Thinking of offering an ownership stake in your business to an employee? Here are some things you might want to know first.

If your business is an LLC

Interest in an LLC may pass to an employee in one of two ways: either the employee may become a new owner (called a member), or the owners of the LLC may transfer some of their interests to the employee.

Adding a new owner:

- Adding a new owner to an LLC usually requires unanimous consent of the rest of the owners.
- Generally, adding a new owner to the LLC is tax-free for the LLC, the new owner, and the existing owners if the new owner provides a contribution other than his/her services. The new member may be subject to tax if his/her only contribution to the LLC is his/her services. The new member may also be subject to tax if his/her contribution to the LLC consists of an asset that is subject to indebtedness.
- The existing owners of the LLC will have tax consequences if any part of the new owner's contribution is paid directly to them.
- Adding a new owner to what had been a one-owner LLC triggers additional tax reporting obligations, including the need to file a partnership tax return.
- If the business decisions of the LLC are made by all of its owners (it is member-managed), the new owner will have the right to participate in management and will have the authority to act as the LLC's agent to the outside world. The new owner will be able to enter the LLC into binding contracts and the LLC will be liable for the new owner's representations to the outside world.
- If the business decisions of the LLC are made by selected managers (manager-managed), the new owner will have the right to vote for managers.
- Care must be taken so that the new owner does not receive a disproportionately large interest in the business, thereby diluting the interests of the rest of the owners.

Transferring some of the existing owners interests to an employee:

- Owners of an LLC can usually transfer their economic interests in an LLC.
- Without unanimous consent of the existing owners, the employee would only acquire the right to receive distributions that the LLC makes to owners. The employee would not have the right to participate in management, vote, and act as an agent for the LLC.
- The employee would have the right to seek judicial dissolution of the LLC if the employee feels he/she is being treated unfairly.
- If the economic interest is sold to the employee for money or for other assets, the transfer will generally result in capital gain (or loss) or ordinary income tax consequences.
- In some cases, securities laws may be implicated.

If your business is a Corporation:

You may transfer stock, and thus ownership of your business, by selling the stock of one or more existing owners to a new owner either for money or other assets. You may also issue stock to a new owner out of stock held by the corporation and not issued.

- In some cases, you may choose to issue voting or non-voting stock to your employee.
- The new holder of voting stock will have the right to vote on some key decisions, in proportion to his/her number of shares as well as to vote for directors and thus influence how the corporation is managed.
- If you have the option of issuing non-voting stock, new holders of non-voting stock will have a financial stake in the corporation, but will not influence management.
- If care is not taken, issuing additional stock can dilute the value of the shares held by the original stockholders.
- If the transferor is an individual shareholder, the seller realizes a taxable gain or loss.
- In some cases, securities laws may limit the ability to transfer shares.
- Generally, a corporation does not face tax consequences when it issues its own stock. However, a corporation may face tax consequences if it issues stock in exchange for payments spanning more than one taxable year.
- If your business is an S-Corporation and adds too many shareholders, or if any of the shareholders are not individuals, your S election may be terminated and you will be taxed as a C corporation.

Thinking of reorganizing your business, merging with another company or separating from the other owners of your business?

There are seven ways to reorganize a corporation without immediate tax consequences. These seven types of reorganization are transactions in which the owners of a corporation continue to have an interest in the assets or the business of the corporation after the transaction, though in a modified form. Most of the seven methods of tax-free reorganization require that 1) the reorganization have a business purpose other than the desire to avoid paying taxes, 2) the owners of the business retain an interest in the business after the reorganization, in its modified form, rather than receiving money or assets directly, and 3) the business of the corporation continues after the reorganization, in its modified form. Among other things, these provisions ensure that the transaction is a reorganization and not a sale of the business. A brief layout of five of the seven types of reorganization follows.

Type A: Statutory Merger or Consolidation (the fusing of two corporations)

Merger: the assets and liabilities of the target corporation are taken over by the acquiring corporation and the target corporation ceases to exist.
Consolidation: two or more corporations join to form a third new corporation.

- To be tax-free, a merger or consolidation the transaction must qualify as a merger or consolidation under state or federal corporate law.
- The companies must have a plan of reorganization and the reorganization must be accomplished pursuant to the plan.
- In some instances, the board of directors and the shareholders must approve the plan of reorganization.
- Shareholders of the target corporation must exchange at least 50% of their stock for stock of the acquiring corporation. That stock may be voting or non-voting and may or may not be common stock.
- Shareholders of the target corporation may receive money or assets in addition stock of the acquiring corporation in exchange for their stock in the target corporation, but will face tax consequences for the money and assets.
- The target company can dispose of some of its assets prior to a merger so that the acquiring corporation does not need to acquire all of the target corporation’s assets.

Type B: Acquisitions of Subsidiaries for Stock

In a Type B reorganization, the acquiring corporation acquires the stock of the target corporation in exchange for stock of the acquiring corporation. The target corporation becomes a subsidiary of the acquiring corporation.

- The shareholders of the target corporation must receive only voting stock of the acquiring corporation or its parent corporation.
- Immediately after the transaction, the acquiring corporation must have at least 80% control of the target corporation. This means that the acquiring corporation must own 80% of the total number of outstanding shares of the target corporation and 80% of the voting shares of the corporation.
- In some cases, the exchange of the stock can happen over a period of time, rather than in one transaction.

Type C: Acquisitions of Assets for Stock

In a Type C reorganization, the acquiring corporation acquires substantially all of the target corporation's assets. The business of the target corporation ends up with the acquiring corporation and the target corporation ceases to exist.

- The acquiring corporation inherits some but not all of the target corporation's liabilities.
- Some of the value received in exchange for the target's assets may be money or property, with the rest being stock of the acquiring corporation.
- After the transaction, the target corporation liquidates and distributes its remaining assets, including stock of the acquiring corporation, to its shareholders.

Type D: Corporate Separations

Unlike Type A, B, and C reorganizations, Type D reorganizations break up the corporation. A type D reorganization consists of either getting rid of some corporate assets or of transferring the assets of a corporation to one or more new corporations. This can be accomplished in a Downstream Merger or a Divisive Reorganization.

In a Downstream Merger:

- The corporation transfers most of its assets to a corporation it controls and then liquidates.
- The stock of the subsidiary is distributed to shareholders of the transferring corporation in liquidation.
- The liquidation can also be used to distribute some assets from the original corporation that the new corporation does not want to own.

In a Divisive Reorganization:

- The corporation transfers some of its assets to a corporation it controls, but does not liquidate.
- Some of the controlled corporation's stock is distributed to one or more shareholders of the transferring corporation.
- After the transfer, some shareholders may have an interest in only one of the corporations while others have an interest in both, but the transferring corporation or its shareholders must be in control of the controlled corporation.

Type E: Re-capitalizations

Type E reorganizations involve re-capitalizing a single corporation through the exchange of the stocks or securities of a corporation for other stock or securities of the same corporation. A few reasons corporations might want to re-capitalize include:

- Re-capitalization can be used to exchange preferred stock with common stock.
- Re-capitalization can be used to provide a new class of non-voting stock to be given to children of stockholders or to employees of the corporation.

One final thought:
Though these transactions are often referred to as tax-free, you may, in fact, experience tax consequences from these transactions at a later time, such as when you later sell your interest in the reorganized corporation.