

Small Business Strategies

Issues to consider when funding a startup

One of the most pressing questions facing entrepreneurs involved in any new business venture is whether to fund the start-up through debt (borrowing) or by giving up equity (selling stock or other ownership interest). Investors often face the same choice. It's a good idea for potential backers to closely investigate the tax and legal implications of their chosen funding method before getting involved in any new enterprise.

This column examines the legal and tax issues associated with investors, from the perspective of a CPA, Cindy Gomerding, and an attorney, Joel Russman.

CPA: For an investor, "risk" is a technical accounting term that the Internal Revenue Service applies in determining investment tax advantages and disadvantages.

Attorney: From a legal point of view, investors should be concerned with how much liability they face. As if standing to lose all the money put into a business isn't scary enough, under some circumstances investors can face personal responsibility for some or all of the liabilities of that business.

Partnerships, once a common form of business organization, are rarely chosen today because all partners are liable for all partnership obligations, even if they were not involved in the decision or action that resulted in the partnership liability.

In Colorado, there are a myriad of choices that will provide limited liability to owners. Most common are corporations (S or C) and limited liability companies (L.L.C.s).



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CPA: I generally don't recommend C corporations because of the double taxation of distributions. But remember that an S corporation may not be allowed if you plan to have more than 75 shareholders or certain investors other than individuals, or if the entity plans to provide preferential distributions to the investors.

Attorney: Besides potential business liability for debts inherent in the structure of a partnership, any passive investor also must bear in mind that everyone is potentially liable for his or her own actions. So an investor in a corporation, L.L.C., or other limited liability entity may still face liability if the investor is actively involved in the management of the business. It is not unusual these days to see lawsuits against directors of a corporation or against managers of an L.L.C. if the business does not perform well. The safest approach for investors who do not want to risk lawsuits is to be shareholders, not directors or officers (in the case of a corporation), or to be members, not managers (in the case of an L.L.C.).

CPA: Remember, many investors are looking for short-term tax write-offs with potential long-term gain. Both the actions of investors and their role in the business will have an impact on their ability to deduct losses and recognize income without being subject to self-employment tax.

The IRS has a test for L.L.C.s under which investors may avoid paying the self-employment tax if they do not "materially participate" in the business. In order to materially participate in a business, investors generally need to work more than 500 hours per year in the business. However, there are numerous other factors.

Self-employment tax is never assessed on the profits of an S corporation.

Attorney: Sometimes owners and those running a business fail to treat the business as a separate entity. Some examples of this are: failing to hold or keep minutes of meetings, failing to sign documents in their representative capacity on behalf of the business and failing to keep assets, bank accounts, etc. in the business name without co-mingling funds. In cases where this occurs, courts may hold owners and operators of a business personally responsible for the business's liabilities by "piercing the corporate veil."

CPA: Equally important to the investor will be the issue of the deductibility of losses. Business losses may not be deductible if an investor does not materially participate in the business. In addition, the losses will be limited, based on amounts invested. An advantage of an L.L.C. is that loan guarantees may be used to increase the deductibility of losses. For an S corporation, only direct obligations and investments can be used for such deductions.

Attorney: The degree of involvement in the business, maintaining a separate entity and the amount of investment or guarantee of the business's debt should all be considered by the investor in a business to maximize the tax benefits while minimizing the potential liability.

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