

Forming Your Esports Organization

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Introduction

In 2014 over 27 million people watched the League of Legends World Championships on Twitch and ESPN3. This viewership exceeds that of Game 7 of the World Series or the NBA Finals games. Esports is exploding, and consequently, the number of esports organizations and the legal issues related to them have similarly grown.

The most fundamental legal issue that you as the owner (or owners) of an esports organization will face is something called “corporate formation.” Businesses and organizations can take several different forms. To list just a few examples, there are corporations, limited liability companies (or “LLCs”), general partnerships, limited partnerships, and sole proprietorships. One of the first and most important decisions you will need to make is choosing between these different options and selecting the best legal form for your team—bearing in mind that there are no right or wrong choices.

If you do nothing, you have begun your organization as a sole proprietorship or—if more than one owner is involved—a partnership. The benefit of such structures is that they are inexpensive and uncomplicated. The cost is that owners can be personally liable if the team becomes involved in litigation. This means that the owners can be sued as individuals and their personal assets can be exposed. Sole proprietorships or general partnerships make especially good sense for a business structure where personal liability is not a big worry—for example, a home-based consulting business in which lawsuits are unlikely because there are few contracts and no employees.

But esports organizations regularly enter into contracts and employ both players and staff. As such, there is considerable potential liability for the owners. If the team owners want to avoid personal liability, they must form a corporation or an LLC.

Forming and operating a corporation is more complicated and costly than a sole proprietorship or partnership, but it is worth it for most teams. The main benefit is that team owners can limit their personal liability. Assuming team owners abide by the law and maintain the corporate form, their corporations become separate “persons” in the eyes of the law. If there is litigation, the corporations are sued instead of their owners, and only the corporations’ assets are exposed. Another benefit is a more favorable tax rate structure that, in certain circumstances, enables the team to stash away earnings at a

relatively low tax rate. In addition, a corporation can provide a range of fringe benefits to employees (including the owners), such as allowing tax deductions for business expenses. And because a corporation—unlike the other types of business entities—issues stock certificates to its owners, it can be an ideal vehicle if the team wants to bring in outside investors, reward loyal employees with stock options, or eventually go public.

Finally, you could form your team as an LLC, a newer kind of legal entity. LLCs offer the same protection against personal liability as a corporation, but they are a little more complicated and costly to set up and run than a corporation. That said, an LLC can be more flexible than a corporation in the way you divide profits and management duties. In addition, forming an LLC allows you a tax benefit over the taxation of a corporation. An LLC is taxed like a partnership (profits are taxed on the personal returns of the owners), and there is no “double tax” on corporate profits.

Choice of a corporate form for your esports organization does not have to be permanent. You can start out as a sole proprietorship or partnership and later, if your team grows or the risks of personal liability increase, convert into a corporation or limited liability company. Your accountant or other tax adviser may help you with your determination, since tax issues and your personal financial situation are critical factors.

Sole Proprietorships

If you are the sole owner of a team (the team members are employees or independent contractors of your team) and you are doing business without forming an LLC or corporation, you are doing business as a sole proprietorship. Establishing a sole proprietorship is cheap and relatively uncomplicated. All you really need to do is adopt a team name (making sure you don't use one too close to anyone else's) and file a fictitious business name (“DBA” or “doing business as”) statement. In addition, you may have to obtain a business license to do business under state laws or local ordinances.

From an income tax standpoint, a sole proprietorship and its owner are treated as a single entity. Business income and business losses from the team are reported on your own federal tax return. If you have a business loss, you may be able to use it to offset income that you receive from other sources.

Personal Liability

The main problem with operating an esports team as a sole proprietor is that you have unlimited personal liability. If your business fails, or is sued, the people to whom you owe money (“creditors”) can go after not only your business assets, but your other property as well. This can include your house, your car, and your personal bank accounts. One of the major reasons to incorporate or form an LLC is that, in theory at least, you can avoid this personal liability.

