



PROGRAM MATERIALS
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Choosing the Right Business Entity

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Choosing the Right Business Entity:

Legal Structure, Tax Treatment, and Other Considerations

Presented By | **Caitlin Rieser**



ABOUT ME

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Today's Topics

- Overview of entity options
- Formation requirements and governing documents
- Ownership requirements and considerations
- Equity types and considerations
- Equity incentives / stock-based compensation
- Other tax considerations
- Management structures
- Ownership transfers and restrictions
- Exit planning and liquidity/dissolution events
- Common pitfalls

CHOICE OF ENTITY

Sole
Proprietorship


Partnership

LLC


C Corporation

S Corporation

	Limited Liability	Taxation	Ownership Restrictions	SE Tax on Profits	Sep. EIN Required
SP	No	Single	No	Yes	No
GP	No	Single	No	Yes	Yes
LP	Some	Single	No	Some	Yes
LLP	Yes	Single	No	Yes	Yes
LLC	Yes	Single	No	Yes	Maybe
C-Corp	Yes	Double	No	No	Yes
S-Corp	Yes	Single	Yes	No	Yes



	Management	Tax on Formation	Tax on Exit	Separate Tax Return
SP	Owner	No	No	No
GP	Owners	No	No	Yes
LP	General Partner	No	No	Yes
LLP	Owners	No	No	Yes
LLC	Owners or Managers or Board	No	No	Maybe
C-Corp	Board	No	Yes	Yes
S-Corp	Board	No	Yes	Yes



Preliminary Formation Matters

Help the client select the right entity type

- Is the client aware of the different structures and their legal and tax considerations?

Select the state of formation

- Delaware is the most popular choice, but is there a reason to select another state?
- Where will the business be physically located?
- Will the business need to qualify to do business in other states?
- What are the associated filing fees and state and local-level taxes?

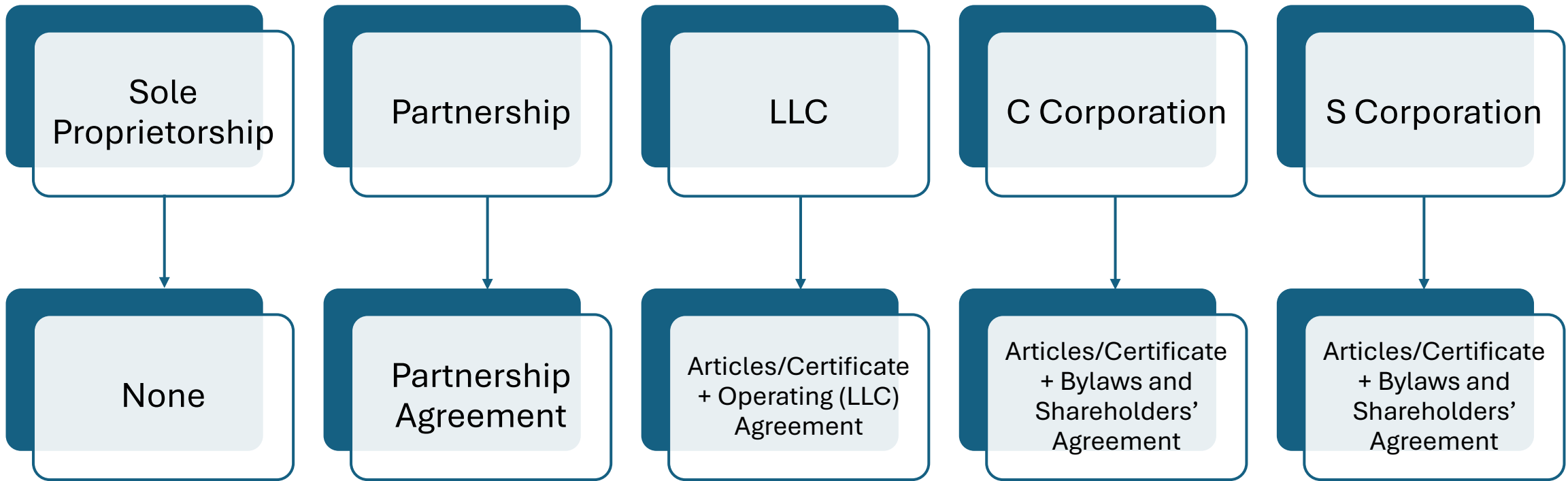
Choose a company name

Decide ownership, management, registered agent, etc.

Draft and file the formation document

ENTITY TYPES

AND THEIR GOVERNING DOCUMENTS



Formation Documents

Partnerships may not require formation documents. Formation is tax free under Code section 721.

