# SHARING THE WEALTH: ALLOCATING PROFITS AND LOSSES AMONG BUSINESS OWNERS

When starting a new business venture, one of the biggest questions to consider (after, how much money can I make), is how will I fund development and start up?

One approach is through traditional financing. A lot has been written about the SBA 7(a) loan program, which provides guaranteed loans to small businesses.

Another approach, however, is to find a partner, or one or more investors, willing to invest in the deal. While bringing on partners is often more expensive than traditional borrowing – investors demand a higher return on their investment in exchange for placing their money at risk, they also may bring with them certain knowledge or skills, making the additional cost worthwhile. Or investor money may be the only money available, in which case the benefits of this option are self-evident. This article discusses the various types of business entities, and some of the tax characteristics of certain business structures.

### *Background*

Legal entities are organized and exist under state law. Each state has its own rules pertaining to the formation and operation of corporations, general partnerships, limited partnerships, limited liability companies, etc., and state law governs how the entity will be managed, as well as the relationship between the entity and its owners.

Regardless of how a business is organized for state law purposes, the IRS will either "disregard" it as an entity separate from its owners, or treat it as a partnership or corporation for tax purposes. A corporation or entity classified as a "corporation" or "association" for tax purposes, can be taxed as a "C" corporation or as an "S" corporation. An unincorporated entity, e.g., a general partnership, limited partnership, or LLC, will be taxed as a partnership, but may affirmatively elect to be classified as an "association" and taxed as a corporation.

It is important to consider these differences at the planning stage, as they may be important as to how the partnership or investment relationship is ultimately structured.

### *Corporations*

Corporations – just like people – own their own property, enter into their own contracts, and conduct business on their own. A corporation is an artificial person, and owners typically hold "shares of stock" in the corporation – each share representing an interest in the corporation as a whole.

The type of stock and number of shares held by a shareholder determine the shareholder's right to receive dividends and distributions. Shareholders of a corporation with only one class of stock will hold common stock: that is, shares with voting and distribution rights. Shareholders of a corporation with more than one class of stock may hold common stock (which typically has full voting rights) and/or preferred stock (which typically has more restricted voting rights, but pays higher and more regular dividends and, upon liquidation, returns the preferred shareholders' investment before common shareholders can receive liquidating distributions).

Classes of stock may further be divided into series, with each series having different dividend and liquidation rights and preferences rights over the other series. For example, a corporation may have Series A preferred stock with each share entitled to a 5% annual, cumulative dividend and a liquidating distribution equal to par value, and Series B preferred stock with each share entitled to a 3% annual, cumulative dividend and a liquidating distribution equal to par value. If all of the corporation's assets were to be sold and the proceeds of the sale were insufficient to fully pay past due dividends and liquidating distributions, the articles of incorporation or certificate of designation creating the series would specify whether Series A or Series B shareholders would be paid first. If Series A were paid first, then the excess would be paid to Series B shareholders, and so on. Common shareholders typically get paid last, sharing proportionately in any proceeds left over after preferred shareholders are fully paid.

It is common for investors to want preferred stock. It also is important to note, however, that an "S" corporation can only have one class of stock. An entity taxed as a corporation, therefore, cannot offer preferred stock to investors and still enjoy pass-through tax treatment as an "S" corporation. For this reason, you may want to consider, instead, forming a limited partnership or LLC taxed as a partnership. Entities taxed as partnerships typically providing more flexibility in dividing up the profits and losses, and have fewer operating formalities.

***Partnerships***

Although partnerships and LLCs are generally considered entities separate from their owners, under current tax laws, they are sometimes viewed as entities separate from their owners (the entity approach) and sometimes viewed as an aggregate of their owners (the aggregate approach). This melded approach makes partnership taxation very different from corporation taxation.

Under partnership taxation principles, each partner has his or her own "capital account," which increases by the amount of the partner's contributions and distributive share of the partnership's income and gain, and decreases by the amount distributions made to the partner and the partner's distributive share of the partnership's losses. The partnership agreement dictates how the partners will share profits and losses.

In many partnerships, the partners have simple sharing agreements in which their share of capital, profits and losses are the same. (For example, each partner contributes 50% of the capital to the partnership, each partner is entitled to 50% of the partnership's income, gain, etc., and each partner is entitled to distributions equal to 50% of available cash.) These types of arrangements are sometimes referred to as "straight up" or "vertical slice" ownership interests, and allocations of this type generally do not pose any potential tax concerns.

Because of the flexibility inherent in partnership tax accounting, however, partnership agreements can be written to reflect whatever economic sharing arrangement and risk sharing arrangement the parties' desire. Over the years, therefore, more complicated structures have developed and it is more common to see what are known as "special allocations" of items of partnership income, gain, loss, or deductions among the partners. For example, a partnership agreement may allocate all of the depreciation deductions to one partner, while income, gains, and losses are shared ratably among the partners. Or, a partnership with two divisions, Division A (managed by Partner A) and Division B (managed by Partner B), may allocate all of the profits and losses of Division A to Partner A, and all of the profits and losses of Division B to Partner B.

Special allocations will be respected if they are determined to have "substantial economic effect." If the IRS determines that an allocation does not have substantial economic effect, it will reallocate the income or loss to reflect what the IRS believes is appropriate considering the partner's interest in the partnership which can create unexpected and unintended tax consequences.

These types of allocations, however, can disappoint investors if they result in liquidation distributions different than anticipated. Beginning in the early 1990s, therefore, a new drafting approach emerged that focused on distributions rather than tax allocations. Under the new approach (sometimes referred to a "targeted allocation" or "forced allocation" approach), partnership agreements dictate the percentages of partner distributions and rely on the partnership's CPA to force the proper tax allocations so that each partner's ending capital account balance equals what it must to allow the partnership to liquidate in accordance with the distribution waterfall and to ensure that each partner's capital account is reduced to zero.

A distribution waterfall provision might provide, for example, that available cash will be distributed 80% to Partner A and 20% to Partner B until such time as Partner A has received total distributions in an amount equal to 100% of his initial contribution, then 70% to Partner A and 30% to Partner B until such time as Partner A has received total distributions in an amount equal to 200% of his initial contribution, then 60% to Partner A and 40% to Partner B until such time as Partner A has received total distributions in an amount equal to 300% of his initial contribution, *etc*. Investors like these agreements because they are easier to understand and produce a more certain result. They make lawyers and CPAs a little nervous because the IRS has never issued guidance on them, and there is concern that targeted allocations may lack substantial economic effect. But again, the business people prefer them and, therefore, they are likely here to stay.

Unlike corporations, partnerships are inherently pass-through tax entities. So regardless of how profits and losses are shared, allocated tax items pass through to the partner level.

***Conclusion***

Choosing the appropriate business entity involves careful tax planning and understanding of corporate and partnership law. In addition to federal tax law, each state has its own rules concerning entity organization and governance, as well as its own tax system (which doesn't necessarily follow the Federal tax system).

Most importantly, however, it is important to know the type of investor you are seeking, and understand the investor's appetite and expectations with respect to the type of venture you are contemplating. There is no one-size-fits-all structure when it comes to investment, but it is good to prepare yourself and to look for investment with your eyes open.

*Mullin Russ Kilejian is a full service commercial law firm founded in 2003. The firm is nationally recognized in the area of franchise law, and provides legal services in the areas of corporate, tax, employment, trademark, technology, and commercial litigation.*

*Cheryl Mullin holds a JD from Widener University School of Law and an LL.M in Taxation from Southern Methodist University Dedman School of Law. Cheryl can be reached at (972)852-1703 or cheryl.mullin@mrkpc.com.*