Income Taxes

As a sole proprietor, you and your team are the same for income tax purposes. The income of your business is taxed to you in the year that the team receives it, whether or not you remove the money from the business. By contrast, a corporation is a separate entity for income tax purposes. A shareholder in a corporation does not pay tax on money earned until the shareholder receives payments as compensation for services or dividends. The corporation also pays its own taxes as profits.

Partnerships

If the team will have more than one owner without forming a corporation or LLC, the team is a partnership.

The best way to form a partnership is to have a partnership agreement, although you can have a partnership without a written agreement. Beyond a written agreement, the paperwork for setting up a partnership is minimal—about on par with a sole proprietorship. The income tax paperwork for a partnership is marginally more complex than that for a sole proprietorship.

Personal Liability

As a partner in a general partnership, you face personal liability similar to that of the owner of a sole proprietorship. Your personal assets are at risk for the team's business in addition to all assets of the partnership.

In a partnership, any partner can take actions that legally bind the partnership entity. That means, for example, that if one partner signs a contract on behalf of the partnership, it will be fully enforceable against the partnership and each individual partner, even if the other partners weren't consulted in advance and didn't approve the contract. Also, each partner is liable for injuries caused by any partner while on partnership business.

Income Taxes

The tax situation for a partnership is basically the same as that of a sole proprietorship. A partnership does not pay income taxes. It must, however, file an informational return that tells the government how much money the partnership earned or lost during the tax year. It also tells what share of the income or loss belongs to each partner. Each partner then pays income tax on his or her share, whether or not this income was actually distributed during the tax year. If the partnership loses money, each partner can deduct his or her share for that year from income earned from other sources.

Corporations

The most important feature of a corporation is “limited liability.” You may own all the stock of your corporation, but—if you follow simple procedures—you and your fellow

owners of the corporation will have your personal assets protected from team-related liabilities.

Limited Liability

The main advantage of incorporating an esports team is that, in most circumstances, doing so limits your personal liability. If a court judgment is entered against the team in the form of a corporation, you stand to lose only the money that you've invested in the business. Generally, as long as you have acted in your corporate capacity (as an employee, officer, or director) and without the intent to defraud creditors, your car, home, personal bank accounts, and other property cannot be touched by a creditor. However, banks and landlords (and sometimes clever creditors) often require the personal guarantee of individuals within the corporation. So the limited liability gained from incorporating is not always available. Also, limited liability doesn't protect you if you fail to deposit taxes withheld from employees' wages—especially if you have anything to do with making decisions about what bills the corporation pays first. Because this debt is not dischargeable in bankruptcy (most others are), you want to make sure to deposit all withholdings before you do anything else with money from the team.

The limited liability feature of corporations can be valuable, protecting you from personal liability for:

- Debts that you have not personally guaranteed.
- Injuries suffered by people who are injured by business activities not covered adequately by insurance.

Incorporating can also offer a great deal of protection from the misdeeds or bad judgment of your co-owners. In a partnership, as noted above, each partner is personally liable for the business-related activities of the other partners.

Income Taxes

You may have heard of "S" corporations. This designation refers to a tax election. A regular corporation (sometimes called a "C corporation") is treated as a tax-paying entity separate from its shareholders and must pay corporate federal income tax. A corporation that chooses "S corporation" status does not pay federal income tax; instead, income taxes are passed through to the corporation's owners.

"S" Corporations

Electing to do business as an "S" corporation allows shareholders of corporations to pay income taxes on the same basis as a sole proprietor or a partner. Among other things, this means business losses of the team can be used as an offset against your other income—reducing, maybe even eliminating, your tax burden. An "S" corporation itself does not

pay taxes, but files an informational tax return telling what each shareholder's portion of the corporate income is.

S corporation status (rather than that of a regular corporation) is advisable for several reasons:

- Income from an "S" corporation is taxed at only one level rather than two.
- With an "S" corporation, you generally can pass a first year's loss through to your personal income tax return, using it to offset income that you may have from other sources.
- Your decision to elect to be an "S" corporation is not permanent. If you later find there are tax advantages to being a regular corporation, you can easily drop your "S" corporation status, but timing is important.

