Start-Up Opportunities

The Internal Revenue Code permits the exclusion of certain gains from qualified small business stock

MOST business owners and founders are aware of the basic forms of corporate structure such as C corporations, S corporations, limited liability companies, and limited or general partnerships. However, their related decision-making often ignores alternatives that may offer similar protections but greater advantages or that supplement these core structures. These alternatives include qualified small business stock, dual classes of stock, and various tax incentives targeted at encouraging research and development.

Under Internal Revenue Code Section 1202, certain gains on stock that meets the definition of qualified small business stock (QSBS) are excluded from tax when sold if certain conditions are met. This provision became permanent with the passage of the Protecting Americans from Tax Hikes (PATH) Act on December 18, 2015. If stock qualifies, part or all of the total gain on the sale of the stock is excluded from federal tax depending on when the initial stock investment was made.

If the stock was acquired before February 18, 2009, the exclusion is 50 percent; if between February 18, 2009 and September 27, 2010, the exclusion is 75 percent; and if acquired thereafter, the exclusion is 100 percent. In application, this means that only 50 percent, 25 percent, and zero percent of the respective sales proceeds will be subject to tax, with the

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remaining amount being tax-free. If only a partial exclusion applies, the capital gain rate that applies to the nonexcluded percentage is 28 percent, assuming that the taxpayer is in the 15 or 20 percent bracket for long-term capital gains.6 A per-issue limitation on eligible gain exists, which limits the aggregate amount of eligible gain under Section 1202 to $10 million or 10 times the aggregate bases during the taxable year.7

To qualify as QSBS, the corporation must be a domestic C corporation (not an S corporation or LLC) and it must have been a C corporation for substantially all of the time that the shares were held.8 The corporation cannot have over $50 million in assets when the stock is initially issued or immediately thereafter.9 Furthermore, the stock must have been acquired at its original issue and not on the secondary market.10 Also, during substantially all of the time the stock was held, at least 80 percent of the corporation’s assets must have been used in the active conduct of a qualified business.11

The active business definition12 excludes a number of business types from the benefits of Section 1202. Investment vehicles, banking, insurance, financing, and leasing are not active businesses. Service businesses are excluded and are defined to include health services, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, financial services, brokerage services, consulting, and any other business in which the principal asset of the business is the skill or reputation of one or more of its employees. Farming is also excluded, as well as any business that produces a product subject to percentage depletion. Finally, operating a hotel or restaurant does not constitute an active business.

Additionally, the stock must have been held for five years prior to sale for Section 1202 to apply.13 Interestingly, should the company be bought by another company before the five-year holding period has passed, the shares might still qualify for the Section 1202 exclusion. If the acquirer uses its own stock in exchange for the stock of the target company, the resulting shares of the acquirer could become QSBS shares to the extent of gain as of the date of the transaction.14 Only the gain that occurs after the transaction date would be taxed under the normal rules. Gains can also be rolled over from one QSBS to another under Section 1043. To qualify under Section 1043, the QSBS must have been held for more than six months and the sales proceeds must be invested in another QSBS within 60 days of the first sale.15

State tax and the alternative minimum tax (AMT) for individuals still apply to gains on the sale of QSBS. California formerly offered preferential tax treatment for QSBS but ended the preference for tax years following 2012.16

The Section 1202 federal exclusion applies to both investors and company employees, as long as the requisite conditions are met. Thus, angel investors and some venture capital investors benefit from the provision. However, the holder of the stock must be an individual and not a corporation. This structure is popular in the venture capital infrastructure in which LLCs and partnerships have yet to gain a foothold. Traditionally, these investors aimed for an initial public offering (IPO) of their portfolio companies, for which a C corporation structure was required. Even as IPOs have been partially replaced by acquisitions for a variety of reasons, many companies and investors still favor the C corporation structure and benefits of Section 1202. For companies on this path, the Section 1202 option is a powerful incentive.

