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# Executive Compensation Planning for Privately-Held Businesses

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**EXECUTIVE COMPENSATION PLANNING FOR**  
**PRIVATELY-HELD BUSINESSES**

by

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I. INTRODUCTION

A. Preliminary Considerations

1. How is the business organized?
  - a. Tax status.
  - b. Ownership structure.
2. What are the long-term objectives for the business?
  - a. Continue indefinitely as closely-held.
  - b. Position for an ultimate sale of the business.
  - c. Sell shares in the public market.
3. What are the characteristics of the management group?
  - a. Executives are already owners, either directly or through family relationships.
  - b. Managers have little or no ownership interests.
4. What are the specific compensation objectives?
  - a. Incentivize long-term performance.
  - b. Attract/retain key managers.
  - c. Other objectives.

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5. What are the desired tax consequences?
  - a. Timing/character of income.
  - b. Deductibility by the employer.
6. How much complexity can be tolerated?
  - a. Administrative complexity.
  - b. Perceptions of affected employees.

B. The Planning Process

1. Consider What Forms of Incentive Compensation Will Further the Business Objectives
  - a. The various methods incentive compensation should be weighed and compared to determine the optimal mix of compensation forms for the company's workforce.
  - b. This analysis should take into account the tax consequences both to employees and to the company of each form of compensation, and other factors, such as the relative financial accounting impact of each form of compensation.
2. Develop and Implement Incentive Compensation Plans
  - a. Plans should be designed to provide the selected forms of compensation. These plans should be flexible enough to provide the company with an ability to alter its compensation practices as dictated by business circumstances.
  - b. Care should be taken in addressing securities, ERISA and potential employment law concerns before the plans are implemented.
3. Periodically Assess Effectiveness of Existing Programs
  - a. It is helpful to have a framework for periodically assessing the effectiveness of the company's compensation programs.
  - b. Periodic assessments should measure whether current compensation programs are working to attract and retain key employees, and otherwise meeting other business goals.

## II. FORMS OF INCENTIVE COMPENSATION

### A. Incentive Stock Options (ISOs)

#### 1. Description

- a. Incentive stock options (ISOs) are a form of tax-advantaged stock option. They may only be granted by corporate employers to their employees.
- b. In order to provide employees with the tax advantages of ISOs, employers must comply with a number of conditions and limitations. These conditions and limitations can make ISOs a relatively inflexible device for meeting all of an employer's compensation objectives.

#### 2. Tax Treatment

- a. There are no income or alternative minimum tax consequences when an ISO is granted to an employee. See I.R.C. §§ 421(a), 56(b)(3) (tax event is the transfer of a share, not the transfer of the right to purchase a share).
- b. As a general rule, option holder does not recognize any income on exercise of the option or upon receipt of the underlying the shares, and the employer is not entitled to any deduction for transferring the shares, if both of the following requirements are met:
  - (1) At all times during the period beginning with the date of option grant and ending three months before the date of exercise, the option holder was an employee of the employer or of a parent or subsidiary of the employer (except in the case of option holder's disability, in which case the period is extended to 1 year before the date of exercise), and
  - (2) The option holder makes no disposition of the stock during two years from the date of option grant or during one year from the date of option exercise.

See I.R.C. §§ 421(a), 422(a).

- c. If the option holder meets the conditions described in above, he will have basis in the shares equal to the exercise price, and any gains recognized on disposition of the shares will be taxed at long-term capital gains rates. See I.R.C. §§ 421(a)(3), 1222(3)

- d. If the option holder does not meet the employment condition described in subsection (b)(1) above, the option will be treated as a nonstatutory stock option, and the option holder will recognize ordinary income at the time of option exercise on the amount by which the FMV of the stock exceeds the option exercise price. The employer is entitled to a deduction of an equivalent amount in the year of exercise. See I.R.C. § 83 (discussed in greater detail below).
- e. If the option holder does not meet the condition described in subsection (b)(2) above, the holder will recognize ordinary income equal to the lesser of:
  - (1) The option spread at the time of exercise (i.e., difference between FMV of stock and exercise price), or
  - (2) The excess of the amount realized upon disposition of the option and the option exercise price

The employer is entitled to an equivalent deduction in the same taxable year. See I.R.C. § 421(b).

- f. The spread between the fair market value (“FMV”) of the stock and the option exercise price is alternative minimum taxable income to the holder of the ISO when the ISO is exercised. See I.R.C. §§ 55, 56(b)(3).
- g. Employers are not required to withhold FICA or FUTA taxes on the option spread at the time the ISO is exercised. Likewise, no FICA, FUTA or income tax withholding is required for any income recognized as a result of disposition of shares before the end of the holding periods described in subsection (b)(2) above. See I.R.C. §§ 3121(a)(22), 3306(b)(19), 421(b) (as added or amended by the American Jobs Creation Act of 2004).

### 3. ISO Qualification Requirements.

- a. ISOs may only be granted by corporations to their employees or the employees of affiliated corporations. At all times during the period beginning on the date of grant to three months before exercise, the option holder must be an employee of the corporation that granted the option or an employee of a “parent” or “subsidiary” of the granting corporation. A parent or subsidiary relationship exists if there is an unbroken chain of ownership of at least 50% of the voting power at each corporate level. See I.R.C. §§ 422(a)(2), 424(e), 424(f).

- b. ISOs may only be granted with respect to stock of a corporation. Any type of stock will qualify (voting, nonvoting, common, preferred, etc.). See Treas. Reg. § 1.421-1(d).
- c. ISOs must be granted under a written or electronic plan that was approved within 12 months before or after the plan was adopted by the corporation's board of directors. A change in the class of eligible employees, the number of shares reserved for issuance, the corporation granting options or the stock available for ISOs is treated as the adoption of a new plan which requires new shareholder approval. See Treas. Reg. § 1.422-2(b)(1), (2).
- d. The written plan must (1) state the employees or class of employees who are eligible to receive ISOs, and (2) state the aggregate number of shares that may be issued as ISOs under the plan. Provisions which permit increases in the number of shares authorized for issuance are permitted under certain limited circumstances. See Treas. Reg. § 1.422-2(b)(4), (3).
- e. Neither the option plan nor the ISOs granted under it may have a term of more than ten years. In determining whether the plan meets this rule, the term is measured from the earlier of the date the plan was adopted or the date on which it was approved by shareholders. See I.R.C. § 422(b)(2), (3).
- f. The exercise price of the ISO must be at least equal to the FMV of the stock on the date the ISO is granted. The employer may use "any reasonable valuation method" for determining the exercise price. Even if this requirement is not met, the option will qualify as an ISO if, under the facts and circumstances, there was a good faith attempt to set the option exercise price at no less than the FMV of the stock on the date of option grant. For a private company, a good faith attempt is deemed to have been made if the price was determined based on the average of appraisals by "completely independent and well-qualified experts." See Treas. Reg. §§ 1.421-1(e), 1.422-2(e).
- g. The ISO must state that it cannot be transferred, except by will or by descent and distribution. In addition, the ISO cannot be exercised during the optionee's lifetime by anyone other than the optionee (or his representative in the event of his death). See I.R.C. § 422(b)(5); Treas. Reg. § 1.421-1(b)(2). Under this rule, a transfer of an ISO to a grantor trust established by the option holder does not disqualify the ISO. However, a transfer incident to divorce or a domestic relations order would disqualify the ISO.

- h. No more than \$100,000 worth of shares under the option can first become exercisable in any one year. The limit is determined at the time of grant, is based on the FMV of the shares at the time of grant and is determined without regard to how many shares the employee actually exercises. See I.R.C. § 422(d); Treas. Reg. § 1.422-4.
  - (1) For example, assume an employer wants to grant to an employee 60,000 shares under an ISO when the shares are worth \$2 per share. A maximum of 50,000 shares can become exercisable in the year the ISO is granted ( $50,000 \times \$2 = \$100,000$ ). The remaining 10,000 shares can become exercisable in the second year ( $10,000 \times \$2 = \$20,000$ ), along with the 50,000 that first became exercisable in the prior year.
  - (2) All of the ISOs held by an employee are taken into account in applying the limit. The limit is applied by taking options into account in the order in which they were granted.
- i. Special limitations apply to ISOs that are granted to persons who own more than 10% of the total combined voting power of all classes of stock of the employer corporation or any parent or subsidiary corporation (a “10% shareholder”). First, the option term can be no longer than five years. Second, the option exercise price must be at least 110% of the FMV of the underlying shares at the time of grant. See I.R.C. § 422(c)(5); Treas. Reg. § 1.422-2(f).
- j. A modification, extension or renewal of the terms of an ISO is considered the granting of a new option. As a result, the modification, extension or renewal can cause the option to lose ISO status if it does not meet all of the ISO requirements as of the date of modification, extension or renewal (such as the exercise price requirement). See I.R.C. § 424(h)(1); Treas. Reg. § 1.424-1(e). There are a number of rules for determining which types of changes to an ISO constitute a “modification.” See Treas. Reg. § 1.424-1(e)(4)(i), et seq.
- k. ISO option agreements and ISO plans are not required to specify the three month exercise condition described in Section II.A.2.b.(1) above. An ISO that by its terms permits exercise beyond the three-month period following termination of employment will still qualify for ISO treatment if it meets the other requirements applicable to ISOs and it is in fact exercised within that period. See Treas. Reg. § 14a.422A-1, Q&A 23 (transition rules which

predate final regulations). If the option is exercised after the end of the three-month period, the option is treated as a nonstatutory stock option and is taxed under the rules applicable to such options. See Treas. Reg. § 1.422-1(c).

4. ERISA Considerations. Stock option plans and the options granted under them generally do not constitute welfare benefit plans or pension plans for purposes of the Employee Retirement Income Security Act of 1974 (“ERISA”). See, e.g., Department of Labor ERISA Adv. Op. 79-80A; Oatway v. American International Group, Inc., 325 F.3d 184 (3<sup>rd</sup> Cir. 2003).

B. Nonstatutory Stock Options (NSOs)

1. Description

- a. A nonstatutory option (NSO) is any type of option that does not meet the requirements described above for ISOs. See Treas. Reg. § 1.83-7(a).
- b. Although NSOs do not provide option holders with the same tax advantages of ISOs, they are not subject to the numerous qualification requirements applicable to ISOs and thus provide a greater degree of flexibility than ISOs. Furthermore, NSOs provide employers with a deduction, while ISOs generally do not.

2. Tax Treatment

- a. The tax treatment of NSOs is governed under Section 83 if granted to an employee or another service provider in connection with the option recipient’s performance of services for the grantor of the option. See Treas. Reg. § 1.83-7(a); T.A.M. 200043013 (warrants given by bankrupt company to bank creditor are not taxable under the rules of Section 83, and therefore do not give rise to a compensation deduction, because they were not granted in connection with the bank’s performance of services to the company).
- b. There are no income tax consequences upon grant of an NSO unless the NSO has a “readily ascertainable fair market value” at the time of grant. In order for an option to have a readily ascertainable FMV, the NSO must either be traded on a established market (which is rarely, if ever, the case), or each of the following factors must exist:

- (1) the option is transferable,



- (2) the option is immediately exercisable in full,
- (3) there are no conditions or restrictions on the option property which affect the FMV of the option, and
- (4) the option privilege can be valued with reasonable accuracy.

See Treas. Reg. § 1.83-7(b)(1), (2).

- c. When an NSO is exercised, the optionee recognizes ordinary income on the amount by which the FMV of the underlying shares at the time of exercise exceeds the amount paid by the optionee to exercise the option. However, if the shares are subject to a substantial risk of forfeiture when issued, the taxable spread is not determined until the time the risk of forfeiture lapses. The spread is also considered to be wages for purposes of FICA and FUTA withholding. There are no alternative minimum tax consequences with respect to the exercise of a NSO. See I.R.C. § 83(a); Treas. Reg. § 1.83-7(a).
  - d. The recipient of the optionholder's services is allowed a deduction equal to the amount included in the optionholder's taxable income. See I.R.C. § 83(h), Treas. Reg. § 1.83-6; see also Rev. Rul. 2003-98 (corporation that was the recipient of the services performed by the optionholder is entitled to a deduction in connection with optionholder's exercise of a replacement option granted by acquirer).
  - e. The optionholder's basis in the shares acquired under an NSO is generally equal to the exercise price of the NSO, and the holding period generally runs from the date of exercise. See Treas. Reg. § 1.83-4.
3. ERISA Considerations. As described in Section II.A.4 above, stock option plans and the options granted under the plan generally are not considered to be ERISA welfare benefit plans or pension plans.

C. Restricted Stock

1. Description

- a. The term “restricted stock” broadly refers to shares that are granted outright or sold for some consideration to an employee or other service provider. The stock is generally not transferable and is subject to forfeiture if certain conditions are not met during a specified period of time (typically, the recipient’s continued service for the employer).
- b. Restricted stock has gained in popularity as a result of perceived limitations associated with stock options and due to proposals to eliminate the preferential financial accounting treatment afforded stock options under current accounting standards.

2. Tax Treatment

- a. There are no income tax consequences to the recipient of the stock at the time of receipt, so long as the stock is “substantially nonvested.” Stock is substantially nonvested so long as it is (1) nontransferable, and (2) subject to a substantial risk of forfeiture. The employee (or other service provider) is taxed on the FMV of the restricted stock in the first taxable year in which the stock becomes transferable or is no longer subject to a substantial risk of forfeiture. Only one of these restrictions needs to lapse in order to cause the stock to become taxable. See I.R.C. § 83(a); Treas. Reg. § 1.83-3(b).
- b. Stock is considered nontransferable if the holder cannot transfer any interest in the stock to any person other than the transferor. Stock is not considered transferable merely because the holder can designate a beneficiary to receive the stock in the event of his or her death. See Treas. Reg. § 1.83-3(d).
- c. A “substantial risk of forfeiture” exists where the holder’s rights in the stock are conditioned, directly or indirectly, on either:
  - (1) the performance of future substantial services (or refraining from the performance of such services), or
  - (2) the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.

The determination of whether a risk of forfeiture is substantial is dependent upon the individual facts and circumstances surrounding the transfer. See Treas. Reg. § 1.83-3(c).

