

The logo for Dentons, featuring the Chinese characters '大成' followed by 'DENTONS' in a bold, sans-serif font, all contained within a white arrow-shaped graphic pointing to the right.

**大成 DENTONS**

Global Venture Technology

# Angel Investing Tax Tips

## Presented to Tech Coast Angels

**Amit Singh**

Partner and Co-Head Global Venture Technology Group  
Southern California

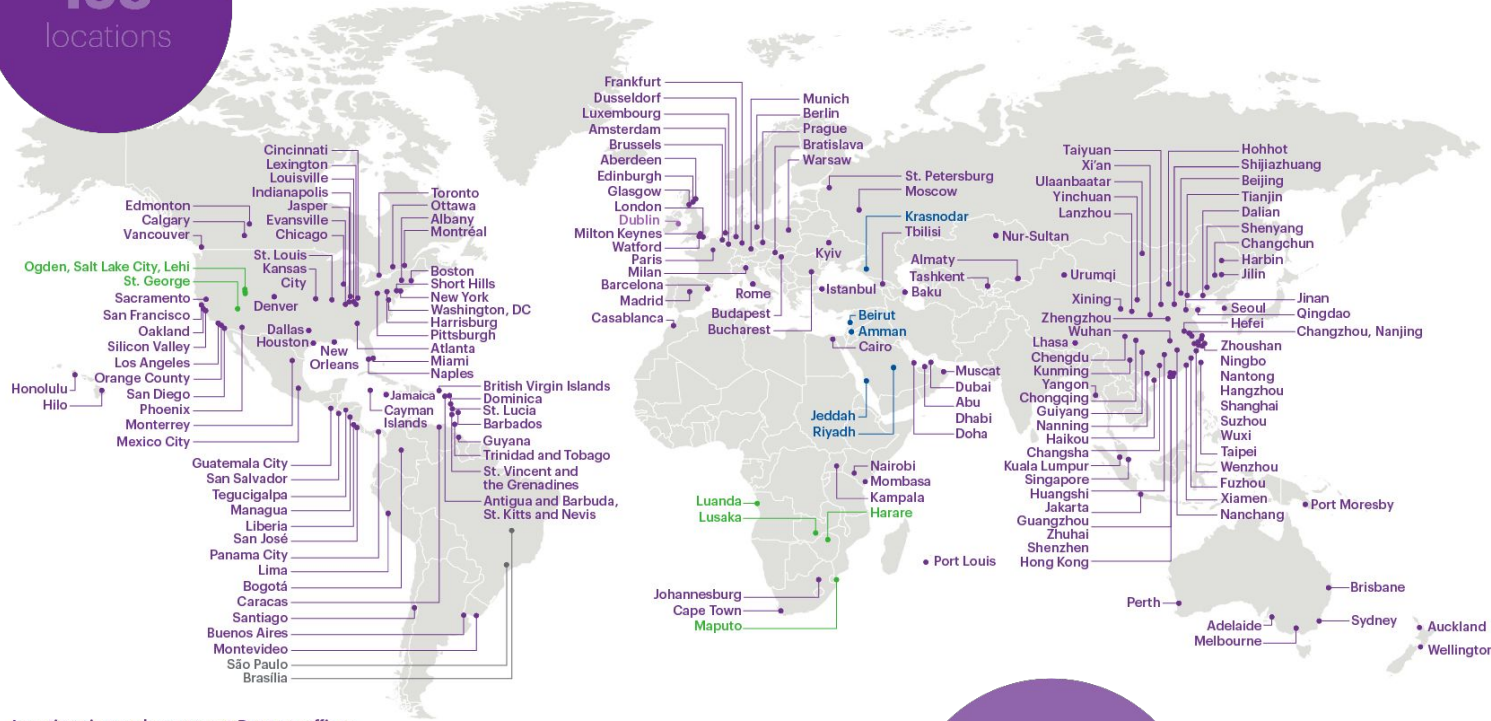
**Timothy J. Santoli**

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*April 22, 2021*

# Dentons by the Numbers

**198**  
locations



Locations in purple represent Dentons offices.  
Office opening in 2020.  
Locations in blue represent associate firms, offices and special alliances.  
Locations in green represent proposed combinations that have not yet been formalized.  
Locations in gray represent Brazil Strategic Alliance.



