MGT 816 · The Private Firm CFO — Session 3

Legal & People Infrastructure

Entity choice · the document set · who counts as an employee

Mon Sep 14, 2026 · Prof. John Barrios · Yale SOM

Today, in three parts

1. **Entity choice** — the tax math, QSBS, and why your investors care **(50′)**
2. The legal document set — charter to cap table **(13′)**
3. People infrastructure — W-2/1099, exempt/non-exempt, cost of getting it wrong **(15′)**

Boards & governance → Session 10

Case 1 memo due Wed 9/16, 1:00 pm — tonight work on the memo. This session is prep-light on purpose.

Entity choice is a CFO decision

- Legal form drives **tax liability** across the company's life
- Sets **personal liability exposure** to debts and lawsuits
- Gates **ability to raise VC / PE capital**
- Adds **administrative and maintenance cost**
- Complicates **ownership transfers and exit**

Focus: forms used by start-ups and preferred by VC & PE.

Legal form ≠ tax form

Legal shells

- Sole proprietorship
- Partnership (GP, LP)
- Corporation (C, S)
- LLC

IRS buckets

- Sole prop → **Schedule C** (Form 1040)
- Flow-through → **Form 1065** (partnerships, multi-member LLCs) or **Form 1120-S** (S-corps), with K-1s
- C-corp → **Form 1120**

An LLC may elect to be taxed as a C-corp.

The forms, one by one: sole prop & partnerships

Sole proprietorship

- One owner; nothing to file — no separation between you and the business
- Income and expenses on your own 1040 (Schedule C)
- Sue the business = sue you; personal assets exposed
- Fits gig work; wrong once there are employees or investors

General partnership

- Two+ owners; forms **by default** — no filing required
- You can be in one by accident (profit-splitting on a handshake)
- Files Form 1065; income flows to partners on K-1s
- Each GP fully liable — including for a partner's mistakes

Limited partnership

- One GP runs it and keeps unlimited liability
- LPs are passive; loss capped at their investment
- The fund structure — VC and PE funds are LPs
- An LP who takes control can lose the cap — the rule varies by state

Liability and control travel together: you run it, and you own its debts.

The forms, one by one: corporations & the LLC

C-corp

- Chartered by the state; a separate legal person
- Its own taxpayer (Form 1120) — the double-tax form
- Unlimited shareholders; multiple share classes — common **and preferred**
- What VCs buy and public markets require; Delaware is the standard

S-corp

- Legally still a C-corp — "S" is only a **tax election** (flow-through)
- ≤ **100 shareholders**, US individuals only, **one class of stock**
- No preferred stock → no VC; no public listing
- Fits small profitable firms, not venture-track startups

LLC

- State filing + a private **operating agreement** that runs everything
- Members, not shareholders; allocations set by contract
- The hybrid: partnership taxation + corporate liability shield
- Pass-through by default; may elect C-corp taxation

Startups on the VC track: Delaware C-corp. Closely held / PE-backed: LLC. S-corp: rarely either.

