



# MBG Entrepreneurship



Nochi Entity Election



# Overview

- C Corporation
    - Flexibility and Legal Aspects
    - Tax
  - LLC (Current Election)
    - Flexibility and Legal Aspects
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  - LLC (Corporation Election)
    - Flexibility and Legal Aspects
    - Tax
    - 1202 Stock
  - Recommendation
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# C Corporation

- ❖ Flexibility
- ❖ Taxes



# C Corporation: Flexibility

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## 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

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## 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

# LLC

Current Election

- ❖ Flexibility and Legal Aspects
- ❖ Taxes



# LLC (Current)-Flexibility

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## 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

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## 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



# LLC

## Corporation Election

- ❖ Flexibility
  - ❖ Taxes
  - ❖ Form 1202
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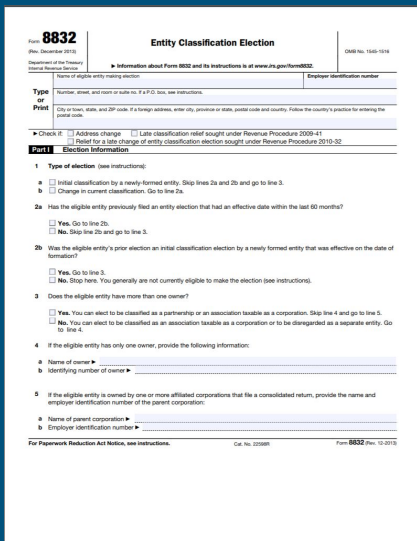
# LLC (Corporation Election)-Flexibility

Pros:

- ❖ Form 8832 is a fairly simple check-the-box form

Cons:

- ❖ IPO is not a viable exit strategy



Form **8832** Entity Classification Election

Department of the Treasury Internal Revenue Service

OMB No. 1545-0048

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

Name of eligible entity making election \_\_\_\_\_ Employee identification number \_\_\_\_\_

Type or Print \_\_\_\_\_

Number, street, and town or village, etc. If a P.O. box, see instructions. \_\_\_\_\_

City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code. \_\_\_\_\_

Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41 ☐ Petition for a late change of entity classification election sought under Revenue Procedure 2010-32

**Part I** Election information

1 Type of election (see instructions):  
☐ Initial classification by a newly formed entity. Skip lines 2a and 2b and go to line 3.  
☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?  
☐ Yes. Go to line 2b.  
☐ No. Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?  
☐ Yes. Go to line 3.  
☐ No. Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?  
☐ Yes. You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.  
☐ No. You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:  
a Name of owner ▶ \_\_\_\_\_  
b Identifying number of owner ▶ \_\_\_\_\_

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employee identification number of the parent corporation:  
a Name of parent corporation ▶ \_\_\_\_\_  
b Employee identification number ▶ \_\_\_\_\_

For Paperwork Reduction Act Notice, see instructions. Cat. No. 220889 Form **8832** (Rev. 12-2015)

# LLC (Corporation Election)-Taxes

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## 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

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## 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

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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

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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

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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

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- 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