DEMYSTIFYING SILICON VALLEY TAX ISSUES

By David Lefkowitz, CPA

Topics We Will Cover

- Introduction
- Tax Issues for Investors and Entity Structure
  – C-Corporation
  – S-Corporation
  – Limited Liability Company (LLC)
- Tax Issues for Founders and Employees
  – At formation
  – Compensation
  – Sale of the Company
  – Qualified Small Business Stock (QSBS)
- Research & Development Credit
- Current Events – CARES Act

PRESENTER

Professional Background

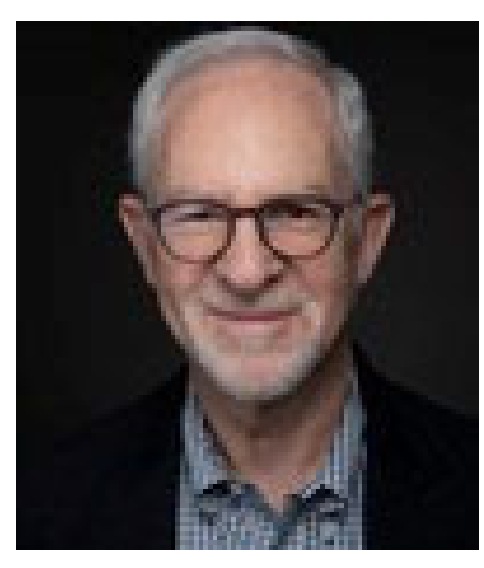
- *1989-2019* Managing Partner Lefkowitz and Company LLP, operating in California and Florida
- Of Counsel to TYS, LLP, a CPA Firm with offices in San Francisco, Walnut Creek, New York, and Miami *(2020-present)*

Entrepreneurial Background

- *1980-1989* Crude oil and gas producer in Oklahoma and Texas

Education and Licenses

- BSBA University of Central Florida
- CPA Licensed in California and Florida



David Lefkowitz, CPA
o | 415-529-6176 c | 415-260-1851
www.tysllp.com
dlefkowitz@tysllp.com
7300 Biscayne Blvd, Suite 200, Miami, FL 33138

Business and Tax Philosophy

- Taxes are a cost of doing business
- Strategies for managing
- Rules constantly in flux, driven by Government changes
- Tax advisors support companies and founders

BUSINESS ENTITY TYPE AND SELECTION

C-Corporation

- This structure is the one most preferred by Investors
- C-Corporations pay Federal and possibly State tax on their taxable earnings
- Taxes paid by a C-Corporation are the most straight forward, although calculations of taxes, in general, are hardly straightforward
- Units of ownership are called shares
  - C-Corporations can create multiples classes of shares, with each class conferring different rights and benefits to the shareholders.

S-CORPORATION

- S-Corporations are initially formed as a C-Corporation, which then make a formal election to be taxed as an S corp.
- S-Corps do not pay Federal taxes on their earnings. Rather, the shareholders pay tax on their respective share of the S-corporation's profits, and during that portion of the tax year that they have ownership
- S-Corps are referred to as "flow through" entities, this because their earnings/losses are not taxed at the corporation level, but directly to their shareholders.
  - Thus, early-stage taxable losses create tax benefits to their owners

S-Corporation cont.

- S-Corporations have many restrictions on their tax structure, including
  - a limit to the number of shareholders,
  - limited to only a single class of stock, and the inability to issue stock options
  - limitations on certain tax-deductible expenses, which are regularly allowed for C-corporations

As a result of these limitations, there is a smaller percentage of investors who find this structure desirable

LIMITED LIABILITY COMPANIES (LLCs)

- LLCs are also “flow-through” tax entities, but have greater structural flexibility than S Corporations.
- LLCs are allowed to “elect to be treated” for tax purposes, as a corporation (C or S), but this creates a clunky structure to deal with from a business perspective.
- Because they must follow the LLC rules for corporate governance, even though they are taxed as a corporation, this fact may put them at odds with legal structure choices that are standard with C-Corporations.

LIMITED LIABILITY COMPANIES CONT.