Clients should be advised to document any potential QSBS investments carefully. As many small or starting companies do not always keep meticulous records, documenting a path later may not be possible. Especially important is documenting that the company had less than $50 million in assets immediately after the initial purchase and that at least 80 percent of the assets were used in the active conduct of a qualifying business. Clients should also obtain a stock certificate issued to them and keep a copy of the cancelled check or other documentation showing the initial investment.

Dual Classes of Stock

Historically, different classes of stock have been used for a variety of purposes. For estate planning purposes, dual classes of stock were used as part of “estate freeze” strategies,17 which were designed to allow a transferor to retain voting rights and a nonappreciating economic interest in a company, while transferring to a younger generation an interest in the business that will appreciate. Chapter 14 of the Internal Revenue Code was enacted to limit these types of strategies. Titled “Special Valuation Rules,” Chapter 14 provides guidance for valuing a variety of interests for estate and gift tax purposes. For transfers of interests in corporations, the rules under Chapter 14 would require the value of the transferred interest in the company, for gift tax purposes, to include the value of the nonappreciating interest that the transferor retained, resulting in a high valuation and defeating the estate planning strategy.18 In adding these estate and gift tax valuation rules, the government effectively limited how company owners could allocate the appreciation in their stock going forward.

Although the rules under Chapter 14 have limited taxpayers’ ability to use dual classes of stock to delink voting rights from economic rights in the corporation. Recently, multiple classes of shares have been utilized in the tech industry to allow company founders to retain control, with Google creating Class C shares with no voting rights19 and Snap selling only nonvoting shares in its recent IPO.20 Other companies have been using this strategy for many years. For example, with Ford’s long-standing dual class of stock capital structure, the family retains 40 percent of the voting rights through ownership of the company’s Class B shares, even though those shares represent only a small percentage of the company’s total equity.21 Berkshire Hathaway is well known for its two classes of shares—Class A and Class B. Although better known for the difference in price between the Class A and Class B shares, the company’s Class A shares have more voting rights than the Class B shares and can be converted into B shares,22 with both classes of common stock trading separately on the stock exchange.

Typically, this structure creates two classes of stock, with differing voting rights. For the sake of this discussion, they shall be labelled A and B. An example of a common structure would be to give the Class A shares 10 times the voting rights of the Class B shares, with the Class A shares owned by the company founders or other select shareholders, and the Class B shares sold to the public. Additionally, liquidation provisions may specify a liquidation preference for the Class A shares. However, only C corporations, and not S corporations, can have dual classes of stock that differ with respect to rights to distributions or liquidation proceeds.23

This structure can have multiple benefits. For company founders trying to expand their start-up business, this structure allows the founders to retain control of the corporation while being able to obtain financing from new investors. A class of stock with little or no voting rights also has the advantage of allowing a company’s management to reward and incentivize employees by compensating them.
START-UP OPPORTUNITIES

1. Qualified Small Business Stock (QSBS) is always excluded from tax, regardless of circumstances.
   True.  False.

2. To qualify as QSBS, a corporation must be a C corporation; an S corporation or other flow-through entity does not qualify.
   True.  False.

3. Under Internal Revenue Code Section 1202, service businesses (e.g., law and accounting) are included in the definition of eligible businesses under QSBS requirements.
   True.  False.

4. Shares of a corporation qualify as QSBS after the company is sold to another company if the acquirer used its own stock in exchange for the stock of the target company.
   True.  False.

5. The Internal Revenue Service has limited the use of estate-freezing techniques for estate planning purposes.
   True.  False.

6. The application of dual classes of stock is a new phenomenon that started with “hot” online companies such as Facebook.
   True.  False.

7. Only C corporations may have dual classes of stock.
   True.  False.

8. Stock in the same class may have different voting, but not preference, rights in the capital structure.
   True.  False.

9. The use of dual classes of stock may allow management to retain voting control over a corporation while still raising outside funds.
   True.  False.

10. Investors view dual classes of stock favorably, preferring that management retain voting control of the company while allowing inside investors to benefit from upside potential.
    True.  False.

11. Qualifying research and experimentation expenditures have been reduced under the new Tax Cuts and Jobs Act.
    True.  False.

