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Employee Benefit Plan Review

Analysis of Certain Startup Investor and Business Owner-Related Changes Under the 2025 Tax Legislation

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The wide-ranging tax legislation, P.L. 119-21 (the Legislation), signed on July 4 by President Donald Trump will affect nearly every sector of the economy and every type of taxpayer.

The Legislation makes important taxpayer-favorable changes to provisions relating to investors and business owners, including with respect to expanding benefits for certain investments in qualified small business stock (QSBS) of C corporations, making permanent the Opportunity Zone (OZ) program, making permanent the Section 199A deduction for qualified business income and expanding opportunities for accelerated depreciation.

There is a possibility for one or more additional reconciliation bills during late 2025 and 2026 and therefore opportunities for enactment of additional provisions, as well as changes and improvements to the Legislation. Also, the importance of engaging with the IRS and Treasury Department as they develop guidance to implement some of the more complex provisions of the Legislation cannot be overstated.

This article explains and analyzes the implications of certain investor-related provisions of the Legislation.

QSBS/Section 1202

Many individual investors look for opportunities to invest, directly or through flow-through entities, in small business C corporation stock that would meet the numerous requirements of Section 1202 to avoid paying some (or any) capital gains taxes on the future sale of such stock.

Before enactment of the Legislation, an investor was required to invest in such stock at a time when the value of a C corporation's assets did not exceed $50 million and hold the stock for at least five years before selling it. If these and other requirements were met, upon the sale of such stock, an investor could avoid paying tax on the greater of (i) $10 million of taxable gain, or (ii) taxable gain in the amount of 10 times the investor's aggregate adjusted basis in the sold stock.

After the enactment of the Legislation – and as is generally applicable for new issuances of qualifying C corporation stock after July 4, 2025 – (a) the $50 million asset value threshold is increased to $75 million and will be inflation adjusted for taxable years beginning after 2026, (b) the five-year minimum holding period is relaxed to allow for a three-year or four-year

holding period to qualify for a partial gain exclusion benefit, and (c) the $10 million gain exclusion amount is increased to $15 million and will be inflation indexed for taxable years beginning after 2026. No adjustments were made under the Legislation to expand the scope of trades or businesses that are "qualifying" trades or businesses for Section 1202 purposes, and not all trades or businesses conducted by a C corporation meet the requirements of Section 1202.

The changes made by the Legislation signal to investors that the Section 1202 gain exclusion benefits will be available for the foreseeable future. For investors, due consideration should be given to whether the Section 1202 gain exclusion might be available for a particular investment, as this may substantially increase an investment's after-tax ROI.

Investments in Opportunity Zones

Another potential opportunity for an individual investor to avoid paying capital gains taxes is through the OZ program. Before enactment of the Legislation, under Section 1400Z-2, an investor could defer paying tax on certain types of realized gains (i.e., generally, capital gains) until December 31, 2026, by investing the amount of such gain in a qualified opportunity fund (QOF), which in turn would invest in a project or business located in an OZ, typically through an investment by the QOF in a lower-tier entity known as a qualified opportunity zone business (QOZB). If the investor held its QOF investment for a certain period of time, up to 15 percent of that deferred gain could be permanently excluded from gross income.

In addition to the aforementioned deferral/exclusion benefits, the investor could exclude from gross income any appreciation on its QOF investment as long as such investment was held for at least 10 years. These benefits, however, were available only for investments in QOFs made with gains realized prior to December 31, 2026. With the enactment of the Legislation, the OZ program has become permanent (i.e., gains realized after December 31, 2026, now may be invested in QOFs in exchange for the tax benefits previously described, with some modest modifications, specifically including that if an investor holds their interest in a QOF for 30 years or more, the tax-free appreciation benefit is capped at such investment's fair market value on that 30-year anniversary date).

Additional changes to the program by the Legislation include the following: (i) adjusting the deferral period so that each investor has a five-year deferral period beginning on the date of their investment in the QOF (unless the investment is sold earlier), and (ii) providing additional benefits for investments in "rural" QOFs.

