Rethinking Choice of Entity — Section 1202 Stock

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We tax advisors spend plenty of time assessing whether a particular business is better suited operating as a flow-through entity or as a tax-paying "C corporation." Flow-through entities generally include sole proprietorships, partnerships, limited liability companies (LLCs) taxed as partnerships, and S corporations. Flow-through entities generally do not incur entity level taxation, and items of income or loss are subject to U.S. federal income taxation at the partner, member, or shareholder level. C corporations are subject to U.S. federal income tax at the corporate level. A shareholder of a C corporation is not subject to U.S. federal income tax on the corporation's income unless and until the corporation pays dividends or the owner sells or exchanges its stock.

Unquestionably, the tax treatment of C corporations and their owners is inferior in some respects to the tax treatment of flow-through entities and their owners. The principal disadvantages of the C corporation form are the double taxation of C corporation income and the inability of C corporation owners to use C corporation losses to offset owner income from other sources. In some cases, however, the tax benefit provided by IRC section 1202 to C corporations outweighs the disadvantages. When it applies, IRC section 1202 can completely eliminate tax on gain from the sale of C corporation stock.

Section 1202 excludes from an individual taxpayer's gross income 100 percent of the gain recognized on the sale of "qualified small business stock" (QSBS) that was held for at least five years before the sale. The amount of the exclusion is limited to the *greater* of $10 million or ten times the taxpayer's tax basis in the QSBS stock. This limitation applies on a per-company basis for each individual. *Stated more emphatically, most shareholders holding QSBS will never pay any capital gains tax! In addition, application of section 1202 may also eliminate the 3.8 percent Net Investment Income Tax (NIIT) and state taxation in many states!*

In order to qualify as QSBS, the following requirements must be met:

1. Stock is acquired by the taxpayer upon original issue in exchange for money, property (not including stock), or as compensation for services.
2. The corporation is engaged in an active trade or business.
3. The corporation is engaged in a qualified trade or business.
4. The corporation is an eligible domestic entity.
5. The aggregate gross assets of the corporation do not exceed $50 million immediately before and after the issuance of shares.

The section 1202 exclusion does not apply to corporations engaged in certain types of businesses. In particular, section 1202 does not apply to businesses involving most professional services and some other personal services, business involving farming, mineral-extraction, restaurant and hotel activities, and certain capital-intensive financial activities. Tax advisors should carefully consider whether or not clients meet the QSBS rules prior to analyzing potential benefits.

[1] The 100 percent exclusion applies to stock issued after September 27, 2010. Partial exclusions apply to stock issued after August 10, 1993, but before September 28, 2010.

Assuming tax advisors and their clients get comfortable with all of the section 1202 requirements, additional items should be considered, including:

1. Losses and business failures — Tax advisors should consider whether it would be better to enable owners to take advantage of any losses generated in a flow-through structure. Losses in a corporate entity may be trapped (subject to applicable carryforwards), with limited value to a potential buyer. Worthless stock of a corporation may generate an ordinary loss for the stockholders if the stock meets the requirements in IRC section 1244.

2. Dividends and working capital needs — Tax advisors should consider anticipated dividends and working capital needs of the business. Dividends may give rise to a second layer of taxation, and additional cash infusions in exchange for new shares may not meet the section 1202 requirements.

3. Untimely stock sales — Section 1202 requires stock be held for at least five years. A client's startup business may not have such durability, especially when an attractive suitor comes knocking.