- LLC's can have multiple classes of equity, similar to a C Corporation, and assign different rights to those classes
- LLC's lack the governance requirements of a corporation, which reduces structural controls inherent in corporations
- Similar to S Corporation owners, the types of investors who like LLC's are more heavily tax-focused.
- Because most early-stage companies generate taxable losses in their early years, the losses "flow-through" to the owners, allowing them to generate tax-savings from those losses

What are Favored Jurisdictions for Corporate Formation?

- **Delaware Corporations – most favored for their legal advantages**
  - Pay only Federal income tax
  - Also pay annual Franchise Tax based on number of authorized shares.
  - An alternate valuation method can reduce the franchise tax from a maximum $200,000 to a few hundred dollars
- **Nevada Corporations**
  - Pay only Federal income tax
  - Also pays a nominal State "Gross Receipts" tax
  - Gross receipts are taxable if >$4million

TAX ISSUES FOR FOUNDERS

HOW SHARES ARE ACQUIRED

- Shares are purchased from the Corporation upon the founding of company, most often at the company's par value
  - The purchase price is stated in the articles of incorporation, (i.e.) $0.0001/share. In this example the founder purchases 4,000,000 shares for $400.00
- Since there are no assets or other significant value when the corporation is formed, the price paid for these shares equals their value
- When the shares are purchased for an amount equal to their market value, no taxable gain occurs from the transaction
- HOWEVER, if the founder receives shares of stock, where the value of the shares "exceeds the price paid" for the shares, a ***taxable event*** occurs, based upon the difference between the value and the purchase price paid

AT FORMATION CONT.

- Upon subsequent acquisition of shares, exercising stock options may create taxable income upon exercise, due to the increased value of the company's shares (vs. price paid)
- As well, stock grants create taxable income equal to the value of the shares. When grants are based on a vesting schedule, these shares create taxable income ***as they vest***
- We also see founders taking a loan from the company in order to purchase additional shares or to exercise options
  - These loans benefits the founders by their gaining a greater equity stake in the company, and without having to fund the purchase using their personal resources
  - It should be noted that there are several business and legal hurdles to overcome around this type of transaction, so you will want to confer with the Board and legal counsel

COMPENSATION METHODS

- Cash-paid salaries are straightforward and easily valued compensation: the Board determines your salary, and pays periodically (i.e. twice monthly)
  - payroll and other taxes are withheld from your paycheck and, after those taxes are deducted, you receive the net pay,

COMPENSATION - NONCASH

- Non-cash compensation include stock options and other equity grants.
- There are 2 general types of stock options issued in the US:
  – Incentive Stock Options, and
  – Restricted Stock Units

INCENTIVE STOCK OPTIONS (ISO'S)

- Incentive Stock Options (ISOs) are issued pursuant to a formal plan that meets specific IRS guidelines
  - Issued only to employees
  - Typically have the following components
    - no more than a 10-year life
    - Usually subject to a vesting schedule (i.e. 4-year vesting, with a 12-month cliff, plus periodic vesting, such as 1/48 of the shares vest starting with month 13)
- When ISOs are awarded to an employee, the employees receive an "Award document" which defines the terms of the award

INCENTIVE STOCK OPTIONS (ISO'S) CONT.

- Exercising one's ISOs does not create taxable income to the employee (and there are exceptions to this), but does potentially create alternative minimum taxable income, referred to as AMT
- As the employee exercises his ISOs, his options convert to shares of stock in the Company.
- This event starts the "long-term capital gains" clock on beneficial tax treatment when he ultimately sells his shares
- In any year when ISOs are awarded, the ***exercise value*** of those ISOs in excess of $100K worth of stock options lose their ISO characteristics, and are deemed to be less tax-favorable NQSOs by the IRS

Nonqualified Stock Options

- NQSOs contain many of the same tax characteristics as ISOs, but with substantially fewer restrictions
- While ISOs can be awarded only to employees, NQOs can be awarded to contractors, directors, or other entities, usually in exchange for services.
- NQSOs are non-cash compensation which permit the company to pay for services with its equity, as opposed to using its precious cash
- Upon the exercise of NQOs, the holder is subject to taxable income, equal to the market value of the shares, less the exercise or strike price paid.
- If held by an employee, the taxable income (value of shares less strike price) amount received from the exercise will be reported on the employee's annual W-2 form , and payroll taxes are withheld by the employer

