

Entity Choice for the Privately-Held Company Post-OBBBA

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The right choice of entity for a privately-held company is often tax-driven and depends in large part on the business or activity the company will engage in, who the owners will be and how the owners expect to profit from the company. The recently enacted “One Big Beautiful Bill Act” (the “OBBBA”) made permanent or improved a number of tax provisions that had previously made the C corporation more attractive (or at least less unattractive) as compared to the limited liability company (“LLC”) or the S corporation for privately-held companies. This memorandum explores factors that go into choosing from among the C corporation, the LLC and the S corporation for a privately-held company post-OBBBA.[1] The discussion in this memorandum is not intended to be exhaustive and, in particular, does not discuss foreign, state or local tax rules except as expressly noted.

I. The C Corporation.

A C corporation is a corporation that isn’t an S corporation. It’s a fairly typical choice for a company that is expected to (i) have more than a few stockholders, (ii) grow using investor capital and/or retained earnings, (iii) incentivize employees and other service providers by making standard and traditional types of equity awards to them, and (iv) benefit its owners primarily through an ultimate sale of the company.

Pros.

(i) A C corporation (and not the stockholders) reports its income, gains, losses and deductions and pays tax on any income or gain it has. The OBBBA made permanent the reduction in the maximum federal corporate tax rate from 35% to 21% effected by the Tax Cuts and Jobs Act of 2017 (the “TCJA”).[2] The stockholders of a C corporation are generally taxed only on gains they have from selling their shares and on any dividends they receive from the corporation (at, in each case for individual stockholders, a maximum federal rate of 20% assuming, as to the gains, that the shares have been held for more than a year, although an additional 3.8% tax can apply to “net investment income,” which includes capital gains and dividends, of individuals with “modified adjusted gross income” exceeding a threshold amount). As a result, the C corporation generally avoids “phantom income” and other “pass-through” tax issues for its stockholders (and also U.S. tax issues for tax-exempt and non-U.S. investors, including tax-exempt and non-U.S. investors in investment funds that invest in the corporation).

(ii) C corporations (and only C corporations) that meet certain “qualified small business” and “active business” requirements can issue “qualified small business stock” (“QSBS”).[3] If a C corporation meets those requirements, an individual stockholder who has held his or her QSBS for at least a threshold period of time before selling it can exclude a portion of his or her gain from the sale, subject to a cap.[4] Since the enactment of the QSBS rules in 1993, the threshold period of time for holding QSBS before selling it with the ability to exclude gain has been 5 years, and the cap limiting the amount of gain excludible by a stockholder has been the greater of \$10 million or 10 times the stockholder’s basis in his or her QSBS. The percentage of a stockholder’s

gain that could be excluded was initially only 50% but was increased to 75% in 2009 and then to 100% for QSBS acquired after September 17, 2010. For QSBS acquired after July 4, 2025, the OBBBA (A) added a 50% gain exclusion for QSBS held for at least 3 but less than 4 years and a 75% gain exclusion for QSBS held for at least 4 but less than 5 years, and (B) increased the cap on a stockholder's excludible gain to the greater of \$15 million (to be inflation adjusted for issuances after December 31, 2026) or 10 times the stockholder's basis in his or her QSBS.[5]

(iii) Because the income of a C corporation is taxed at a maximum federal rate of only 21% while the income of an LLC or S corporation is taxed to the owners at their rates (which may be as high as 37% depending on the type of income, the applicability of any deductions and preferential rates, and the owners' tax brackets), the retained earnings of a C corporation can be taxable at a lower effective rate than the retained earnings of an LLC or S corporation.[6]

(iv) Stockholders of a C corporation don't have to file state tax returns in states where the corporation is required to file merely because the corporation has to file in those states.

