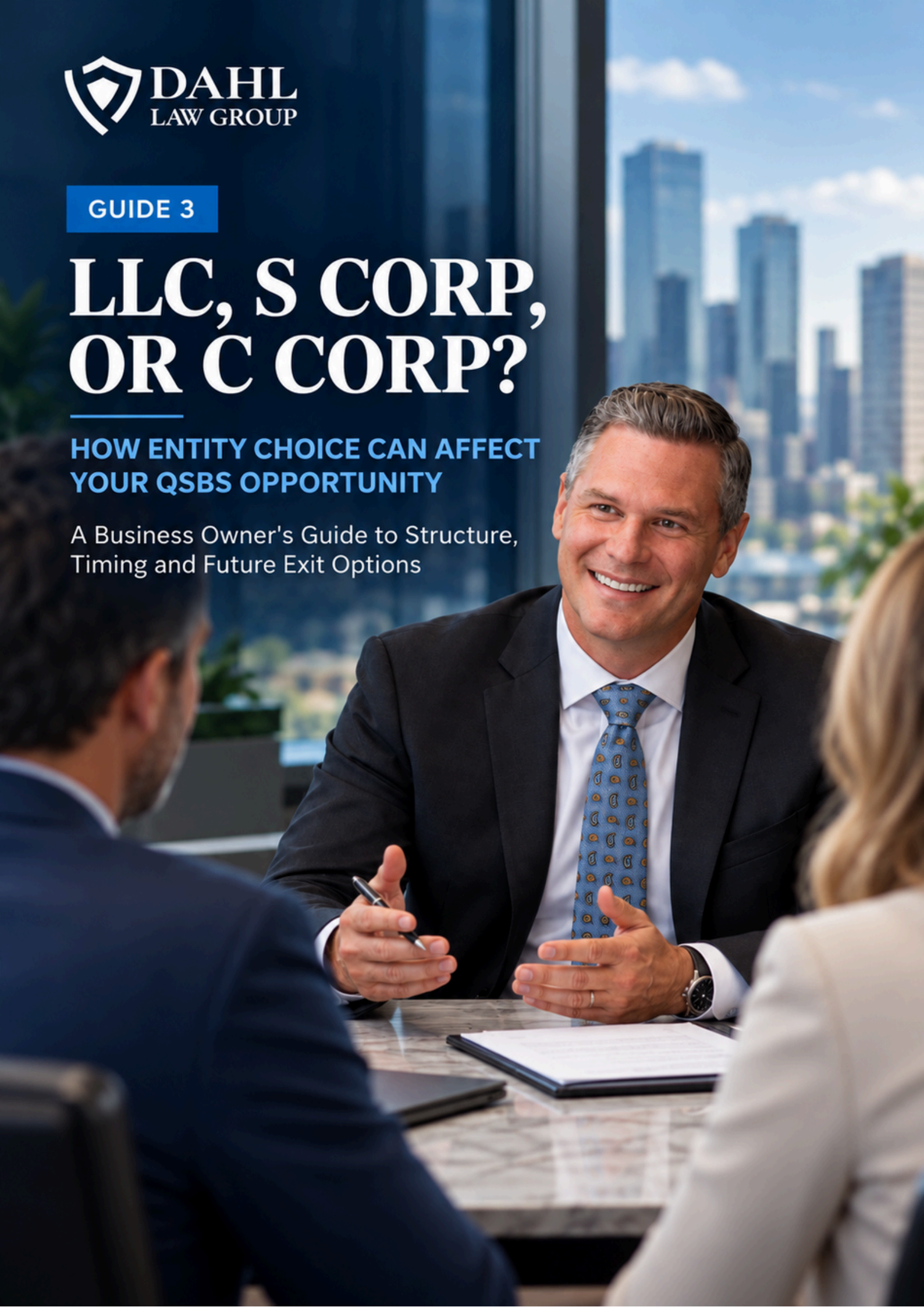
DAHL LAW GROUP

GUIDE 3

LLC, S CORP, OR C CORP?