Restricted Stock Units (RSUs)

- Companies having a liquid market for their shares (i.e. public companies) can issue shares to their employees called Restricted Stock Units, or RSUs.
- The value to the company of issuing RSUs are that:
  - Shares that are issued do not require the Company's cash for compensation; rather, the liquidity used to compensate the employee, is derived from the sale of the company's shares in the public market
  - The total value of the RSUs, as they vest, are deemed to be wages
  - A portion of the vested shares are sold into the market for payment of the employee's payroll taxes, and the remaining shares are transferred directly to the Employee, to be sold or held for capital appreciation
  - The employer benefits from a taxable deduction equal to the value of the shares on the vesting date, without having to use its own cash

Vesting of shares and Importance of filing an 83(b) election

- The 83(b) election permits the shareholder to "accrue the increased value", and pay taxes on the total gain at disposition

Example - Founder receives 1,000,000 shares of common stock (equal to 10% of the company at founding), vesting over 4 years, or 250,000 shares/year.

Par value is $0.0001/share, and founder pays $100.00 for his shares

	Total value of share	Increase in value or taxable income	Federal income tax (assumes single)	Cumulative tax paid	Sell for $3.5 million
Value of Shares end of year 1	$ 100,000	$ 100,000	$ 18,174	$ 18,174	
Value of Shares end of year 2	$ 500,000	$ 400,000	$ 115,194	$ 133,368	
Value of Shares end of year 3	$ 750,000	$ 350,000	$ 97,694	$ 231,061	
Value of Shares end of year 4	$ 2,000,000	$ 1,650,000	$ 575,488	$ 806,549	

83(b) election Cont.

File 83(b) election within 30 days of acquiring stock, Sell for $3.5million, and pay only long-term capital gains tax on the sale at 20% or $699,980
($3,500,000 - $100) x 20% =
$699,980)

OR,

Fail to timely file the 83(b) election,
and
pay capital gains tax of $538,670 ($3,500,000, less purchase price of $100, less taxes paid on increase value $806,549, times 20%)
PLUS the ordinary income tax of $806,549. (total taxes paid $1,345,219 an extra ***$645,239*** in unnecessary tax)

SALE OF COMPANY – TAX EFFECT TO SHAREHOLDERS

- When Sale of corporation's shares for is 100% cash
  - Each shareholder receives cash for their stock,
  - Options are converted to stock and sold
  - Depending on the term each shareholder has held their shares, they will pay tax
    - at long term rates (if owned > 1 year) or
    - short term taxed as ordinary income if they have owned their shares for < 1 year (including same day sale from conversion of options
- Sale of corporation's shares for cash plus stock in acquiring company
  - Where shareholders receive shares in exchange (or partial exchange) for their shares in the selling company, only the cash received is subject to capital gains taxes

QUALIFIED SMALL BUSINESS STOCK (QSBS) CODE SEC. 1202(C)

QSBs have the following characteristics:

- The stock must be received by an eligible taxpayer (not a corporation).
- The stock must be held for at least 5 years.
- The stock must have been originally issued to the stockholder by the corporation.
- The stock must have been issued after August 10th, 1993
- The stock must have been acquired for consideration (meaning cash, services, or other eligible property).
- The stock must have been issued by a qualified small business
  - Firms in the technology, retail, wholesale, and manufacturing sectors are eligible as QSBs, while those in the hospitality industry, personal services, the financial sector, farming and mining, are not
  - The Company must always have been a C Corporation
  - Aggregate Gross Assets of the corporation before the issuance of the shares did not exceed $50,000,000

RESEARCH AND DEVELOPMENT CREDIT CODE SEC. 41

- The R&D Tax Credit may be claimed by taxpaying businesses that develop, design or improve products, processes, formulas or software.

What business efforts qualifies for the R&D Credit?