(v) Equity awards by C corporations generally take fairly standard and traditional forms. Most typically, at least for bigger corporations, awards are structured as option grants, where the recipient receives the right up front to buy shares of stock in the future at a price determined up front. As long as the exercise price of the option is at least equal to the value of the stock at the time the option is granted, the recipient generally has no tax to pay with respect to the option unless and until he or she exercises the option and buys the stock (or receives a payment for the cancellation of the option).[7] Alternatively, an award can be of "restricted stock," where the recipient receives the stock (and owns it) up front and is generally taxed up front (assuming, if the stock is subject to vesting, that he or she makes a "Section 83(b) election") on any excess of the value of the stock when he or she receives it over what he or she paid for it.

(vi) For stockholders who are also employees, the corporation (A) withholds income tax and the employees' shares (1/2) of employment tax (FICA/FUTA) from the employees' compensation and pays it over to the taxing authorities on their behalf (the corporation bears the other half of the employment tax), and (B) sends W-2's to the employees annually showing their compensation and withholdings. The withholding by the corporation and W-2 reporting can serve to spare the stockholders who are employees from having to make quarterly tax filings and payments.

(vii) The value of employer contributions to many fringe benefits are deductible by the corporation and not taxable to the employees, including stockholders who are employees. These fringe benefits include health insurance, long-term care, group term life insurance up to \$50,000 per employee, medical reimbursement plans, company vehicles and public transportation passes.

Cons.

(i) The primary disadvantage of the C corporation is that any income or gain of a C corporation (including gain from an asset sale) that is distributed to the corporation's stockholders is subject to tax again to the stockholders as dividends or, in the case of a liquidating distribution following an asset sale by the corporation, as gains from the cancellation of their shares. The "double-tax" can result in an overall effective federal rate on distributed income or gain as high as 36.8%, plus any additional 3.8% "net investment income" tax due at the stockholder level). Given today's 21% corporate tax rate and the 20% rate applicable to an individual's dividends and long-term capital gains, double-tax on the distributed income or gain of a C corporation isn't as much of an issue as it's been in the past when corporate rates were significantly higher, but there can still be a disparity in favor of an LLC or an S corporation for a company that distributes income or gain depending on the nature of the income or gain and the rates at which it would be taxed to the owners if the company were an LLC or an S corporation (taking into account any applicable deductions and preferential rates).[8]

(ii) Stockholders of a C corporation are generally not able to claim losses with respect to their investments in the corporation until they sell their shares, and then, with a limited exception,

their losses are capital losses. Individuals may use their capital losses only against capital gains and small amounts of ordinary income.

(iii) In-kind contributions to the corporation for stock can be made tax-free only if the person making the contribution controls, or is part of a group contemporaneously contributing cash or property for stock that controls, the corporation immediately after the contribution.

(iv) With limited exceptions, in-kind distributions by corporations to their stockholders are generally treated as taxable sales at fair market value by the corporation and dividends or distributions to the stockholders. As a result, it can be very difficult to change corporate structures on a tax-free basis through spin-offs and similar transactions.

(v) Once a company goes the C corporation route, it can become an S corporation without being taxable on the change (although any “built-in gain” inherent in its assets at the time of the change can remain subject to tax at two levels if the assets are sold within 5 years after the change, and any outstanding stock of the corporation that is “qualified small business stock” will likely cease to be so treated), but there’s generally no changing to an LLC without the company being treated as if it had sold its assets (including goodwill) at fair market value and distributed the proceeds to its owners.

II. The LLC.

The LLC can be a good choice for a company that will be closely held and have earnings that it will periodically distribute to its owners.

Pros.

(i) An LLC’s income and gain is taxed only once and to its members as reported to them on Schedules K-1 each year (in the same character as recognized by the LLC and at the members’ rates taking into account any applicable deductions and preferential rates), and distributions of income or gain reportable by the members are not separately taxed. As a result, the use of an LLC avoids the double-tax on distributed income or gain that’s characteristic of the C corporation. The avoidance of double-tax is particularly useful if the LLC will distribute its earnings periodically to its members and if the LLC’s income or gain is taxable to the members at rates that are lower than the effective rates that would apply to the distributed income or gain if the LLC were a C corporation (because, for example the income or gain is long-term capital gain or “qualified business income”).^[9]

(ii) The losses of an LLC are reported by its members as well and deductible by them against other income they may have subject to any applicable deductibility limitations (such as the limitations applicable to losses for which the members are not “at risk” or that are “passive activity losses” in the hands of the members).^[10]

(iii) As compared to an S corporation, the profits and losses of an LLC need not be allocated to its members on a pro rata basis and instead can be allocated to them so as to give effect to any preferences or other terms of their business deal.

