

MBG Entrepreneurship

Nochi Entity Election





Overview

- C Corporation
 - Flexibility and Legal Aspects
 - Tax
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 - Flexibility and Legal Aspects
 - Tax
- LLC (Corporation Election)
 - Flexibility and Legal Aspects
 - Tax
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C Corporation

- ❖ Flexibility
- ❖ Taxes



C Corporation: Flexibility

Pros:

- ❖ Ability to IPO if becomes relevant
 - Easier access to capital
- ❖ Laws regarding C Corp are well established
 - Better prediction of legal consequences to inform investors on the impact of change on corporate structure

Cons:

- ❖ More legal formalities such as board of directors meetings
- ❖ Would need to convert existing entity into a C Corporation
 - Could file a certificate of conversion
 - Will likely incur legal fees associated with conversion



C Corporation: Tax

Pros:

- ❖ Current corporate rate of 21% vs max individual rate of 37%
- ❖ May be able to minimize corporate tax by paying shareholder bonus
 - Salary must be reasonable
- ❖ Employee fringe benefits are tax deductible
- ❖ Less tax compliance costs

Cons:

- ❖ Double taxation
- ❖ Entity subject to state taxation
- ❖ Limited availability for buyer tax shield
 - Consideration upon harvest diminished
- ❖ Less flexibility in capital structure



Current Election

- ❖ Flexibility and Legal Aspects
- ❖ Taxes



LLC (Current)-Flexibility

Pros:

- ❖ No preparation of forms, hiring of lawyers/accountants required if maintain current election
- ❖ Flexibility in allocating profits to members in varying amounts
- ❖ More flexibility in capital structure

Cons:

- ❖ Cannot IPO as an LLC if that is an ultimate strategy
- ❖ Cannot pay self a salary
 - Must be an after-tax distribution



LLC (Current)-Taxes

Pros:

- ❖ Pass-through taxation lends itself to providing the owner with a higher basis in the company
 - Sale by passthrough entity is preferred by buyers
 - Provides capital gains tax shield to owner
- ❖ Qualified Business Income Deduction (QBID)
 - 20% tax deduction on income
 - Reduces maximum rate from 37% to 29.6%

Cons:

- ❖ Preparation of Schedule K-1
- ❖ Potential for self-employment tax on earnings
- ❖ Owners unable to receive W-2 from company
- ❖ Entire income of entity is taxed to its members
- ❖ Additional compliance costs at individual level as a result of K-1 income
- ❖ Multi-state compliance may be expensive



Corporation Election

- ❖ Flexibility
- ❖ Taxes
- ❖ Form 1202



LLC (Corporation Election)-Flexibility

Pros:

- ❖ [Form 8832](#) is a fairly simple check-the-box form

Cons:

- ❖ IPO is not a viable exit strategy

The image shows the top portion of Form 8832, 'Entity Classification Election'. The form is titled 'Form 8832 Entity Classification Election' and includes the IRS logo. It contains several sections for providing information about the entity, including 'Type of entity', 'Address change', and 'Election information'. The form is designed to be a 'check-the-box' form, allowing taxpayers to quickly elect the classification of their LLC.

Form 8832
Entity Classification Election

OMB No. 1545-0046

Department of the Treasury
Internal Revenue Service

Information about Form 8832 and its instructions is at [www.irs.gov/form8832](#)

Name of eligible entity making election

Employer identification number

Type of entity

Address change

Check the box for the type of entity you want to classify. If you are changing your classification, check the box for 'Change in current classification'.

1. Type of election (see instructions)

2. Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

3. Does the eligible entity have more than one owner?

4. If the eligible entity has only one owner, provide the following information:

5. If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

For Paperwork Reduction Act Notice, see Instructions. Cat. No. 22408B Form 8832 (Rev. 12-2015)



LLC (Corporation Election)-Taxes

Pros

- ❖ Pay corporate tax rate and can pay self salary to be deducted (to a certain extent)
- ❖ Owners can participate in tax-free fringe benefits such as employer provided health insurance

Cons

- ❖ Can run into double taxation situation
- ❖ Reasonable compensation - the rest must be taxed as a dividend
- ❖ Less flexibility in capital structure



LLC (Corporation Election)-Taxes

Ohio

- ❖ Pro:
 - No corporate income tax at state level
- ❖ Con:
 - Commercial activity tax: ranges from a min of \$150 for business that have annual taxable gross receipts of more than \$150,000 to the \$150 plus 0.26% tax rate quarterly on receipts above \$1 million



LLC (Corporation Election)-Form 1202 Election

Step One: A company has to be a qualified small business and have Qualified Small Business Stock (QSBS).

Definition:

A qualified small business is an active domestic C-Corporation whose gross assets--valued at the original cost--do not exceed \$50 million on and immediately after its stock issuance.



LLC (Corporation Election)-Form 1202 Election

Step Two: The Small business stock will only qualify for a tax break only if all of the following are true:

- The use of at least 80% of the corporation's assets is for the active conduct of one or more qualified businesses
- The issuing corporation does not purchase any of the stock from the taxpayer during a four-year period beginning two years before the issue date
- The issuing corporation does not significantly redeem its stock within a two-year period beginning one year before the issue date. A significant stock redemption is redeeming an aggregate value of stocks that exceed 5% of the total value of the company's stock



LLC (Corporation Election)-Form 1202 Election

Step Three: For the investor to successfully claim the tax benefit, all of the following must apply:

Definition:

- The investor must not be a corporation.
- The investor must have acquired the stock at its original issue and not on the secondary market.
- The investor must have purchased the stock with cash or property, or accepted it as payment for a service.
- The investor must have held the stock for at least five years
- At least 80% of the issuing corporation's assets must be used in the operations of one or more of its qualified trades or businesses.

Recommendation:

**If qualify for 1202 Stock,
using form 8832, elect to be
an LLC treated as a
corporation for tax purposes.**



Benefits of Our Recommendation

- Lower tax rate
- Deduction of a reasonable salary
- No corporate income tax at state level
- 1202 Stock eliminates the largest cons of corporation taxation
 - No capital gains tax!
- The switch is easy, just a simple check-the-box form
 - Recommend that still seek advice from a lawyer/CPA
 - 60 month limitation*



Appendix A: 1202 Stock Requirements

- It was issued by a domestic C-corporation other than a hotel, restaurant, financial institution, real estate company, farm, a mining company, or business relating to law, engineering, or architecture
- It was originally issued after August 10, 1993, in exchange for money, property not including stocks, or as compensation for a service rendered
- On the date of stock issue and immediately after, the issuing corporation had \$50 million or less in assets



Appendix B: Accessing Form 8832

[Form 8832](#)