to them.

Investors in a corporation are limited in their risk of loss to the amount paid for their shares.

Corporate status requires adherence to certain corporate formalities, such as the holding of meetings, keeping minutes, etc., which formalities generally are not required for unincorporated business enterprises.

S Corporations

- Small Business Corporations ("S Corporations") are domestic corporations for which a special election has been made under federal tax law to be taxed under rules applicable to S corporations. Corporate formalities must still be observed.
- Generally S corporations avoid the two tier tax regime applicable to normal corporations and their profits are only taxed once in a manner similar to a pass-through entity, such as a partnership. Each shareholder takes into account his/her pro rata share of the income of the corporation, whether or not the income is distributed.
- A shareholder's risk of loss is limited to his/her investment in the S corporation.
- Unlike the general partnership and LLC, business earnings are not subject to self-employment tax unless paid as salary (must be "reasonable compensation").

S Corporation Restrictions/Eligibility

- An S corporation must be a domestic corporation and cannot:
  - have more than 100 shareholders
  - have corporate shareholders
  - have foreign shareholders
  - issue more than one class of stock
  - be an “ineligible corporation”, such as an insurance company, a financial corporation using a debt reserve, or a domestic international sales corporation, among others.
- An S corporation which fails to meet the eligibility requirements loses S corporation status and becomes a regular corporation subject to two levels of taxation on its profits.
- An S corporation must recognize gain on the sale of any C corporation assets during the 10 year period following the election.
- S corporations may have 80% C corporation subsidiaries but may not be included on a consolidated return.
- An S corporation may have a fully owned subsidiary and elect to treat it as a qualified subchapter S subsidiary. For tax purposes this subsidiary is disregarded and its assets and liabilities treated as held directly by S corporation parent.

Partnership

- A partnership is a pass-through entity in which each owner is deemed to own an undivided portion of the partnership's assets. Partnerships can have disproportionate allocations.
- Unless the partnership is a limited partnership and the partner is a limited partner, partners are at risk for the losses of the partnership.
- There is no tax imposed at the partnership level. However, the partnership's income, loss, credits, deductions and other tax attributes are determined at the entity level and this calculation is used to determine each partner's allocable share of the partnership's tax items.
- Each partner is responsible for paying tax on his/her share of the partnership's taxable income whether or not such income is distributed.
- Partners in a general partnership will be subject to self-employment tax on their share of net earnings from the partnership, whether or not distributed.

Partnership Variations

Limited Partnership (LPs)

- Popular in the 1970s-80s before LLCs , they are now mainly used for family estate planning, films and short-lived projects.
- An LP has at least one general partner who manages the business for a fee, with full personal liability exposure, and more than one limited partner (investors) who don't participate in business management and are committed to the extent of their investment but are not responsible for partnership debts.
- The burden of self-employment tax is borne by the general partner and not the limited partners, technically. Limited partners who actively participate in the business may not qualify for exemption from self-employment tax (their status as limited partners not respected for tax purposes).

Partnership Variations- cont.

Limited Liability Partnership (LLPs)

- Added as a partnership variation after LLCs became poplar and similar to an LLC. However, LLPs may only be used for certain types of professional practices as enumerated under state statute—generally lawyers, accountants, architects, doctors, therapists and certain other licensed professions.
- Partners have limited liability for all but personal acts, e.g., for acts by third parties, but not for personal malpractice. Partners can be shielded from malpractice by another partner.
- Some states may require such a practice to be set up as a PLLC.

Limited Liability Company

- Limited Liability Companies ("LLCs") were introduced in the mid-1990s and now every state has legislation allowing for their creation.
- LLCs are a very versatile form of entity and offer benefits of both corporations and partnerships. With increased flexibility regarding entity classification for federal tax purposes (under "check the box rules"), business owners can essentially chose how their LLCs will be characterized for tax purposes.
- Unless an election is made to be treated as a corporation, a domestic LLC with two or more owners generally will be taxed as a partnership for federal income tax purposes.
- Owners in an LLC treated as a partnership enjoy limited liability under rules that are similar to those applicable to corporations under state law.

Entity Choice – Tax Planning

Help your client select the entity that best serves its business needs, while also keeping tax efficiency in mind. Choose carefully because changing later can have significant tax consequences and will involve legal costs!

An S corporation, with its restrictions, may not be an appropriate choice of entity in certain circumstances.

If corporate investors or foreign investors are expected, or widely held ownership is contemplated in the near term, and/or if the parties desire flexibility to issue different classes equity interests, a C corporation or LLC taxable as a corporation or partnership may present a better choice of entity than an S corporation.

Entity Choice- Tax Planning cont.

- LLCs are the most widely used form of entity among small businesses as they allow for greater flexibility on formation and lack the formal record keeping and formality requirements of corporations. Most choose to be treated as partnerships or elect S corporation status for federal income tax purposes and therefore enjoy single level taxation.
- LLCs taxed as partnerships are useful when the business arrangement includes other than pro rata allocation of expenses and/or income. This is possible in an LLC treated as a partnership
- Corporations, S corporations or LLCs taxed as corporations or S corporations must allocate income and expense in proportion to capital contribution.

Entity Choice – Tax Planning cont.

- Tax planning and reporting for partnerships is more complicated than for corporations, partially because of the flexibility allowed in allocating income, expense and other tax attributes other than according to capital contribution as among the owners.
- Partnership income is reported to investors on Schedule K-1. Investors, more often used to receiving Form 1099 for their dividends, interest and gains, may be more hesitant to make investments through partnerships, which are considered more risky and complicated.

