Small Business Finance, Tax, and Corp Structure

Choosing a Legal Structure for Your Business

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Why is Choosing the Right Legal Structure Important

A business's legal structure has many ramifications

- Liability Protection
- Taxes
- Ability to attract investors
- Ability to obtain a loan
- Complexity of paperwork requirements
- Startup costs
- Ownership control

Initial Factors to Consider Before Choosing a Legal Structure

- Simplicity of Management and Paperwork Requirements
- Importance of Liability Protection
- How Will This Affect My Taxes
- Importance of Ownership Control
- Future Fundraising and Investors

Most Common Legal Structures

- Sole Proprietorship
- General Partnership
- Limited Liability Company – LLC
- Corporation

An S-Corp is not a separate legal structure – it is a tax structure

Sole Proprietorship

- Simplest business entity
- No liability protection of personal property
- Profits and loss pass through to owner
- Owner has complete control
- Meaningful growth generally requires conversion to a different legal structure

General Partnership

- Business owned by two or more individuals
- Should have a partnership agreement
- No liability protection of personal property
- Profits and loss pass through to partners
- Partners have complete control
- Limitations on fund raising as profits and loss are closely tied to the partners

Limited Liability Company

- Business owned by one or more members
- Must file Articles of Organization with state
- Operating Agreement defining operation of the company
- Liability protection if maintain corporate formalities
- Profits and loss pass through to partners
  - May minimize employment taxation with S-Corporation tax status
- Members may operate business or assign a manager
- Limitations on fund raising as investor would need to become a member to have ownership in business

Corporation

- Business owned by shareholders
  - Can be C-Corp or S-Corp tax structure
    - C-Corp taxed twice
    - S-Corp pass through taxes to shareholders (100 max)
- Greater complexity in management
- Must file Articles of Incorporation with state
- Must have Bylaws that define management of company
  - Duties of Shareholders – Board – Management
- Liability protection if maintain corporate formalities
- Preferred by investors

Other Common “Entities”

- Limited Liability Partnerships
- Limited Partnerships
- Professional Limited Liabilities and Partnerships
- S-Corporations
- Public Benefit Corporations
- B-Corporations
- Tax Exempt Organizations

Choosing a Tax Structure for Your Business

Brad A. Tafoya, Tafoya Barrett and Associates PC

Legal Structure vs. Tax Structure

Legal Structures

- Corporation ==→
- Limited Liability Company== →
- Partnership (General, LP, LLP, LLLP etc,) ==→

Tax Structures

- C Corporation or S Corporation

C Corporation	S Corporation
Double Tax	Single Tax
Losses Stuck	Losses Pass Thru
	Needs Timely Election

- Sole Prop; C or S Corp; or Partnership = 1-2 Timely Elections
- Partnership

HOW DO YOU DECIDE? (what questions to ask)

1. Business Deal – Must drive all decisions – don’t let attorney or CPA kill the deal by putting you and structure that doesn’t fit the deal
2. What are my legal/liability concerns
3. How do I minimize federal and state income tax
4. How do I minimize Self-Employment (Social Security & Medicare) Tax
5. Do I need flexibility with ownership?
6. Do I plan to sell, need investor or go public?
7. Will I own the Real Estate (= Partnership)
8. Do I want maximize retirement plan contribution?

Comparison of Entities Checklist – Highlights

Characteristic	Sole Prop.	Single Member LLC's	"C" Corp.	"S" Corp.	Partnership	LLC (except SMLLC's)
Title	Owner	Member	Shareholder	Shareholder	Partner	Member
Limited Liability	No	Yes	Yes	Yes	No (a)	Yes
Number of owners	1	1	1 or more	1-100	2 or more	2 or more
Able to use lower corp. tax rate (21%)	No	No	Yes	No	No	No
Split income between family members	No	No	Yes	Yes	Yes	Yes
Double tax-earnings	No	No	Yes	No	No	No
Can avoid **FICA taxes** by						
a. Distributions	No	No	Yes	Yes	No (a)	Maybe
b. paying children under 18	Yes	Yes	No	No	No	No
Deduct business loss on individual return	Yes	Yes	No	Yes	Yes	Yes
Can Distribute Appreciated Assets Tax-Free	N/A	N/A	No	No	Yes	Yes
Can increase basis by 'step-up' election	N/A	N/A	N/A	No	Yes	Yes
Can **specially allocate** income and expense	N/A	N/A	N/A	No	Yes	Yes
Able to deduct expenses paid personally	Yes	Yes	No	No	Yes	Yes

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Title	Owner	Member	Shareholder	Shareholder	Partner	Member
Can transfer assets 'tax free' where debt > basis	N/A	N/A	No	No	Yes	Yes
Basis for loss includes owner's share of debt	N/A	N/A	N/A	No	Yes	Yes
Can deduct interest on money borrowed to invest as business interest	Yes	Yes	No	Yes	Yes	Yes
Qualifies for ordinary loss under Section 1244	No	No	Yes	Yes	No	No
May offset active income with passive losses	No	No	Yes	No	No	No
Unreasonable compensation issues	No	No	Yes	Yes	No	Maybe
Home office deduction advantage	Yes	Yes	No	No	Yes	Yes
Avoid payroll taxes and administration	Yes	Yes	No	No	Yes	Yes
Qualified Business Income Deduction	Yes	Yes	No	Yes	Yes	Yes
Section 1202 Stock	No	No	Yes	No	No	No

Debt Financing Considerations

Kris Oyler – Peak Food & Beverage

- Why Use Leverage
- Business Planning
- Lender Requirements
- Debt to Equity Ratios / Cash Flow

Why Use Debt Financing for Growth

- Resource Allocation
  - Balancing Risk with Seizing Growth Opportunities
- Growing Beyond what can be Achieved with Cash Alone
- Maintaining Cash Reserves
  - Weathering Hard Economic Conditions
  - Provide ROI to Investors
    - Capital Gain
      - Investing in Productive Resources Using Debt to Leverage
    - Dividends or Distributions
- Less Attractive During Credit Tightening
  - Increased Costs of Borrowing

Where To Start

- Vision, Mission, Core Values
  - Sense of Purpose
- Business Plan Creation and/or Revisions
  - Specifying Growth Opportunity Event(s)
    - Market Research and Analysis
    - Competitive Analysis
    - Strategy –
      - Plans, Policies and Actions

What Lenders Will Need

- Business Plan
  - Management Experience
  - Uniqueness of Business or Product
- Three Years of Financial Statements
  - Completed and Filed Tax Returns
- Three Years of Projections
  - Denote the Necessary Sales Levels to Cover Overhead and Make Profits
- Specify What Collateral is Available to the Lender and Willingness to Provide Personal Guarantees

Debt-To-Equity Ratio / Cash Flow

- Measures total debt relative to the amount originally invested and earnings over time
- Total Liabilities divided by Shareholders' Equity
  - Number of Times a Company can Pay Off its Current Liabilities
  - Generally for Small Business, a Debt-To Equity Ratio of Approximately 2 to 2.5 is Considered Good
- Cash Flow Model
  - Monthly or Even Weekly Models to be Certain of Debt Coverage & Address Seasonality / Business Cycles

Q & A