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**GRAY REED & MCGRAW, P.C.**

# **TAX AND CORPORATE CONCERNS FOR STARTUPS**

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- Overview:

- Entity Selection
- Owner Payment
- Conversions
- Common Corporate and Tax Mistakes
- Maximizing Deductions

# Legal Entity Choices

## *Texas Examples*

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### 1. Corporations

- a) For-Profit
- b) Non-Profit
- c) Professional

### 2. Partnerships

- a) General Partnership (GP)
  - i. LLP Registration (LLP)
- b) Limited Partnership (LP)
  - i. LLP Registration (LLLP)

### 3. Limited Liability Companies

- a) LLC
- b) PLLC

### 4. Associations

- a) Cooperative
- b) Professional

# Federal Taxation Types (Federal Tax Form)

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- Corporation

- C Corporation (1120)
- S Corporation (1120S)

- REIT (1120-REIT)
- Tax Exempt (990)

- Partnership

- General (1065)
- Limited (1065)

- MLP (1065)

- Sole Proprietorship (Schedule C)

# Federal Tax Treatment of Domestic Entities

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## Default Treatment

- a) Corporations and “Associations” = C Corporation
- b) Partnerships = Partnership (*unless partners are disregarded*)
- c) LLCs
  - i. One Member = Disregarded entity (sole proprietorship)
  - ii. Two or More Members = Partnership

Note – Rules for state tax and foreign entities are different

# Federal Tax Treatment of Domestic Entities (Continued)

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- Check The Box Flexibility (Form 8832):  
ONLY Associations, Partnerships, and LLCs
  - a) Can only elect once every 5 years
  - b) Foreign rules are different
  - c) Corporations cannot check the box
  
- Corporations: S Corporation Elections (Form 2553)

# Taxation Type Example: LLC

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## Single Member Texas LLC

- a) Default Tax Status: Disregarded entity
- b) Election Options: C or S Corporation
- c) Admission of Member: Keeps default taxation, but next year gets a second member. Taxation type?
  - i. Must file as a partnership.
  - ii. Partial year as disregarded entity, partial year as partnership.  
Deemed Transaction – Rev. Rul. 99-5
- d) Effect of two member LLC losing one during year  
*See Rev. Rul. 99-6*