HOW ENTITY CHOICE CAN AFFECT YOUR QSBS OPPORTUNITY

A Business Owner's Guide to Structure, Timing and Future Exit Options



WHY ENTITY CHOICE MATTERS

YOUR ENTITY CHOICE CAN CHANGE WHEN THE QSBS CLOCK STARTS

Business owners usually choose an entity based on current taxes, cash flow, ownership and administrative needs. But if a future sale is possible, another question belongs on the list:

COULD THIS ENTITY STRUCTURE AFFECT MY FUTURE QSBS OPPORTUNITY?

QSBS generally requires qualifying stock issued by a domestic C corporation. An LLC, partnership or S corporation cannot itself issue QSBS directly. That does not automatically mean every business should become a C corporation. It means entity choice can influence when a potential QSBS opportunity begins, whether it begins at all, and how much future appreciation may fall inside that opportunity.

LLC / PARTNERSHIP

LLC

- Pass-through structure
- No QSBS stock issued yet
- QSBS clock generally has not started

S CORPORATION

S

- Pass-through taxation
- S-corporation shares are not QSBS
- Later conversion does not retroactively change old shares

C CORPORATION

C

- Can issue qualifying stock
- If all other requirements are satisfied
- QSBS holding period can begin

WHAT THIS MEANS FOR YOU

The real question is not “Which entity is best?” It is: “Which entity best supports my business today without closing off options I may want later?”

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

DECISION 1

ONLY A C CORPORATION CAN ISSUE QSBS

The starting point is straightforward:

THE ISSUING ENTITY MUST BE A C CORPORATION

Qualifying stock generally must be acquired at original issuance from the corporation or underwriter in exchange for money, qualifying property or services.

DOMESTIC C CORPORATION
Issuing entity

↓

ISSUES NEW STOCK
Direct original issuance

↓

POTENTIAL QSBS
If the other §1202 requirements are met

LLC
Cannot issue QSBS directly

PARTNERSHIP
Cannot issue QSBS directly

S CORPORATION
Cannot issue QSBS directly

POTENTIAL BENEFIT

If qualifying C-corporation stock is issued early, the shareholder may begin building toward the applicable QSBS holding period while the company continues to grow.

POTENTIAL CONSEQUENCE

If the business remains in a structure that cannot issue QSBS, years of growth may occur before the QSBS clock ever begins.

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

DECISION 2

AN LLC CAN PRESERVE FLEXIBILITY – BUT THE QSBS CLOCK IS NOT RUNNING YET

Not every founder wants C-corporation taxation on day one. A "wait-and-see" LLC can preserve flexibility while owners decide whether a future C-corporation structure and QSBS opportunity are worth pursuing.

START AS AN LLC

- Pass-through taxation
- Operational flexibility
- No immediate need to commit to C-corporation taxation

BUT

0

NO QSBS CLOCK IS RUNNING YET

TWO POSSIBLE FUTURES

PATH A – STAY PASS-THROUGH

- Remain pass-through or make an S election
- Preserve pass-through treatment
- No direct path to newly issued QSBS while remaining an S corporation

PATH B – MOVE TO C CORPORATION

- Move the business into a C corporation
- New C-corporation stock may potentially qualify
- QSBS holding period begins when qualifying stock is issued

POTENTIAL BENEFIT

An LLC can give founders time to evaluate whether their business model, growth trajectory and likely exit make C-corporation/QSBS planning worthwhile.

POTENTIAL CONSEQUENCE

Waiting also has a cost: earlier LLC years generally do not become years of QSBS ownership simply because the business later converts.

WHAT THIS MEANS FOR YOU

Flexibility can be valuable. But flexibility and delay are not the same thing. If the business begins appreciating rapidly, the cost of waiting may grow with it.

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

DECISION 3

AN S CORPORATION CAN SOLVE ONE TAX PROBLEM WHILE CLOSING ANOTHER DOOR

An S corporation is attractive to many closely held businesses because it preserves pass-through taxation and may provide payroll or self-employment-tax planning opportunities. But from a QSBS perspective, S corporations cannot issue QSBS.

