Ledgers and Law: Start With an Ending in Mind When Building a New Business

October 14, 2020

Ledgers and Law Ep2: Start With an Ending in Mind When Building a New Busin…

Starting a business is not for the faint of heart. Your best chance at survival and success is to plan out the life cycle of your company from the beginning and how you are going to exit at the end. The decisions you make when starting a business will be critical to the success you enjoy or the disadvantages you may suffer. Barry Weins, a member of the professional practices group at Cherry

Bekaert, discusses the long-term tax and legal implications entity selection can have on your company.

About Ledgers and Law: Lessons From the Trenches

Ledgers and Law: Lessons from the Trenches brings experienced business and legal leaders together to discuss current topics at the intersection of tax, law, and business. Ledgers and Law is co-hosted by Kevin McCoy, shareholder at Carlton Fields, and Chris Rux, Assurance Partner and Healthcare & Life Sciences Industry Practice Leader at Cherry Bekaert.

Transcript:

Kevin McCoy: Good afternoon. We're back. This is a podcast collaboration between Carlton Fields and Cherry Bekaert. We're bringing you episode two of some of the latest issues that are affecting our clients from an accounting and a legal perspective. I'm Kevin McCoy. I'm a shareholder in the Tampa office of Carlton Fields. And I have with us today Chris Rux and Barry Weins from Cherry Bekaert so Chris take it away with some introductions.

Chris Rux: Yes. Again, Chris Rux, an audit partner in our Tampa Bay practice for Cherry Bekaert. And we have Barry Weins who's one of our tax experts, also in our Tampa practice. And our goal here today is just discuss, you know, really when you're a start-up company, what type of, you know, issues should companies be considering as they, you know, navigate that world. So, Barry I don't know if you want to give just a quick overview of you and your practice?

Barry Weins: Sure, Chris. I'm a member of what we call the Professional Practices Group, so I serve as a resource for all of our offices in areas focusing on transactions, C-corps, S-corps, partnerships, things along those lines. So we do talk with a lot of clients about how to start out their business and the different options they have available to do it.

Chris Rux: So, perfect. Barry, that's a great segue. Could you maybe share with us a high-level discussion of the advantages and disadvantages of various types of what people need to think about? I'm thinking in terms of when they're ready to exist. So what decision do they need to make at the beginning in order to be successful at the end.

Barry Weins: Certainly Chris. Thanks. For the decision process really has to start at the very beginning. So you need to understand what's the life cycle of your project, your plan, your corporation, company, whatever and how are you going to exit at the end. Because sometimes the decisions we make at the beginning are critical as to the advantages or disadvantages we have on the back end planning. So you really need to stop and think what's going to happen at each of these different cycles at the start-up, as I raise additional capital and then ultimately on the exit. So generally there's two types of entities that we think of; you have a C-corp, which is a taxable entity in

and of itself and then you have what we call pass-throughs. Pass-throughs can either be partnerships and S-corps and like the name what it means is all of the income is being reported at the individual owner's level. So the main disadvantage with the C-corp is that there's a double level of tax. So the C-corporation itself pays a level of taxes that earns the income and when it distributes those profits out to its shareholders their tax generally is dividends. So you have two layers of tax. With pass-throughs, generally there's only one layer of tax. So the tax is at the individual level, it's not necessarily at the entity level. Then the distributions can be taken on a tax-free basis because the tax has already been paid on that. So the levels of tax are the main difference and where it gets taxed.

The rate of tax is obviously a difference, too. Inside a C-corp, right now it's 21% plus state. And then when it's distributed out to the shareholders it's a potential another 20% tax. With pass-throughs right now if you qualify as a qualified trader business under what we call Section 199A you get a 20% reduction and in essence in your tax rate bringing the top tax rate for an individual from 37 down to 29.6. So if you're looking at 29.6 versus 21 and then the exit, the other advantages on a pass-through generally on an exist, you could get as low as 20% tax rate. So there are some different tax savings and it's a question of cash flow in the interim versus exit tragedy and the level of tax there.

Chris Rux: So Barry, what if a company makes a mistake and we're kind of past that initial stage? Is there flexibility in terms of changing an entity type prior to exit in order to have more tax savings?

Barry Weins: Sometimes. [*laughs*] You know, there's not a definite answer, there is some flexibility. However, moving from a partnership to an S-corp or a C-corp, is generally a taxfree transaction. Going from an S-corp to C-corp is generally also a tax free transaction. Moving out of a C-corp into an S-corp you can generally do that. There are some issues with what we call built-in gains, but after a five-year period those go away. But you cannot go from a C-corp to a partnership. That can be a very expensive transaction and it's very hard to do. So if you're uncertain generally start out as a partnership because we can move easily into the other type of entities if - at the different times you get different funding levels, you know, those investors may want different things. So if you're going to start out and you're not quite sure a pass-through is sort of, as a partnership, is generally going to be the safest place to start.

