Tax Considerations and Pitfalls to Avoid for Fintech Startups

**A Practical Guidance® Article by
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Creating a financial technology (fintech) firm comes with a host of tax considerations and implications. Decisions about the business's structure, along with the location of both the business itself as well as its employees, can affect the entity's tax obligations.

Formation

Characteristics of a fintech business and specific concerns of the business owner(s) will ultimately drive its structure. Considerations about the insulation of personal assets from the business, whether the entity is the right fit for the business model, and tax characteristics all play into the final decision. Each structural option comes with its own system for how the income and losses of a business will be taxed, including the following.

Sole Proprietorships

- For tax purposes, the individual owner is the owner of the business.
- An individual's tax rate depends on whether the relevant income is ordinary or capital in nature.
- Losses can generally offset income, subject to limitations.
- There is no liability protection, meaning the owner is responsible for all debts and obligations of the business.

Limited Liability Companies (LLCs)

- LLCs are a state law entity concept that has no direct entity mirror under federal tax rules.
- Tax determination is made via certain default rules or, in some cases, through a so-called "check the box" election, which generally allows an unincorporated organization to elect to be treated either as an association taxable as a corporation or as a partnership if it has multiple members.

- Fintechs set up as LLCs often choose to be treated as corporations for tax purposes.

C Corporations

- Earnings are subject to two levels of taxation: the corporation and shareholder levels.
- Certain corporate losses, if not fully utilized, can be carried forward but may be used only against 80% of taxable income.
- C corporations are popular among fintechs since they make for a great form should the business owners wish to issue an initial public offering in the future, and they are also often preferred by venture capital investors.

S Corporations

- S corporations are not subject to tax at the entity level and are treated as flow-through entities.
- Income and losses pass through to shareholders.
- A corporation must meet several requirements to be an S corporation on an ongoing basis, such as not having more than 100 shareholders and having a single class of stock.
- Tax consequences are potentially severe if eligibility is lost.

Partnerships

- Partnerships are not subject to tax at the entity level and are treated as flow-through entities.
- Partners pay tax on the partnership earnings regardless of whether earnings are distributed to the partners.
- Partnerships are extremely flexible, as there are no major restrictions on the types of owners or number of owners, and the structure allows for giving a preferential rate of return for some owners.

No matter the formation choice, owners should meet with a tax advisor to fully understand the tax implications of each option.

Qualified Small Business Stock

A hot topic among fintechs, qualified small business stock (QSBS) can offer tax savings if structured correctly. Section 1202 of the Internal Revenue Code (the Code) provides for the exclusion of some or all of the gain if a QSBS is sold after a five-year holding period. The exclusion primarily requires stock of a C corporation to be acquired at "original issuance" and for the business to meet the qualified small business and active business thresholds.

To maximize one's benefits, those with QSBS should (1) not contribute the stock to a partnership, (2) consider QSBS implications before redeeming any shares, and (3) understand the impact of QSBS representations to potential investors.

To avoid some of the potential pitfalls associated with QSBS, fintech owners should also keep in mind that rollovers can present QSBS issues, there are valuation implications for contributed property, there is no guarantee of continued benefits, and, when "stacking" benefits, take care not to dilute them.

Offshore Tax

From inception to early stages, fintech companies frequently face pressure to look at the potential of going offshore for a number of reasons, including due to regulatory pressures in the United States or foreign investor preference for offshore structures.

However, setting up an international structure can come with some tax traps for the unwary. Therefore, those considering such a move should keep in mind that cross-border structures raise several common tax considerations, including the following:

- **Impact of cross-border transfers of "intangible property" under Code Section 367(d):** "Intangible property" is a broad category that includes any patent, invention, formula, process, design, pattern, or know-how to a program, system, procedure, customer list, technical data, or any item the value or potential value of which is not attributable to tangible property or the services of an individual.
- **"Inversion" issues:** The United States has two sets of "anti-inversion" rules that could impact a transaction involving a foreign owner: Code Section 367(d), which may cause a stock-for-stock exchange to become taxable, and Code Section 7874, which could potentially cause a foreign acquisition corporation to be classified as a US corporation following a stock-for-stock exchange.
- **Remote employees:** Employees in foreign jurisdictions create a taxable presence, whether they are there on a permanent or long-term basis. This means a business will have withholding for employees or social contribution taxes, regardless of the business's profitability.

State and Local Tax

- Potential tax filing requirements should be considered in states where a company has owned or leased real or personal property; employees, agents, or independent contractors; or sales to customers in the state.

- Before opening a facility or office in a particular location, ask if the state or locality offers incentives or credits to businesses. Many areas offer incentive packages to attract economic development, and it is in businesses' interest to attempt negotiating one prior to starting a business.
- Keep track of where employees are working, particularly if they are remote, to avoid tax troubles down the line. Employees working from home can create nexus in a jurisdiction, and if a business is caught unaware, a tax bill may come as a surprise. Therefore, it is important to have controls in place to track withholding tax obligations for remote employees.
- Understand local tax requirements, particularly in places such as the Bay Area, Washington State, and New York City that have specific local taxes that (if owners are not familiar with them) can become unexpected costs for a business.
- Since each state has its own way of taxing equity compensation such as stock options, it is important to understand the rules in a particular state to properly source that compensation for withholding purposes.

For more information on tax considerations, view our presentation Tax Implications for Fintechs as part of the firm's Technology Marathon webinar series.

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