- d. The employer is entitled to a compensation deduction equal to the amount that the employee recognized in income. The deduction is allowed in the same taxable year in which the holder of the stock recognized income, or the taxable year in which ends the holder's taxable year. See I.R.C. § 83(h).
- e. However, the deduction may be lost if the employer does not properly report the income recognized by the holder on Form W-2 or Form 1099, as applicable. See Treas. Reg. § 1.83-6(a)(1), (2).

### 3. The Section 83(b) Election

- a. If restricted stock is nontransferable and subject to a substantial risk of forfeiture when transferred, the recipient of the restricted stock may make an election to be taxed on the FMV of the stock at the time of transfer. See I.R.C. § 83(b).
- b. The advantages of making a Section 83(b) election are that (1) the holder limits the amount of ordinary income that he must pay if the stock appreciates in value during the restriction period, and (2) he will start a holding period for purposes of qualifying for long-term capital gain treatment upon a later disposition of the shares. See I.R.C. § 1.83-4(a).

The disadvantage of the election is that the recipient may end up paying more ordinary income than he would have paid in the event that the shares decrease in value over the restriction period. In addition, the recipient will not be entitled to any loss deduction for the taxes he paid in the event that he ultimately forfeits the shares. See Treas. Reg. § 1.83-2(a).

- d. A Section 83(b) election is subject to a number of requirements. The election must be made within 30 days of transfer of the restricted stock, and must contain specified information concerning the transfer. The election is filed with the IRS office where the taxpayer files his income tax return. Additional copies of the election must be filed with the transferor of the restricted stock and must be included with the taxpayer's income tax return for the taxable year of the transfer. The election cannot be revoked unless consented to by the IRS. See Treas. Reg. § 1.83-2.

- c. Section 83(b) elections can even be made in circumstances in which the employee has paid an amount equal to fair market value for the stock. This may be desirable in those cases where the employer can repurchase the shares for a period of time at a price equal to the employee's original purchase price or some formula price. Such a call right will generally be treated as creating a substantial risk of forfeiture. See Treas. Reg. § 1.83-3(c)(4), Example 1.
  - f. The employer is entitled to a compensation deduction in the taxable year in which the employee or other service provider recognizes income as a result of the election, equal to the amount of income recognized by the employee. See I.R.C. § 83(h).
4. ERISA Considerations. Restricted stock awards are generally not considered to be ERISA welfare benefit plans or pension plans. However, if awards are structured so as to permit shares to continue to vest following termination of employment, the arrangement could constitute an ERISA pension plan. See Department of Labor ERISA Adv. Op. 80-29A.

D. Stock Appreciation Rights (SARs)

1. Description

- a. A stock appreciation right (SAR) gives the holder the right to receive a benefit equal to the appreciation in value of the employer's stock over a period of time. SARs can be settled in cash, stock or a combination of the two.
- b. SARs are very similar to stock options in that the holder determines when he or she will exercise the SAR. At exercise, the holder receives the difference between the value of the shares on the date of exercise and the exercise price, without having to actually pay the exercise price. SARs can be granted in tandem with stock options. A common reason for using tandem SARs is to provide the employee with funds to pay taxes on the exercise of a NSO. There are restrictions on the use of tandem SARs in connection with ISOs. See Treas. Reg. § 1.422-5(d)(3).

2. Tax Treatment

- a. There is no tax to the holder of an SAR at the time of grant. The holder is taxed on any amounts received upon exercise of the SAR at ordinary income rates. See Rev. Rul. 80-300, 1980-2 C.B. 165; Rev. Rul. 82-121, 1982-1 C. B. 79. The amount received under the SAR is also subject to FICA and FUTA tax at the time of exercise.

See Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii) (SARs are not subject to the special early inclusion rule applicable to nonqualified deferred compensation plans, thus FICA tax is payable only when the SAR is exercised).

- b. The employer is permitted a compensation deduction for the amount income recognized by the holder of the SAR at the time of exercise. See I.R.C. § 162(a)(1).
- c. ERISA Considerations. SARs are generally not considered to be ERISA welfare benefit plans or pension plans. However, SARs that provide for automatic settlement upon termination of the holder's employment or retirement may constitute ERISA pension plans. See ERISA § 3(2).

E. Phantom Stock Plans

1. Description

- a. Phantom stock shares are units that typically are assigned a value equal to the value of the employer's stock. The units give a holder the right to receive the original value of the unit and any subsequent appreciation in value if certain conditions are met, such as the holder's completion of a specified period of future service with the employer. However, a phantom stock plan can be structured to provide a benefit based only on the appreciation in value of the units over time, instead of on the value of the entire unit.
- b. Payment of benefits under a phantom stock plan can be structured in a variety of ways. For example, payment can be made in a single lump sum immediately following completion of a vesting schedule. Alternatively, payment can be delayed to termination of employment or some later specified date (such as attainment of retirement age) and can be paid in installments.

2. Tax Treatment

- a. If the payment date for any benefits under the plan is fixed at the time the employee receives the phantom stock units, or is payable solely at the discretion of the employer, the employee will recognize ordinary income at the time payment is actually received. Income will be based on the amount of cash or the FMV of the property received by the employee. See I.R.C. § 451; Treas. Reg. § 1.451-2(a); P.L.R. 9501032.

- b. If the payment date is instead subject to the employee's discretion, the employee is taxed on the value of the phantom stock unit as of the first date on which the employee had a vested right to the unit or when the employee first had a right to direct payment. See I.R.C. 451; Treas. Reg. § 1.451-2(a); P.L.R. 8829070; T.A.M. 8632003.
  - c. FICA and FUTA taxes must generally be withheld at the later of when the phantom units are awarded to the employee or when the employee has a vested right to receive a benefit with respect to the units. See I.R.C. § 3121(v); Treas. Reg. 31.3121(v)(2)-1(b)(4)(ii).
3. ERISA Considerations. Phantom stock plans may be ERISA pension plans if benefits are payable at termination of employment or retirement, or if benefits are deferred to a date at which employees can generally be expected to retire or terminate employment. See Department of Labor ERISA Adv. Op. 79-60A. For this reason, phantom stock plans are often designed to pay benefits at the end of specified measurement periods, without any acceleration or deferral of payment on account of early or late retirement. See Department of Labor ERISA Adv. Op. 84-12A. Alternatively, phantom stock plans are structured to limit participation to only a select group of executive employees so that the plan may qualify as a "top-hat" plan. See discussion in Section II.F below.

F. Deferred Compensation Arrangements

- 1. Description
  - a. The traditional method to compensate employees is with cash. Deferred payment of cash is frequently used to retain executive talent or as an incentive for attainment of specific performance objectives. In addition, deferred compensation is used to provide supplemental retirement income.
  - b. Deferred payment of cash raises a number of tax and ERISA considerations that must be taken into account in designing and implementing a deferred compensation plan.
- 2. Tax Treatment
  - a. Amounts payable under a deferred compensation plan are taxed at ordinary income rates. The benefits are generally taxed only at the time of actual receipt, unless the recipient is deemed to be in constructive receipt of the benefits. See Treas. Reg § 1.446-1(c)(1)(i).

b. The question of whether and when an employee is in constructive receipt of deferred compensation benefits is not always clear. The IRS has traditionally taken a very conservative approach. Under a long line of rulings, the IRS takes the position that taxation of deferred compensation will be deferred so long as:

- (1) The employer's obligation to pay the deferred compensation is merely a contractual obligation not evidenced by notes or secured in any way against the claims of the employer's general creditors
- (2) The deferral agreement or plan was entered into before the executive performs the services to which the compensation relates
- (3) The deferral agreement or plan specifies the time when or circumstances under which the deferred compensation will be paid.

See Rev. Rul. 60-31, 1960-1 C.B. 174; Rev. Proc. 71-19, 1971-1 C.B. 698, as amplified by Rev. Proc. 92-65, 1992-33 C.B. 428. Although the 1971 and 1992 revenue procedures are only a statement of the criteria that a plan must meet in order for the IRS to issue a private letter ruling, they have traditionally been viewed as representing the IRS's general position on constructive receipt for non-qualified deferred compensation plans.

c. The courts typically have not applied as strict an interpretation of constructive receipt as has the IRS. See, e.g., Veit v. Commissioner, 8 T.C. 809 (1947); Commissioner v. Oates, 207 F.2d 711 (7<sup>th</sup> Cir. 1953), aff'd 18 T.C. 570 (1952) Martin v. Commissioner, 96 T.C. 814 (1991); Childs v. Commissioner, 103 T.C. 634 (1994). As a result, deferred compensation plans are generally not designed to satisfy all of the conditions contained in the revenue procedures described above.

d. Although deferred compensation benefits generally are not subject to income tax until received, such benefits are subject to FICA and FUTA taxes at the later of (1) when the benefits are earned or (2) when the benefits are no longer to a substantial risk of forfeiture. See I.R.C. § 3121(v)(2); Treas. Reg. § 31.3121(v)(2)-(1).

### 3. Recent Legislative Changes

a. As of the date of this outline, both chambers of Congress passed the American Jobs Creation Act of 2004 which contains extensive

new requirements that a deferred compensation plan must satisfy, both in form and in operation, in order to avoid current taxation of amounts deferred under those plans. See Section 885 of the AJCA (expected to be signed by the President).

- b. The new requirements apply to all “nonqualified deferred compensation plans” (“NDCPs”), a term which is broadly defined to mean any plan that provides for a “deferral of compensation.” See I.R.C. § 409A(d). The only statutory exceptions are for (1) qualified retirement plans and certain other tax-advantaged savings and retirement vehicles, and (2) plans providing vacation leave, sick time, compensatory time, disability pay or death benefits. In addition, the Conference Report indicates that the following are not to be considered NDCPs:
  - (1) Arrangements under Code Section 83 providing for the grant of an option on employer stock with an exercise price not less than the fair market value of such stock on the date of grant, as long as the arrangement does not include a deferral feature other than allowing the optionee to exercise the option in the future. As a result, arrangements which permit the deferral of gain on the exercise of stock options will be NDCPs.
  - (2) Incentive stock options and qualified employee stock purchase plans.
  - (3) Annual bonuses or other annual compensation amounts paid within 2½ months after the close of the taxable year in which the relevant services required for payment have been performed.
- c. Section 409A imposes specific conditions that a NDCP must satisfy to avoid current taxation of compensation deferred under the plan. If the plan fails to meet one or more of these new requirements, there will be several adverse tax consequences. The new requirements to avoid constructive receipt are in the following areas:
  - (1) Restrictions on deferral elections under a plan.
  - (2) Specification of the times when distributions can be made.
  - (3) Restrictions on the accelerated payment of benefits.



- d. There are severe tax consequences for failing to meet the new requirements:
  - (1) Unless the participant's right to the deferred compensation is subject to a "substantial risk of forfeiture," all compensation that has been deferred under the plan for all years through the year in which the noncompliance occurs is taxable to the participant (unless previously taxable). For this purpose, a substantial risk of forfeiture exists if the participant's rights are conditioned upon his or her performance of substantial services.
  - (2) Interest will be charged at the underpayment rate, plus one percentage point, on the underpayments that would have occurred had the deferrals been includable in gross income for the taxable year in which first deferred, or if later, the first taxable year in which the deferrals are not subject to a substantial risk of forfeiture.
  - (3) A 20% additional income tax is charged on the amount of the deferral.
- e. The new requirements apply to amounts deferred after December 31, 2004. However, amounts deferred in taxable years beginning before January 1, 2005 will also be subject to the new rules if the plan under which the deferral is made is "materially modified" after October 3, 2004. The Conference Report states that the addition of a benefit, right or feature to a plan will be treated as a material modification. Therefore, the addition after October 3 of a new distribution right or the addition of conditions that accelerate the time when distributions are made would generally cause the plan to be subject to the new rules. The reduction of an existing benefit, right or feature will not be a material modification, nor will the amendment of a plan to remove a distribution provision. In addition, ministerial changes, such as a change in the plan's administrator, will not be material modifications.

#### 4. ERISA Considerations

- a. Deferred compensation plans typically are ERISA pension plans because benefits are paid upon termination of employment or retirement, or defer benefits beyond those dates. See ERISA § 3(2).
- b. In order to effectively defer the taxation of benefits under a nonqualified deferred compensation plan, the plan generally must

qualify as a “top-hat” plan. Top hat plans are exempt from all of ERISA’s substantive requirements, except for certain reporting requirements and ERISA’s enforcement provisions. See ERISA §§ 201(2), 301(a)(3), 401(a)(1).

- c. A deferred compensation plan will qualify as a top-hat plan if the plan is unfunded, and is maintained to provide deferred compensation to a “select group of management or highly compensated employees.”
  - (1) A plan will generally be considered to be unfunded so long as plan participants and their beneficiaries do not have any secured claim against any assets of the employer, and the employer has not set aside any assets for their benefit free from the reach of creditors. See Belka v. Rowe Furniture Corp., 571 F. Supp. 1249 (D. Md. 1983).
  - (2) The Department of Labor has never adopted final guidance providing standards for determining a select group of management or highly compensated employees. The courts have recognized that the determination is fact-sensitive, and generally have refrained from adopting definitive standards for making this determination. See, e.g., Demery v. Extebank Deferred Compensation Plan (B), 216 F.3d 283 (2<sup>nd</sup> Cir. 2000); Gallione V. Flaherty, 70 F.3d 724 (2<sup>nd</sup> Cr. 1995); Simpson v. Ernst & Young, 879 F. Supp. 802 (S.D. Ohio 1994).

### III. SPECIAL TAX PLANNING CONSIDERATIONS

#### A. Considerations for Employers Organized as S Corporations

- 1. Compliance with Qualifying Shareholder Limitations
  - a. S corporations can have no more than 100 shareholders. None of those shareholders can be nonresident aliens. An election can be made to allow all family members to be counted as a single shareholder. See I.R.C. § 1361(b)(1)(A), (C) (as amended by the American Jobs Creation Act of 2004, effective for taxable years after December 31, 2004). Violation of these limitations will generally cause a loss of S corporation status.
  - b. Options for, or outright awards of, S corporation stock must be carefully monitored to avoid violating these limits. In accordance with general tax principles, holders of stock options generally are

not considered to hold the underlying stock until the option is exercised.

- c. Holders of restricted stock are not considered to be S corporation shareholders for as long as the stock is substantially nonvested (i.e., subject to a substantial risk of forfeiture and nontransferable). However, if the holder makes an 83(b) election the stock is treated as outstanding and the holder will be considered a shareholder. See Treas. Reg. § 1.1361-1(b)(3).