Kevin McCoy: Barry, when you first described the C-corp I was struggling to find any advantages as you were describing. You had me at double taxation as quite a turn-off. What would be a consideration that someone would put in to a potential advantage of a C-corp? Because I didn't hear many there.

Barry Weins: [*laughs*] If you have international operations there are some advantages but there's another code section that we refer to as Section 1202 and if you can obtain 1202 status for your C-corp then there's a significant benefit and elimination of some that double taxation. What the

Section 1202 does is if you qualify then when you sell the stock of your C-corp, you can exclude from income up to $10 million or ten times your cost basis. So if you put in less than $1 million I can exclude up to $10 million from tax, zero tax. If I put in more than $1 million dollars I would multiply that by ten. So $2 million investment times ten is a $20 million exclusion of gain from tax. So that is very powerful and even dealing with an exit tragedy where you do an asset deal to give the benefit for the buyers you then can wind up limiting yourself to only one level of tax inside the corporation at 21% which means equivocal to the exit on a pass-through. If you can fall into that window then C-corps look very attractive because they also have a lower tax rate on your cash flow that you're generating from operations during the interim.

Kevin McCoy: Does the size of the company factor into any of these decisions? I mean, you know, I think a lot of the time we're dealing with folks who start off as just "this is an idea" they go through the, you know, validation process and then into growth and then they get bigger. But say you're coming in with an established business. How does the size of the company impact this analysis from a tax perspective?

Barry Weins: So from a 1202 perspective, so this really good benefit, the company has to be less than $50 million and there's a couple different tests on the $50 million. Some are based on a value and some are based on what's your historical costs basis for the assets. So assuming we're talking less than $50 million then either one we can start out as, it's not really dependent. It's if you're over $50 million and you want some of these other benefits then, you know, a corporation as you said you've got the double level of tax, you're not going to get the 1202 benefit and you really then need to just figure out what the economics of the transaction are.

Chris Rux: So Barry, regarding this 1202 benefit, as you mentioned before the safest way to start is just a pass-through entity. If you convert to a C-corp, can you still get that 1202 benefit? Because it seems pretty powerful on an exit.

Barry Weins: You're correct, is it very powerful. But one of the requirements for the exit in order to take advantage of this is you have to have held the "stock" for more than five years. If you're a pass-through, the time period that you own it prior to it converting to a C-corp will not count. And we have to be careful in the manner in which we convert you from a pass-through to the C-corp in order to make sure you qualify but then you have a five year holding period. So that's the only disadvantage of starting as a pass-through is that time that you're a pass-through does not count toward that five year requirement. And that's really one of the biggest challenges with 1202 stock is you don't know when that exit is going to be. When is that buyer going to show up, when is your product or service going to be ready to really monetize that? Before five years you're out of luck. Once you get pass that five years then you wind up with a benefit. Not only that, that benefit only is available individual so if you have corporate owners they're not going to get to take advantage of that. So you can have both

pass-throughs and C-corps, the entity selection type will have a different tax impact depending on the different types of owners you have.

Kevin McCoy: Can you just explain that a little more Barry? In terms of the types of - what do you mean by the types of owners, if you can give us an example?

Barry Weins: Sure. So, if I have a C-corp and let's say I have individuals or trust or pass-throughs who own it and they owned it more than five years and everything qualifies, they can take a benefit of 1202. A corporate owner who owns the stock does not get any benefits. So they could wind up with the double taxation or they could wind up being taxed on the sale while other shareholders may not. And because of the five year requirement you could have shareholders coming in after the date that don't qualify. So the 1202 is particular to a shareholder, it's not particular to the company.

Kevin McCoy: Do any of these decisions lend themselves more to one industry type versus another? Or is this just general across the board? It doesn't matter if you're selling, building widgets, or you're selling services, or somewhere in between.

Barry Weins: So I would say generally if you're dealing with real estate those are almost always in pass-throughs. Real estate inside C-corps is not a good idea. If it's part of the operating business that's a different story but if it's a pure real estate deal those are always partnerships because of a lot of different reasons and the flexibility we have with structuring the economic arrangement. Other than that, it's all going to depend on the type of business, your investors, what they desire. We have a lot of people who say "Oh, I need to start as a C-corp because investors later on are going to demand it." Well that's true in some cases but in some cases they want pass-throughs. If I start as a pass-through and get an investor who wants me to be a C-corp I can switch to accommodate them at the time of the transaction and I'm not penalized before that. So, again, that's why sometimes starting as a pass-through gives you a lot more flexibility for what's going on beyond that.

Chris Rux: Yeah, Barry, I think that the crux here is really knowing what your business plan is and really looking out on the horizon because as you've mentioned with 1202 that five years and a day really prevents you from having the benefit there. I guess what recommendations would you have other than starting as a pass-through to companies as they're considering how they structure their company and what they think their exit may be?