**80+**  
languages spoken



**US\$48,600,000+**  
value of pro bono and volunteer work

**77**  
countries

## Lawyer numbers

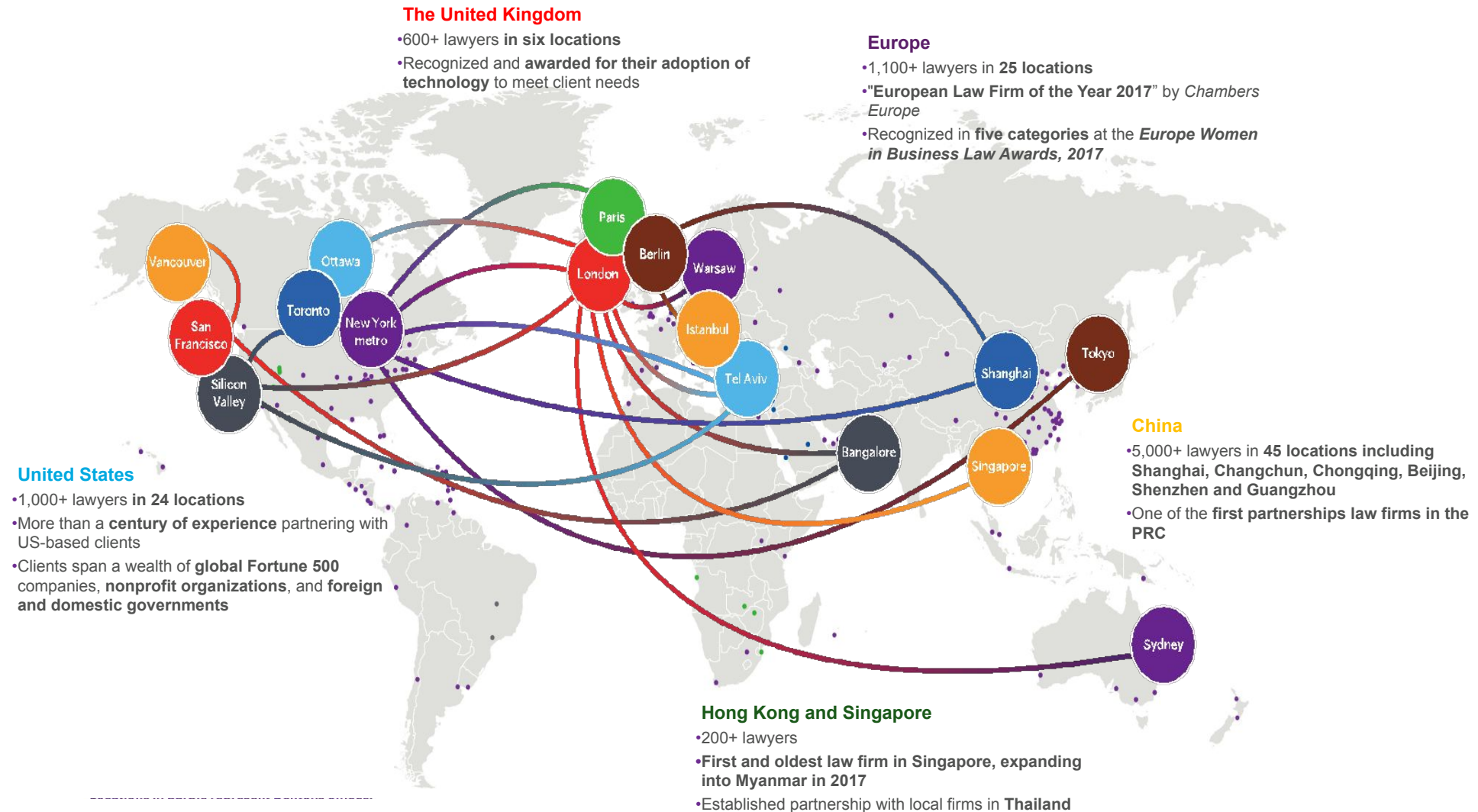


**10,500+**  
Total number of lawyers

**14,000+**  
All timekeepers

**19,000+**  
Total number of people

# Committed to the markets important to you



## Innovation. Acceleration. Disruption.

### Dentons Venture Technology:

Boutique approach—unmatched global presence.



**500+**

investor relationships



**1500+**

startup clients



**15+**

sectors served



**20+**

startup centers



**400+**

venture tech lawyers



**1400+**

2020 transactions

# Key Contacts

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## Amit Singh

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Amit Co-Heads Dentons' Venture Technology and Emerging Growth practice group in Southern California.

Amit is highly skilled in business transactions. He focuses on venture capital and private equity transactions, mergers and acquisitions, joint ventures, technology transactions, and general corporate law for companies whose core value derives from intellectual property. In the hundreds of M&A, venture capital and other sophisticated business transactions he's led over the last two decades and as outside general counsel to life sciences and technology companies, Amit has immersed himself in his clients' businesses, providing practical legal advice in the context of the clients' overall business goals.

He also represents managers and investors in the formation of venture capital, private equity and hedge funds. Amit has extensive experience counseling companies and investors in a broad range of industries, including life sciences, software, hardware, communications and networking, Internet, manufacturing and distribution, and medical devices.

Amit is a frequent speaker and author on startups, venture capital and M&A and has written hundreds of thought leadership articles on his blog – [www.startupblog.com](http://www.startupblog.com).