## 2. Second Class of Stock Concerns

- a. S corporations may not have more than one class of stock. See I.R.C. § 1361(b)(1)(D).
- b. Stock options issued to employees or independent contractors in connection with the performance of services for the S corporation or for a more than 50% owned subsidiary corporation of the S corporation will not be considered to create a second class of stock if the following conditions are met:
  - (1) The compensation provided by the option is not excessive in relationship to the services performed,
  - (2) The option is not transferable by the optionee (as determined under the regulations of I.R.C. § 83), and
  - (3) The option does not have a readily ascertainable fair market value (as determined under the regulations under I.R.C. § 83).

See Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(2).

- c. Phantom stock arrangements, SARs and deferred compensation plans generally do not create a second class of stock if they do not confer any voting rights to employees, merely represent an unfunded promise to pay an amount in the future, are issued to an employee or independent contractor in connection with the performance of services, and are issued under a plan pursuant to which the employee or independent contractor is not currently taxed. See Treas. Reg. § 1.1361-1(b)(4); P.L.R. 9840035; P.L.R. 9040035.
- d. Restricted stock will not be a second class of stock so long as it is substantially nonvested. Shares that have become vested or for which an employee has made a Section 83(b) election will not

create a second class of stock so long as the stock provides distribution rights and liquidation rights that are identical to those of other shares. Differences in voting rights are generally disregarded. See Treas. Reg. § 1.1361-1(l)(1), (3).

B. Considerations for Employers Organized as LLCs or Partnerships

1. ISOs Are Not Available

- a. ISOs may only be granted with respect to the stock of a corporation. See Treas. Reg. § 1.421-1(a)(1).
- b. Therefore, options to acquire LLC or partnership interests cannot qualify for ISO treatment, except in the case of an LLC that has elected to be taxed as a corporation. See Treas. Reg. §§ 1.421-1(i)(1), 301.7701-3(a).
- c. By contrast, S corporations are treated as corporate entities and options on S corporation stock can qualify for ISO treatment. See Treas. Reg. § 1.421-1(i)(1); P.L.R. 9840035.

2. Outright Grants and Options on Membership/Partnership Interests

- a. Except as described above, partnerships and LLCs generally may grant all of the same types of equity-based incentive compensation awards that corporate employers may award. The tax treatment of these awards is generally dependent upon whether the underlying equity interest is a capital interest (a right to receive a share of the business's assets upon liquidation) or a profits interest (a right only to a share of the profits of the business).
- b. Transfer of a capital interest in exchange for services is generally not considered eligible for non-recognition treatment. See I.R.C. § 721; Treas. Reg. § 1.721-1(b)(1). The amount and timing of tax recognition is determined under the rules of Sections 61 and 83.

- (1) Unrestricted Interests. The fair market value of an unrestricted capital interest (i.e. one that is fully vested at the time of transfer) is ordinary income to the recipient on the date of transfer, less the amount (if any) that the recipient paid for the interest. See Treas. Reg. § 1.721-1(b)(1). The LLC or corporation will be able to deduct or amortize the amount the recipient reports in income. See I.R.C. § 83(h), 162 and 212.

- (2) Restricted Interests. If the interest is subject to a substantial risk of forfeiture at the time of transfer, the fair market value of the capital interest (less the amount paid by the transferee, if any) will be ordinary income to the transfer when the risk of forfeiture lapses. The LLC or partnership will be able to deduct or amortize the payment at the time the recipient reports the income. In addition, the recipient may elect to make an election to be taxed on the fair market value of the interest as of the date of transfer. See I.R.C. § 83(b). The recipient will immediately become a member if the 83(b) election is made. See Treas. Reg. 1.83-2(a).
- c. The tax treatment of compensatory options to acquire capital interests is not entirely settled. However, the general view is such options should be taxed within the framework of the Section 83 rules (see previous discussion regarding the tax treatment of NSOs).
  - d. A transfer of profits interests to a service provider in exchange for services to the LLC/partnership will not be a taxable event for either the recipient of the interests or for the members/partners if:
    - (1) The recipient is already acting in a partner capacity or the award is in anticipation of the recipient acting in a partner capacity,
    - (2) The interest does not relate to a “substantially certain and predictable stream of income,”
    - (3) The partner holds the interest for at least two years after receipt, and
    - (4) The LLC/partnership is not publicly traded.

See Rev. Proc. 93-27, 1993-2 C.B. 343.
  - e. The IRS has clarified this position in response to concerns with whether this treatment would apply to restricted profits interests (i.e., those subject to vesting conditions). The IRS will consider an unvested interest to have been transferred to the recipient on the date of grant if all of the conditions of Revenue Procedure 93-27 are met and:
    - (1) the recipient of the profits interest is treated as the owner of the interest from the date of grant and the recipient takes

into account the distributive share of tax items associated with the interest for the entire period that the recipient holds the interest, and

- (2) neither the LLC/partnership nor any of the members/partners deduct any amount for the fair market value of the profits interest when the interest is granted or when it becomes vested.

See Rev. Proc. 2001-43, 2001-2 C.B. 191.

f. These IRS positions create an attractive compensation planning opportunity that cannot be replicated under any of the equity-based incentive compensation arrangements available to corporate employers. However, certain issues should be considered before granting employees profits interests:

- (1) If the partnership/LLC attaches a vesting schedule to the award, recipients may still wish to make protective Section 83(b) elections.
- (2) Because the special rule only applies to persons who are partners or who are expected to become partners, grants to non-partner employees may not qualify for the rule unless the employee will have some attributes of a partner. Consideration should be given the employee's management rights and other indicia of partner status. See P.L.R. 9533008.
- (3) In order to avoid some of the uncertainties surrounding the special rule, partnerships and LLCs may want to consider another form of incentive compensation. For example, a phantom stock plan may be a more efficient and simpler arrangement to administer.

#### IV. FINANCIAL ACCOUNTING ASPECTS OF INCENTIVE COMPENSATION

##### A. Significance of Financial Accounting Rules

1. Amounts paid to employees and consultants in exchange for their services must generally be recorded as a compensation expense for balance sheet purposes. Unlike public companies, private businesses generally are not as sensitive to the impact of compensation arrangements on their financial statements. However, companies planning for a public offering and those whose financial statements are the subject of loan covenants or conditions

imposed by outside investors may be concerned with minimizing compensation expenses.

2. There are a number of special rules governing how much, if any, compensation expense must be recognized in connection with various types of incentive-based compensation. One of the traditional attractions of stock options is that they may, under certain circumstances, be awarded without generating a compensation expense under current financial accounting standards.

B. General Accounting Principles for Stock Compensation

1. There are two alternative methods of computing the value of stock compensation for employees. Under current accounting standards, an employer is required to elect and consistently use one of the methods.
  - a. Intrinsic Value Method. This is the most popular method because it often will not result in recognition of any compensation expense for stock options. The intrinsic value method is used by the vast majority of private companies to account for employee stock compensation. See APB Opinion No. 25, Accounting for Stock Issued to Employees (“APB 25”); FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation (“FIN 44”).
  - b. Fair Market Value Method. This method requires that some expense be recognized in connection with a compensatory stock award. The expense is based on the fair market value of the stock award on the date on which it was granted. Fair market value is typically computed based on a formula that considers a number of factors. See FASB Statement of Financial Accounting Standards, Accounting for Stock-Based Compensation (“FAS 123”).
2. Stock awards to non-employees must be accounted for under the fair market value method of FAS 123. However, employers have the option to measure the compensation expense based on either the fair value of the incentive award or the fair value of the goods or services received from the non-employee, whichever is more reliably determinable.
3. There is an important exception to the requirement that awards to non-employees be accounted for under FAS 123. Non-employee directors of corporate entities are treated as employees and awards to them are measured under the intrinsic value method of accounting under APB 25. See FIN 44, ¶¶ 7, 8.

4. Even though the fair market value method of accounting under FAS 123 is optional, employers that use the intrinsic value method of APB 25 are required to disclose on a pro forma basis in the footnotes to their financial statements what their earnings and earning per share would have been if FAS 123 had been applied.

C. Basic Principles of the Intrinsic Value Method of Accounting (APB 25)

1. APB 25 requires that a compensation expense be measured and reflected for all stock option, purchase, award and bonus rights granted by an employer corporation to an individual employee. However, if a stock plan qualifies as a “noncompensatory plan,” no compensation expense is required to be recognized for awards made under the plan. In order to be a noncompensatory plan, a plan must meet the following conditions:
  - a. Only one employer stock can be issued,
  - b. Substantially all full-time employees who meet limited employment qualifications must be eligible to participate in the plan,
  - c. Options or awards must be granted equally to all employees, or based on a uniform percentage of salary,
  - d. The discounted purchase price of any option under the plan must be reasonable. A 15% discount is a safe harbor for purposes of these rules, and
  - e. The time permitted for exercise of options under the plan must be reasonable.
2. If a plan does not qualify as a noncompensatory plan, compensation expense must be measured as of a “measurement date.”
  - a. The determination of the measurement date is a key factor in determining how much, if any, cost must be recognized under an award. The measurement date is typically the first date on which both of the following factors are known:
    - (1) The number of shares the employee is entitled to receive under the award; and
    - (2) The option or purchase price, if any.
  - b. Performance conditions that are limited solely to the employee’s continued service are ignored for purposes of determining how



many shares the employee will be able to acquire. As a result, applying a service-related vesting schedule to an award will not cause the measurement date to be delayed beyond the date on which the award was granted.

- c. However, if vesting is based solely on the attainment of corporate performance objectives, the measurement date generally will not occur unless and until the performance criteria are met. It may be possible to avoid this result by using a vesting schedule that merely accelerates vesting upon attainment of performance criteria.

See APB 25, ¶ 10

3. If both of these factors are known at the time the award is made, the award is fixed. Under “fixed plan” accounting, the amount of compensation cost is measured based on the difference between (1) value of the stock on the measurement date, and (2) the amount the employee is required to pay to receive the stock, if any. Therefore, options that qualify for fixed plan accounting will not give rise to any compensation expense if the exercise price is equal to the fair market value of the stock on the date of grant.
4. If the factors described above are not known at the time the award is granted, the award is variable. Under “variable plan” accounting, the difference between (1) value of the stock on the measurement date and (2) the amount the employee is required to pay to receive the stock, if any, is recognized on the date the award was granted, and increases or decreases in the fair market value of the stock are periodically recognized until the measurement date occurs.
  - a. For example, a stock option that is subject to variable plan accounting will give rise to a compensation expense as a result of future increases in the value of the underlying stock, even though the exercise price of the option was equal to the after market value of the stock on the date it was granted.
  - b. Two types of awards that are always subject to variable plan accounting are SARs and phantom stock plans. Variable plan accounting for SARs often make them a less desirable compensation vehicle than stock options and restricted stock, which can qualify for fixed plan accounting. See FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.
5. There are a number of rules governing the period over which an expense must be recognized.

- a. For awards subject to fixed plan accounting, compensation expense under the award must be recognized “using a systematic and rational method” over the employee’s total service period. Companies generally elect to recognize the expense on a straight-line basis over the vesting period of the award.
- b. For awards subject to variable plan accounting, compensation expense must also be recognized over the employee’s service period. However, this expense must be periodically adjusted to reflect changes in the value of the employer’s stock.

See APB 25, ¶¶ 12-15.

D. Proposed New Accounting Standards (Share-Based Payment Standards)

1. In response to criticism over the intrinsic value method of accounting, FASB has issued an exposure draft with entirely new standards of accounting for stock compensation. Based largely on the FAS 123 fair value standards, the exposure draft would eliminate intrinsic value accounting.
2. Under the proposed new standards, a company would be required to recognize an expense for stock-based awards according to the fair market value of the awards on the date of payment. Awards that are designed to be settled in stock, such as a stock option, would be subject to fixed accounting. The company granting the option would be required to determine the fair market value of the option as of the date on which it was granted, and then recognize this fixed compensation cost over the option’s “requisite service period” (which is typically the vesting period).
3. The exposure draft has been subject to intense review since it was issued in April, 2004. Particular attention has been focused on the appropriate method for valuing options and other “equity instruments.”
4. The new standards are proposed to take effect for non-public companies for years beginning after December 15, 2005. However, there have been reports that FASB is considering delaying the effective date of the new rules. A new draft of the standards is expected to be released later this year or early next year.

E. Deferred Compensation and Other Cash Compensation

1. General Rules
  - a. The liability that accrues under a cash-based deferred compensation plan is required to be recognized as an expense. As

a general matter, expense from the plan is required to be recognized over the employee's required service period. See APB 12, Omnibus Opinion – 1967; FAS 87, Employers' Accounting for Pensions.

- b. The aggregate amount that is accrued over the service period should equal the present value of the benefits that ultimately are expected to be paid. If the amount to be paid is not known with certainty due to an unknown variable (such as how long the employee will continue to work), the accrual is made based on best available estimates.
- c. If corporate owned life insurance is purchased to informally fund the expected future liability under the deferred compensation plan, increases in the cash surrender value of the policy can generally be recorded as an asset that offsets the cost of the benefit accruing under the plan. See FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance

## V. SECURITIES LAW ASPECTS OF INCENTIVE COMPENSATION

### A. Types of Compensation Plans Affected by Securities Laws

#### 1. Stock-Based Plans

- a. These plans include traditional stock option and SAR arrangements.
- b. For securities purposes, there are two potentially registrable securities under these plans. One security is the actual stock that is issuable under the plan. The other security is a derivative security, such as a stock option. Generally, it is not necessary to separately register or exempt from registration a derivative security if the underlying stock issuable under the plan is registered or exempt from registration.

#### 2. Deferred Compensation Plans

- a. An employee's deferrals into a deferred compensation plan are often credited with a hypothetical or deemed investment return. The employee's account is adjusted up or down based on the performance of the target investment.
- b. As explained in more detail below, the SEC staff has said that it is "not prepared to disregard" the argument that deferred

compensation obligations are analogous to investment notes, which typically are viewed as securities.

