Your Legal Structure and Tax Status

What is the legal structure of your business? Here are the main possibilities:

- Sole proprietorship or partnership (this means that you haven't filed any entity formation documents with a state government)
- Corporation
- Limited liability company (LLC)
- Nonprofit organization (usually a type of corporation)
- Cooperative

If you have formed an entity, under what state law was it formed? Each state has slightly different rules for entities formed under their laws.

How is your business taxed? Is it an S Corp or C Corp? Is it taxed like a partnership? Exempt from tax because it conducts charitable and educational activities?

In this guide, we will discuss the implications of all of these structure and tax choices (possibly made many years ago without complete information) for your capital raising strategy.

Sole Proprietorships and Partnerships

If you never filed papers with a state government to create a legal entity for your business, you have either a sole proprietorship (if you are just one person) or a partnership (if you are two or more people). A sole proprietorship can raise money from investors in the form of loans, but not equity. A partnership can raise money in the form of loans and can also bring on additional partners who can purchase equity in the partnership.

If you want to raise money from investors, it is generally recommended that you go ahead and form some kind of entity. The formation of an entity allows you to protect your personal assets in case something goes wrong. Corporations and LLCs have something called *limited liability,* which means that owners of these entities generally don't put their personal assets (e.g., their home or car) at risk. If the entity defaults on a loan or loses a lawsuit, the owners can lose their entire investment in the company, but their personal assets (in most cases) will be shielded from liability. Another reason to form an entity before raising money from investors is that it gives you a lot more options for how you can bring in investors. Finally, it makes you look more serious about your business because you have invested the resources necessary to create a formal structure.

Taxation of Sole Proprietorships and Partnerships

Sole proprietorships and partnerships are "disregarded" for tax purposes. This means that the sole proprietorship or partnership is not itself taxed, and all tax items are passed through to the owners. So at the end of the company's fiscal year, the company's accountant

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closes the books and figures out if the company made a profit or loss and whether there are any other tax items to report. These items are passed through to the owners of the company, and they fill them in on their personal tax returns. This *pass-through tax treatment* is available for other kinds of entities as well, as discussed below.

Corporations

A corporation is an independent legal entity, separate from the people who own, control, and manage it. You form a corporation by choosing a state where you want to incorporate and filing a document called the Articles of Incorporation or the Certificate of Incorporation with the state government. The state statute under which you form your corporation lays out various requirements, such as the number of people you must have on your board of directors, what officers you must have, how you have to give notice for shareholders' meetings, and the like. Corporate statutes are very similar from state to state—the corporate structure was invented hundreds of years ago and generally includes the same basic building blocks regardless of the state. These building blocks include a board of directors that has ultimate responsibility for all corporate decisions; officers (usually a president, secretary, and treasurer), who may or may not be board members but who are chosen by the board to manage the corporation; and the owners of the corporation, who are called *shareholders* or *stockholders.*

The ownership of a corporation is divided up into shares of stock. Generally speaking, the number of shares you own divided by the total number of outstanding shares that have been issued (i.e. sold to shareholders) represents the percentage of the company that you own. For example, if you own 300,000 shares, your cofounder owns 200,000 shares, and no one else owns any shares, you own 60 percent of the corporation, and your cofounder owns 40 percent. The shareholders with voting rights elect the board of directors.

Corporations can offer different types of stock to investors. Different types of stock are called *classes* (or sometimes *series*). So, for example, you could have a class of voting stock and a class of nonvoting stock.

All corporations have *common stock.* This is the stock that is issued to the founders when they first form the new company. Common stock is very simple and usually comes with the right to vote (one share, one vote).

Benefit Corporations and Social Purpose Corporations

Over the last several years, there has been a movement to create new corporate statutes that are designed to allow corporate leaders to consider the interests of all stakeholders (workers, suppliers, customers, the environment, the community, and so on) when making decisions, without fear of getting sued by shareholders. This movement was spurred by stories of mission-driven public companies that were pressured by shareholders to

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sell the company to the highest bidder even though the founders feared that the mission of the company would be compromised by the sale.

Approximately 30 states have adopted these statutes, known as *benefit corporation, social purpose corporation,* or *public benefit corporation statutes.*

Companies formed under these statutes have the same options in terms of the types of securities they can offer and are taxed in the same way as regular corporations. The primary difference between these corporate forms and plain vanilla corporations is that the board of directors has more protection if it makes a decision in the name of public or environmental benefit that shareholders do not consider to be in their best financial interest. These companies are generally required to be evaluated pursuant to a third-party standard to demonstrate that they have a public benefit or social purpose.

Whether you form your company as a regular corporation, a benefit corporation, or a social purpose corporation, there is no effect on the tax treatment of the business or its shareholders.

Taxation of Corporations

C Corps

The default rule under federal tax law is that corporations are taxed under Subchapter C of the Internal Revenue Code.

If the corporation is taxed under Subchapter C (i.e., is a *C Corp*), the company's profits are taxed at the corporate level at corporate tax rates. If the company pays out a share of the profits (dividends) to its shareholders, the shareholders have to pay income tax on the dividends. This is known as the "double tax" because the same profits are taxed twice—once at the entity level and then at the individual shareholder level when they are paid out as dividends. Note, however, that dividends are often taxed at a lower rate than the regular income tax rates.

S Corps

Many smaller corporations elect to be taxed under Subchapter S of the Internal Revenue Code because it allows them to avoid the double tax.