However, "S" corporation status is available only to corporations with a limited number of shareholders, and there are limitations on who may be shareholders. (For example, non-resident aliens may not be shareholders). This can affect teams that might have non-U.S. resident owners. Also, "S" shareholders may find themselves with income tax on money that the corporation earned but did not distribute to shareholders. "S" corporations cannot have preferred stock, which may discourage the ability to attract some investors.

Regular "C" Corporations

A regular "C" corporation is a separate entity from its shareholders. This means that the corporation pays taxes on any income left after business expenses have been paid.

A regular "C" corporation reports its income on Form 1120 and pays taxes on that income. In addition, if income is distributed to shareholders in the form of dividends, the shareholders pay taxes on the dividends they receive.

In practice, however, a regular corporation may not have to pay any income tax even though it is a separate taxable entity. If the owners are also employees, they receive salaries and bonuses as compensation. The corporation then deducts this "reasonable" compensation as a business expense. In an esports team, compensation to owner-employees may eat up all the corporate profits, and therefore avoids taxable income for the corporation to pay taxes on.

Fringe Benefits/Options

A "C" corporation can treat the cost of fringe benefits it gives employees, including owner-employees, as tax-deductible business expenses. . For example, a corporation can provide medical insurance for its employees and deduct these payments as a business expense, including the portion paid for the employee-owners of the corporation. Also,

incorporating allows you to offer your employees stock options, which can incentivize employees, such as team members, to increase the profitability and value of the team.

Attracting Investors

To start and successfully run an esports organization, you may need cash. You have two basic options in raising money from outside sources: borrowing it or getting it from investors. If you expect to seek money from investors—even if they are family members, friends or business associates—there is a substantial advantage in forming a corporation. Most investors want to receive a stock certificate in a corporation.

Structuring your team as a corporation is not only advantageous but actually essential if—like many small business owners—you dream of someday attracting investors through a public offering.

Limited Liability Companies

Limited liability companies (LLCs) are a newer form of business entity. The LLC form gives you the limited liability advantages of a corporation with the tax treatment and flexibility of a partnership.

Limited Liability

Owners of an LLC (who are called members) enjoy limited personal liability. This means that a member of an LLC is not normally exposed to legal liability for business debts and court judgments against the business. As with a corporation, you will be responsible for any business debts that you personally guarantee. By contrast, owners of a sole proprietorship or partnership have unlimited liability for business debts.

Tax Flexibility

An LLC will be treated as a partnership for tax purposes with each partner reporting and paying income tax on his/her share of income.

Flexible Management Structure

The members jointly run the LLC unless they choose to have it run by a single member, an outside manager, or a management group. The members must negotiate and sign an operating agreement which spells out how the business will be managed. This can be a time consuming and expensive process, but provides a great deal of flexibility for the management of the team.

Flexible Distribution of Profits and Losses

The members of an LLC can decide to split up the LLC profits and losses any way they want. Although it is common to divide LLC profits according to the percentage of the

business's assets each member contributed, this is not legally required. In comparison, a corporation's shareholders must receive dividends according to the number of shares they own.

Choosing Between a Corporation and an LLC

The flexibility of the LLC makes it a better choice if flexibility in management or distribution of profits from the team is important.

Certain factors about your team and plans may tip the balance toward a corporation. Such factors include the following:

- You expect to have multiple investors or to raise money from the public. While an LLC works fine when you have just a few investors—especially those who will be active in the day-to-day operations of the business—it may get more awkward when the number of investors increases.
- You want to entice or keep key employees by offering stock options and stock bonus incentives. LLCs don't have stock; corporations do. Therefore, if you plan to offer ownership in your business as an employee incentive, it makes sense to incorporate rather than form an LLC.

Conclusion

This article provides you with general information to assist you in deciding how to best organize your esports team. Obviously, however, it is impossible to cover every nuance of tax and business law that applies. Unless your team will start small and have a very simple ownership structure, before you make your final decision on a business entity, you'll want to check with your accountant or tax adviser as well as your lawyer.

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