3. Bonus Plans Involving Stock and Phantom Stock Plans

- a. From the SEC's perspective, a bonus plan is a plan that does not require any payment by an employee to receive either the stock or a cash benefit based on the value of employer stock. For this purpose, an employee's performance of future services are not treated as payment for receipt of such stock or cash.
- b. For broad-based bonus plans, the SEC position is that there is no "sale" involved. If there is no sale, the stock issued under the plan does not have to be registered or exempted from registration. See Ecolab, Inc., SEC No-Action Letter (February 11, 1991).
- c. For individually negotiated arrangements, there may be a "sale" of the bonus stock which would require registration or exemption from registration. See Pacific Telesis Group, SEC No-Action Letter (June 30, 1992).

B. Securities Laws that Apply to Compensation Arrangements

1. Securities Act of 1933

- a. The Securities Act of 1933 ("1933 Act") is the primary controlling statute for securities offerings. The 1933 Act controls all offers or sales of securities. All offers and sales of covered securities must be registered unless an exemption applies.
- b. The basic remedy for a registration violation is a right of rescission. Under rescission, a purchaser of a security is allowed to rescind the transaction and recover the consideration paid for the security, plus interest. See Section 12(a), 1933 Act.

2. Securities Exchange Act of 1934

- a. The Securities Exchange Act of 1934 ("1934 Act") provides for the registration of companies traded on an exchange or that have more than \$1 million in assets and 500 or more shareholders. See Section 12, 1934 Act.
- b. The principal provisions of the 1934 Act affecting executive compensation are the Section 16 rules on reporting of holdings and short swing profit recovery, as well as a prohibition on employer loans to executive officers. See Sections 16 and 13k, 1934 Act.

### 3. State Blue Sky Laws

- a. States and the federal government share responsibility for the regulation of securities. In most cases where a federal registration issue arises, there is a parallel state law issue. The state laws that regulate securities are commonly referred to as "blue sky" laws. A company does not have to be conducting business in the state for a stock award to be subject to a state's securities regulations.
- b. Federal law preempts state blue sky law in certain circumstances. For example, offers of securities that are listed on an established exchange are generally not subject to state blue sky laws. However, transactions involving most private companies are subject to state blue sky laws.
- c. Many states exempt employee benefit plan transactions from registration, or exempt transactions that involve only a small number shares or a small number of offerees in the state. However, some states, notably California, have a developed system of regulating private company stock option plans. Attention should be paid to these rules when developing plans that will provide for grants in such states. See Cal. Code Regs. tit. 10, § 260.140.41.

### C. Why Register or Exempt Compensation Plans?

1. Plans Involving Sales of Securities. The sale of an unregistered security makes the seller subject to liability. Therefore, registration or qualification for an exemption is necessary to avoid this potential liability.
  - a. Stock options involve a sale of a security by the issuer company to the optionee. The exercise of an option involves the payment of the exercise price in exchange for the issuance of stock. Registration or exemption of the underlying shares, rather than the options themselves, is required.
  - b. The option generally is considered a derivative security. Because the option generally is given to the optionee, the option is treated as a bonus that does not involve a sale (see Section V.A.3 above).
2. Plans that Defer Compensation
  - a. Following the Supreme Court decision in International Brotherhood of Teamsters v. Daniel (439 U.S. 551, 1979), the SEC issued two releases designed to clarify the application of the 1933 Act to compensation arrangements. The releases conclude that two

elements are required to make an employee compensation plan subject to the 1933 Act: (1) voluntary participation, and (2) contributions by participants. Plans that are not both voluntary and contributory generally are not considered to involve any potential sale of securities. The releases focus on tax-qualified plans and plans involving sales and purchases of employer stock. See Employee Benefit Plans, Release No. 33-6188 (February 1, 1980); Employee Benefit Plans, Release No. 33-6281 (January 15, 1981).

- b. In the two releases, the SEC relied on the test in SEC v. W.I. Howey Co., 328 U.S. 293 (1946) to determine the existence of an investment contract. Under Howey, a financial interest must have four elements to be a security: (A) investment of money, (B) in a common enterprise, (C) with an expectation of profits, (D) from the efforts of others.
- c. Before 1991, the SEC issued a series of no-action letters involving registration of interests in deferred compensation plans. These letters typically involved one of two scenarios.
  - (1) First, the SEC staff took a no-action position on the failure to register interests in deferred compensation when the yield was measured other than by employer stock price. See McKesson Corp., SEC No-Action Letter (Jan. 9, 1990) (compensation committee sets rate); Shearson Lehman Hutton, Inc., SEC No-Action Letter (May 29, 1986) (Treasury bill rate).
  - (2) Second, in circumstances where employer stock was used as a means of measuring benefits, the no-action letters that did not require registration dealt with plans that benefited only a few highly compensated employees and the plans were “mirror” arrangements for qualified plans that were registered. See St. Paul Companies, Inc., SEC No-Action Letter (Feb. 25, 1988).
- d. In 1997, the SEC staff changed its position. It announced that it would cease to issue no-action letters for any non-qualified deferred compensation plans, including interest-only plans, because “it was not prepared to disregard the argument that the debt owed to plan participant is analogous to investment notes, which typically are viewed as debt securities.” See SEC Div. of Corp. Fin., Current Issues and Rulemaking Projects, pp. 56-57 (November 14, 2000).

3. Consequences of Not Registering or Exempting Sales under the Plan

- a. As discussed above, the purchaser of the security has the right to rescind the sale. The purchaser can sue for a period of up to one year for recovery of the amount paid for the security, plus interest. See Section 12(a), 1933 Act.
- b. In addition, violations of the registration rules can result in adverse publicity and could negatively impact plans to go public. See Google Discloses Possible Violations, Associated Press article (Aug. 5, 2004)

D. Federal Registration Exemptions for Privately-Held Companies

- 1. Rule 701. Rule 701 is the primary exemption for offerings of securities under employee benefit and other compensatory plans. Some of its conditions are similar to those that apply to the short form of registration available to public companies for registering their plans with the SEC.
  - a. Rule 701 applies to any issuer that is not subject to the reporting requirements of Section 13 or 15(d) of the 1934 Act. The rule applies to securities issued while a company is private, even if the company later becomes a public reporting company. See 17 C.F.R. § 230.701(b).
  - b. Rule 701 covers "compensatory benefit plans" which are purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plans or contracts. See 17 C.F.R. § 230.701(c)(2). The issuer, its parent or majority-owned subsidiaries of it or its parent can establish the plan. See 17 C.F.R. § 230.701(c).
  - c. The eligible participants are employees, directors, general partners, trustees of business trusts, officers, consultants or advisors. See 17 C.F.R. § 230.701(c). Consultants or advisors can only participate if they are natural persons, provide bona fide services to the registrant and the services are not in connection with a sale of securities in a capital-raising transaction. See 17 C.F.R. § 230.701(c)(1).
  - d. In addition, Rule 701 applies to an employee's family member through the exercise of a transferable option that was transferred through a gift or domestic relations order. A family member is a child, stepchild, grandchild, parent stepparent, grandparent, spouse,

former spouse, sibling, niece, nephew, certain in-laws, a trust in which these persons have more than 50 percent interest and similar foundations or other entities. See 17 C.F.R. § 230.701(c)(3).

- e. Rule 701 has no limits on the amount of securities than can be offered under the exemption. It does impose a maximum limit on the amount of securities that can be sold in any 12-month period. The limit is the greatest of (A) \$1 million, (B) 15% of the total assets of the issuer, or (C) 15% of the outstanding securities of the class being offered. See 17 C.F.R. § 230.701(d)(2). For purposes of this limit, the grant of a stock option is treated as a sale (without regard to when the option will become exercisable). The sale price is the exercise price of the option. See 17 C.F.R. § 230.701(d)(3).
  - f. There are explicit disclosure requirements for offerings under the rule. In all cases, the issuer must deliver a copy of the compensatory benefit plan or contract to the reward recipient. In addition, if the aggregate sale price of securities sold in any 12-month period exceeds \$5 million, the issuer must provide (A) information about the risks associated with the investment, (B) its financial statements, and (C) a summary of the terms of the plan See 17 C.F.R. § 230.701(e).
  - g. Unlike some other exemptions, the use of Rule 701 does not disqualify the company from other exemptions and the securities issued under Rule 701 are not integrated with other offerings. See 17 C.F.R. § 230.701(d)(3)(iv), (f).
  - h. All securities issued under Rule 701 are restricted securities for purposes of Rule 144. See 17 C.F.R. § 230.701(g).
2. Regulation D. Under Regulation D of the 1933 Act, there are several possible exemptions from registration for limited offerings. For small groups of executives, many of these exemptions may be available. These exemptions may be most applicable to officers of a company since those officers are likely to have information about the financial and business situation of the issuer.
- a. Under Rule 505 of the 1933 Act, an issuer can offer up to \$5 million in securities within a 12-month period. There can be no more than 35 purchasers under a Rule 505 offering. See 17 C.F.R. § 230.505(b)(2). The issuer must provide financial and other information to the purchaser. See 17 C.F.R. § 230.502 (b).
  - b. Under Rule 506, any amount of securities can be offered to no more than 35 purchasers. See 17 C.F.R. § 230.506(b). Each



purchaser must be an accredited investor or have the knowledge and experience to evaluate the merits and risks of the investment. See 17 C.F.R. § 230.506(b)(2)(ii).

- c. In addition, Rule 504 applies to offerings that are less than \$1 million in a 12-month period. See 17 C.F.R. § 230.504(b)(2). The issuer generally must provide financial and other information to the purchaser. See 17 C.F.R. § 230.502(b).
- 3. Rule 147. Section 3(a)(11) of the 1933 Act exempts sales of securities that are conducted entirely within a single state. There are a number of conditions for this exemption which limit its usefulness, such as the requirement that all offerees and purchasers have their principal residence in the state. See 17 C.F.R. § 147(d).

## VI. EMPLOYMENT AND LABOR LAW ASPECTS OF INCENTIVE COMPENSATION

### A. Federal Hourly Wage Laws

- 1. Fair Labor Standards Act of 1938 (FLSA)
  - a. The FLSA regulates the manner in which pay is computed for employees who are not otherwise exempt from the act (i.e., “non-exempt employees”). There have been questions for a number of years as to whether grants of stock options and other forms of stock based-compensation to non-exempt employees must be taken into account in computing wages under the FLSA.
  - b. In 1999, the U.S. Department of Labor issued an opinion letter in which it concluded that stock options did not fall within any recognized exemption from the FLSA. See Department of Labor, Wage and Hour Division Op. Let., Feb. 12, 1999.
- 2. Worker Economic Opportunity Act of 2000 (WEOA)
  - a. The uncertainty created by the Department of Labor’s FLSA ruling led to enactment of legislation which creates a limited safe harbor from the FLSA for certain types of stock awards. The WEOA provides that grants of stock options and SARs, and rights to acquire stock under a stock purchase plan, will be excluded from calculating an employee’s regular pay under the FLSA if certain conditions are met. See 29 U.S.C. § 207(e)(8).
  - b. The safe harbor provided by the WEOA does not cover restricted stock awards.

c. The general conditions for the exemption are:

- (1) In the case of stock options and SARs, there must be at least a six month period between the date of grant and the date on which the option or SAR is first exercisable. In addition, the exercise price for the stock option or SAR must be at least 85% of the FMV of the underlying stock on the date the award is granted.
- (2) Employees must be informed of the material terms and conditions of the plan and their rights under it either at the beginning of their participation or at the time they are granted an award (e.g., the expiration of the award, exercise price, exercise period, etc.)
- (3) The employee's right to exercise the award under the plan must be voluntary. However, employers are permitted to automatically exercise an award at the time it would expire so long as the employee had not previously notified the employer that he or she did not want the employer to exercise the award on their behalf.
- (4) Additional requirements apply if the award is performance based, or if the plan is an employee stock purchase plan.

B. Employment Law Issues

1. Recent Litigation Involving Stock Options and Other Awards

a. There have been number cases brought by employees in recent years concerning rights under options and other stock awards. Some of the areas of dispute that typically arise involve:

- (1) Whether termination of an employee's employment was initiated to prevent the employee from vesting in his or her unvested incentive awards.
- (2) Whether alleged oral promises made concerning future incentive awards or the terms of existing awards are enforceable against the employer.
- (3) Proper interpretation of ambiguous terms in incentive awards.

b. Although employers generally cannot fully insulate themselves from these types of claims, they can take steps to minimize the risk

that employees or former employers could succeed on such claims. Some helpful practices include:

- (1) Careful drafting of incentive awards to eliminate any language that would appear to provide employees with vesting rights beyond those that the employer intends to apply. For example, plans and grants should clearly state that unvested awards are granted in consideration of future services and that the award is not an employment contract.
- (2) Companies should consider monthly vesting formulas (instead of the standard yearly formula), and should not grant awards with significant future vesting terms to poorly performing employees.
- (3) Termination, vesting, and exercise provisions should be clearly set forth in plans and individual award agreements.
- (4) All incentive awards should be evidenced by written agreements.

## 2. Use of Noncompetition Agreements in Stock Awards

- a. The traditional means for employers to enforce non-compete agreements has been to seek a judicial injunction. This is often costly, and courts are typically hostile to non-competition agreements that are not specifically tailored to address the employer's particular business concerns. In addition, some courts will not enforce non-competes unless the employee was provided some specific economic benefit (other than mere continued employment) in exchange for the non-compete. See, e.g., Young v. Mastrom, Inc., 99 N.C. App. 120, 392 S.E. 2d 446 (N.C. 1990)
- b. In recent years, employers have been adding non-compete provisions to stock option awards. A common approach is to require that the award be cancelled if the employee breaches the non-compete, and that the employee disgorge any gains that he or she received under the award as a result of any exercise that occurred within a specified time prior to the breach.
- c. The courts that have reviewed these agreements have generally held them to be enforceable. See IBM v. Bajorek, 191 F.3d 1033 (9<sup>th</sup> Cir. 1999); IBM Corp. v. Martson, 37 F. Supp. 2d 613 (S.D.N.Y. 1999).