LLCs require Articles of Organization (or Certificate of Formation)

Corporations require Articles (or Certificate) of Incorporation. Formation is tax free under Code section 351.

Basic Provisions:

- Name of company
- Name and address of registered agent
- Principal office address
- Management structure
- Amendments
- Miscellaneous provisions (e.g., indemnification, limited liability, etc.)

Additional Documents to Consider at Formation

Form SS-4 (and Authorization)

- Most entities will need to obtain an FEIN

Organizational (Incorporator) Action and/or Board Action

- What actions does the entity need to take/authorize to get up and running?

Certificate of Authority (if out-of-state)

Tax Registrations

Tax Elections (e.g., Form 8832 or Form 2553)

Nonprofit Considerations

- If the entity is a nonprofit, it will need to file Form 1023 or a similar form to obtain tax-exempt status. There may also be state-level requirements, such as registering to fundraise, etc.

Regulatory Considerations

- Does the entity need licensing or other regulatory approval depending on its industry?

Ownership Considerations

C Corporation:

- One or more stockholders.
- No restrictions on the types of owners.

S Corporation:

- One to 100 stockholders.
- With certain limited exceptions, only US individuals (citizens or residents) can be stockholders. Certain trusts and exempt organizations can also be stockholders.
- Only eligible US entities can make an S-corporation election.

LLC:

- One or more members.
- No restrictions on the types of members.

LP:

- Two or more persons, consisting of one or more general partners and one or more limited partners.
- No restrictions on the types of owners.

Equity Considerations

C Corporation:

- Equity takes the form of capital stock. There are two basic types: common stock and preferred stock.
- There may be multiple classes and series of stock with different rights and preferences.
- Some stock may be eligible for qualified small business stock (QSBS) exemption.

S Corporation:

- Only one type of capital stock: common stock.
- Only one class of stock is permitted (e.g., same rights with respect to distributions), but there can be differences in voting rights.
- Certain debt instruments as well as certain options, warrants, and similar instruments may be treated as a second class of stock and thus terminate the S-corp election. If the governing document is drafted incorrectly regarding stock classes / distributions, it could also threaten the election.

LLC:

- Equity generally expressed as a percentage interest or may be represented by Units (similar to corporate stock)
- Can have classes with different rights and preferences (e.g., regarding voting, distributions, etc.)

LP:

- Partnership interests split between general partner(s) and limited partner(s)

Brief QSBS Overview

Definition of QSBS: Stock of a US C-corporation, that is a qualified small business conducting a qualified active business, which such stock is acquired at its original issuance

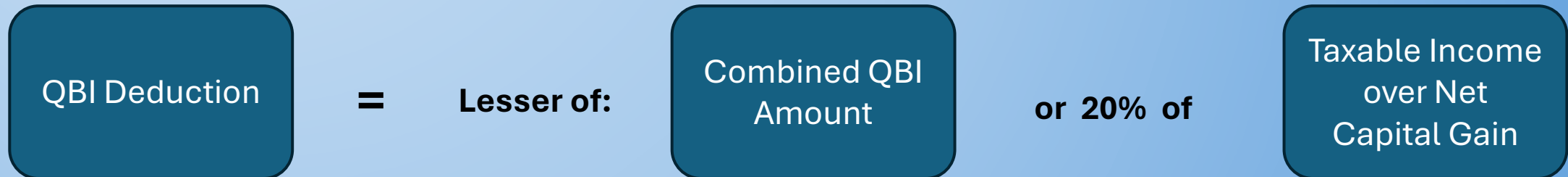
Gain Exclusions:

- For qualifying stock acquired after August 10, 1993 and on or before September 28, 2010, there is partial gain exclusion if a more than five-year holding period is met.
- For qualifying stock acquired after September 27, 2010 and on or before July 4, 2025, there is 100% gain exclusion if a more than five-year holding period is met.
- For qualifying stock acquired after July 4, 2025, there is a three-tier percentage gain exclusion structure, with the percentage of excludable gain depending on whether the taxpayer meets either a three-year, four-year, or five-year holding period (with 100% gain exclusion if the taxpayer has held the stock for at least five years).

Brief QBI Overview

Source: Code Section 199A

Basic Formula:



Equity Incentives

C Corporation:

- Stock options can be granted to employees and can qualify as incentive stock options (ISOs).
- Other common forms of equity compensation include stock appreciation rights (SARs), restricted stock, restricted stock units (RSUs), and performance awards.

S Corporation:

- Same as C corporations but care must be given to second class of stock issue.