If the corporation is taxed under Subchapter S (i.e., is an *S Corp*), the company's profits are taxed at the shareholder level and not at the entity level. This means that regardless of whether the company pays dividends, the shareholders have to pay tax on their share of the company profits. If the company has a loss, it may be deductible on the shareholders' tax returns. This type of taxation is called *pass-through* because the tax items are "passed through" to the shareholders. The company must issue a K-1form to its investors every year to tell the

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investors what they must report on their taxes. Paying dividends to the investors does not affect the amount of income tax they have to pay because the investors pay tax on their pro rata share of the company profits, not on the actual cash they receive.

Many investors do not like pass-through taxation because it makes the preparation of their personal taxes more complicated and because of the risk that they will have to pay tax on profits they do not actually receive (known as the “phantom income” problem). At the same time, investors who have passive gains on other investments may like the idea of investing in an early-stage S Corp that is making losses, because the investor may be able to use the losses to offset the gains from other investments.

Taxation under Subchapter S can be very favorable in some circumstances, depending on the shareholders’ individual tax situations. There are some limitations on whether a corporation is allowed to elect taxation under Subchapter S:

- An S Corp cannot have more than one class of stock (unless the only difference between the classes is their voting rights)—in other words, all shareholders must have the same economic rights.
- Only individuals and not entities can be shareholders in S Corps.
- Only US citizens or permanent residents can be shareholders in S Corps.
- There is a cap on the number of shareholders an S Corp can have (one hundred).

Limited Liability Companies (LLCs)

LLCs are not corporations. They are a fairly recently invented entity that combines the limited liability protection of a corporation and the flexibility of a partnership. You form an LLC by choosing a state where you want to form and filing a document called the Articles of Organization or the Certificate of Formation with the state government. The state statute under which you form your LLC lays out various requirements governing the LLC, which are much fewer than for a corporation. Under state LLC law, you can write almost anything you want into the LLC’s internal governing document (known as the operating agreement. You can have multiple classes of equity, each with different rights, and you can also be creative with how the LLC is governed. Unlike corporations, LLCs are not required to have a board of directors, officers, or even meetings.

The equity interests in an LLC are called *memberships* or *membership interests.* From time to time, you may also hear them referred to as *units.* Generally, you would not use the term *share* or *stock* when referring to an equity interest in an LLC.

LLC Taxation

The default type of taxation for an LLC is taxation under Subchapter K (partnership taxation). Subchapter K provides for pass-through treatment for the tax items of the entity. Remember, S Corps also have pass-through treatment, but the two subchapters do have some

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differences. For example, with partnership taxation (Subchapter K), everyone who owns an equity interest in the LLC who also works for the LLC has to pay self-employment tax on all income from the LLC, regardless of whether it is called a salary or profit sharing. Under Subchapter S, dividends paid to shareholders who work for the company are not subject to employment tax.

This is why some LLCs elect to be taxed under Subchapter S instead of Subchapter K. They can also elect to be taxed under Subchapter C (or Subchapter T if the LLC operates like a cooperative—see the next section for details).

Co-ops

Co-ops are very diverse because each state co-op statute is different. Many states have more than one co-op statute governing different types of co-ops. Generally, the equity owners of a co-op are called *members.* The members of the co-op include "patrons" of the co-op. The term *patron* applies to anyone who does business with the co-op, which can include customers, producers, or workers, or a combination of multiple kinds of patrons. However, co-ops can generally have nonpatrons as equity investors (i.e., members) as well.

One of the considerations for co-ops when raising money from investors is the importance of ensuring that the patron members remain in control. (This usually means that they have the right to elect a majority of the board of directors and to have final say over major decisions such as sale of the company, merger, or the choice to convert to another type of entity.) Most cooperative statutes do not allow outside investors to choose a majority of the board or have other rights to control the cooperative. Many state co-op statutes also limit the financial returns that can be paid to outside investors.

Cooperative Taxation

There is a section of the tax code called Subchapter T that is designed to be used by co-ops. Subchapter T provides a beneficial treatment of dividends that are paid to patrons – unlike dividends paid to investors, patronage dividends are not subject to the double tax. Some co-ops elect to be taxed under Subchapter T; others may choose a different tax treatment. Recently, a new type of cooperative structure has been adopted in several states called the *limited cooperative association* (LCA). Many co-ops formed as LCAs elect to be taxed under Subchapter K (partnership tax).

Nonprofits

Nonprofit organizations are usually a special kind of corporation that is just like a regular corporation except that it does not have the ability to issue stock. In other words, a nonprofit cannot be owned by anyone. Unlike in a corporation, in which the shareholders choose the board, in a nonprofit, the board itself elects new board members. (Some nonprofits have voting members who elect the board, but this is not very common.)

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Because a nonprofit does not have any ownership interests, it can only raise money from investors in the form of debt; it cannot offer an equity investment.

There may be some other limitations on what a nonprofit can offer to investors depending on the details of the statute under which it was formed. For example, in California, a majority of the board of a charitable nonprofit must be people who do not receive any compensation from the nonprofit. This means that it would be illegal for a majority of the board to be investors in the nonprofit.

Nonprofit Taxation

The default rule is that nonprofits are taxed just like any corporation, but the majority of nonprofits apply for federal tax-exempt status. There are many different categories of federal tax-exempt status. The most well-known is tax exemption under Section 501(c)(3), which is available for charitable and educational organizations. Tax-exempt status usually means that the nonprofit is prohibited from compensating anyone at a level that would be considered above market rate. This includes investors, so the nonprofit would want to be careful to do some research about comparable investment opportunities and the interest rates they are offering before designing the debt instrument they plan to offer to investors.

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