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U.S. LEGAL ENTITY FORMATION AND FEDERAL INCOME TAX STRUCTURING GUIDE

As of November 2023

You're starting a new enterprise. Perhaps it's a business. Perhaps it's a socially conscious business. Perhaps it's a non-profit. You might be wondering whether you need an LLC or some other kind of legal entity. And you also might be wondering how to be smart about taxes and tax planning as you set up your new venture.

This guide helps make sense of it all.[1]

<u>Question 1: Do I need to set up a legal entity?</u>

Short answer: Generally, yes. You technically can operate as a "sole proprietorship," which means you have a business (i.e., customers, revenue, expenses, a website, etc.) but no legal entity for the business. That said, a legal entity is quick and easy to set up and can help protect your personal assets from your business' creditors, which is especially helpful if your business gets sued, fails, or runs out of money.

<u>Question 2: Should I form my legal entity in my state or in another state?</u>

Often, it makes sense to form your legal entity in the state where your business has its primary operations. This is because you will avoid duplicate registration fees. For example, if you form a legal entity in Delaware but operate your business in California, Delaware will charge you money for legal entity formation and then California likely will charge you fees and taxes to operate as an out-of-state Delaware business in California. You likely would incur lower overall fees by simply forming a California legal entity for your California business, in this example.

That said, a Delaware entity is always a solid choice because it is the most widely recognized. If you have big plans for growth, plan to take on investors, or eventually want to sell your company to a buyer, Delaware makes sense.

[1] LEGAL, INVESTMENT AND TAX NOTICE: This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. The reader should under no circumstances rely upon this information as a substitute for obtaining specific legal or tax advice from his or her own legal or tax advisors.

Question 3: When it comes to legal entities, what is the menu of available options?

Most U.S. states allow you to form the following types of legal entities:

1. Corporation ("C-Corp") (a.k.a., General Stock Corporation)
2. Limited Liability Company ("LLC")
3. General Partnership ("GP")
4. Limited Partnership ("LP")
5. Professional Corporation ("PC") (a.k.a., Professional Service Corporation)

And some U.S. states allow you to form more specialized types of legal entities:

1. Public Benefit Corporation ("PBC") (a.k.a., Benefit Corporation)
2. Social Purpose Corporation
3. Close Corporation
4. Professional Limited Liability Company ("PLLC") (a.k.a., Professional Service Limited Liability Company)
5. Limited Liability Partnership ("LLP")
6. Limited Liability Limited Partnership ("LLLP")
7. Cooperative ("Coop")
8. Cooperative Association
9. Limited Cooperative Association
10. Specialty Cooperative (e.g., Agriculture, Cannabis, etc.)
11. Non-Profit Corporation
12. Decentralized Autonomous Organization ("DAO")

You might be thinking – What?!?!? You have GOT to be kidding me. How are there so many options?! Don't panic yet. The tax questions below will help you narrow down your choice of legal entity.

Question 4: Does every legal entity listed above provide liability protection?

Unfortunately, no. Some entity types provide more protection than others. For example:

- In a General Partnership, each general partner is fully liable for the partnership's liabilities.

- In a Limited Partnership, the general partner is fully liable for the partnership's liabilities. This general partner itself can be a person or it can be another legal entity.
- Professional Corporations and Professional Limited Liability Companies provide general liability protection but do not protect the professionals against liability for negligence or malpractice (e.g., legal or medical malpractice).
- Limited Liability Partnerships protect partners against some liabilities but not others, and details vary a lot by state.
- Decentralized Autonomous Organizations are relatively new and untested. States with DAO statutes generally imbue DAOs with liability protection, but that protection may not hold up in other jurisdictions (i.e., other states, countries, etc.).

The other types of legal entities generally provide good liability protection. But there are two things to note.

First, be aware that the unique legal documents for your legal entity (e.g., corporate bylaws, LLC operating agreement, etc.) could waive, alter, or weaken the entity's liability protection. This is because those documents can override your state's default laws.

Second, your entity must observe corporate formalities. If it doesn't, a creditor could argue that your entity is not a real legal entity and therefore should not protect you from liability. Corporate formalities include things like:

(a) the legal entity should have its own bank account,

(b) the legal entity should maintain separation between business assets and the owners' personal assets,

(c) the legal entity should follow the procedures outlined in its legal documents (e.g., holding quarterly or annual board meetings), and

(d) the legal entity should keep good books and records (e.g., board meeting minutes, financial statements, etc.).

<u>Question 5: What about the S-Corporation and the 501(c)(3)? I didn't see those on the list of legal entities.</u>

One of the most important mental distinctions in the legal and tax arena is the distinction between state law classification and U.S. federal income tax classification. For state law purposes, there is no such thing as an S-Corporation or a 501(c)(3). Those designations are creatures of the Internal Revenue Code of 1986, as amended (the "Tax Code" or simply the "Code").