The forms at a glance

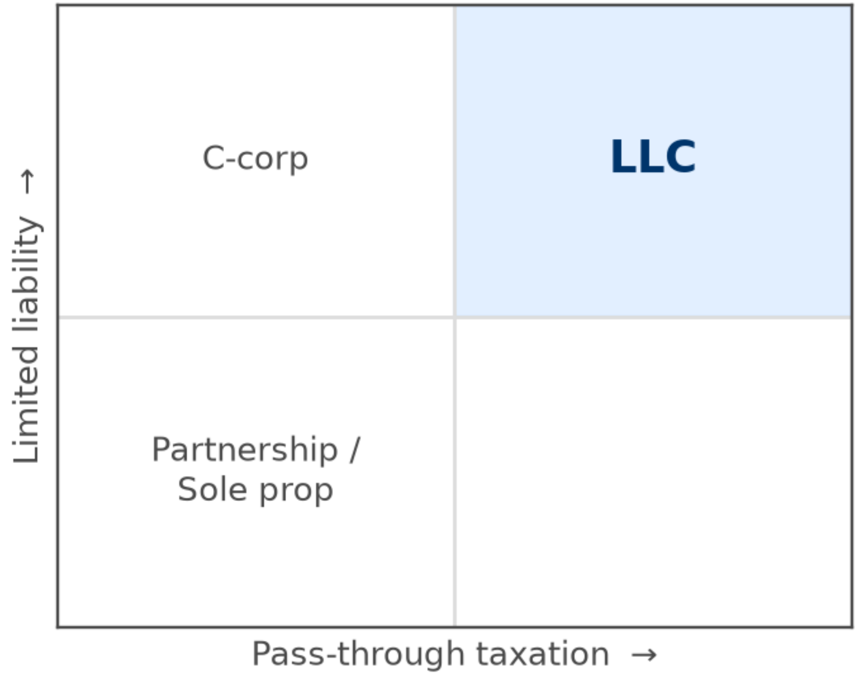
Attribute	Sole prop	Partnership	S-corp	LLC	C-corp
Liability shield	None	GP: none / LP: partial	Yes	Yes	Yes
Tax layers	1 (personal)	1 (pass-through)	1 (pass-through)	1 (pass-through)*	**2** (corp + shareholder)
Formalities	Minimal	Low	High + election limits	Low–moderate	High (meetings, minutes)
Outside-capital fit	Poor	Poor	Poor (≤100, one class)	Moderate (PE)	Strong (VC)

**LLC may elect C-corp taxation. S-corp is a tax election on a C-corp.*

C-corp = 2 layers: corporate tax on profits + shareholder tax on dividends/gains.

Pass-through mechanics — and phantom income

- Earnings taxed on **owners' returns** per operating-agreement allocations
- **Losses pass through** — early-startup benefit if founder has other income
- **Phantom income** — tax due even if no cash distributed
- **Character passes through** — capital gain stays capital gain
- Reported via annual **K-1** to each owner



LLC: partnership taxation with a corporate liability shield.

Exercise: after-tax cash, LLC vs. C-corp

One business, $100 of pre-tax profit, fully distributed this year. Two legal forms. Where does the owner end up?

Task: Compute owner's after-tax cash under (a) LLC pass-through and (b) C-corp — pay corporate tax, then dividend-tax the remainder.

Time: 3 min solo · 2 min pair · calculator / phone out.

Poll: Which form wins, and by how much per $100?

A) LLC by <$5   B) LLC by ≥$5   C) C-corp wins   D) tie

Tax rates for this exercise

Ordinary **$t_{ord} = 37\%$**

Corporate **$t_c = 21\%$**

Shareholder **$t_s = 23.8\%$**

t_s = 20% capital-gain + 3.8% NIIT.

QSBS §1202: the capital-gains exclusion ★

- §1202 can exclude **capital gains on qualified small business stock** from federal tax
- **C-corp original-issuance stock only** — bought directly from the company
- **Founder stock qualifies** if purchased at formation (ties to Pied Piper $100)
- Business must be **active & qualified** — not services, finance, or real estate
- **Two regimes now** — the parameters turn on your **issue date** (next slide)

Explainers written before July 2025 are out of date — OBBBA (7/4/25) changed the rules.

QSBS: two regimes — know your issue date ★

§1202 after the July 4, 2025 law (OBBBA)

	Issued ≤ 7/4/2025 (grandfathered)	Issued after 7/4/2025
Gross-asset test at issuance	≤ **\$50M**	≤ **\$75M** (inflation-indexed)
Exclusion cap	greater of **\$10M** or 10× basis	greater of **\$15M** (indexed) or 10× basis
Holding-period rule	**cliff: 100% only after 5 yrs** (nothing before)	**tiers: ≥3 yr→50% · ≥4 yr→75% · ≥5 yr→100%**

Shared: domestic C-corp only · original issuance · active qualified business (not services / finance / real estate) · held by the acquirer at issuance.