Appendix

Following is an example of a situation where the tax benefits of section 1202 outweigh the tax disadvantages of C corporation status:

Tax Advisor is approached by the founders of Tech Startup to assist with organizing a new entity to operate the business. Tech Startup has ten 10 percent individual owners, each of whom will contribute $100,000 to the business. Six of the ten individuals will materially participate in the business. The remaining four are passive investors. Tech Startup will develop and market a software-as-a-service solution. Tech Startup anticipates that it will spend one to two years developing the software before its product is widely launched and sales dramatically increase. Further, it is anticipated that it will take an additional one to two years before Tech Startup generates a profit. The owners intend that, if Tech Startup is profitable, they will take it public with an IPO or sell their stock. Tech Startup's founders projects that its business will produce the tax results listed below over the first eight years:

	Year 1	Year 2	Year 3	Year 4
Revenue	$ 10,000	$ 10,000	$ 100,000	$ 300,000
Cost of Goods Sold	$ 10,000	$ 10,000	$ 75,000	$ 150,000
Gross Profit	$ -	$ -	$ 25,000	$ 150,000
Expenses	$ 150,000	$ 150,000	$ 150,000	$ 150,000
Tax Income/(Loss)	$ (150,000)	$ (150,000)	$ (125,000)	$ -

	Year 5	Year 6	Year 7	Year 8
Revenue	$ 600,000	$ 1,200,000	$ 2,400,000	$ 4,800,000
Cost of Goods Sold	$ 300,000	$ 500,000	$ 1,000,000	$ 2,000,000
Gross Profit	$ 300,000	$ 700,000	$ 1,400,000	$ 2,800,000
Expenses	$ 150,000	$ 175,000	$ 225,000	$ 325,000
Tax Income/(Loss)	$ 150,000	$ 525,000	$ 1,175,000	$ 2,475,000

At the end of Year 8, Tech Startup owners expect to sell the company for $25 million. The total expected tax as a result of operations and the sale are as follow:

		C Corporation	
	Flow-Through	section 1202	No section 1202
Total Tax	$ 6,700,000	$ 1,400,000	$ 7,100,000

If Tech Startup had organized as a flow-through entity (e.g., an LLC or S corporation), the losses generated in the first three years would flow through to its owners and potentially would be available to offset other items of income. Similarly, the income generated in Year 5 through Year 8 would flow through to Tech Startup's owners and would be subject to marginal tax rates as high as 39.6 percent (plus an additional 3.8 percent NIIT to the four passive owners) and produce roughly $1.7 million in total taxes if taxed at the highest marginal rate. An allocation of taxable income to owners increases their tax basis in their membership interest. At the end of Year 8, each Tech Startup owner has a $490,000 tax basis in his or her membership interest ($100,000 initial investment plus $390,000 of allocated income). The sale at the end of Year 8 gives rise to taxable gain of roughly $2 million to each owner. This gain is generally subject to long-term capital gain taxation at marginal rates of up to 20 (plus the additional 3.8 percent NIIT on the passive owners who do not materially participate). This sale could result in U.S. income tax of approximately $500,000 for each passive owner, and nearly $5 million in total. The total U.S. federal income tax from operations and sale is approximately $6.7 million.

If Tech Startup had organized as a C corporation (e.g., a corporation not electing subchapter S treatment), the losses generated in the first three years generate net operating losses available to offset taxable income in Year 5 and Year 6. Once the net operating losses are utilized, the remaining taxable income would be subject to marginal tax rates as high as 35 percent and produce roughly $1.4 million in total taxes if taxed at the highest marginal rate. Unlike flow-through entities, corporate owners do not receive an increase in their tax basis for income generated by the entity. The sale at the end of Year 8 gives rise to gain of $2.4 million to each owner. Absent section 1202, this gain is generally subject to long-term capital gain taxation at marginal rates of up to 20 percent (plus the additional 3.8 percent NIIT). This could result in U.S. income tax of approximately $570,000 for each passive owner, and $5.7 million in total. However, when section 1202 applies, the entire $5.7 million in tax is avoided. The total U.S. federal income tax when section 1202 does not apply is approximately $7.1 million and $1.4 million when it does.

This simplified example ignores the impacts of any applicable state income taxes, and U.S. federal income tax results may be altered by the circumstances in any specific case. This example highlights the tax savings section 1202 can provide. Given the potential benefits of section 1202, tax advisors should seriously consider the C corporation form of organization when forming new businesses.

Visit Lane Powell's Taxation Practice Group webpage or Cannabis Practice Group webpage for more information.

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