S CORPORATIONS CANNOT ISSUE QSBS

STAY OR BECOME AN S CORPORATION

- Pass-through taxation
- No C-corporation entity-level income tax
- Potential payroll-tax planning benefits depending on the facts

QSBS CONSEQUENCE

Shares issued while the business is an S corporation are not QSBS.

LATER CONVERT TO A C CORPORATION

C

After conversion, newly issued stock may potentially qualify if all other QSBS requirements are independently satisfied.

IMPORTANT

Old S-corporation shares do not become QSBS retroactively.

POTENTIAL BENEFIT

An S corporation may make sense when the immediate pass-through tax advantages matter more than a future QSBS opportunity.

POTENTIAL CONSEQUENCE

If substantial value has already been created, converting later may leave much of the earlier ownership history outside the potential QSBS benefit.

WHAT THIS MEANS FOR YOU

Do not treat an S election as only a current-year tax decision. Ask: “If this company becomes very valuable, what exit options am I giving up today?”

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

IMPORTANT DISTINCTION

AN LLC MAY HOLD QSBS EVEN THOUGH IT CANNOT ISSUE IT

An LLC may be unable to issue QSBS but, depending on how it is taxed, may sometimes hold qualifying C-corporation stock without destroying the individual owner's treatment.

SINGLE-MEMBER LLC



If the single-member LLC is disregarded for federal income tax purposes, the individual owner is generally treated as directly holding the QSBS for §1202 purposes.

WHY OWNERS MAY USE THIS STRUCTURE

- Asset-protection planning
- Privacy
- Estate-planning flexibility

THE CAUTION

If that LLC elects to be taxed as a corporation, the tax treatment changes. The LLC itself may become the corporate shareholder, and corporate taxpayers are not eligible for the §1202 exclusion.

WHAT THIS MEANS FOR YOU

Do not confuse "An LLC cannot issue QSBS" with "QSBS can never be held through an LLC." The tax classification of the LLC can be more important than the letters "LLC" in its name.

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

PARTNERSHIP OWNERSHIP

A PARTNERSHIP OR MULTI-MEMBER LLC CAN ALSO HOLD QSBS - BUT THE RULES GET TIGHTER

A partnership can hold qualifying stock directly, and gain from a later sale can potentially flow through to eligible partners under §1202, subject to specific conditions.



FOUR IMPORTANT CONDITIONS

1. **CONTINUOUS OWNERSHIP**
   The partner generally must hold the partnership interest from the time the partnership acquires the QSBS through the sale.

2. **THE PARTNER'S BENEFIT IS LIMITED**
   The potential exclusion is generally tied to the eligible interest held when the partnership acquired the stock.

3. **NEW PARTNERS DO NOT GET A WINDFALL**
   A person who becomes a partner later generally cannot step into the QSBS benefit attached to stock the partnership already owned.

4. **DISTRIBUTED STOCK MAY RETAIN QSBS CHARACTER**
   QSBS distributed from the partnership to an eligible partner can retain relevant holding-period and QSBS attributes, subject to the applicable rules.

POTENTIAL BENEFIT

A partnership structure does not automatically destroy QSBS when the partnership itself owns qualifying stock.

POTENTIAL CONSEQUENCE

Ownership changes inside the partnership can alter who may benefit and how much.

WHAT THIS MEANS FOR YOU

If a partnership owns QSBS, changes in partners should not be treated as routine administrative events. Ask: "What does this ownership change do to each partner's QSBS position?"

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

IF YOU CONVERT AN LLC TO A C CORPORATION, TIMING CAN DETERMINE HOW MUCH VALUE IS ACTUALLY INSIDE

A potential path is to contribute LLC interests to a new C corporation in a qualifying §351 exchange. If properly structured, the C-corporation stock received can potentially satisfy the original-issuance requirement. But conversion is not a time machine.

WHERE THE QSBS CLOCK STARTS



Prior years of holding the LLC interest generally do not simply carry into the new QSBS holding period. Value created before the C-corporation stock is issued may not receive the same §1202 treatment as subsequent appreciation.