(iv) The members of an LLC include their shares of the LLC’s debt in their bases in their interests in the LLC for purposes of deducting losses of the LLC subject to any applicable deductibility limitations (such as the limitations applicable to losses for which the members are not “at risk” or that are “passive activity losses” in the hands of the members) and receiving distributions from the LLC tax-free.

(v) In-kind contributions to an LLC for equity can generally be made tax-free without the need to satisfy a “control” requirement.

(vi) With limited exceptions (including an exception for assets contributed to the LLC), in-kind

distributions of assets by an LLC can generally be made tax-free.

(vii) An LLC can make awards to employees and other service providers of “profits interests” (interests only in future value and earnings, which are deemed to have zero values) without requiring the recipients to pay purchase price or tax upon receiving the awards. Existing members have to be provided preferential rights to receive distributions equal to the liquidation value of the LLC at the time of an award before the recipient can share in sale proceeds, but the recipient can share after the preferential rights of the existing members are satisfied. Profits interests are equity and allow the recipients to participate in distributions and sale proceeds as owners (including to share in sale proceeds at capital gain rates), subject to the preferential rights of the pre-award members as to sale proceeds.

(viii) If an LLC makes a special “Section 754” election, a transferee of an interest in the LLC may “write-up” his or her share of the LLC’s bases in its assets (thereby enabling the transferee to report less income or gain, or greater deductions or losses, with respect to the assets). A transfer of shares in a C corporation generally has no effect on the corporation’s bases in its assets.

(ix) Buying owners out of LLC’s can be complicated, but the rules applicable to LLC buy-outs can be flexible in terms of tax results. Unlike stock buy-out payments by a corporation, equity buy-out payments by an LLC can provide asset basis increases and, particularly if the LLC is a service LLC, even deductions (or the equivalent) for the LLC (at the expense of capital gain treatment for the owner who is bought out).[11]

(x) An LLC can generally be converted to a corporation (C or S) without too much trouble, although (A) the conversion can be taxable to the extent that any debt assumed by the corporation exceeds the LLC’s tax basis in its assets, and (B) if the conversion is to a C corporation, any pre-conversion losses of the LLC are generally not thereafter usable by the corporation.[12]

Cons.

(i) The income, gains, losses and deductions of an LLC are reported by the owners each year without regard to the amounts of their distributions from the LLC. As noted above, the income of an LLC may be taxed to the owners at federal rates as high as 37%, which can result in a significantly higher effective rate applicable to the retained earnings of an LLC than the 21% corporate rate applicable to the retained earnings of a C corporation. Often, the members need “tax distributions” from the LLC to cover their tax liabilities.

(ii) The members of an LLC can have to file returns and pay tax in states where the LLC is required to file returns.

(iii) An LLC doesn’t withhold from payments or distributions (including from salary payments, which are referred to as “guaranteed payments”) to its members (including holders of “profits interests”) for income (or self-employment) tax purposes, so the members generally have to make quarterly filings to satisfy their tax obligations.[13]

(iv) The members of an LLC are also generally subject to self-employment tax on their compensation and, with certain exceptions, their shares of the LLC’s income (as members). A member’s self-employment tax burden includes the share of the employment tax burden on the member’s compensation the company would bear if the company were a corporation (typically, compensation payments to LLC members get grossed up for the additional self-employment tax burdens).