# CHOICE OF ENTITIES CHART<sup>1</sup>

## Choice of Entity: Pre-Organization Considerations

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Definition</b>	An association of two or more persons to carry on, as co-owners, a business for profit. Va. Code §§ 50-73.79, -73.88. A partnership is an entity distinct from its partners. Va. Code § 50-73.87.	A GP or LP in which the owners may, in certain circumstances, be shielded from personal liability for the errors and omissions of other co-owners. Va. Code §§ 50-73.1, -73.78, -73.79.	A partnership formed by two or more persons having one or more general partners and one or more limited partners. Va. Code § 50-73.1.	An entity, having one or more members, that is an unincorporated association without perpetual duration. Va. Code § 13.1-1002.	A corporation for profit organized under the laws of Virginia. Va. Code § 13.1-603.	Same as C corporation, but which is taxed as a partnership by electing S corporation status; a small business corporation as defined in I.R.C. § 1361.	An unincorporated business, trust, or association that is governed by a governing instrument pursuant to which (i) the trust property is transferred or conveyed to one or more trustees or (ii) the business of the trust is carried on by one or more trustees, all for the benefit of the beneficial owners of the trust. Va. Code § 13.1-1201. A business trust is a separate legal entity. Va. Code § 13.1-1208.
<b>Governing statutes</b>	Va. Code §§ 50-73.79 to -73.149. <sup>2</sup>	VRUPA: Va. Code §§ 50-73.79 to -73.149; VRULPA: Va. Code §§ 50-73.1 to -73.78.	Va. Code §§ 50-73.1 to -73.78.	Va. Code § 13.1-1000 <i>et seq.</i>	Va. Code § 13.1-601 <i>et seq.</i>	Va. Code § 13.1-601 <i>et seq.</i> ; I.R.C. §§ 1361-1379.	Va. Code §§ 13.1-1200 to -1284.

<sup>1</sup> The Choice of Entities chart follows a format first created by Robert R. Keatinge, Wayne J. Carey, Mary Beth M. Clary, Lawrence A. Goldman, Harry J. Haynsworth IV, Elizabeth G. Hester, Donald Kelley, John DeBruyn, Richard B. Robinson, Michael A. Sabian, Norton L. Steuben, Anthony van Westrum, George W. Coleman, Allan G. Donn, James L. Jerue, and Eric A. Mazie for the American Bar Association, © 1994, reproduced with permission of the authors but updated and modified to reflect Virginia law. LLC provisions updated by James J. Wheaton, November 2004.

<sup>2</sup> The Virginia Revised Partnership Act (VRUPA) (Va. Code §§ 50-73.79 to -73.149) became effective July 1, 1997, for all partnerships formed after that date, and on January 1, 2000, for all other partnerships. All references in this chart to statutes governing partnerships are to VRUPA or to the Virginia Revised Uniform Limited Partnership Act (VRULPA) (Va. Code §§ 50-73.1 to -73.78).

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Limits on number of owners</b>	At least two. Va. Code § 50-73.79.	At least two.	General partner, one or more limited partners. Va. Code § 50-73.1.	May have one or no members. Va. Code § 13.1-1002.	May have one or more shareholders.	No more than 100, under 2004 tax act. I.R.C. § 1361.	May have one or more beneficial owners. Beneficial owners may be trustees. Va. Code § 13.1-1201.
<b>Limits on who can be an owner</b>	No limits on who can be an owner.	Same as GP.	Same as GP.	Same as GP. Va. Code § 13.1-1002.	Same as GP.	Nonresident aliens and entities other than certain qualified trusts and estates may not be S corporation shareholders. I.R.C. § 1361.	Same as GP. Va. Code § 13.1-1201.
<b>Limits on classes of ownership</b>	None; default rule is equal distribution to partners but partners may make any financial arrangements they wish. Va. Code § 50-73.99.	Same as GP or LP as applicable.	None; default rule is distribution in proportion to value of contributions but partners may make any financial arrangements they wish. Va. Code § 50-73.35.	None; default rule is distribution in proportion to value of contributions but members may make any financial arrangements they wish. Va. Code §§ 13.1-1022, -1029, -1030. New § 13.1-1022F expressly permits classes of membership.	C corporation may have different classes of stock with different voting and distribution rights. Va. Code § 13.1-639.	S corporation may have only one class of stock, but stock may have different voting rights; distribution is according to share ownership. I.R.C. § 1361.	None; default rule is distribution in the proportion of the entire undivided beneficial interest in the business trust owned by the beneficial owner, but articles of trust or governing instrument may provide any financial arrangement. Va. Code § 13.1-1226.
<b>Facilitation of gift transfers</b>	Partnership interest may be expressed in units and certificated to facilitate transfer. Gift to an assignee does not per se admit the donee to partner status. Va. Code § 50-73.107.	Same as GP or LP as applicable.	Partnership interest may be expressed in units and certificated to facilitate transfer.	Membership interest may be expressed in units and certificated to facilitate transfer.	Share certificates facilitate transfer.	Same as C corporation.	Beneficial ownership may be expressed in units and the issuance of certificates to facilitate transfer.
<b>Gift and estate tax aspects of transfers of interests in the entity</b>	Transferor's excessive retention of control of the entity, excessive diversion of income, or excessive right to compel accumulation of income may cause the transferred interests to be included in transferor's taxable estate. I.R.C. §§ 2036, 2038.	Same as GP or LP as applicable.	Transferor's excessive diversion of income, or excessive right to compel accumulation of income may cause the transferred interests to be included in transferor's taxable estate. I.R.C. §§ 2036, 2038.	Excessive rights granted to the transferor by the operating agreement or articles of organization may cause the transferred interests to be included in the transferor's taxable estate. I.R.C. §§ 2036, 2038.	Excessive restrictions on gifted stock may cause loss of annual exclusion. The mere retention of voting control does not result in the inclusion of stock in the transferor's taxable estate. I.R.C. §§ 2036, 2038.	Same as C corporation.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Restriction on business that may be conducted (non-tax)	Any lawful business except as otherwise limited in any partnership agreement.	Same as GP or LP as applicable.	An LP may do anything that a GP may do, except as otherwise limited in the partnership agreement. Va. Code § 50-73.9.	An LLC may conduct any lawful business except as otherwise limited in the articles of organization. Va. Code § 13.1-1008.	Any lawful business except as limited in the articles of incorporation. A corporation conducting such businesses as banking and insurance must so state in its articles of incorporation and has no power to conduct any other business. Va. Code § 13.1-620.	Same as C corporation, but prohibited by tax law from operating certain kinds of businesses, such as insurance and banking businesses. I.R.C. § 1361.	Any lawful business, except as otherwise limited by the articles of trust or Virginia law. Va. Code § 13.1-1209.
Restriction on business that may be conducted (tax)	None.	None.	None.	None.	None.	May not conduct banking, insurance, or certain other businesses. I.R.C. § 1361.	None.
Limits on what assets the entity may own	None.	None.	None.	None.	None.	None. Treated as a C corporation in its capacity as shareholder of another corporation. I.R.C. § 1371.	None.
Limits on kinds of income	None.	None.	None.	None.	None.	Excessive passive income may cause S corporation status to be terminated. I.R.C. § 1362(d).	None.
Application of securities law	A facts and circumstances test of the ability of a holder of an interest in a GP to participate in the decisions of the GP is used to determine if it is a security.	Same as a GP or LP as applicable.	Because limited partners are limited in their ability to participate in the management and control of an LP, their interests may constitute securities.	Membership interests in professional LLCs sold to individuals intending to practice with the LLC are not securities. Va. Code § 13.1-514(B)(17). Otherwise, same in Virginia as a GP.	Although there are some exceptions (for example, some associations), the general rule is that shares of stock are securities.	Same as C corporation.	Same as C corporation.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Owner's income subject to self-employment tax</b>	Payments for services determined without regard to partnership income are treated as ordinary income and subject to tax as such. I.R.C. §§ 707, 1402.	Same as GP or LP as applicable.	Same as LLC.	Under revised proposed regulations, an LLC member is not subject to employment taxes except on guaranteed payments for services rendered to or on behalf of the LLC unless the member has personal liability for the LLC's obligations and authority to contract on behalf of the LLC and participates in the LLC's trade or business for more than 500 hours during the LLC's taxable year. Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997).	Corporations and shareholder-employees pay FICA tax on salary or wages; other income to shareholders is taxed as a distribution.	Same as C corporation.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Fringe benefits available for owners</b>	Partners are generally not eligible for tax-free benefits.	Same as GP.	Same as GP.	Members are generally not eligible for tax-free benefits.	Shareholder-employees are eligible for tax-free benefits without restriction.	Owners of more than 2% of S corporation shares generally not eligible for tax-free benefits. I.R.C. § 1372.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Duration of entity</b>	No required term.	Same as GP or LP as applicable.	The latest date of dissolution must be stated in the certificate of partnership. Va. Code § 50-73.11.	No date of dissolution needs to be stated in the articles of organization. Va. Code §13.1-1011.	Perpetual.	Perpetual.	No date of dissolution needs to be stated in the articles of trust or governing instrument. Va. Code § 13.1-1212.



### Choice of Entity: Tax Issues

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Classification for tax purposes</b>	Check-the-box regulations allow owners to elect tax classification; if no election, the default classification is partnership. Treas. Reg. §§ 301.7701-1 to -3.	Same as GP.	Same as GP.	Same as GP except that the default classification for a one-member LLC disregards the entity for tax purposes so that the LLC is treated as a sole proprietorship. A single-member LLC may elect to be taxed as a corporation.	Taxed as a corporation. This results in double taxation, since the corporation is taxed on its income, and the shareholder is also taxed on distributions.	A domestic corporation meeting certain qualifications, such as limits on number of shareholders, may elect to be an S corporation with tax treatment similar to a partnership. I.R.C. §§ 1361, 1363.	Same as LLC, except that a Virginia business trust will be classified as a trust for federal income tax purposes if its purpose is solely to protect or conserve property for the trust's beneficial owners. <sup>3</sup>
<b>Federal tax return form</b>	Form 1065.	Form 1065.	Form 1065.	If more than one member, Form 1065 unless the LLC has elected to be taxed as a corporation, in which case it would file Form 1120.	Form 1120.	Form 1120S.	Same as LLC.
<b>Tax year</b>	A GP usually has the same tax year as a majority of its partners or, if the majority of its partners do not have the same tax year, the taxable year of its principal partners or, if the principal partners do not have the same taxable year, the calendar year. I.R.C. § 706(b)(1)(B).	Same as GP.	Same as GP.	Same as GP, unless it has elected corporate tax status.	A C corporation, other than a closely held corporation or personal service corporation, may adopt any taxable year. Treas. Reg. § 1.441-1(b).	An S corporation, a closely held corporation, or a personal service corporation must use the calendar year unless it can establish a business purpose fiscal year or elects to use a September, October, or November fiscal year. A deposit equal to the tax deferral received by the shareholders must be paid if a fiscal year is elected. I.R.C. §§ 441, 444, 1378.	Same as GP, unless it has elected corporate tax status.

<sup>3</sup> This chart does not describe the taxation of business trusts classified as trusts for federal income tax purposes.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Requirement for IRS representative to be designated</b>	Except for small partnerships with fewer than 10 partners, a partnership must designate a tax matters partner to represent the entity in audits and other proceedings. I.R.C. § 6231.	Same as GP or LP as applicable.	Same as GP except that the LP may designate a limited partner if a general partner is not available. I.R.C. § 6231(a)(7); Treas. Reg. § 301.6231(a)(7).	A member-manager of an LLC, or if no member serves as manager of the LLC, any member may be treated as a member manager and designated as the tax matters partner for the LLC. I.R.C. § 6231.	A C corporation does not have to designate a responsible officer for tax matters.	Rules similar to those applicable to partnerships have been adopted for S corporations.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Accounting method required</b>	A GP may use the cash receipts and disbursements method of accounting unless it sells goods out of inventory, Treas. Reg. § 1.446-1(c)(2)(I), or has a C corporation as a partner, I.R.C. § 448.	Same as GP or LP as applicable.	An LP may not use the cash method of accounting if it sells goods out of inventory (Treas. Reg. § 1.446-1(c)(2)(I)) or is a "tax shelter" as defined in I.R.C. § 461(I)(3) (interests in the LP are not sold in a registered offering, more than 35% of its losses are allocated to limited partners, or the principle purpose of using the cash method is avoidance or evasion of federal income tax).	An LLC is similar to an LP in its ability to use the cash method, unless it is a "tax shelter" as defined in I.R.C. § 461(I)(3) (same as LP).	A C corporation with average gross receipts of over \$5 million per year must use an accrual method of accounting. I.R.C. § 448. Exceptions exist for corporations with gross receipts of \$5 million or less or that are qualified personal service corporations. I.R.C. § 448(b).	An S corporation may generally use the cash method of accounting unless it sells goods out of inventory. I.R.C. § 448; Treas. Reg. § 1.446(c)(2)(I).	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Taxation of the entity on receipt of property in exchange for an ownership interest</b>	A GP does not recognize gain on the receipt of property in exchange for a partnership interest. I.R.C. § 721(a).	Same as GP.	Same as GP.	Same as GP, or if the LLC has elected to be taxed as a corporation, same as corporation.	A corporation does not recognize gain on the receipt of property in exchange for stock. I.R.C. § 351.	Same as C corporation.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Taxation of income at the entity level</b>	Not taxed at the entity level; all income and loss are passed through to the partners. I.R.C. § 701.	Same as GP	Same as GP.	Same as GP unless it has elected to be taxed as a corporation.	A C corporation is subject to tax on its income at the entity level. I.R.C. § 11(a).	Same as a GP. An S corporation is taxed at the highest rate on net recognized built-in gains if it was previously a C corporation or on passive investment income if it has accumulated earnings and profits. I.R.C. §§ 1361-79, 1374(a), 1375.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Tax rates	Individual and fiduciary (trustee) partners taxed at rates up to 39.6%; corporate partners taxed at rates up to 35%. I.R.C. §§ 1, 11.	Same as GP	Same as GP.	Same as GP unless it has elected to be taxed as a corporation.	From 15% to 34% on taxable income over \$75,000, and 35% on taxable income over \$10 million. 39.6% rate imposed on any taxable personal holding company income and on accumulated taxable income. I.R.C. § 11.	Same as GP except for taxable personal holding company income and accumulated taxable income, which are taxed at the same rate as C corporations.	For business trusts taxed as partnerships, same as GP. (The maximum tax rate for individuals is 38.6% for 2003.) For business trusts taxed as corporations, same as C corporation.