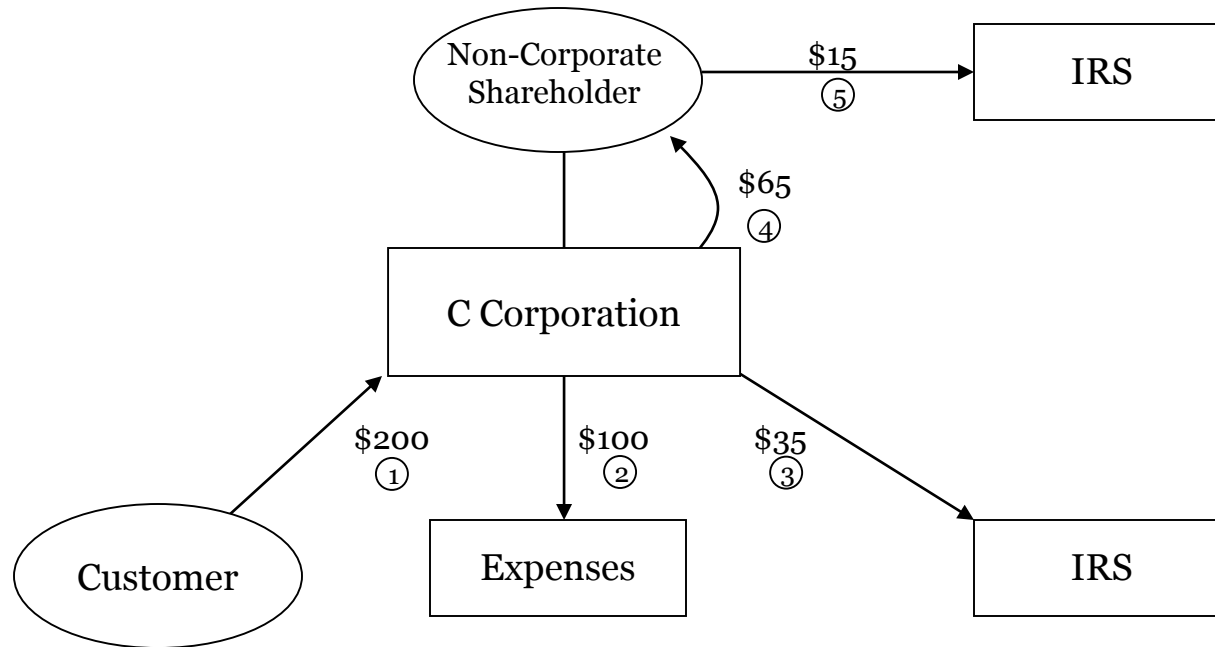
# Common Tax Drivers

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1. Federal Taxation: Double Taxation (Entity and Owner) v. Single Taxation (Owner Only)
2. State Taxation of Entity
3. Taxation of In Kind Distributions
4. Differences in Profit/Capital Sharing



# Double Tax Example: Ordinary Income

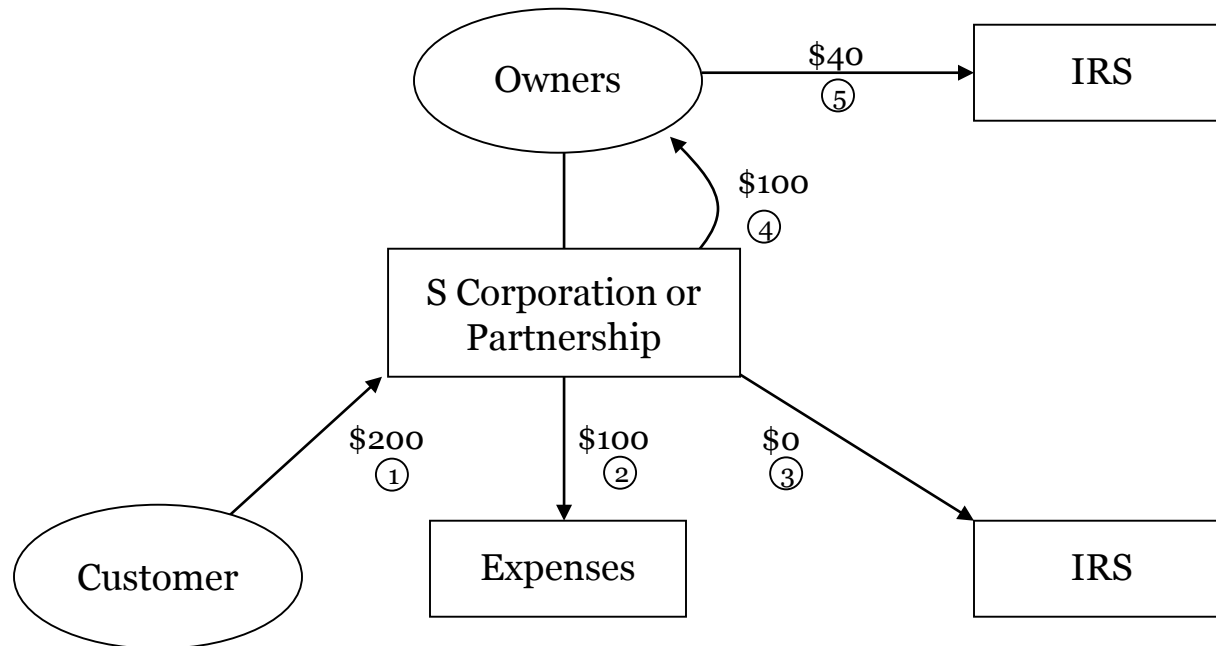


Revenue	200
Expenses	-100
Net Income	100
Less: 35% Corporate Tax	-35
After-Tax (Corporate)	65
Less: 23.8% Dividend Tax	-15
To Shareholder After All Taxes	50
<b>Aggregate Tax Rate</b>	<b>50%</b>

If the \$65 of after-tax earnings are retained in the C Corporation, Shareholder's Tax Basis in the Shares does not increase.