<u>Question 6: When it comes to U.S. federal income tax classification, what is the menu of available options?</u>

In the eyes of the U.S. federal income tax law, a legal entity can be classified as:[2]

1. An entity disregarded as separate from its owner (a.k.a., a "disregarded entity" or "DRE")
2. A Partnership (Sections 701 to 761 of the Code) (a.k.a., "Subchapter K")
3. An S-Corporation (Sections 1361 to 1379 of the Code)
4. A Cooperative (Sections 1381 to 1388 of the Code) (a.k.a., "Subchapter T")
5. A C-Corporation
6. A C-Corporation that is a qualified small business (Section 1202 of the Code) ("QSB")
7. A Non-Profit (Section 501 of the Code)

<u>Question 7: Of the available federal tax classifications, which one do I want to choose? Which tax classification will help me pay the least amount of U.S. federal income tax?</u>

Most start-ups and small businesses choose pass-through classification – either S-Corporation or partnership. S-Corporation classification can help reduce payroll taxes, but the 100-shareholder limitation can be a problem for some businesses. A business that does not plan to raise money from a private equity fund, from international

[2] Specialty tax classifications like Farmer Cooperatives under Code Section 521, Insurance Businesses, Banks, Real Estate Investment Trusts ("REITs"), Real Estate Mortgage Investment Conduits ("REMICs"), Regulated Investment Companies ("RICs"), Investment Companies, Domestic International Sales Corporations ("DISCs"), Series LLCs, Utilities (including electric or telephone service to rural areas), and Indian tribal governments are beyond the scope of this guide. Trusts also are not included here because they generally cannot be formed for business purposes.

investors, or from more than 100 shareholders likely will choose S-Corporation classification for maximum tax-efficiency; otherwise, partnership classification could be the best choice. This is because a partnership can raise capital from a wider variety of investors.

Disregarded entity classification is rare for businesses that want to grow sizably because the entity can only have one owner/shareholder. This means the business can only attract debt capital, not equity, from outside investors. It also means that the business cannot grant equity ownership to motivated employees. That said, if you are growing a business that is not capital intensive and you want to own and control 100% of the equity in the business for the foreseeable future, a DRE could be a simple and elegant solution. Independent contractors and solo practitioners with modest income often use DREs. Then, as the independent contractor or solo practitioner's income grows, he or she might convert the DRE to an S-Corporation to shield a portion of his or her income from payroll tax.

Although most start-ups and small businesses choose pass-through classification, C-Corporation classification can make sense if the business plans to reinvest most or all of its profits into the business to fuel rapid growth. You'll often hear that C-Corporations mean "double taxation." This is because, as you can see in the chart below, the corporation itself pays 21% tax on profits *and then* the shareholders pay tax at up to 40.8% on dividends they receive from the corporation. This means that up to 61.8% of a C-Corporation's profits can end up in the hands of the federal government! This is a really high tax, and it's dramatically more than the top rate of 40.8% for a pass-through like a partnership or S-Corporation. But, if the management of the C-Corporation does not plan to pay dividends to shareholders but instead plans to keep all the money inside the corporation, then, in practice, there is only single taxation – the 21% corporate-level tax, which is more favorable than the 40.8% top pass-through tax. Bottom line: For a business that plans to reinvest all its profits, grow rapidly and then sell its stock to a strategic buyer, a C-Corporation might be a good fit.

On the topic of C-Corporations, Section 1202 QSB status simply magnifies the benefits of C-Corporation classification for a start-up that plans to reinvest profits aggressively, grow quickly, and exit with a stock sale. Section 1202 says that shareholders do not have to pay capital gains tax on all or a portion of the capital gain inherent in their C-Corporation stock when they sell that stock, if the stock is qualified small business stock ("QSBS"). This means that, at the end of the day, owners of QSBS and investors/shareholders of QSBS could potentially pay almost no tax. The reasoning here is that owners/investors/shareholders of QSBS (a) probably won't get dividends from the growing company, and (b) likely won't pay any capital gains tax on exit when a buyer buys the stock of the company.

Cooperatives also are a type of C-Corporation – one that meets the requirements of Subchapter T of the Code. It can make sense to choose cooperative tax status if your business will look and feel like a traditional cooperative – think a consumer, producer, or buyer cooperative like a grocery store coop, an agricultural coop or a small business purchasing coop. However, if you are a business that is capital intensive or that wants to scale quickly, you might consider using an LLC taxed as a partnership or an S-Corporation. This is because you can still adopt cooperative principles (e.g., democracy, autonomy, equality, etc.) in the management and legal documents of your LLC or S-Corporation, but you don't have to shoehorn your business model into Subchapter T of the Code. Under Subchapter T, the IRS generally expects you to govern your cooperative and make economic distributions to members in a way that accords with their relatively traditional view of cooperatives. Bottom line: If you plan to look and feel like a traditional coop, Subchapter T cooperative status could be a good fit. But, if you simply want to adopt cooperative principles in your business, an LLC or S-Corporation could give you more freedom and flexibility in how you run your business.