Worked: Founder buys Pied Piper shares for \$100 at formation (Jul 2026). Exit gain \$20M in 2032 (>5 yrs) → excluded = greater of \$15M or 10×\$100 = \$15M excluded; \$5M taxable. Same sale in year 3 → only 50% of eligible gain excluded.

Only gain the 50%/75% tiers leave unexcluded is taxed at 28%; gain above the cap is taxed at the usual 20% (+3.8% NIIT). CA does not conform.

Decision scorecard: LLC vs. C-corp

Favors LLC	Favors C-corp
Single tax layer	QSBS: ~0% on qualified gains
Losses pass through to owners	Standard ISO / option plans
Special allocations of profit/loss	VC-ready (many VCs can't hold flow-throughs)
Step-up worth ~10%+ to an acquirer	Tax-free reorganizations
Fewer formalities; private operating agreement	Easy share transfer; developed case law
—	No K-1s — no delays, no extended returns

Mini-case: VCs demand C-corps; PE prefers LLCs — why?

- VCs refuse flow-throughs and insist on **C-corps**.
- PE firms prefer **LLCs** and avoid C-corps where they can.
- Both raise from the **same tax-exempt LPs** — pensions, endowments.

Reconcile it.

think 2′ · pair 4′ · share 5′.

Debrief: the business model picks the entity ★

	VC	PE
Return model	Equity value at a growth exit; losses for years, no distributions	Current cash flows; dividends, recaps
Tax logic	Flow-through losses useless to funds & tax-exempt LPs (UBTI/K-1 pain); QSBS + IPO-ready standardization favor C-corp	Pass-through profits skip the corporate layer; asset step-up worth ~10%+ to next buyer; losses/allocations usable
Admin reality	30–40 portfolio K-1s = extended returns, chasing companies	Few, large positions — K-1 cost worth the tax savings

Same LPs, different cash-flow engines → different entity demand.

Many startups begin as LLCs and convert to DE C-corp at the first VC round — routine, but costs time/fees at the worst moment.

Part 2

The legal document set — charter to cap table

The document map: company, shareholder, employee

Company docs

- charter
- bylaws
- stock / option plan

Shareholder docs

- cap table
- investor rights agmt (IRA)
- voting agreement
- share purchase agmt (SPA)

Employee docs

- offer / contract
- confidentiality
- IP assignment
- option agreements

Founders watch: control, dilution, vesting.

Investors watch: pro-rata, liquidation preference.

Economics of those terms → S11.

Charter vs. bylaws (and the LLC twin)

Charter

- public, filed with Secretary of State
- creates the company; authorizes shares
- sets each class's rights / preferences
- **liquidation preference lives here**

Bylaws

- internal operating manual
- meetings, notice, quorum
- voting
- officers' powers & duties

LLC analogue = Operating Agreement — contract law, near-total flexibility, not public.

C-corps must keep minutes; sloppy formalities → pierce the corporate veil → personal liability.

The cap table is a legal record ★

- The cap table + stock ledger **evidence who owns the company**
- It's **diligence exhibit #1** in every financing and exit
- Errors compound: lost certificates, unsigned 83(b)s, phantom grants
- This is **why Carta exists** (see S02)

You built the spreadsheet Wednesday; today it's evidence.

Investor paper, one slide: IRA & SPA

Investor Rights Agreement

- pro-rata rights
- information / inspection rights
- registration rights
- board / observer rights
- protective provisions (investor-veto list)

Share Purchase Agreement

- price & shares
- representations & warranties
- covenants
- disclosure schedule ("the exceptions list")

If a rep is false → indemnity / price adjustment. Deep dive on terms: S11 Fundraising.

Employee docs: at-will, plus what everyone signs

- Most employees are **at-will** — no employment contract
- CEO / senior team **sometimes contracted**
- But **everyone** signs: offer letter, confidentiality, IP assignment
- Plus an **option agreement with vesting**

Vesting matters among founders too — Feedburner, Wednesday.