Barry Weins: Well, really the first thing we like to say is don't let the tax tale wag the dog. So you need to figure out what are the economics of your deal. Who is going to be investing, where are you getting your source of funds, am I going to be generating a lot of losses early on? Because those losses can then shelter income but inside of C-corp there's rules as I add more and more owners. So there's a lot of different rules that come into play and while in general we would say, you know, a pass-through kind of gives you more flexibility, it doesn't mean it's the right answer in every

circumstance. It's really a facts and circumstances test. Figure out what the economics are, who your investors are, who they're going to be, what type of returns are they looking to, what flexibilities do you need? And that's really what should be driving this, is what makes sense from an economic perspective and then figure out can I enhance the economics through tax planning?

Chris Rux: Got you. Now that makes complete sense. Kevin, do you have any thoughts from a legal stand point? Obviously we're focusing on tax structuring here but what have you seen in your practice that impacts the structuring piece of this?

Kevin McCoy: Well, you know, I usually encounter it on the back end because I don't do transactional work but I see it on the back end when there is a partnership dispute. There's a logjam of partners and no one can figure out who has the majority or they're deadlocked. And so those present their own challenges. Obviously, if you can have more freedom in the, you know, what I'll call the pass-through, partnership, type arrangement and you trust the people that you're doing business with, that's great. And you don't have to deal with some of the administrative and overhead levels of bureaucracy that maybe come with a C-corp arrangement. But, you know, it really depends on how closely do you trust your business partners and unfortunately by the time they get to me [*laughs*] they're usually nobody's trusting anybody and everybody's ready to duke it out. And I find that in the partnership scenario more often, you have people who are closer to the business, they are more emotionally invested in the business than when I represent a corporation. You know, maybe the people who are in management of the corporation, they didn't start the business, they aren't the founders, they're the next generation of management after a transaction. So they're not as emotionally invested but when I get into the disputes that are the original partners, it can be as bad as a marital breakup. You know, folks are fighting over, you know, in marriages they say people fight over the toaster you would be shocked at what people will hold out for in a business divorce among partners or an LLC or one of those types of arrangements. So, to me it really comes down to know who you're doing business with and that's a big driver, I think on the front end in terms of how you set this up, what protections are there, especially if you're doing a partnership deal. But then on the back end, like I said, by the time they get to me everybody's mad at everybody.

Chris Rux: Yeah. No, I think that's a very fair summary, is know who you're getting in bed with, if you will, and then also planning for that exit ahead of time so that there are no surprises and you don't have that marital breakup, if you will. Obviously, it may still happen but if you can put precautions in place from the get-go I think it would be very helpful.

Kevin McCoy: Yeah, you know, I'll add to that one other piece. I get this from people all the time who come to me and they say, "Listen, you know, this is an uncomfortable conversation. I've known this person my whole life, we're going to go into business together. I don't really want - I think they'll take offense to putting this in like I don't trust them." And my response to that always is you have the agreements and you have the provisions in the agreements not for right now; it's for when

everything goes to hell. You know, you have contracts for the scenarios that are uncomfortable in the future. That's why you write it all out. And if you don't want to have those conversations now, that's fine, but if this plays out in the worst type way then you're going to be exposed. And nobody ever thinks that their business partner is going to do them wrong, or double cross, or cheat and steal, or anything else or take opportunities for themselves but it happens every single day and it happens every day to people who never saw it coming and it's because a lot of times they just didn't want to have those uncomfortable conversations on the front end. So, if there's a legal takeaway to today's discussion that's what I would say is, don't be afraid. If you're going to get into business with somebody, you know, be mature enough to have those hard conversations about what happens if everything goes bad.

Chris Rux: Yeah, I think that's a great point. And if you're unable to have those conversations with that person, then you might not really want to be in business with them in the first place.

Kevin McCoy: Yeah. Yeah.

Chris Rux: I think that's, you know, kind of wraps up what we, you know, wanted to cover today. You know, Kevin or Barry, do you have any final thoughts before we close this out?

Barry Weins: Now again, I think it's up-front planning. And as Kevin said, even for the bad situations, so you want to plan for the operational aspects and you want to plan for the tax aspects. So all of those go together. No one of them is going to drive or make the difference, but again this is a business. You have to make the business decision first and then layer in all these other things.

Kevin McCoy: Yeah. I think Barry said it about as well as you can say it.

Chris Rux: Fair enough. All right. Well, hey Barry, Kevin thank you for your time today, really appreciate it. I thought there were some really great insights and we'll follow up with more discussions as our audience would like.

Kevin McCoy: Yep. And for all of you listening you can find this content on the websites of Carlton Fields and Cherry Bekaert. And for those of you who are in the space looking to launch a business and get some free insights and some planning, Carlton Fields has a resource "Launch to Thrive" available that you can find free resources in terms of typical form documents and other things that may be useful as you're trying to get your arms around literally birthing a business and getting it off the ground in those initial stages. So, this has been a great discussion. We look forward to a next episode. So, Chris, Barry, thank you so much.

Chris Rux: Thank you.

Barry Weins: Thank you guys.

Kevin McCoy: All right.

Presented By

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