Entity Restructuring

It is possible that the issuer may want to reorganize into a different form of entity in connection with the new issuance.   The tax effects of any such restructuring should be considered.

- Generally, incorporation of an unincorporated entity can be effected on a tax-free basis.
- Movement from corporate status to an unincorporated entity, on the other hand, will generally be a taxable event.

Entity Restructuring continued

- *Conversion of LLC to a C corporation*
  Generally tax-free.

- *Incorporation of partnership*
  Generally tax-free

- *Conversion of an S corporation to a C corporation*
  Effected either by revocation of an S corporation election with IRS or a failure to meet the S corporation eligibility requirements.
  Generally tax-free.

Entity Restructuring continued

- *Conversion of C corporation to S corporation*

  No immediate tax, but built-in gain from years as a C corporation is taxed if the corporate assets are sold within the next 10 years, with gain measured on the date of conversion. Conversion is made by filing an election with the IRS to be treated as an S corporation. All shareholders must agree to the change.

- *Conversion of C corporation to Partnership or LLC*

  Can produce two levels of tax on a deemed liquidation of the corporation. However, if assets have depreciated, there may be little or no tax cost.

- *Conversion of S corporation to LLC or Partnership*

  Treated as taxable liquidation of the S corporation, resulting in a single level of tax to the S corporation shareholders if the corporation holds appreciated assets.

Tax Implications of Equity, Debt and Other Securities

- Equity

An issuer could choose to issue different classes of common ownership, with or without rights to convert into shares or units of another class (unless the issuer is an S corporation, as discussed previously).

– *Common stock or other unit of ownership*

Represents ownership in the issuer. Proceeds from a stock issuance represent paid in capital of the issuer.

Equity ownership generally does not entitle an owner any return of or on the investment. In a corporation, each stockholder receives his/her pro rata share of any distributions of profits from the issuer remaining after payment of taxes and other expenses in the form of dividends.

Shareholders are only taxed when they receive taxable dividends. Payments of profits to owners is not a deductible expense to the issuer, unlike interest paid on a debt security .

– *Preferred stock or unit of ownership*

Represents ownership in the issuer, but contains certain preferential rights to profits distributions or dividends and generally a liquidation preference over common shares or units of ownership.

An issuer could issue preferred stock convertible into common stock or common stock convertible into preferred.

Tax Implications of Different Securities continued…

- Debt
  - Represents an enforceable legal right to repayment from the issuing entity in the amount of the principal of the note, on the date of maturity, as well as a right to interest at a stated rate.
  - Unlike the payment of dividends or other profits to owners, interest paid to note holders is deductible by the issuer.
  - An issuer may issue debt which is convertible into stock or another equity interest in the issuing entity. It is also possible to issue debt with interest paid in the form of stock of the issuer, although this may raise some issues as to whether the security is itself debt or equity (see discussion to follow).

Debt/Equity Characterization Issues

- Just because a security is called debt or equity doesn't mean the IRS or a court will not challenge this characterization for tax purposes.
- Any note should be carefully structured to include the earmarks of debt. The IRS and courts consider the following factors:
  - right to repayment
  - relative subordination in right to repayment
  - a fixed date of maturity
  - market rate interest (at least the AFR, or interest will be imputed for tax purposes)
  - legal enforcement remedies on the part of debt-holders
  - the issuer's ability to make payments
  - the relationship of the parties

Tax Implications of Different Securities continued…

- Equity Options and Warrants
  - An equity option or warrant represents the right (but not the obligation) to acquire stock or another ownership interest in the issuer at a specified price sometime in the future. An option or warrant may be issued separately, or as a component of another security, such as a convertible note or convertible preferred stock, as discussed previously.
  - Unless the option or warrant is issued in the employment context, exercise of the right to purchase equity does not give rise to taxable gain or loss on the part of the option-holder. The option holder acquires a tax basis in the equity acquired equal to the option exercise price.
  - Issuance of options or warrants, and the grant of stock pursuant to these rights, do not result in tax to the issuer.

Treatment of Conversion Rights

A convertible security is treated as a financial instrument with two components, e.g., the underlying security, stock or debt and an option right.

However, for tax purposes, the conversion rights imbedded in the security, such as convertible stock, or convertible debt, are essentially ignored when determining basis, and no basis is allocated to the conversion right. Generally, absent unusual circumstances, conversion rights do not impact treatment of the stock or debt under federal income tax rules. A holder is still treated as holding equity or debt regardless of what the instrument is convertible into.

General Considerations for Investors

An investor generally will be taxable on a disposition of the securities to the extent the amount received exceeds his/her basis in them. If, as is likely to be the case, the security is held as a capital asset of the investor, any such gain will be taxable at capital gains rates, currently 15% maximum for individuals, scheduled to increase to 20% in 2013.

Unless legislation is enacted, the marginal rates applicable to individuals will increase in 2013, and dividend income from corporations will no longer be taxable at the lower rate applicable to capital gains (currently 15%) but instead will be taxable at the graduated income tax rates applicable to ordinary income.

Current income tax rates are scheduled to expire at the end of 2012. Without legislative intervention, existing graduated individual income tax rates, which range from 10%-35% ,will increase to a range of 15%-39.6%.

Effective in 2013, some individuals will be subject to an additional 3.8 % tax on unearned income (e.g. dividends, interest, royalties and rents).