(v) Contributions by the LLC to health insurance premiums and other fringe benefits provided to members are generally treated as “guaranteed payments” to the members (deductible by the LLC subject to applicable deductibility limitations; taxable to the members). Members are, however, able to take “above-the-line” tax deductions for the premiums and other benefits,

subject to certain limitations (but only for income, and not self-employment, tax purposes).

III. The S Corporation.

An S corporation is a corporation that qualifies as, and elects to be, an S corporation. The tax rules applicable to an S corporation and its stockholders are sort of a hybrid between the C corporation rules and the LLC rules. An S corporation may have some reporting and employment tax advantages over an LLC, but the qualification requirements and potential for foot-faults significantly limit the usefulness of the S corporation.

Like an LLC:

(i) In general, like with an LLC, the income and gain of an S corporation is taxed directly to its stockholders (at their rates, taking into account any applicable deductions and preferential rates, and without regard to the amounts of their distributions) as reported to them on K-1's (which can require filing estimated taxes quarterly as with an LLC), and the stockholders generally aren't separately taxed on distributions of the corporation's income or gain they receive (so, there's generally no double-tax on distributed income or gain), but:

- A. because an S corporation can have only a single class of stock outstanding (differences in voting rights are generally permissible, but differences in economic rights are not), income, gains, losses and deductions generally have to be shared pro rata by the stockholders based on their relative share holdings;^[14] and
- B. if an S corporation has been a C corporation (or has acquired assets tax-free from a C corporation), (1) the corporation can have to pay tax under certain circumstances if it sells assets with built-in gain from the C corporation years or has too much passive investment income, and (2) distributions of earnings and profits remaining from the C corporation years are taxable to the stockholders as dividends.

(ii) The treatment of the costs of fringe benefits for stockholders who own more than 2% of the corporation's stock is similar to the treatment of the costs of fringe benefits for members of LLC's. The cost of health insurance is deductible by the corporation and taxable to the covered stockholder-employees (although not included in compensation for employment tax purposes), but the covered stockholder-employees can deduct the premiums paid for their insurance subject to certain limitations.

Not like an LLC:

(i) Stockholders who are also employees aren't subject to self-employment tax. The corporation (A) withholds both income tax and the stockholder-employees' shares (1/2) of employment tax from their compensation and (B) reports their compensation and withholdings to them on W-2's.

(ii) Only compensation to the stockholders – and not their shares of the corporation's income (as stockholders) – is subject to employment tax.^[15]

(iii) Stockholders of an S corporation are generally not able to include their shares of the corporation's debt to third-party lenders in their bases in their shares for purposes of deducting losses of the corporation or receiving distributions from the corporation tax-free.

(iv) Because an S corporation can have only a single class of stock outstanding, an S corporation can't issue profits interests to employees or other service providers.^[16]

(v) Like with a C corporation, (A) in-kind distributions are taxable as if they were sales at fair market value, and (B) in-kind contributions of assets for equity require the satisfaction of a "control" test to be tax-free.

(vi) In addition to being limited to only a single class of outstanding stock, there are limitations on the number and types of stockholders an S corporation can have (in general, only U.S. resident

individuals, estates and certain types of trusts can be owners).[17]

(vii) If an S corporation becomes a C corporation, stock held by the stockholders before the change can't be QSBS.[18]

For more information, please contact Attorney [Chip Wry](#).

[1] For tax purposes, an LLC is generally classified as a partnership if it has more than one owner (owners of LLC's are referred to as "members") or a "disregarded entity" (basically, a sole proprietorship) if it has only a single member, although the member(s) can elect to have it be classified as a corporation (including an S corporation if it meets the requirements for qualifying). This memorandum assumes that an LLC is classified as a partnership.

[2] There is no preferential rate applicable to the long-term capital gain of a C corporation, so the 21% rate applies to long-term capital gain as well as ordinary income.

[3] In addition to the requirements that the issuing corporation be a "qualified small business" and satisfy an "active business" test for its stock to be QSBS, the stock generally must have been acquired directly from the issuing corporation, and the corporation may not have redeemed too much of its stock within a year before or after the issuance of the stock (or within 2 years before or after the issuance of the stock from the stockholder or someone related to the stockholder).

