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# Start-ups benefit from tax rules

**By Aly Dossa and Phyllis Guillory**

*New US tax laws give IP-generating start-ups a variety of options, explain **Aly Dossa** and **Phyllis Guillory***

The 2017 Tax Cuts and Job Act (the "2017 Act") has changed how startups may structure their business for US tax purposes. Generally, start-ups can be formed as a limited liability company (LLC) (a "flow-through" entity for US tax) or a 'C' corporation. Previously, the vast majority of start-ups elected the LLC route and then operated using this single LLC. For start-ups that were generating IP, all of their worldwide rights in the IP would be held in this single LLC. As a result, all IP licences, (eg, with US entities and non-US entities), would be with the single LLC and any resulting revenue or royalties from these licences would be paid and taxable to the single LLC. Prior to the 2017 Act, this structure was a simple and efficient solution for start-ups because it provided a single, low tax rate, as compared to the double taxation that would be incurred using a C corporation. The single LLC also provided benefits of losses flowing through.

With the passage of the 2017 Act, numerous changes have occurred and it may be beneficial for start-ups to reassess whether the traditional single LLC approach is still the most tax efficient structure. There are two primary considerations that start-ups should evaluate.

The first consideration is whether to use an LLC or a C corporation. While C corporations are still subject to double taxation, the change in the corporate tax rate to 21% makes the overall effective tax rate (corporate tax rate plus tax on shareholder dividend) for C corporations often equivalent to the effective tax rate on LLC income. An LLC may still be favoured if the new Section 199A deduction (which can be up to 20% of the tax but is applicable only to certain flow-through income) is available to reduce the effective tax rate of the LLC. By contrast, if the start-up does not qualify for the Section 199A deduction, a C corporation may be advantageous as the start-up can potentially defer at least the shareholder-level dividend tax.

The second consideration relates to whether the IP that is generated by the startup will be used by non-US customers. As startups work to expand their reach, it has become commonplace for US-based start-ups to have non-US customers. In these scenarios, it may be advantageous to: bifurcate the IP licensing between US and non-US customers or set-up a US-based IP-holding company.

With a bifurcated licensing approach, the goal is to have non-US income, generated by licensing IP to non-US customers, paid to a non-US company. This company is typically referred to as a non-US IP holding company and is a wholly-owned subsidiary of a US parent entity (ie, a C corporation). If such a company is formed, care must be taken to select an appropriate non-US jurisdiction, namely, a non-US jurisdiction with no or minimal corporate tax. Prior to the 2017 Act, the goal of a non-US IP holding company was to defer tax on the non-US income until distributions were made to the US parent, by making sure the company had significant activity to avoid current tax under "Subpart F" of the IRC. The 2017 Act has made it more difficult for these companies to defer tax due to the Global Intangible Low Tax Income (GILTI) provisions. However, the GILTI provisions also provide a bit of a tax break. Under the GILTI provisions, while income is currently taxable, the effective tax rate of the US parent C corporation for the GILTI income of the non-US IP holding company is half its normal rate (ie, 10.5%). The US parent entity may also be able to claim a foreign tax credit on some of the taxes paid by the non-US IP holding company. Although this approach can provide a favourable effective tax rate, the US parent entity must be a C corporation.

An alternate approach is to set up a separate US IP holding company as a C corporation that is a wholly-owned subsidiary of a US parent entity (which may be an LLC or a C corporation). In this scenario, all IP may be licensed via the US IP holding company instead of bifurcating the IP licensing. This approach has the benefit of a more simplified IP licensing structure.

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Further, this structure may benefit from the Foreign Derived Intangible Income (FDII) provisions in the 2017 Act, which can potentially reduce the effective corporate tax rate to 13.125% on the foreign income of a US C corporation.

Overall, the 2017 Act has provided startups with substantially more structuring options to consider. Start-ups should carefully evaluate each option to ensure they are utilising the structure that best suits their needs.


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