12. Research and experimentation expenditures may include expenditures for activities that further develop and expand upon an existing, legacy product and that are already certain to work.
    True.  False.

13. Research and experimentation expenditures may include attorney’s fees and costs incurred in obtaining a patent.
    True.  False.

14. Internal Revenue Code Section 41, concerning research tax credits, was repealed in the Tax Cuts and Jobs Act.
    True.  False.

15. Research tax credits are allowable when they include in-house research expenses of a start-up if the principal purpose of the expenditure is to use the results of the research in the active conduct of future trade or business.
    True.  False.

16. Qualified research includes nontechnological aspects of a product, e.g., market research and advertising.
    True.  False.

17. Net operating losses can still be carried back under the Tax Cuts and Jobs Act.
    True.  False.

18. The Tax Cuts and Jobs Act allows for 100 percent expensing of certain business assets acquired after September 27, 2017.
    True.  False.

19. Under The Tax Cuts and Jobs Act, the time for capitalization and amortization for research conducted outside the United States will be 10 years.
    True.  False.

20. The new corporate tax rate is 21 percent under the Tax Cuts and Jobs Act, which encompasses only C corporations and not S corporations.
    True.  False.

INSTRUCTIONS FOR OBTAINING MCLE CREDITS

1. Study the MCLE article in this issue.

2. Answer the test questions opposite by marking the appropriate boxes below. Each question has only one answer. Photocopies of this answer sheet may be submitted; however, this form should not be enlarged or reduced.

3. Mail the answer sheet and the $20 testing fee ($25 for non-LACBA members) to:
   Los Angeles Lawyer
   MCLE Test
   P.O. Box 55020
   Los Angeles, CA 90005

   Make checks payable to Los Angeles Lawyer.

4. Within six weeks, Los Angeles Lawyer will return your test with the correct answers, a rationale for the correct answers, and a certificate verifying the MCLE credit you earned through this self-study activity.

5. For future reference, please retain the MCLE test materials returned to you.

ANSWEERS

Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1.  
   - True  - False

2.  
   - True  - False

3.  
   - True  - False

4.  
   - True  - False

5.  
   - True  - False

6.  
   - True  - False

7.  
   - True  - False

8.  
   - True  - False

9.  
   - True  - False

10.  
    - True  - False

11.  
    - True  - False

12.  
    - True  - False

13.  
    - True  - False

14.  
    - True  - False

15.  
    - True  - False

16.  
    - True  - False

17.  
    - True  - False

18.  
    - True  - False

19.  
    - True  - False

20.  
    - True  - False
with company stock, without the risk of new investors coming in and diluting management’s control. From an estate planning perspective, although the Internal Revenue Code now limits the estate and gift tax advantages to issuing dual classes of stock, this structure also allows a founder to retain voting control while transferring economic ownership of the business to younger generations.

However, for companies looking to use this structure to raise outside funds, this type of structure might be a cause for concern for potential new investors. Investors want a degree of control when they invest money into an entity. Thus far, recent companies that have used this structure have been the “hot” ones, which are likely to be dictating terms. Nonetheless, this concern for potential new investors has caused the company to raise outside funds, this type of structure might be a cause for concern for potential new investors. Investors want a degree of control when they invest money into an entity. Thus far, recent companies that have used this structure have been the “hot” ones, which are likely to be dictating terms. Nonetheless, this concern for potential new investors has caused the company to retain voting control while transferring economic ownership of the business to younger generations.

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One such incentive provision applies to research and experimentation expenditures paid or incurred by a taxpayer in connection with the taxpayer’s trade or business. Under Section 174 of the Internal Revenue Code, taxpayers have the option of electing to treat qualifying research and experimentation expenditures as currently deductible expenses. When such expenses are taken as a current deduction, there is no recapture upon the subsequent sale of the resulting technology. Under the new Tax Cuts and Jobs Act, effective for amounts paid or incurred beginning after December 31, 2021, specified research or experimental expenditures will be capitalized and amortized over a five-year period. The time allowed for capitalization and amortization will be 15 years if the research is conducted outside the United States. This capitalization and amortization requirement applies to certain types of activities, including software development. Additionally, under this act, the application of the new provision is treated as a change in the taxpayer’s method of accounting under Internal Revenue Code Section 481, but no adjustment is made for research or experimental expenditures made before January 1, 2022.