The protective trio

- **Confidentiality** = how confidential information is handled
- **Invention / IP assignment** = company owns employee creations
- **Non-compete** = post-employment field / customer restrictions
- **Non-compete status:** FTC's 2024 ban was **set aside in court**; **state law governs** — **void in CA**, restricted in several states
- CFO practice: **rely on confidentiality + IP assignment; treat non-competes as fragile**

Missing IP assignments are a classic diligence finding — acquirers make sellers fix them before closing.

Why does Uber want drivers on 1099s?

Uber / Lyft fight to keep drivers as 1099 contractors.

What exactly are they avoiding?

W-2 or 1099? The IRS control test

Behavioral

- who controls how work is done
- training
- right to assign extra work

Financial

- who bears costs / tools
- pay by hour vs. by project

Relationship

- permanency
- benefits
- exclusivity

Substance over label — a contract saying "contractor" does not decide.

What W-2 status costs the company

Tax	Rate	Base / note
Social Security (FICA)	6.2% employee + 6.2% employer match	up to wage base **$184,500** (2026)
Medicare (FICA)	1.45% + 1.45% match	no cap
Additional Medicare	+0.9% employee-only	wages over $200,000 (no employer match)
Income-tax withholding	per W-4	employer withholds (IRS Pub. 15)
FUTA	6.0% of first $7,000	≤ 5.4% state credit → net ≈ $42–$420/employee/yr

Employer's own add-on cost ≈ 7.65% of payroll + FUTA + state UI — this is what 1099 classification dodges.

SSA resets the wage base every October; $184,500 applies to 2026 wages.

The misclassification bill ★

10 × $80,000 × 2 yrs — reduced §3509 rates (1099s filed)

Your startup paid contractors 10 × $80,000 × 2 yrs — wages $1,600,000, 20 worker-years. An IRS/state audit reclassifies them all as W-2. Tally the federal bill.

Line item	Amount
Employer FICA (7.65% × wages)	$122,400
Employee-FICA share (1.53%)	$24,480
Income-tax withholding (1.5%)	$24,000
FUTA ($420 × 20 wkr-yrs)	$8,400

Federal bill

$179,280

≈ 11.2% of wages

≈ 11% of every contractor dollar, before interest, state UI, benefits — rates DOUBLE if no 1099s were filed; ~100% exposure if willful (+ officer liability).

Separate FLSA exposure — misclassified non-exempt workers add 2–3 yrs of back overtime × 2 liquidated damages.

Exempt vs. non-exempt: the three-gate test

FLSA governs; non-exempt = overtime (1.5×) + minimum-wage protections.

1. Salary level

at least \$684/wk (\$35,568/yr) federally; some states set higher (CA 2026: \$70,304)

2. Salary basis

guaranteed minimum, not docked for quality / quantity of work

3. Exempt duties

(next slide)

Fail any gate → non-exempt → overtime due.

Exempt duties — and the "everyone's a manager" trap

Executive

supervises 2+, management is primary duty, hire/fire influence

Administrative

office work tied to management/operations + independent judgment on significant matters (clerical ≠ administrative)

Professional

advanced-knowledge fields — law, medicine, accounting, engineering, IT

Title inflation ("Shift Manager") without real duties fails the duties test → back overtime 2–3 yrs + liquidated (double) damages + attorney fees under FLSA.

Takeaways ★

1. Legal form ≠ tax form; the CFO owns the entity decision.
2. Pass-through wins the static math: compare **(1−t_ord)** to **(1−t_c)(1−t_s)** — deferral and QSBS can flip it. ★
3. QSBS §1202: C-corp originals only — post-7/4/25: $75M test, $15M/10× cap, 50/75/100% at 3/4/5 yrs; older stock keeps 5-yr/100%/$10M. ★
4. VCs demand C-corps (exit equity, QSBS, no K-1s); PE prefers LLCs (cash flows, step-up). ★
5. Charter is public and holds share rights; bylaws run the company; the cap table is a legal record.
6. Worker status follows control facts, not labels — misclassification ≈ 11%+ of wages plus penalties and overtime back-pay. ★

Wed: Case 1 Feedburner — memo due 1:00 pm · PS1 due 9/23 · Boards → S10.