The permanency of the OZ program included in the Legislation provides investors with a dual opportunity – to both (i) defer the recognition of current capital gain, and (ii) exclude the appreciation in value of an investment from future capital gains taxes. For investors, after a gain realization event, due consideration should be given to an investment in a QOF.

Furthermore, investors should keep in mind that if a QOF invests in a QOZB organized as a C corporation, if the Section 1202 requirements are met, it would be possible for an investor to qualify for both QSBS and OZ tax benefits. For example, an investor would potentially obtain the current gain deferral/exclusion benefits associated with an OZ investment and also benefit from the tax-free appreciation associated with the QOF's QSBS investment, which requires a shorter holding period.

Qualified Business Income Deduction/ Section 199A

As indicated above, choice of entity is an important consideration for investors. Prior to the Tax Cuts and Jobs Act (TCJA), investors may have preferred pass-through entities, such as partnerships and S corporations, which are not subject to an entity-level tax (as compared to C corporations). The TCJA changed this landscape by reducing the corporate tax rate to 21 percent and enacting Section 199A, which generally provides certain individuals and other noncorporate taxpayers with a deduction for up to 20 percent of "qualified business income" with respect to pass-through entities and certain other amounts. While the corporate tax rate reduction was permanent, the Section 199A benefit was scheduled to expire on December 31, 2025.

The Legislation makes Section 199A permanent. In addition, the Legislation:

- Increases phase-in ranges (certain limitations do not apply if a taxpayer's income is below the applicable income threshold, and the limitations are phased in if the taxpayer's income is less than the sum of the applicable income threshold and a specified amount); and
- Provides a minimum (inflation-adjusted) $400 deduction for taxpayers having at least $1,000 of qualified business income from one or more "active qualifying trade[s] or business[es]."

The permanence of Section 199A preserves the existing parity between C corporations and pass-through entities with respect to TCJA-era tax rate reductions. Other considerations, like QSBS availability and flexibility, will continue to impact the choice of using a C corporation, an S corporation or a partnership now that the Section 199A deduction is permanent.

U.S. Tangible Property Investments

To encourage domestic manufacturing and production, the Legislation makes several significant changes to existing U.S. tax law.

First, it permanently reinstates "bonus" depreciation to covered assets (e.g., equipment) acquired and placed in service after January 19, 2025, meaning a domestic enterprise may now claim a deduction for 100 percent of an asset's cost in the year the asset is placed in service.

Second, it increases Section 179 expensing limits. Finally, and perhaps most significantly for those planning to increase their U.S. production capacity, the Legislation allows for immediate expensing of 100 percent of the adjusted basis of "qualified production property" (e.g., U.S.-situs property that is integral to manufacturing tangible items or to agricultural or chemical production) that is placed in service between July 4, 2025, and January 31, 2031, and meets certain other requirements (including that construction must begin after January 19, 2025).

These provisions are intended to incentivize U.S. manufacturing and production. The qualified production property benefit is particularly compelling in that it provides taxpayers with an immediate deduction for property that might otherwise be subject to depreciation over a 39-year period (e.g., the manufacturing portion of a new facility).

Conclusion

The most important early decision to both a founder of a business and a business investor from a tax perspective is the type of entity to use and its tax treatment. The choice of entity at formation and ongoing choice-of-entity decisions during the life of the entity can have a substantial impact on the tax consequences from the later sale of the business by the founders and investors. Discussions regarding the benefits/pitfalls of using a C corporation, an S corporation or a partnership to conduct business will continue given the various changes made by the Legislation as discussed above.

With this first budget reconciliation bill of the new Trump administration enacted, taxpayers should determine the expected impacts and consider adjustments and compliance issues as appropriate.

Some of the proposed changes and spending cuts that were dropped solely because the Senate parliamentarian ruled that inclusion would have violated the Byrd Rule, which governs the reconciliation process, may be revisited during the fiscal year 2026 appropriations process and through stand-alone legislation during the remainder of the 119th Congress. With respect to provisions included in the Legislation, taxpayers should turn their focus toward offering input as the Treasury and the IRS develop and issue implementing regulations and related guidance.

There is likely to be one or more additional reconciliation bills during late 2025 and 2026 and therefore additional opportunities for the enactment of additional provisions, as well as changes, corrections and improvements to the Legislation.

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