Research and experimentation expenditures, herein defined as “research and development costs in the experimental or laboratory sense,” generally include all such costs incident to the development or improvement of a product. For example, attorneys’ fees incurred in obtaining a patent are considered research and experimentation expenditures. The regulations under Section 174 explain that expenditures represent research and development costs in the experimental or laboratory sense if they are for “activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.” Uncertainty is considered to exist if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

The Internal Revenue Code also offers business tax credits for certain research activities that can be used by companies incurring research and development costs. Designed to encourage research, the research tax credit under Section 41 is a nonrefundable credit for a percentage of qualified research expenses. These expenses generally must be paid or incurred “in carrying on” an established trade or business of the taxpayer; however, there is an exception to this requirement that allows in-house research expenses of a start-up to qualify if the principal purpose of the expenditures is to use the results of the research in the active conduct of a future trade or business.

The credit is available for qualifying research activities related to the development or improvement of a business component. For purposes of this discussion, the definition of “qualified research” can be distilled into a four-part test: 1) the research must be for one of the following permitted purposes: creating new, or improving existing, functionality, performance, reliability, or quality of a business component; 2) it must be undertaken with the intent of eliminating uncertainty concerning the development or improvement of the business component; 3) it must be a process of experimentation; and 4) the process must be technological in nature, defined as relying on principles of the physical or biological sciences, engineering, or computer science.

If these conditions are met, then the business generally qualifies for a research and development credit. The regulations elaborate on this oversimplification and provide concrete examples. Wages, supplies, and contract research and basic research payments qualify for the credit. These credits can be carried forward 20 years and back one.
Net operating losses (NOLs) can also be utilized to save taxes on income earned after the development stage of a company. NOLs are loss amounts incurred by companies during their down years that can be deducted against future and past earnings to lower taxes paid. Under the Tax Cuts and Jobs Act, these losses can be carried forward indefinitely, but can no longer be carried back.35

**New Planning Opportunities**

The Tax Cuts and Jobs Act has created more opportunities for corporations and their business cohorts, partnerships and LLCs, to use the tax code to maximize their financial results and options. The 21 percent corporate rate36 is a tremendous advantage, especially given that capital gains and dividends are still taxed at a preferred rate. While the dividends-received deduction for corporations37 has been reduced, it still exists, meaning that corporations with dividend income will pay an even lower effective tax rate. Double taxation can be avoided at the shareholder level by holding stock in a Roth IRA or by holding the stock until death, at which point heirs get a step-up basis in the stock. The 20 percent deduction38 allowed to flow-through entities—with exclusions for service businesses above a certain income level—may create additional planning opportunities for taxpayers considering how best to set up a new business. Seemingly, both corporations and flow-through entities can still deduct state and local taxes without the cap applicable to individuals, along with a broader array of expenses than can individuals. The Tax Cuts and Jobs Act also allows 100 percent first-year expensing of certain depreciable assets placed in service after September 27, 2017.39 However, as the act is still in its foundational stage of being implemented, further guidance and IRS regulations to define the application of some of its murkier (or taxpayer-favorable) provisions are expected.

When starting a new business, it is critical for business owners to find the right corporate and tax structure to build their business for the long term. Too often, advisors look only to obvious answers and ignore more complex provisions in the Internal Revenue Code that may offer business owners options better tailored to their distinct needs, as well as financial incentives to assist them in getting a business off the ground. When starting or running a business, every penny can make a difference. Time not spent on planning may also lead to excessive tax or litigation costs down the road. Subtle planning differences can magnify greatly when revenues become meaningful. With extensive new changes enacted to go into effect in 2018, many of which are intended to help businesses succeed, individualized tax code optimization has become even more important. ■