### Choice of Entity: Organizing the Entity

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Name	No restriction.	Must include the words registered limited liability partnership or the abbreviation R.L.L.P., L.L.P., RLLP, or LLP as the last words or letters in the name. Va. Code § 50-73.133.	Must include the words limited partnership or the abbreviation L.P.; may not include the name of a limited partner who is not a general partner. Va. Code § 50-73.2.	Must include the words limited company, limited liability company or the abbreviation L.L.C, LLC, L.C., or L.C. Va. Code § 13.1-1012(A). Effective 10/1/04, name must be distinguishable from similar names used for other entities.	Must include the word corporation, incorporated, company, or limited or the abbreviation corp., inc., co., or ltd. Va. Code § 13.1-630.	Same as C corporation. Va. Code § 13.1-630.	Must include the words "company," "association," "club," "foundation," "fund," "institute," "society," "union," "syndicate," or "trust," or abbreviations of like import. Va. Code § 13.1-1214(A).
Filing with State Corporation Commission (SCC) required to establish or create	None required. Optional filing. Va. Code § 50-73.83.	Yes. Va. Code § 50-73.132.	Yes. Va. Code § 50-73.11.	Yes. Va. Code §§ 13.1-1004(B), -1010.	Yes. Va. Code § 13.1-621.	Yes. Va. Code § 13.1-621.	Yes. Va. Code § 13.1-1211.
Public filings required	None required with SCC but may file optional statement of partnership. Va. Code § 50-73.83. File fictitious name certificate in Circuit Court Clerk's Office of city or county where business is to be conducted if operating under a fictitious name.	Application to become an LLP must be filed with SCC. Va. Code § 50-73.132. File fictitious name certificate in Circuit Court Clerk's Office of city or county where business is to be conducted.	Certificate of limited partnership must be filed with SCC. Va. Code §§ 50-73.11, -73.17. File fictitious name certificate in Circuit Court Clerk's Office of city or county where business is to be conducted.	Articles of organization must be filed with SCC. Va. Code §§ 13.1-1004(B), -1010. Fictitious name certificate is filed in Circuit Court Clerk's Office of city or county where business is to be conducted.	Articles of incorporation must be filed with SCC. Va. Code § 13.1-621. File fictitious name certificate in the Circuit Court Clerk's Office of city or county where business is to be conducted if operating under a fictitious name.	Same as C corporation. Va. Code § 13.1-621.	Articles of trust must be filed with the SCC. Va. Code § 13.1-1211. Fictitious name certificate, if any, is filed in circuit court clerk's office of city or county where business is to be conducted.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Effect of public filings	Disclosure. Va. Code § 50-73.83.	Disclosure and notice. Va. Code § 50-73.136.	Disclosure. Va. Code §§ 50-73.11, -73.19.	Disclosure and principal operating document. Va. Code § 13.1-1011.	Disclosure and principal operating document. Va. Code § 13.1-621.	Same as C corporation. Va. Code § 13.1-621.	Creation and disclosure of entity, but not trustees or beneficial owners. Va. Code § 13.1-1212.
Requirement for having agent for service of process identified and name on file with SCC	No.	Yes. Va. Code § 50-73.135.	Yes. Va. Code § 50-73.4.	Yes. Va. Code § 13.1-1011(A)(2).	Yes. Va. Code § 13.1-634.	Yes. Va. Code § 13.1-634.	Yes. Va. Code § 13.1-1212(A)(2).
Amount of public disclosure	Minimal. Must identify partners if fictitious name used.	Minimal. Must identify partners if fictitious name used. SCC filing gives notice of limited liability. Must also file annual report with SCC. Va. Code § 50-73.134.	Minimal. Must identify general partner(s). Va. Code § 50-73.11.	Minimal. Va. Code § 13.1-1011.	Minimal. Va. Code § 13.1-618. Must also file annual report with SCC identifying officers and directors. Va. Code § 13.1-775.	Minimal. Same as C corporation. Va. Code §§ 13.1-618, -775.	Minimal. Va. Code § 13.1-1212.

#### Choice of Entity: Owners

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Designation of owners	Partners.	Partners or general partners and limited partners.	General partners and limited partners.	Members. Va. Code § 13.1-1002.	Shareholders.	Shareholders.	Beneficial owners. Va. Code § 13.1-1201.
Persons with authority to bind the entity	Partners. Va. Code § 50-73.91.	Same as GP or LP as applicable.	General partners but not limited partners. Va. Code §§ 50-73.24, -73.29.	Members or managers. Va. Code § 13.1-1021.1. LLC may also designate non-manager officers. § 13.1-1022D.	Directors and officers. Va. Code §§ 13.1-673, -694.	Directors and officers. Va. Code §§ 13.1-673, -694.	Trustees, unless otherwise provided by articles of trust or governing instrument of the business trust. Va. Code § 13.1-1228.
Owner consents or elections required for tax classification	None.	None.	None.	None.	None.	Must elect S corp. status by filing with IRS. I.R.C. § 1362.	None.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Limits on owner's participation in management	None, unless partnership agreement provides otherwise. Va. Code § 50-73.99.	Same as GP or LP as applicable.	Only general partners can participate in management; limited partners may not. Va. Code §§ 50-73.24, -73.29.	Members may participate or may appoint a manager or managers. Va. Code §§ 13.1-1022, -1024.	Shareholders elect directors who determine policy and appoint officers as their agents to carry out policy. Va. Code §§ 13.1-675, -693.	Same as C corporation. Va. Code §§ 13.1-675, -693.	Trustees generally manage the affairs of the business trust, unless otherwise provided by the articles of trust or governing instrument of the business trust. Va. Code § 13.1-1228. The articles of trust or the governing instrument of the business trust may contain any provision relating to the management of the business and affairs of the business trust and the rights, duties, and obligations of the trustees, beneficial owners, and other persons. Va. Code § 13.1-1219.
Permissible contributions by owner in exchange for interest in the entity	A general partner may contribute cash, property, or services or a promissory note or other obligation to contribute cash, property, or services.	Same as GP or LP as applicable.	A general or a limited partner may contribute cash, property, or services, or a promissory note or other obligation to contribute cash, property, or services. Va. Code § 50-73.32	A member may contribute cash, property, promissory notes, services, or promise to contribute property or perform services in the future. Va. Code § 13.1-1027.	A shareholder may contribute cash, property, promissory notes, services, or promise to contribute property or perform services in the future.	Same as C corporation.	A beneficial owner may contribute cash, property, services, promissory notes or promises to contribute cash, property or to perform services. Va. Code § 13.1-1224.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Taxation of owner's receipt of interest in the entity in exchange for property	A partner is generally not taxed on receipt of an interest in the entity in exchange for a contribution of property to a partnership unless the liabilities on the contributed property exceed the contributor's tax basis in the property. I.R.C. §§ 721, 752(b); Treas. Reg. § 1.752-1(c).	Same as GP or LP as applicable.	Same as GP.	Same as GP unless the LLC has elected to be taxed as a corporation, in which case the corporation rules would apply.	Gain or loss is recognized on the contribution of appreciated or depreciated property for stock unless the contributors own 80% of the stock after contribution, the fair market value of the contributed property is not less than the value of the stock received, and the liabilities on the contributed property do not exceed its tax basis. I.R.C. §§ 351, 1001.	Same as C corporation.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
Taxation of owner's receipt of an interest in the entity in exchange for services	A partner will be taxed on the value of a capital account given by the partnership in exchange for services (Treas. Reg. § 1.721-1(b)(1)) but will generally not recognize income on the receipt of a share of the profits in exchange for services contributed to the partnership. Rev. Proc. 93-27, 1993-2 C.B. 343.	Same as GP.	Same as GP.	Same as GP unless it has elected to be taxed as a corporation.	Unless the stock is subject to a substantial risk of forfeiture, its value will be included in the owner's income when it is received. I.R.C. § 351.	Same as C corporation.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
Owner's right to transact business with the entity	A partner may lend money to and transact other business with the partnership, subject to other applicable law. On winding up, claims of creditors who are partners are subordinate to claims of non-partner creditors. Va. Code §§ 50-73.85, -73.102, -73.123; I.R.C. § 707; Treas. Reg. §§ 1.707-1, 1.721-1(a).	Same as GP or LLP as applicable.	A partner may transact business with the partnership and will have the same rights and obligations as third parties. On winding up, creditors who are partners share equally with non-partner creditors to the extent permitted by law. Va. Code §§ 50-73.10, -73.52.	Members may transact business with LLC, and subject to applicable law, have the same rights and duties as persons who are not managers or members. On winding up, member and non-member creditors share equally. Va. Code §§ 13.1-1026, -1049.	No prohibitions on transactions between shareholders and the corporation as long as they are fair and equitable. Va. Code § 13.1-725. Directors may only transact business with the corporation after full disclosure and approval by directors or shareholders or if the transaction is fair to the corporation. Va. Code § 13.1-691.	Same as C corporation. Va. Code §§ 13.1-691, -725.	No statutory prohibitions for beneficial owners. Trustees of a business trust are subject to the standards of conduct provided for directors of a Virginia corporation. Va. Code § 13.1-1229.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Owner's liability for obligations of the entity</b>	Unlimited. Va. Code § 50-73.96(A). But see Va. Code § 50-73.97 (a judgment against the partnership is not a judgment against a partner).	Partners are not personally liable for LLP debts. Va. Code § 50-73.96(D).	General partner has full liability; limited partners who do not participate in management are liable only to the extent of their capital contributions. Va. Code §§ 50-73.24, -73.29.	Members and managers are not liable beyond the extent of their respective capital contributions. Va. Code § 13.1-1019.	Shareholders are not liable for debts of the corporation except to the extent of their respective capital contributions. Va. Code § 13.1-644. Directors are only liable to the extent of unlawful distributions or misconduct. Va. Code §§ 31.1-692, -690.	Same as C corporation. Va. Code §§ 13.1-644, -690.	Beneficial owners are entitled to the same limitation of personal liability extended to shareholders of a Virginia corporation. Va. Code § 13.1-1225. In addition, beneficial owners or other persons may participate in the management of the business trust without incurring personal liability for the obligations of the business trust. Va. Code § 13.1-1228(B).
<b>Owner's fiduciary duties</b>	A partner is liable for breach of the fiduciary duties of care and loyalty and to give certain information to the partnership. Va. Code §§ 50-73.101, -73.102.	Same as GP or LP as applicable.	General partner has duties similar to those owed by a general partner in a GP. Va. Code § 50-73.29.	Members of a member-managed LLC and managers have duties of good faith and fair dealing and conduct reasonably believed to be in the best interests of the LLC. Va. Code § 13.1-1024.1.	Directors and officers are subject to statutory duties of good faith, exercise of care of an ordinarily prudent person and conduct reasonably believed to be in the best interests of the corporation. Va. Code §§ 13.1-690.	Same as C corporation. Va. Code §§ 13.1-690, -691.	Trustees of a business trust are subject to the standards of conduct provided for directors of a Virginia corporation. Va. Code § 13.1-1229.
<b>Liability of the entity for owner's wrongful conduct</b>	Yes. Va. Code § 50-73.95.	Same as GP or LP as applicable.	Yes. Va. Code § 50-73.95.	The entity may indemnify members and managers. Va. Code § 13.1-1009(16).	No, but the corporation may indemnify officers and directors.	Same as C corporation.	No, but a business trust may indemnify any trustee, officer, employee or agent of the business trust. Va. Code § 13.1-1230. A trustee or officer of a business trust is entitled to mandatory indemnification to the same extent as a director or an officer of a Virginia corporation. Va. Code § 13.1-1230(B).

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Owner's liability to the entity and to other owners	Fiduciary duties of care and loyalty apply only in the conduct and liquidation of the business of the partnership. Va. Code §§ 50-73.99, -73.102. A partner must contribute to the partnership obligations upon winding up. Va. Code §§ 50-73.122, -73.123.	Same as GP or LP as applicable.	A general partner's liability is the same as in a GP. Limited and general partners are liable for unmade contributions and for certain returns of distributions. Va. Code §§ 50-73.29, -73.33, -73.43.	Members in a member managed LLC and managers generally are liable for breaches of fiduciary duties. Va. Code § 13.1-1024.1. Members are also liable to make their agreed contributions. Va. Code § 13.1-1027. Managers and members assenting to or knowingly receiving wrongful distributions are liable to restore the distributions. Va. Code § 13.1-1036.	Shareholders are liable to the corporation and its creditors for the consideration for which shares are issued. Va. Code § 13.1-644. Directors are liable for wrongful distributions and are entitled to contribution from shareholders who received the distribution. Va. Code § 13.1-692.	Same as C corporation. Va. Code § 13.1-644, -692.	Beneficial owners are liable to make their agreed contributions. Va. Code § 13.1-1224.
Piercing the corporate (entity) veil	Assets of partners are available to creditors after assets of GP so there is no corporate veil to pierce. Va. Code §§ 50-73.95, -73.96.	The doctrine of piercing the corporate veil is not expressly applicable to LLPs, but similar theories may evolve.	A limited partner who participates in the control of the business is liable to persons transacting business with the partnership who reasonably believe that the limited partner is a general partner. Va. Code § 50-73.24.	The doctrine of piercing the corporate veil is not expressly applicable to LLCs, but similar theories may evolve. Cases in other states almost universally apply corporate standards.	Failure to respect the corporation's separate identity combined with the doing of a "legal wrong" may expose shareholders to personal liability. Va. Code § 13.1-725 <i>et seq.</i>	Same as C corporation. Va. Code § 13.1-725 <i>et seq.</i>	The doctrine of piercing the corporate veil is not expressly applicable to business trusts, but similar theories may evolve.
Entity actions against owner; owner actions against entity or against another owner	A GP may bring an action against a partner for breach of the partnership agreement or of a duty to the partnership; a partner may bring an action against the partnership or another partner. Va. Code § 50-73.97.	Same as GP or LP as applicable.	A general partner in an LP has the same rights as a general partner in a GP. A limited partner has the right to an accounting and to bring a derivative action. Va. Code §§ 50-73.62, -73.97.	An LLC may bring an action against a member for breach of the operating agreement or violation of a duty to the LLC. A member may bring an action, with or without an accounting, against the LLC, another member, or a manager. Va. Code §§ 13.1-1009, -1042.	A shareholder may enforce the corporation's rights through a derivative action. Va. Code § 13.1-672.1.	Same as C corporation. Va. Code § 13.1-672.1.	A business trust may bring an action against a beneficial owner for breach of the governing instrument. A beneficial owner may bring a derivative action in the same manner that a shareholder of a Virginia corporation may bring a derivative proceeding. Va. Code §§ 13.1-1210, -1231, -1235.