Non-profits, like trusts, are not generally suitable for a business enterprise. If you plan to accept donations and give away money, non-profit classification makes sense. If you plan to sell products or run a company, non-profit classification is almost never a good fit. This is true even if you are selling products to people in need for below-market prices. For example, the IRS denied 501(c)(3) status to a non-profit organization that raised money and invested that money in an affiliate company that manufactured fuel-efficient stoves. That stove company sold those stoves to people in developing countries for cost in order to "alleviate poverty in the developing world by empowering communities to improve the lives of their members through the implementation of programs which yield economic, social, and environmental change."[3] The IRS wasn't convinced. In the IRS' eyes, non-profit tax classification and business don't mix. Bottom line: If you're starting a business, non-profit status is not a viable option. If you're starting a charity, non-profit status likely is the right fit.

Question 8: Ok. I know which legal entity I'd like to choose. I know which federal income tax classification I would like. How do I match these up and put them together?

Take a look at the list of available legal entity types in your state. From the name, consider whether that legal entity might be a good fit for the type of business you want to operate. For example, if you are starting a cooperative, consider whether a cooperative association might be the right entity choice. Then, consider how you would like to be taxed. For example, you might decide that S-Corporation classification is best for you because you do not anticipate having more than 100 individual shareholders. Finally, take a look at the chart below and see whether the legal entity you are considering can be taxed the way you want to be taxed. If the contemplated legal entity is not eligible for the federal tax classification you want, pick another legal entity that offers similar liability protection (see Question 4 above) but that also allows you to enjoy the federal tax classification you want.

[3] IRS Private Letter Ruling 201424024.

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	How can this legal entity be classified for U.S. federal income tax purposes?						
	DRE	**Partnership**	**S-Corporation**	**Cooperative**	**C-Corporation**	**QSBS**	**Non-Profit**
Corporation	No	No	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	Yes
Limited Liability Company ("LLC")	Yes	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	Yes
General Partnership ("GP")	No	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	No
Limited Partnership ("LP")	No	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	No
Professional Corporation ("PC")	No	No	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Technically, yes. But, it will be difficult because most professional services are not "qualified trades or businesses" under the QSBS rules.	No

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	How can this legal entity be classified for U.S. federal income tax purposes?						
	DRE	**Partnership**	**S-Corporation**	**Cooperative**	**C-Corporation**	**QSBS**	**Non-Profit**
Public Benefit Corporation ("PBC")	No	No	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	Yes
Social Purpose Corporation	No	No	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	Yes
Close Corporation	No	No	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	Yes
Professional Limited Liability Company ("PLLC")	Yes	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	No
Limited Liability Partnership ("LLP")	No	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	No
Limited Liability Limited Partnership ("LLLP")	No	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	No

	How can this legal entity be classified for U.S. federal income tax purposes?						
	DRE	**Partnership**	**S-Corporation**	**Cooperative**	**C-Corporation**	**QSBS**	**Non-Profit**
Limited Partnership Association	No	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	Yes, if all QSBS requirements are met	No
Cooperative (“Coop”)	No, unless only 1 member	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	No	No
Cooperative Association	No, unless only 1 member	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	No	No
Limited Cooperative Association	No, unless only 1 member	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	No	No
Specialty Cooperative (e.g., Agriculture, Cannabis, etc.)	No, unless only 1 member	Yes	Yes	Yes, if the entity is taxed as a C-Corporation	Yes	No	No
Non-Profit Corporation	No	No	Not Applicable	Not Applicable	Not Applicable	Not Applicable	Yes
DAO	Unclear. The IRS has not issued guidance on this yet.						

APPENDIX 1

Entity Formation Checklist and Next Steps

1. Form legal entity under state law on your state's Secretary of State website.
2. File Form SS-4 with the IRS to obtain an Employer Identification Number ("EIN") for your new entity, if necessary. This form can be filed online at https://www.irs.gov.
   a. Check with your state department of revenue to see whether a state tax ID number is required.
3. File Form 8832, 2553, or 1023 with the IRS to elect your federal tax classification, if necessary.
4. Hire a lawyer or online legal service to create your formation documents. These will vary by legal entity. For example, an LLC has an operating agreement whereas a corporation has bylaws.
5. File a Beneficial Ownership Information Report with the U.S. Financial Crimes Enforcement Network ("FinCEN"), if required. Make sure to update the report any time the information in the report changes. https://www.fincen.gov/boi.
6. Open a separate bank account in the name of your legal entity so that you avoid comingling business and personal funds.
7. Check any business formation or registration requirements in your state, county, and/or town (e.g., business licenses, workers' compensation, unemployment insurance, etc.)
8. Maintain financial records and statements. An accountant and/or accounting software like Quickbooks can be helpful here.
9. Consider whether you need any human resources infrastructure such as an employee handbook, company policies, a bonus or stock option plan, a retirement plan, group medical/dental/vision insurance, etc.
10. Going forward:
    a. File annual reports and pay the associated fee/tax with your Secretary of State to keep your legal entity in good standing.
    b. Hold regular board meetings as specified in the governing documents for your legal entity. Maintain meeting minutes and records (e.g., board resolutions) for those board meetings.

c. File federal and state tax returns (e.g., income tax, payroll tax, excise tax, etc.) and make necessary tax payments (e.g., annual income tax, quarterly estimated tax, etc.)