Assuming top capital gains rate of 20% and application of 3.8% Net Investment Tax.

# Single Tax Example: Ordinary Income

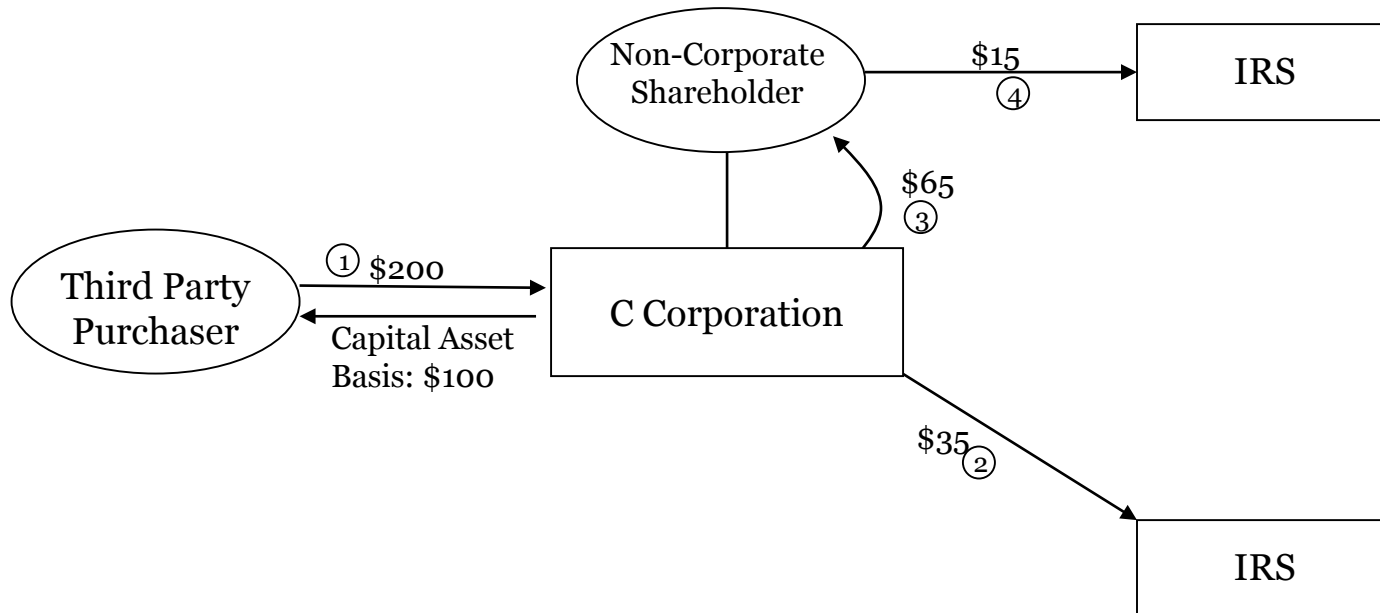


Revenue	200
Expenses	<u>-100</u>
Net Income	100
Less: Corporate Tax	<u>-0</u>
After-Tax (Corporate)	100
Less: 40% Shareholder Tax	<u>-40</u>
Retained Earnings	60

Pass through entity distributes \$100 to Owners Taxes; Owners pay \$40 in tax at ordinary income rates, retains \$60.