[4] An LLC or S corporation can hold QSBS and pass the benefits of the QSBS rules along to its members based on the percentages of the LLC owned by them when the LLC acquired the QSBS.

[5] The OBBBA also increased the limit on the gross assets the issuing corporation may have at the time of a stock issuance to be a "qualified small business" from \$50 million to \$75 million.

[6] The 37% maximum ordinary income rate for individuals was reduced from 39.6% by the TCJA and made permanent by the OBBBA.

[7] Options granted by corporations are generally treated as "incentive stock options" (or "ISO's") or options that are not ISO's (or "non-qualified options"). Upon the exercise of a non-qualified option, the holder of the option has compensation income equal to the amount by which the then value of the stock exceeds the exercise price of the option (the excess is sometimes referred to as the "spread"). The ISO rules are intended to allow for the avoidance of compensation income upon the exercise of an ISO, but the holder has to hold the stock for at least a year after exercising the option (2 years after being granted the option), and the spread can be subject to an alternative minimum tax.

[8] Of course, the potential for double-tax on distributed income or gain also isn't much of a concern for a C corporation that doesn't expect to have income or gain or to pay dividends.

[9] If the income of the LLC is "qualified business income," individual members can deduct up to 20% of their shares of the income (reducing the 37% maximum rate to as low as 29.6%), subject to limitations based on the W-2 wages paid by the LLC and the cost of certain qualified property acquired by the LLC. "Qualified business income" excludes, among other things, capital gains and losses, dividends, interest and compensation (including compensation payments that are "guaranteed payments"). Unfortunately, with an exception for individuals with taxable income below a threshold, income from a consulting or other professional or personal service business (with exceptions for engineering and architecture businesses) is generally not "qualified business income" eligible for the 20% deduction.

[10] Even if a deductibility limitation applies to suspend a loss, the loss retains its character. As a result, for example, an ordinary loss suspended under the "passive activity loss" rules remains an

ordinary loss when it frees up for use.

[11] Deductibility of payments in retirements of stockholders of C corporations can also be achieved by agreements to treat the payments as in recognition of past services rather than for stock.

[12] Stock in the corporation received by the former LLC members can be QSBS in their hands if the qualification requirements are otherwise met.

[13] Because of the burdens to employees that can arise from also being members of an LLC, LLC's sometimes put "phantom equity" arrangements in place for them. Basically, a "phantom equity" arrangement is a bonus plan that pays out to participants as if they owned equity. The participants remain W-2 employees, and the LLC continues to withhold income and employment tax from their compensation. Unfortunately, though, (i) it can be difficult to structure the arrangements so that the participants share in periodic distributions by the LLC, and (ii) the participants can't share in proceeds of a sale at capital gain rates. An LLC can also attempt to preserve W-2 employee treatment for its employee-owners with respect to their compensation by having them own interests in the LLC through a separate entity, but these arrangements can be complicated.

[14] Stockholders of an S corporation can deduct their shares of the corporation's losses against other income they have subject to applicable deductibility limitations, including one that limits their ability to take losses generated by debt of the corporation.

[15] The IRS generally wants to see a reasonable allocation to compensation.

[16] Like LLC's, S corporations can put "phantom equity" arrangements in place for employees and other service providers. Otherwise, awards can follow corporate option or restricted stock models, but care must be taken to avoid S corporation foot-faults, and ownership of stock brings K-1 reporting of a share of income.

[17] The requirements for qualifying as an S corporation are very limiting, provide significant potential for foot-faults, and must be carefully addressed in governing agreements.

[18] If an S corporation contributes its assets to a C corporation for stock of the C corporation, the stock of the C corporation acquired by the S corporation can, however, be QSBS in the hands of the S corporation for the benefit of its stockholders if the QSBS requirements are otherwise satisfied, but the S corporation has to remain in existence as the holder of the stock.