Develops or designs new products or processes

Enhances existing products or processes

Develops or improves upon existing prototypes and software

Research and Development Credit QRE expenses

What Research Expenses qualify for the tax credit (QREs)

In-house Research expenses

Wages, to include income from exercise of stock options, other amounts subject to withholding

Supplies

Computers and ancillary equipment

Contract Research expenses (at 65% of the actual cost)

Engaging in qualified Research
Directly supervising qualified research
Directly supporting qualified research

Company claiming the tax credit MUST have a right to ownership of the results of the research

Startups and small businesses may qualify for up to $1.25 million (or $250,000 each year for up to five years) of the federal R&D Tax Credit to offset the Federal annual payroll taxes

So, even if your company is not yet profitable, it can gain cash flow benefits by not having to pay these Federal payroll taxes saving cash it would otherwise have to shell out to the Government

To be eligible, a company must:

Have less than $5 million in gross receipts for the credit year

Have no more than five years of gross receipts

Research and Development Credit
Calculation of the Credit

Traditional method

Under the traditional method, the credit is 20% of the company's current year qualified research expenses over a base amount.

Companies that have not claimed the R&D credit in the past or that don't have the data necessary to determine their historical qualified research expenses will likely have an easier time using the second method.

Alternative Simplified Credit method

The Alternative Simplified Credit (ASC) method for calculating the research credit involves a four-step process:

1. Figure the company's average qualified research expenses (QREs) for the past three years
2. Multiply that average by 50%
3. Subtract the result of Step 2 from the company's current year QREs
4. Calculate the credit by multiplying the result of Step 3 by 14%.

CARES ACT

The Coronavirus Aid, Relief, and Economic Security Act, also known as the CARES Act, is a $2.2 trillion economic stimulus bill passed by the 116th U.S. Congress and signed into law by President Donald Trump on March 27, 2020, in response to the economic fallout of the COVID-19 pandemic in the United States

The major tax-related portion of the legislation was the SMALL BUSINESS PAYCHECK PROTECTION PROGRAM

This program provided loans to businesses that were impacted by the Pandemic with funds to pay up to 8 weeks of payroll costs including benefits. Funds can also be used to pay interest on mortgages, rent, and utilities

Businesses that used their loan proceeds for these purposes were permitted to have the loans forgiven by the Government

The tax code requires that "forgiveness of debt" is subject to income tax on the amount forgiven. BUT, the CAREs Act rendered this loan forgiveness as NON-taxable income, making the loans essentially free money from the Government

In response to this Law provision, IRS ruled that those expenses paid, that were exempted from income tax, would NOT be tax-deductible, essentially negating the tax benefit bestowed on businesses, and creating taxable income to companies that received the loans

There was an uproar from the business community following this ruling, but IRS stood firm in its decision.

CARES ACT CONT.

CARES Act II - Additional Coronavirus Response and Relief, Title II – Assistance to Individuals,

Signed into Law December 21, 2020, major provisions include:

If your company received a PPP (payroll protection provision) Loan from a bank or other SBA lender expenses claimed as deductions against proceeds from the loan ***are now fully tax deductible***

This reverses IRS' position that these expenses were nondecutible, and creating phantom taxable income to the company

To the extent loans were forgiven NO taxable income resulted, thus overshadowing the provision that forgiveness of debt is taxable income

One lousy caveat….California doesn't conform to the "NO taxable income" provision

<u>If you applied for and received a PPP loan, and used the funds as prescribed, it is now TOTALLY FREE MONEY</u>

CURRENT TOPICS

How the Georgia Senate runoff election might affect your Business and Individual Taxes

If Senate majority party turns Democratic: Look to a

more socially liberal tack in legislation,
potentially less business-friendly,
with higher taxes for businesses and individuals

CURRENT TOPICS-CONT.

If Senate majority party remains Republican: Look to a continuation of business-friendly legislation, keeping taxes low, and retaining or extending tax credits and benefits

Q&A

THANK YOU!

Please contact David Lefkowitz at dlefkowitz@tysllp.com for any questions regarding this presentation.