**Aggregate Tax Rate 40%**

# Double Tax Example: Capital Gain



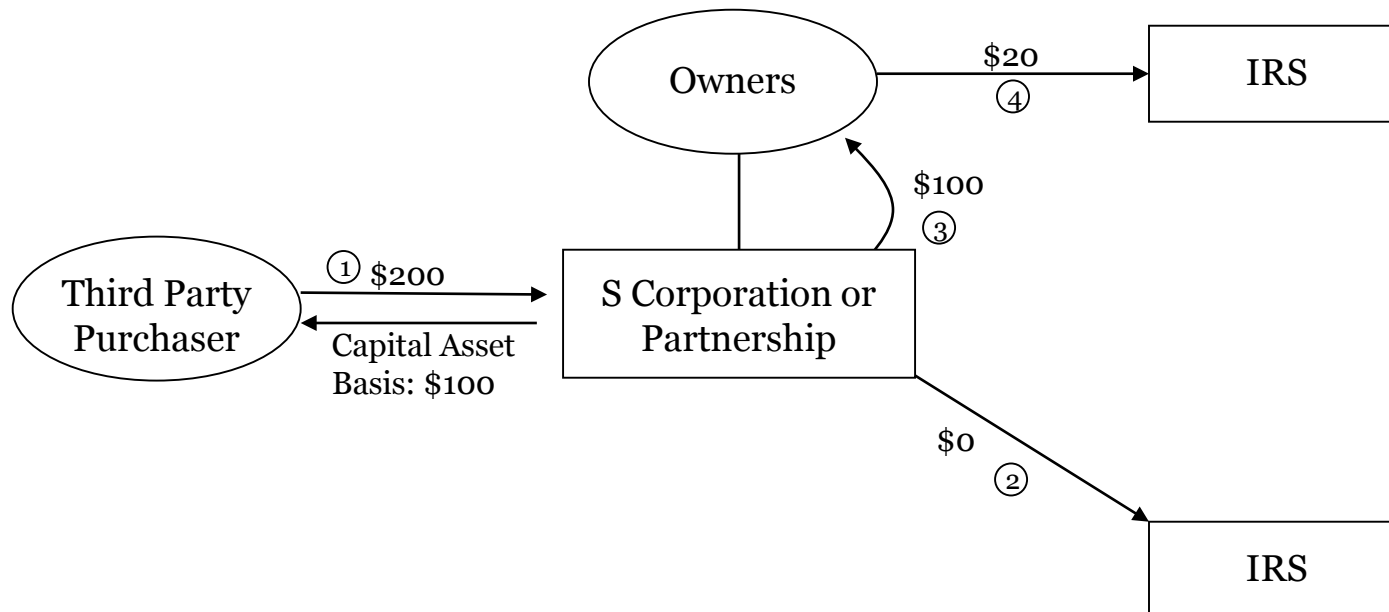
Revenue	200
Basis in Capital Asset	-100
Net Income	100
Less: 35% Corporate Tax	-35
After-Tax (Corporate)	65
Less: 23.8% Dividend Tax	-15
To Shareholder After All Taxes	50

**Aggregate Tax Rate 50%**

If the \$65 of after-tax earnings are retained in the C Corporation, Shareholder's Tax Basis in the Shares does not increase.

Assuming top capital gains rate of 20% and application of 3.8% Net Investment Tax.

# Single Tax Example: Capital Gain



Revenue	200
Basis in Capital Asset	<u>-100</u>
Net Income	100
Less: Corporate Tax	<u>-0</u>
After-Tax (Corporate)	100
Less: 20% Shareholder Tax	<u>-20</u>
Retained Earnings	80
<b>Aggregate Tax Rate</b>	<b>20%</b>

Pass through entity distributes \$100 to Owners Taxes; Owners pay \$20 in capital gain tax, retain \$80.

Assumes active participation by owners to avoid application of 3.8% Net Investment Tax.