# Key Contacts

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Timothy Santoli is a member of Dentons' Taxation practice. He has expertise in a wide variety of domestic and international federal income tax matters, including domestic and cross-border tax-planning strategies as well as taxable and tax-free mergers, acquisitions and dispositions of domestic and foreign corporations.

# Introduction

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- Federal Tax Incentives for Angel Investors
  - IRC§1202 - Qualified Small Business Stock (QSBS) Gain Exclusion
  - IRC§1045 - Tax Deferred QSBS Gain Rollover
  - IRC§1244 - Ordinary Loss Treatment of QSBS Losses
- Typical Investment Structures for Angel Investments
  - Stock (Typically Preferred Stock)
  - Convertible Notes (with or without Warrants)
  - Simple Agreements for Future Equity (SAFEs)

# What is Qualified Small Business Stock (QSBS)?

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- IRC Favors Equity Investments in Qualified Small Business Stock
- Qualified Small Business Stock (QSBS) is stock originally issued by a corporation, that is a Qualified Small Business on the date of issuance, for money, property (other than stock) or services (so long as the services are not underwriter services).
- A Qualified Small Business is:
  - a domestic C corporation;
  - with gross assets at *all* times before the issuance of QSBS and immediately thereafter that don't exceed \$50M (generally based on tax basis, so the FMV of the QSB could generally exceed \$50M);
  - which agrees to submit such reports to the IRS and shareholders as the IRS may require; and
  - satisfies the active business requirement.
- The active business requirement is met if the corporation uses at least 80% of its assets in the active conduct of qualified trade or businesses during substantially all of the holding period for the applicable taxpayer. Qualified trades or businesses generally do not include services businesses (law, etc.), oil and gas businesses, banking or investing, motels and similar businesses.



