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How to Structure IP-Generating Startups

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By **Aly Dossa and Phyllis Guillory** | March 28, 2019

For companies developing intellectual property, structuring decisions have become more complicated due to the 2017 Tax Cuts and Jobs Act. In navigating a host of business decisions, startup companies must consider several changes to the Internal Revenue Code.

The first major decision that a startup must make is the form of their business. Generally, startups can be formed as a limited liability company (typically a “flow-through” entity for U.S. tax) or a C corporation. A common structure in the past for startups generating intellectual property was for all of their worldwide rights in the IP to be held in a single LLC. As a result, all IP licenses (e.g., with both U.S. and non-U.S. entities) would be with the single LLC, and

any resulting revenue or royalties from these licenses would be paid and taxable to the single LLC. Prior to the 2017 act, this structure was a simple and efficient solution for startups because it provided a single tax at the owner's individual tax rate (as compared to the C corporation's higher rate resulting from its income's double taxation) and there were potential benefits of losses flowing through.

With the passage of the 2017 act, there are two new provisions that startups should consider in determining whether a single LLC is still the best structure from a tax perspective.

The basic flow-through tax treatment of an LLC has not changed; however, the applicable rates have. The top individual rate has decreased from 39.6 percent to 37 percent. Further, new Section 199A of the IRC gives the owners of flow-through entities the possibility of a deduction of up to 20 percent of the tax, but there are many limitations to this deduction. One disadvantage of the 2017 act is that the use of losses from a flow-through is now more limited.

The 2017 act significantly reduced the tax rate of C corporations, making the use of C corporations more attractive. While C corporations are still subject to double taxation, the reduction in the corporate tax rate to 21 percent 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. Thus, if a startup does not qualify for the Section 199A deduction, a C corporation may be advantageous as the shareholder-level dividend tax can potentially be deferred.

The startup's potential funding and exit plan strategies (e.g., continuing as a privately held entity, acquisition, transitioning to a publicly traded company) also needs to be considered in choosing an LLC or C corporation because the tax treatment of an eventual sale is different depending on the entity chosen. Additionally, venture capital funds have traditionally favored C corporations. If

a startup LLC needs to be converted into a C corporation prior to obtaining the venture funding, the conversion may not itself be costly, but other related issues such as, e.g., converting a profits interest compensation plan into a stock option plan, may be more costly to convert.

The second major decision for startups is where the entity holding the IP should be located. In the past, for IP being used by non-U.S. customers, companies looked into locating their IP offshore in a non-U.S. IP holding company that was a wholly owned subsidiary of the U.S. parent entity. This often required bifurcating the IP licensing between U.S. and non-U.S. customers.

Generally, the non-U.S. IP holding company would be located in a low-tax jurisdiction. Often these jurisdictions attracted such companies by offering “patent box” tax preferences. Using this structure, the goal was to defer tax on the non-U.S. income until distributions were made to the U.S. parent, by ensuring the company had significant activity to avoid current tax under “Subpart F” of the IRC. The 2017 act has provisions that may make companies rethink this structure.

First, the ability to defer tax on income earned in a foreign subsidiary has been greatly reduced by the Global Intangible Low-Taxed Income provisions. Under these provisions, a controlled foreign corporation (generally a corporation primarily owned by U.S. persons) is subject to immediate taxation on its profits over a specified rate of return based on depreciable assets. For an IP holding company, which has few such assets, most income will be subject to these GILTI provisions. However, the GILTI provisions also provide a bit of a tax break. Under the GILTI provisions, while income is currently taxable, where a U.S. parent C corporation holds the foreign entity, the effective tax rate of the parent entity for the GILTI income of the non-U.S. IP holding company is half its normal rate (i.e., 10.5 percent).

The 2017 act also provides a beneficial U.S. company structure in the vein of a patent box. If the startup establishes a wholly owned U.S. C corporation subsidiary, the Foreign Derived Intangible Income provisions can potentially reduce the effective corporate tax rate to 13.125 percent on the foreign income of this subsidiary. This has the benefit of simplicity. For a startup, it will be generally easier to manage a U.S. entity. In this scenario, all IP may potentially be licensed via the U.S. IP holding company instead of bifurcating the IP licensing.

Therefore, the 2017 act has provided startups with substantially more structuring options to consider. Startups should carefully evaluate each option to ensure they are utilizing the structure that best suits their needs.

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