# Tax Driver Comparison By Tax Status

<i>Taxation Attribute</i>	<i>Federal Tax Status</i>				
	<b>C Corp</b>	<b>S Corp</b>	<b>Partnership</b>	<b>Sole Proprietorship</b>	<b>Tax Exempt</b>
<b>Levels of Taxation</b>	Entity AND Owner	Owner; Sometimes Entity	Owner ONLY	Owner ONLY	Sometimes Entity
<b>In-Kind Distributions Taxed</b>	Yes	Yes	No	No	N/A - Distributions prohibited
<b>Loss Limitations</b>	No Flow Through	Basis and Shareholder Loans	Basis and Most Loans	Few Limitations - At Risk Only	N/A
<b>Disproportionate Distribution of Cash Allowed</b>	Yes (Through preferred stock)	No	Yes	N/A	N/A - Distributions prohibited

<i>Taxation Attribute</i>	<i>State Entity</i>				
	<b>Corporation</b>	<b>LLC</b>	<b>Partnerships</b>	<b>Sole Propr. (No Entity)</b>	<b>Non-Profit Corp.</b>
<b>Subject to Texas Franchise Tax</b>	Yes	Yes	Yes, unless liability is not limited or meets passive entity exception	No	No (if also tax exempt for state tax purposes)

# Owner Payment Options

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## 1. S Corporation/C Corporation

- Owner can be Employee
  - Salary, Deferred Compensation, Restricted Stock/Stock Options
- Dividends to Owners

## 2. Partnership (Including LLC Taxed as Partnership)

- Owner cannot be Employee
  - However, can receive guaranteed payments which are like salary, but subject to Self Employment Tax
- Recognition of Net Income
  - Need to be concerned about Cash Flow for Tax Dist.

# Conversions

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1. LLC to Corporation
  - Section 351 Tax Free Contribution
  - 80% Control after Contribution
  
2. Corporation to LLC
  - First, Taxable Liquidation
  - Then, Tax Free Section 751 Partnership Contribution

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# AVOIDING STARTUP MISTAKES AND KNOWING WHAT TO FILE





# Operating without an Agreement

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- **Issues:**
  - Ownership Amount
  - Salary/Guaranteed Payments
  - Management
  - Non-Compete
  - Non-Solicit
  - Property Disposition Upon Dissolution
  
- **Put it all in Writing!**

# Telling your Secrets without an NDA

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- Non Disclosure Agreements
- Confidentiality in Employment Agreements
- Confidentiality in Operating Agreements



# Messing with Texas: Texas Taxes

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- **Texas Franchise Tax: May 15**
  - Can file online – Keep your webfile number!
  - No Tax Due if Revenues Under \$1,000,000, inflation adjusted
  - MUST STILL FILE RETURN IF NO TAX DUE
  
- **Texas Sales Tax: Monthly, Quarterly, or Annual Returns**
  - Need to obtain Permit
  - Sale for Resale Exemption
  - Manufacturing Exemption

# Messing with Texas: Texas Taxes

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- **Texas Worker Unemployment Insurance Returns:** Quarterly
- **Texas Property Tax:** Business Personal Property Rendition Due April 15
- **Business in other states** – you may need to register and pay taxes in the other state too!



# Forgetting the Feds

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- **Annual Income Tax Return**

- Disregarded Entity (Single Memb. LLC): Schedule C
- Partnership: Form 1065
- C Corporation: Form 1120 (S Corporation: 1120S)

- **Employment Tax Returns**

- Forms 940, 941, 945

- **Payment Information Returns**

- Forms 1099
- Forms W-2

# Mixing Personal and Business

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- Contemporaneous Documentation
- Credit Card Statements DON'T COUNT
- Separate Bank Accounts
- Recordkeeping Requirements



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# MAXIMIZING DEDUCTIONS



# Recordkeeping

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- Contemporaneous Documentation
  - i. Gross Receipts
  - ii. Purchases
  - iii. Expenses
  - iv. Meals and Entertainment
  - v. Charitable Contributions
  - vi. Employment Taxes
  - vii. Car Expenses





# Recordkeeping - *Segregation of Accounts*

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- Not Required BUT...
  - a) Provides clear audit trail
  - a) Helps in hobby loss cases



# Commonly Missed (or misapplied) Deductions

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- Organizational and Start Up Costs
- Personal Use Property (laptops etc.)
- Home Office Deduction
- Commuting
- Travel
- Professional Fees
- Business Gifts
- Meals and Entertainment

See IRS Publication 334

# Questions

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