# Termination of QSBS Status

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- Stock is not QSBS if:
  - Redemptions from the Taxpayer - at any time during the 4-year period beginning on the date 2 years before issuance of such stock, the corporation directly or indirectly in one or more purchases of more than a de minimis amount of its stock from the taxpayer or certain related persons
    - De Minimis Amount - stock acquired from a taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds \$10,000 and more than 2% of the stock held by the taxpayer and related persons is acquired
      - In determining whether the 2% limit is exceeded, the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase
  - Large Redemptions from any Stockholders - during the 2-year period beginning on the date 1 year before issuance of such stock, the corporation makes one or more purchases of more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of its stock as of the *beginning* of such 2-year period
    - De Minimis Amount - stock acquired from a taxpayer exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds \$10,000 and more than 2% of all outstanding stock is purchased
      - In determining whether the 2% limit is exceeded, the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of at the time of purchase) by the value (as of the time of purchase) of all stock outstanding before the purchase
  - Certain redemptions excluded

# IRC§1202 - QSBS Gain Exclusion

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- Exclude up to 100% of gain from sale of QSBS
  - 50% - August 10, 1993
  - 75% - from February 18, 2009 through September 27, 2010
  - 100% - on or after September 28, 2010
- Requirements
  - Hold stock for more than 5 years
  - Holder must not be a C corporation
- Limitations
  - Greater of \$10,000,000 or 10x the adjusted basis of the QSBS
  - Certain redemptions by the issuer can terminate QSBS treatment

# IRC§1202 - Certain Traps for the Unwary

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- Contribution of QSBS to an entity taxed as a partnership terminates QSBS
- If a partner invests into an entity taxed as a partnership after the partnership purchases QSBS, such partner will not obtain the benefit of QSBS - must be a partner at the time the partnership acquires the QSBS
- Sale of an interest in an entity taxed as a partnership that holds QSBS will *not* qualify for QSBS treatment
- Conversion of an LLC to a corporation prior to equity raise - \$50M aggregate basis is applied using FMV. So, if an LLC with a pre-money valuation of \$60M converts to a corporation and consummates an equity raise, the stock in such corporation will not be QSBS even though the tax basis of its assets is \$0
- Carried Interest - QSBS may not apply to a carried interest or profits interest
- Distribution of retained business in the sale of QSBS must be properly structured to obtain QSBS for retained business

# IRC§1045 - Tax Deferred QSBS Gain Rollover

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- Can rollover gain from the sale of QSBS to another QSBS investment
- Requirements:
  - taxpayer is not a corporation;
  - sells QSBS;
  - held original QSBS for more than 6 months;
  - purchases (by original issue) QSBS during 60-day period beginning on date of sale of QSBS; and
  - elects to apply IRC§1045

# IRC§1244 - Ordinary Loss Treatment of Small Business Stock Losses

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- Ordinary loss treatment for individuals who recognize a loss on Section 1244 stock directly or through a partnership
- The maximum amount for any taxable year is \$50,000 (\$100,000 for a joint return)
- Section 1244 stock is:
  - Common or preferred stock issued by a domestic corporation;
  - Originally issued to the individual or partnership recognizing the loss;
  - Issued for money or other property not including stock or securities;
  - Issued by a small business corporation; and
  - During the 5 most recent taxable years ending before the date the loss is sustained, the corporation derived more than 50% of its aggregate gross receipts from sources other than rents, interest, dividends, and sales of stocks or securities
- A corporation is a small business corporation if the aggregate amount of money and other property (valued at adjusted basis to the corporation), reduced by liabilities to which the property is subject or which are assumed, received by the corporation for stock, does not exceed \$1,000,000 at the time of the issuance of the stock

# Application to Convertible Notes

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- What is a Convertible Note?
  - Loan with Principal Amount Due on Maturity Date
  - Interest Accrues
  - Converts into Equity upon Certain Events
    - Qualified Financing
    - Change of Control
- Capital Gains Holding Period likely starts on note issuance
- No tacking holding period back to Note issue date - issue date of the stock is the date of conversion
  - IRC§1202 - QSBS Gain Exclusion
  - IRC§1045 - Tax Deferred QSBS Gain Rollover
  - IRC§1244 - Ordinary Loss Treatment of QSBS Losses