LLC:

- Profits interests are generally granted to employees or service providers, which results in them being treated as partners for tax purposes.
- ISOs are not available. Other equity incentive options are generally not available or at least very uncommon in the LLC context.

LP:

- Same as LLCs (assuming taxed as partnership).

Other Tax Considerations

C Corporation

Two levels of tax

Can participate in tax-free reorganizations under Code section 368

S Corporation

One level of tax (pass-through entity)

Can participate in tax-free reorganizations under Code section 368

LLC/Partnership

Can generally pick its tax treatment (disregarded, partnership, or corporation)

Cannot participate in tax-free reorganizations under Code section 368 (except for SMLLC/DREs in some cases)

Other Tax Considerations

C Corporation

Distributions generally must be proportionate to stock ownership within each class of stock.

Dividends/distributions are taxable.

S Corporation

Distributions must be proportionate or they will violate the one class of stock rule.

LLC/Partnership

Distributions generally governed by detailed provisions in LLC/Partnership Agreement. Same with tax allocations.

Management Structures and Considerations

C Corporation

Governed by Board
of Directors

S Corporation

Governed by Board
of Directors

LLC

May be member-
managed or
manager-managed
or may have a
Board

LP

Management
vested in general
partner(s)

Other Considerations:

- Appointment/Election, Term, Removal, etc.
- Voting mechanics
- Are there 'major decisions' that require shareholder/member approval?
- What happens in the event of a deadlock?

Transfer Restrictions

Corporations transfer provisions are contained in the Shareholders' Agreement.

LLCs transfer provisions are contained in the Operating (LLC) Agreement.

Partnerships transfer provisions are contained in the Partnership Agreement.

Common Provisions:

- Right of First Refusal
- Permitted/Family Transfers
- Drag-Along Rights
- Tag-Along Rights
- Involuntary Transfers

Additional Consideration: Valuation

Exit Planning

Dissolutions:

Corporations generally recognize gain or loss on distributions in complete liquidation (Code sec. 336) and its shareholders generally recognize a capital gain or loss (Code sec. 331). On the other hand, parent-sub liquidations may be tax-free (Code secs. 332 and 337).

No partnership “liquidation” per se, but partners are taxed under Code sec. 731 and 736 on liquidating distributions.

Succession Planning/Exit Strategies:

- IPOs
- Private Third-Party Sales
- Transfer provisions in governing documents

Changing Entity Form: An entity may want to exit its current form (e.g., C-corp to LLC, partnership to S-corp, etc.). Conversions have their own tax consequences.

Common Pitfalls

- Not understanding entity choices and differences
- Poorly drafted (or missing!) Bylaws, Operating Agreements or other governing documents
- Ignoring formalities
- Failing 351 for nonrecognition treatment
- No special/regulatory tax allocations for partnerships
- Incorrect or vague distribution provisions
- Unclear voting mechanics and percentages required to take action
- Preferred returns or other improper language in S-corp governing documents

Practical Example

Target Capital Account Method for Partnership Allocations – SAMPLE LANGUAGE

“Allocation of Net Income and Net Loss. For each Fiscal Year (or portion thereof), except as otherwise provided in this Agreement, Net Income and Net Loss (and, to the extent necessary, individual items of income, gain, loss, or deduction) of the Company shall be allocated among the Members in a manner such that, after giving effect to the special allocations set forth in Section [XX], the Capital Account balance of each Member, immediately after making such allocations, is, as nearly as possible, equal to (i) the distributions that would be made to such Member pursuant to Section [YY] if the Company were dissolved, its affairs wound up and its assets sold for cash equal to their Book Value, all Company liabilities were satisfied (limited with respect to each Nonrecourse Liability to the Book Value of the assets securing such liability), and the net assets of the Company were distributed, in accordance with Section [YY], to the Members immediately after making such allocations, minus (ii) such Member's share of Company Minimum Gain and Member Nonrecourse Debt Minimum Gain, computed immediately prior to the hypothetical sale of assets.”

Miscellaneous Considerations re Entity Choice

- Regulatory compliance – the industry in which the entity operates may require it be formed a certain way and/or in a certain state.
- Variability in LLC statutes – states differ in default rules governing fiduciary duties, member rights, allocation provisions, etc. This may be overcome by the operating agreement but state laws also differ in what can be waived or not.
- Corporate law differences – corporate statutes are more standardized, but key distinctions remain (e.g., Delaware's DGCL vs. home-state rules).
- State-level taxes and fees – franchise taxes, gross receipts taxes, and annual reporting requirements may influence entity and state selection.
- Foreign qualification requirements – operating in multiple states and may require registration and compliance with each state's rules.



Questions?