EARLIER CONVERSION

More future appreciation potentially occurs after qualifying C-corporation stock exists. Converting while the company is still relatively early in its growth may preserve substantially more future appreciation inside a potential QSBS structure.

LATER CONVERSION

Less time remains before an exit, and more value may already have accumulated outside the potential QSBS window. Waiting until a buyer appears may accomplish little beyond changing the entity label.

WHAT THIS MEANS FOR YOU

If a C-corporation conversion may eventually make sense, ask not only “Should we convert?” but “If we are going to convert, when does waiting start costing us?”

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

PLANNING CHECKLIST

BEFORE YOU CHANGE YOUR ENTITY, ASK THESE QUESTIONS

Entity choice affects far more than QSBS. Before forming, converting or electing a new tax status, ask:

1. **WHAT ENTITY DO WE HAVE TODAY?**
   LLC, partnership, S corporation or C corporation?
2. **DO WE ACTUALLY EXPECT A FUTURE STOCK SALE?**
   Does a future qualifying stock disposition realistically fit the plan?
3. **HOW MUCH GROWTH MAY STILL BE AHEAD?**
   The more future appreciation expected, the more timing may matter.
4. **WHEN WOULD THE QSBS CLOCK START?**
   Do not assume earlier operating years count.
5. **WOULD PASS-THROUGH TREATMENT PROVIDE MORE VALUE TODAY?**
   Current-year tax and cash-flow consequences still matter.
6. **WHO WILL HOLD THE STOCK?**
   An individual, disregarded LLC, partnership, trust or another entity can produce different consequences.
7. **ARE OWNERSHIP CHANGES EXPECTED?**
   Adding partners, investors or family members may affect the analysis.
8. **IS A SALE ALREADY BECOMING IMMINENT?**
   Last-minute conversions raise significantly more difficult planning issues.

WHAT THIS MEANS FOR YOU

The goal is not to choose the entity with the most attractive single tax benefit.

Coordinate:

1. Current taxes
2. Ownership
3. Capital needs
4. Asset protection
5. QSBS
6. The eventual exit

WHAT THIS MEANS FOR YOU

The goal is not to choose the entity with the most attractive single tax benefit. The goal is to coordinate current taxes, ownership, capital needs, asset protection, QSBS and the eventual exit.

Sources: 26 U.S.C. §1202; Dahl Law Group QSBS webinar materials.

FINAL TAKEAWAY

THE "BEST" ENTITY CAN CHANGE AS THE BUSINESS CHANGES

A structure that makes sense when a company has little revenue and two owners may not be the structure that makes sense when the same company is raising capital, adding shareholders and preparing for a major exit. Entity planning should not be treated as a one-time filing decision.

THREE DIFFERENT QUESTIONS

NOW

WHAT WORKS TODAY?

How should the business operate and pay tax now?

GROWTH

WHAT PRESERVES FLEXIBILITY?

What future restructuring options are we keeping open?

EXIT

WHAT SUPPORTS THE EXIT?

Will today's structure help or limit the tax opportunities available at sale?

BEFORE YOU MAKE THE NEXT ENTITY DECISION

- Can this entity issue QSBS?
- If not, should we intentionally remain pass-through for now?
- When would a C-corporation conversion become worth evaluating?
- Has substantial appreciation already occurred?
- Who will own the qualifying stock after the restructuring?
- Could an entity election change an existing QSBS position?
- Are we making this decision early enough to matter?

ENTITY CHOICE IS NOT ONLY ABOUT HOW THE BUSINESS IS TAXED TODAY. IT CAN ALSO DETERMINE WHICH OPTIONS EXIST WHEN THE BUSINESS IS EVENTUALLY SOLD.

BOOK YOUR STRATEGY SESSION

Dahl Law Group can help business owners evaluate how entity structure, ownership, QSBS planning, tax strategy and exit timing work together before a major restructuring or transaction.

Scan to schedule

Educational material only; not legal, tax, accounting, investment or financial advice. QSBS rules are technical and fact-specific. Applicable law may change.