# Other Tax Issues for Convertible Notes

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- Original Issue Discount (OID) if interest not paid at least annually
  - Company deduction
  - Income to holder on accrued interest - using constant accrual method
  - Increases tax basis
  - Not taxed again when paid
- Tax on Conversion - taxed on interest converted into shares to the extent not already included in income
  - Deduction for company on conversion
- What if Warrants are issued with the Note?
  - Basis must be allocated b/t Note and Warrant
  - Value of Warrant will increase the amount of OID

# Simple Agreements for Future Equity (SAFEs)

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- Like a Convertible Note, but
  - No Maturity Date
  - No Interest
- Not clear, but likely treated as equity for tax purposes
- **May** be able to tack holding period back to SAFE issue date - issue date of the stock may be the date the SAFE is issued (***not entirely clear***)
  - IRC§1202 - QSBS Gain Exclusion
  - IRC§1045 - Tax Deferred QSBS Gain Rollover
  - IRC§1244 - Ordinary Loss Treatment of QSBS Losses



# Summary

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- Federal Tax Incentives for Angel Investors
  - IRC§1202 - QSBS Gain Exclusion
    - Exclude up to 100% of gain from federal income tax
    - Cap is greater of \$10,000,000 or 10x the adjusted basis of the QSBS
    - 5 year holding period
  - IRC§1045 - Tax Deferred QSBS Gain Rollover
    - Must have held original QSBS for more than 6 months
    - Must reinvest in QSBS within 60 days
  - IRC§1244 - Ordinary Loss Treatment of QSBS Losses
    - Must be first \$1M in capital raised
    - Cap - \$50,000 (\$100,000 if filing jointly)
- Convertible Notes
  - Holding Periods for QSBS benefits don't start until conversion
  - LTCG Holding period likely starts at Note issuance
- Simple Agreements for Future Equity (SAFEs)
  - Holding Periods for QSBS benefits **may** start at SAFE issuance (unclear)

# Measuring our commitment to diversity and inclusion



Dentons global coverage



**76**  
countries



**188**  
locations



**19,000+**  
people

## DIVERSITY

**43%**

of lawyers in 2019 are women

**48%**

of lawyer hires globally in last 12 months were women

**47%**

of the firm's newly elected partners in 2019 were women

**87**

The number of women Global Practice and Sector Leaders has increased from 74 in 2018 to 87 in 2019

**61%**

of director and manager hires globally in last 12 months were women

**100%**

of regions have women on their leadership teams

**45%**

of our 2019 Senior Development Program participants are women

**56%**

of trainee and student hires globally in 2019 YTD were women

**21%**

of Regional Board members are women

**19%**

of Global Board members are women

**617**

members (including allies). Dentons' Global LGBT+ Network is a firmwide group for lesbian, gay, bisexual, trans, nonbinary, queer and questioning colleagues, as well as their allies

**23**

Mental Health First Aiders (11 in the UK and 12 in Australia)

**80+**

languages spoken



## INCLUSION

In 2018 Dentons held its 3rd annual series of Inclusion Events From June 26-28. The series of linked discussions highlighting different aspects of inclusion and the importance across our Firm. In addition, Dentons invited all partners and employees for the 1st time The Big



**The Big Inclusion Project**

conversation to discuss experiences, ideas and potential to create a more inclusive Firm. The Big Inclusion was a truly global event, with colleagues commenting from different locations, across 31 countries and 5 continents. This build on last year's success and continue to make a difference through our Big Inclusion Project (over 200 people engaged in this initiative, including 12 Global Board Members)

## Key facts

**6**

Events

**1540**

Participants

**3000**

comments

**6000**

Platform visits