### Choice of Entity: Operations

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Organizational documents</b>	None. Partnership agreement is optional. Va. Code § 50-73.88.	Registration as an LLP (required); Partnership agreement (not required). Va. Code § 50-73.132.	Certificate of limited partnership (required); partnership agreement (not required). Va. Code § 50-73.11.	Articles of organization (required); operating agreement (not required). Va. Code § 13.1-1002, -1010.	Articles of incorporation, by-laws (required); organizational minutes, stock restriction agreements (not required). Va. Code §§ 13.1-619(A), -624(A).	Same as C corporation; must also file S corporation election with IRS. Va. Code §§ 13.1-619 (A), -624(A); I.R.C. § 1362.	Articles of trust (required); governing instrument (not required). Va. Code §§ 13.1-1212, -1219.
<b>Default management</b>	In the absence of an agreement partners share equally in management. Va. Code § 50-73.99.	Same as GP or LP as applicable.	General partner manages business; limited partners who take an active role in the business are subject to being deemed general partners. Va. Code §§ 50-73.24, -73.29.	In the absence of an operating agreement, members share in management in proportion to their contributions. Va. Code § 13.1-1022.	Shareholders elect directors; directors make policy and appoint officers to carry out policy. Va. Code § 13.1-675.	Same as C corporation. Va. Code § 13.1-675.	In the absence of a governing instrument, trustees manage the business trust. Va. Code § 13.1-1228.
<b>Basic ownership unit</b>	Partnership interest. Va. Code § 50-73.106.	GP or LP partnership interest, as applicable.	Partnership interest. Va. Code § 50-73.44.	Membership interest. Va. Code § 13.1-1002.	Share.	Share.	Beneficial interest. Va. Code § 13.1-1226.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Voting</b>	Unless otherwise agreed in a partnership agreement, a majority vote is required to determine issues in the ordinary course of business and a unanimous vote for issues outside the ordinary course of business and to amend the partnership agreement. Va. Code § 50-73.99.	Same as GP or LP as applicable.	Unless the partnership agreement states otherwise, general partners vote the same as in a GP, and all partners, including limited partners, vote on admission of new general partners and assignees, compromise of a partner's obligation to contribute, dissolution of the partnership, and continuation after an event of withdrawal. Va. Code §§ 50-73.27, -73.31, -73.33, -73.47, -73.49.	Unless modified by the articles of organization or operating agreement, each LLC member has one vote, and matters are determined by majority vote, except a unanimous vote is required to amend the operating agreement, admit a new member other than an assignee, and dissolve or merge the LLC. Va. Code § 13.1-1022. Proxy voting is permitted. § 13.1-1022E.	Subject to alternative provisions in the articles of incorporation, voting trusts, or voting agreements, each share has one vote. Va. Code §§ 13.1-662, -670, -671.	S corporations may have only one class of stock, but the shares may have different voting rights without creating a prohibited second class of stock. I.R.C. § 1361.	Unless otherwise provided by the governing instrument, matters are decided by the trustees. Va. Code § 13.1-1228. Amending or restating the articles of trust requires an affirmative vote by the majority of trustees. Va. Code §§ 13.1-1216, -1217. Mergers require an affirmative vote by the trustees and by two-thirds of the beneficial owners, unless otherwise provided by the articles of trust or the governing instrument of the business trust. Va. Code § 13.1-1258.
<b>Ability of owner to use the entity's losses</b>	Partners can use losses to offset other income, as limited by basis, at-risk, and passive activity rules.	Same as GP.	Same as GP. A limited partner is more likely to be subject to at-risk and passive activity rules.	Same as GP or corporation, as applicable.	No.	Same as GP.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Allocation of profit and loss</b>	Equally among partners unless otherwise stated in the partnership agreement. Va. Code § 50-73.99.	Same as GP or LP as applicable.	Pro rata to contributions less returned contributions, unless otherwise stated in partnership agreement. Va. Code § 50-73.34.	Pro rata to contributions regardless of returned contributions, unless modified in operating agreement. Va. Code §§ 13.1-1029, -1030.	Allocation of profit is pro rata to number of shares, unless varied by different classes of stock. Va. Code § 13.1-653. Loss is not allocated to shareholders of a C corporation.	Pro rata to number of shares; only one class of stock permitted. Va. Code § 13.1-653; I.R.C. § 1361.	Unless otherwise provided in the articles of trust or the governing instrument of the business trust, beneficial owners share profit and loss allocations in the proportion of the entire undivided beneficial interest in the business trust owned by the beneficial owner. Va. Code § 13.1-1226.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Determination of timing and amount of allocations</b>	Both by partnership agreement or majority vote of the partners. Va. Code § 50-73.99.	Same as GP or LP as applicable.	Both at the discretion of the general partner(s) unless otherwise provided in the partnership agreement. Va. Code §§ 50-73.34, -73.41.	At the discretion of the majority of the member-managers in a manager managed LLC; at the discretion of the majority of the members in any other LLC. Va. Code §§ 13.1-1022, -1024.	Both at the discretion of the board of directors, subject to preferred stock constraints. Va. Code § 13.1-653.	Same as C corporation except that only one class of stock is permitted, so there are no preferred stock considerations. Va. Code § 13.1-653; I.R.C. § 1361.	Trustees generally manage the affairs of the business trust, unless otherwise provided by the articles of trust or governing instrument of the business trust. Va. Code § 13.1-1228.
<b>Character and timing for tax purposes of recognition of gain or loss by owner</b>	Partners include shares of income, loss, deductions, and credit of the GP for the year in which earned. I.R.C. §§ 702(a), 704(b)	Same as GP.	Same as GP.	Same as GP unless election to be taxed as a corporation.	Shareholders do not report operating income or loss of the corporation on their individual tax returns.	S corporation's shareholders report a proportionate share of the corporation's income, loss, deduction, and credit for the year earned. I.R.C. §§ 1366, 1377.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Passive activity loss limitations</b>	A general partner may be able to use passive losses from a rental real estate activity in which the partner materially participates against other income. I.R.C. §§ 469(c)(7), 469(l).	Same as GP or LP as applicable.	Special limitations on the use of passive activity losses apply to limited partners who are also limited in their use of passive activity losses for rental real estate. I.R.C. § 469(h)(2).	LLC members will probably be treated like limited partners in determining material participation under the passive activity loss regulations.	A C corporation other than a closely held corporation or a personal holding company is entitled to deduct passive activity losses against income without limitation.	S corporation shareholders are subject to the passive activity loss limitations. I.R.C. § 1375.	For business trusts taxed as partnerships, same as LLC. For business trusts treated as corporations, same as C corporation.
<b>Effect of entity's liabilities on the owner's basis</b>	Partners can include both recourse and nonrecourse debt in basis. The partners' basis is increased by recourse debt in proportion to loss-sharing ratios. I.R.C. §§ 723, 752(a); Treas. Reg. § 1.752-1(e).	Same as GP or LP as applicable.	Unless limited partners bear the economic risk of loss with respect to recourse obligations, they cannot include such obligation in basis, but may include a share of nonrecourse debt in basis. The basis of general partners is increased by recourse debt; the basis of all partners is increased by nonrecourse debt in proportion to profit-sharing ratios. Treas. Reg. § 1.752-3(a).	Since virtually all liabilities of an LLC are nonrecourse for the basis allocation rules, the nonrecourse rules should apply, increasing the basis of all members in proportion to profit-sharing ratios. Treas. Reg. § 1.752-3(a).	The corporation's liabilities do not affect a shareholder's basis in shares. I.R.C. § 58(d)(2).	Same as C corporation. I.R.C. § 58(d)(2).	For business trusts taxed as partnerships, same as LLC. For business trusts treated as corporations, same as C corporation.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Tax on undistributed entity income</b>	Current tax; increase to partner's basis in partnership interest.	Same as GP.	Same as GP.	Current tax; increase to basis in membership interest.	No current tax to shareholders.	Current tax; increase to basis in debt and stock.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Taxation of owner on distributions</b>	Cash or debt: tax-free return of basis in partnership interest, then gain taxed as if from sale of partnership interest. Property: No tax; partner's basis equals partnership basis or partner's basis in partnership interest, if less. I.R.C. §§ 731(a), 732(a).	Same as GP.	Same as GP.	Cash or debt: tax-free return of basis in membership interest, then gain taxed as if from sale of membership interest. Property: No tax; member's basis equals LLC basis or member's basis in membership interest, if less. I.R.C. §§ 731(a), 732(a).	Cash or debt: dividend to extent of current and accumulated earnings and profits, then return of basis in stock, then taxed as if from sale of stock. Property: taxed same as cash. Any gain inherent in distributed property is taxed to the entity; basis in distributed property is fair market value. I.R.C. § 301.	Cash or debt: tax free return of basis in stock, then gain taxed as if from sale of stock. Property: taxed same as cash. Any gain inherent in distributed property is taxed to the entity and passed through to the shareholder; basis is fair market value. I.R.C. § 1368.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Deductibility of entity losses by owner</b>	Current deduction; decrease to basis in partnership interest. I.R.C. §§ 705(a), 733.	Same as GP.	Same as GP.	Current deduction; decrease to basis in membership interest. I.R.C. §§ 705(a), 733.	No deduction.	Current deduction; decrease to basis in stock and debt. I.R.C. § 1367.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Limitations on deductions by owner</b>	Limited to basis in partnership interest plus share of entity debt. Entity debt is shared by all partners. I.R.C. § 465.	Same as GP or LP as applicable.	Basis in partnership interest plus share of entity debt. Recourse debt is shared only by general partners; non-recourse debt is shared by all partners. Treas. Reg. §§ 1.752-2(a), -3(a).	Basis in membership interest plus share of entity debt. Entity debt is shared by all members. I.R.C. § 465.	N/A	Basis in stock and debt. Debt basis is limited to direct loans. I.R.C. § 1367.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Loss carryover by owner</b>	Unlimited to year when additional basis is obtained. I.R.C. § 465(a)(2).	Same as GP.	Same as GP.	Same as GP if taxed as a partnership.	N/A.	Same as GP, except that if S status is terminated, basis must be obtained by the end of the post-termination transition period.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Character of income and loss to owner	Character passed through from entity. I.R.C. § 702(b).	Same as GP.	Same as GP.	Same as GP.	N/A.	Same as GP.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
Taxation of entity on operations	No. I.R.C. §§ 701, 704(b).	No. I.R.C. §§ 701, 704(b).	No. I.R.C. §§ 701, 704(b).	No. I.R.C. §§ 701, 704(b).	Yes.	Usually no, unless passive income exceeds 25% of gross receipts and the entity has "earnings and profits." I.R.C. § 1375.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
Tax to entity on accumulations of income	None. I.R.C. §§ 701, 704(b).	None. I.R.C. §§ 701, 704(b).	None. I.R.C. §§ 701, 704(b).	None. I.R.C. §§ 701, 704(b).	Usually no, except on accumulations beyond reasonable business needs or personal holding company income. I.R.C. §§ 532, 541-547.	No.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
Tax to entity on distributions	None. I.R.C. §§ 701, 704(b).	None. I.R.C. §§ 701, 704(b).	None. I.R.C. §§ 701, 704(b).	None. I.R.C. §§ 701, 704(b).	Cash: Usually no. Property, entity gain: yes, on both liquidating and non-liquidating distributions; Property, entity loss: no, except on liquidating distributions. I.R.C. § 336(a).	Cash or debt: no. Property, entity gain: no, except gain on LIFO benefit recapture is recognized by entity and passed through. I.R.C. § 1363. Property, entity loss: no, except losses on liquidating distributions are recognized by entity and passed through. I.R.C. § 336.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
Taxation of entity on asset sale	No. I.R.C. §§ 701, 704.	No. I.R.C. §§ 701, 704.	No. I.R.C. §§ 701, 704.	No. I.R.C. §§ 701, 704.	Yes. I.R.C. § 1060.	Usually no, unless assets that were previously owned by a C corporation are sold within 10 years of S corporation election. I.R.C. § 1367; Treas. Reg. § 1.1374-4(g).	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
Annual report to SCC required	No.	Yes. Va. Code § 50-73.134.	No.	No.	Yes. Va. Code § 13.1-775.	Yes. Va. Code § 13.1-775.	No.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Effect of failure to file annual report	N/A	Cancellation of registration. Va. Code § 50-73.134.	N/A	N/A	Termination of corporate existence. Va. Code § 13.1-768.	Termination of corporate existence. Va. Code § 13.1-768.	N/A
Annual registration fee required	No.	Yes. Va. Code § 50-73.134.	Yes. Va. Code § 50-73.67.	Yes. Va. Code § 13.1-1061.	Yes. Va. Code § 13.1-768.	Yes. Va. Code § 13.1-768.	Yes. Va. Code § 13.1-1252.
Effect of failure to pay annual fee	N/A	Cancellation of registration. Va. Code § 50-73.134.	Penalty; cancellation of certificate if not paid by 12/31 of year assessed. Va. Code § 50-73.69.	Penalty; certificate canceled if not paid by 12/31 of year assessed. Va. Code § 13.1-1064.	Termination of corporate existence. Va. Code § 13.1-768.	Termination of corporate existence. Va. Code § 13.1-768.	Penalty; certificate of trust cancelled if not paid by December 31 of year assessed. Va. Code § 13.1-1254.

### Choice of Entity: Changes in Ownership

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Restrictions on transfer of ownership	Unless prohibited by the partnership agreement, a partner's economic interest in the partnership is freely transferable, but the transferee will not become a partner unless authorized by the partnership agreement or by the consent of the remaining partners. Va. Code §§ 50-73.106, -107. The transferor retains all rights other than economic interest. Va. Code §§ 50-73.106, -107.	Same as GP or LP as applicable.	The economic interest of a general or limited partner may be transferred, except as restricted by the limited partnership certificate, the partnership agreement, or applicable securities law. The transferee may only be admitted as a substitute partner according to the partnership agreement or with the consent of the remaining partners. Va. Code §§ 50-73.45, -47.	Member's economic interest may be transferred except as restricted by the articles of organization, the operating agreement, or applicable securities law. The assignee may become a member only with the consent of a majority of the other member-managers, not including the assignor, of a manager-managed LLC of which one or more members is a manager or the majority vote of the other members, not including the assignor, of any other LLC. Va. Code §§ 13.1-1039, -1040.	Shares are freely transferable, except as restricted by the articles of incorporation, bylaws, shareholder agreement, or applicable securities law. Va. Code § 13.1-649.	Same as C corporation except that transfer must be restricted to persons who are eligible to be S corporation shareholders. Va. Code § 13.1-649; I.R.C. § 1361.	A beneficial owner's beneficial interest in the business trust is freely transferable unless otherwise provided in the articles of trust or the governing instrument of the business trust. Va. Code § 13.1-1226.
Taxability of transfer to transferor	Capital gain or loss to transferor unless entity has specified assets such as accounts receivable or inventory. I.R.C. §§ 741, 751, 1221.	Same as GP.	Same as GP.	Same as GP.	Generally capital gain to transferor unless corporation is collapsible. I.R.C. §§ 341, 751, 1221.	Same as C corporation.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Effect of transfer of ownership interest on entity's continuity of life for tax purposes</b>	If 50% or more of the total interest in partnership capital and profits is transferred during a 12-month period, or if no part of the business is continued, the GP will be considered terminated. It will be treated as if its assets were distributed in liquidation and the new and remaining partners contributed the assets to a new partnership. I.R.C. § 708(b).	Same as GP.	Same as GP.	Same as GP.	The transfer of an interest in a corporation does not cause a termination for tax purposes. A transfer of more than 50% of the corporation's stock over a three-year testing period will cause an ownership change that limits the use of net operating loss carryovers and other tax attributes. I.R.C. § 382.	The transfer of stock to an ineligible shareholder may cause the termination of the S election. I.R.C. § 1362.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Effect of redemption of ownership interest on owner and entity</b>	Partial: treated the same as cash distribution to owner; Complete: treated the same as cash distribution except that partner loss is recognized and the remaining partners deduct a portion of redemption payment equal to goodwill and accounts receivable. I.R.C. § 736.	Same as GP.	Same as GP.	Same as GP.	Partial: taxed as if from sale of stock unless substantially equal to a dividend and taxed as cash distribution; Complete: taxed as if from sale of stock, unless attribution rules negate completeness and are not waived. I.R.C. §§ 302, 318.	Same as C corporation.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Mergers and exchanges: statutory authority</b>	Va. Code § 50-73.128.	Same as GP or LP as applicable.	Va. Code §§ 50-73.48:1-73.48:4.	LLC may be merged with a general partnership, either domestic or foreign, another LLC, a corporation, a limited partnership or a business trust. Va. Code § 13.1-1070.	Corporation may be merged with another corporation, a business trust or LLC. Va. Code §§ 13.1-716, -722.1.	Same as C corporation.	Business trusts may be merged with and into one or more business trusts or other business entities formed under the laws of Virginia, any other state or any foreign country. Va. Code § 13.1-1257.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Approval required for mergers and exchanges</b>	Unless otherwise agreed, approval of all partners needed for matters outside the ordinary course of business. Va. Code §§ 50-73.84, -73.91(2), -73.99.	Same as GP or LP as applicable.	Unless otherwise stated in the limited partnership agreement, by unanimous vote of the partners. Va. Code § 50-73.48:2.	Unless otherwise stated in the articles of organization or operating agreement, the unanimous vote of the members is required to approve a merger. Va. Code § 13.1-1071.	Unless otherwise stated in the articles of incorporation, the plan of merger must be approved and adopted by the board of directors, and approved by a two-thirds vote of the shareholders. Va. Code §§ 13.1-716, -718.	Same as C corporation.	Unless otherwise provided in the articles of trust or the governing instrument of the business trust, the affirmative vote of the trustees and the holders of two-thirds of the outstanding beneficial interests of the business trust is required. Va. Code § 13.1-1258.
<b>Merger and reorganization: taxation of owner</b>	Generally tax free regardless of classification of surviving entity. Rev. Rul. 95-37, 1995-17 I.R.B. 10; Priv. Ltr. Rul. 90-29-019 (July 20, 1990).	Same as GP.	Same as GP.	Regardless of entity termination, no tax effect unless liability shares are altered in the surviving entity. I.R.C. § 731.	Generally tax-free with basis carryover to the extent the owner continues equity interest in successor entity; any cash received is treated either as a dividend or as a partial sale or exchange of stock. I.R.C. §§ 354, 356.	Same as C corporation.	For business trusts taxed as partnerships, same as LLC. For business trusts taxed as corporations, same as C corporation.
<b>Merger and reorganization: taxation of entity</b>	Generally tax-free regardless of classification of surviving entity. Rev. Rul. 95-37, 1995-17 I.R.B. 10; Priv. Ltr. Rul. 90-29-019 (July 20, 1990).	Same as GP.	Same as GP.	Same as GP.	Generally tax-free provided that the surviving entity is a corporation. I.R.C. § 368.	Same as C corporation.	Same as GP, or if business trust has elected to be taxed as a corporation, same as C corporation.
<b>Merger and reorganization: tax history carryover</b>	No provision in I.R.C. unless surviving entity is deemed to be a continuation of the prior entity (no termination).	Same as GP.	Same as GP.	Same as GP.	Carryover. I.R.C. § 381.	Same as C corporation.	Same as GP, or if business trust taxed as a partnership or if business trust has elected to be taxed as a corporation, same as C corporation.



Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Dissenter's rights	Unanimous approval requirement gives each partner the power to demand cash-out. Va. Code § 50-73.99.	Same as GP or LP as applicable.	Limited partners are protected by requirement of unanimous approval. Va. Code § 50-73.48:4.	Unanimous approval requirement protects member's rights. Va. Code §§ 13.1-1071. Dissenters' rights may be created by agreement. § 13.1-1022G.	Unless waived in shareholder agreement, shareholders have the right to dissent. Va. Code §§ 13.1-729 to -739.	Same as C corporation.	As provided in the articles of trust or the governing instrument of the business trust.

### Choice of Entity: Dissociation and Dissolution

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
Dissociation or withdrawal	Partner may always withdraw from the partnership. Va. Code § 50-73.81. Events of dissociation are described in Va. Code § 50-73.109. If the partnership does not dissolve and wind up its business when a partner dissociates, the partnership must purchase the dissociated partner's interest. Va. Code § 50-73.112.	Same as GP or LP as applicable.	General partner may withdraw at any time upon notice to other partners; limited partners may withdraw only as specified in the partnership agreement. Va. Code §§ 50-73.37, -73.38.	Member may resign only as provided in the articles of organization or operating agreement. Va. Code § 13.1-1032. A member is dissociated upon the occurrence of any of the events specified in Va. Code § 13.1-1040.1. When an LLC's last remaining member dissociates, the LLC may continue without dissolution by admission of a new member (i) as provided in a writing executed by the personal representative of that last member, who may provide for the admission of the personal representative or its nominee or designee to the LLC as a member, provided that the articles or the operating agreement may provide that the personal representative of the last remaining member shall be obligated to agree in writing to the admission of the personal representative of that member or its nominee or designee to the limited liability company as a member, or (ii) in the	Shares may be freely traded or transferred subject to any restrictions contained in a shareholder agreement.	Same as C corporation except to entities whose status as a shareholder would cause loss of S-corp. status. I.R.C. § 1361.	As provided in the articles of trust or the governing instrument of the business trust.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
				manner provided for in the articles or the operating agreement pursuant to a provision of the articles or			
				the operating agreement that specifically provides for the admission of a member to the limited liability company after there are no longer any remaining members. Va. Code § 13.1-1038.1.			
<b>Events causing dissolution</b>	GP for a definite term or particular undertaking: when the express term expires or the particular undertaking is completed, the express will of all partners to wind up the partnership business, or upon the (i) dissociation of a partner through an event of insolvency or bankruptcy; (ii) death or incapacity of an individual partner; or (iii) wrongful dissociation, unless, within 90 days the majority in interest of the remaining partners, including any dissociated partner but not a wrongfully dissociating partner, agree to continue the partnership; At-will GP: upon the receipt of a partner's (but not a wrongfully dissociated partner's) notice to withdraw, unless all partners agree to continue the GP after dissolution of the GP but before liquidation is complete; Any GP: upon (i) the occurrence of an event that makes it	Same as GP or LP as applicable.	An LP will dissolve at the time or upon the occurrence of events stated in the certificate of limited partnership, the written consent of all partners, judicial dissolution, cancellation of the certificate for failure to pay the annual fee, or the withdrawal of a general partner unless there is at least one remaining general partner who continues the business under a written provision of the partnership agreement or unless all partners agree within 90 days after the withdrawal to continue the business. Va. Code §§ 50-73.12, -73.37, -73.49, -73.50.	An LLC will dissolve upon the happening of any dissociation events pertaining to members or member-managers as specified in the articles of organization or any operating agreement. An LLC will also dissolve by entry of a decree of judicial dissolution, automatic cancellation of its certificate, or the unanimous consent of all members. Va. Code §§ 13.1-1046, -1047, -1064.	Shares may be freely traded, redeemed, or otherwise exchanged or transferred without effecting a dissolution of the corporation. The board of directors may propose dissolution for approval by shareholders. Va. Code § 13.1-742.	Same as C corporation, except that transfer of shares to a person or entity that is not eligible to be an S corporation shareholder will terminate the S corporation election. I.R.C. §§ 1361, 1362.	A business trust will dissolve upon the happening of any events specified in the articles of trust or governing instrument of the business trust calling for the dissolution, upon the unanimous written consent of all the beneficial owners, upon the entry of a decree of judicial dissolution or upon the automatic cancellation of the certificate of trust pursuant to the Virginia Business Trust Act. Va. Code § 13.1-1234.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
	unlawful for all or substantially all of the business of the partnership to be continued, unless the illegality is cured within 90 days; (ii) a judicial determination of dissolution; or (iii) the occurrence of an event of dissolution under the terms of the partnership agreement. Any GP may continue its business after dissolution if, before completion of the winding up of the partnership's business, all of the partners, including any non-wrongfully dissociated partner, waive the right to have the partnership affairs wound up and the partnership terminated, in which case the GP will resume carrying on its business as if dissolution had not occurred. Va. Code §§ 50-73.117, -73.118.						
<b>Result of dissolution to entity</b>	Liquidation unless business continues by agreement. Va. Code § 50-73.123.	Same as GP.	Same as GP. Va. Code § 50-73.52.	Liquidation unless business continues by agreement. Va. Code §§ 13.1-1046, -1048.	Liquidation unless merged into another entity. Va. Code § 13.1-745.	Same as C corporation.	Liquidation, unless otherwise provided in the articles of trust or the governing instrument of the business trust. Va. Code § 13.1-1236.
<b>Result of dissolution to owner</b>	Unless otherwise agreed, cash-out according to return of capital and then in proportion to profit share. Va. Code § 50-73.123.	Same as GP or LP as applicable.	Unless otherwise agreed, cash-out according to return of contributions and then in proportion to distribution share. Va. Code § 50-73.52.	Unless otherwise provided, cash-out according to return of contributions and then in proportion to distribution share. Va. Code § 13.1-1049.	Cash-out according to classes of stock. Va. Code § 13.1-745.	Cash-out according to number of shares of stock.	Unless otherwise provided in the articles of trust or the governing instrument of the business trust, cash-out to the beneficial owners in proportion to their share in distributions. Va. Code § 13.1-1237.

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation	Business Trust
<b>Result if business continues</b>	Per agreement; if agreement does not address cash-out for dissociated partner, dissociated partner receives deferred cash-out. Va. Code § 50-73.112.	Same as GP or LP as applicable.	Unless otherwise provided, continuation of business has no effect on remaining partners. Va. Code § 50-73.28.	No effect on members if entity continues.	Effect is per merger agreement or plan of reorganization.	Same as C corporation subject to S corporation restrictions.	No effect on beneficial owners if entity continues.
<b>Owner's post-dissolution liability</b>	Partner is liable for share of winding-up liabilities. Partner who incurs unauthorized or inappropriate obligations is solely liable for such obligations. Va. Code §§ 50-73.114, -73.122.	See Va. Code §§ 50-73.96, -73.122.	General partner remains liable subject to general contract and tort statutes of limitation. Limited partners' liability for distributions continues despite entity termination. Va. Code §§ 50-73.29, -73.43.	Liability shield continues through dissolution. Possible liability for conduct during winding-up phase. Va. Code § 13.1-1048 (liability for post-termination conduct).	Liability up to the amount of liquidating distribution for 1 year after articles of dissolution filed if creditor shows good cause for not previously filing claim against entity. Va. Code § 13.1-755.	Same as C corporation.	Liability shield continues through dissolution.

### Choice of Entity: Estate Planning Considerations

Type of Entity	General Partnership (GP)	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	C Corporation	S Corporation
<b>Facilitation of gift transfers</b>	Partnership interest may be expressed in units and certified to facilitate transfer. Gift to an assignee does not per se admit the donee to partner status. Va. Code § 50-73.107.	Same as GP or LP as applicable.	Partnership interest may be expressed in units and certificated to facilitate transfer.	Membership interest may be expressed in units and certificated to facilitate transfer.	Share certificates facilitate transfer.	Same as C corporation.
<b>Gift and estate tax aspects of transfers of interests in the entity</b>	Transferor's excessive retention of control of the entity, excessive diversion of income, or excessive right to compel accumulation of income may cause the transferred interests to be included in transferor's taxable estate. I.R.C. §§ 2036, 2038.	Same as GP or LP as applicable.	Transferor's excessive diversion of income, or excessive right to compel accumulation of income may cause the transferred interests to be included in transferor's taxable estate. I.R.C. §§ 2036, 2038.	Excessive rights granted to the transferor by the operating agreement or articles of organization may cause the transferred interests to be included in the transferor's taxable estate. I.R.C. §§ 2036, 2038.	Excessive restrictions on gifted stock may cause loss of annual exclusion. The mere retention of voting control does not result in the inclusion of stock in the transferor's taxable estate. I.R.C. §§ 2036, 2038.	Same as C corporation.