

Qualified Small Business Stock (QSBS)

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Introduction – Section 1202

- Internal Revenue Code contains various incentives to encourage small business, capital investment, and R&D in the U.S.
- Section 1202 was enacted as a 50% exclusion in 1993 with higher LTCG rate environment.
 - 28% rate on non-excluded QSBS gain
 - AMT preference item
- In 2003 Jobs Act, LTCG rates were reduced to 15% and Section 1202 became less valuable.

Introduction – Section 1202 (cont'd)

- 2010 –
 - QBSB exclusion increased to 100%
 - No longer subject to AMT
- 2015 – QSBS rules became permanent
- 2017 – C corporations more desirable (21% rate)

Result: Resurging interest in QSBS

Section 1202 – Exclusion of Gain on Sale of Qualified Small Business Stock

General Rules

Section 1202 – Exclusion of Gain on Sale of Qualified Small Business Stock

“In the case of a taxpayer **other than a corporation**, gross income shall not include [100] percent of any gain from the sale or exchange of **qualified small business stock held for more than 5 years.**”

- Section 1202(a)(1) & (4)

Section 1202 – Exclusion of Gain on Sale of Qualified Small Business Stock (*cont'd.*)

The amount of excludable gain depends on when the stock was acquired:

QSBS Acquisition Date	Amount of Gain Excludable
8/11/93 – 2/17/09	50%
2/18/09 – 9/27/10	75%
9/28/10 – Present	100%

Gains above the exclusion subject to 28% capital gains tax plus 3.8% Medicare surtax.

Excluded gain on shares acquired before 2010 also AMT preference item.

Section 1202 – Exclusion of Gain on Sale of Qualified Small Business Stock (*cont'd.*)

- Maximum gain exclusion is greater of:
 - \$10 million (\$5 million for married filing separately) less excluded gain from prior years, or
 - 10x adjusted cost basis of the sold QSBS
- Spouses are single taxpayer
- Parents, children, siblings, complex trusts, etc., are separate taxpayers

“Qualified Small Business Stock”

- Described in Section 1202(c)(1):
 - Stock in a C corporation
 - Originally issued after 1993
 - as of the date of issuance, the corporation is a **qualified small business**, and
 - the stock is acquired by the taxpayer at its original issue (directly or through an underwriter)—
 - in exchange for money or other property (not including stock), or
 - as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).

“Qualified Small Business”

- Domestic C corporation
- **Aggregate gross assets** at all times on and before the issuance did not exceed \$50,000,000.
- Aggregate gross assets immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed \$50,000,000.
- Meets **active business requirements** of Section 1202(e) during substantially all of the taxpayer’s holding period, and
- Agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of Section 1202.

Aggregate Gross Assets (<\$50 million)

- Generally based on tax basis of assets.
- However, when property is contributed to corporation, basis for this purpose is deemed to be fair market value on date of contribution.
 - When LLC converts to a corporation, the resulting “stock” can be QSBS if the LLC has gross asset value (based on fair market value) of less than \$50 million.
 - Stock basis for purposes of gain exclusion will be deemed to be no less than FMV as of date of conversion.
- Staged Investments?
- Bifurcation of corporate targets?

“Active Business Requirements”

During substantially all of the taxpayer’s holding period, the corporation must meet the active business requirements of Section 1202(e).

- at least 80 percent (by value) of the assets of such corporation are used in any trades or businesses except:
 - any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,
 - banking, insurance, financing, leasing, investing, or similar businesses,
 - farming,
 - mining, natural resource production or extraction, and
 - hotel, motel, restaurant, or similar business.

“Active Business Requirements” (cont’d)

During substantially all of the taxpayer’s holding period, the corporation must meet the active business requirements of Section 1202(e) (cont’d).

- The corporation generally cannot own (1) real property that is not used in the active conduct of a qualified trade or business with a value exceeding 10% of its total assets; or (2) portfolio stock or securities with a value exceeding 10% of its total assets in excess of liabilities.
- The corporation cannot be a domestic international sales corporation (DISC) or former DISC, a regulated investment company, real estate investment trust, or REMIC, or a cooperative.

“Active Business Requirements” (cont’d)

During substantially all of the taxpayer’s holding period, the corporation must meet the active business requirements of Section 1202(e) (cont’d).

- Look-Through Rule – stock and debt in any >50% subsidiary is disregarded and the parent corporation is deemed to own its ratable share of the subsidiary’s assets, and to conduct its ratable share of the subsidiary’s activities.
- Working Capital Exception – assets held for reasonably required working capital needs, reasonably expected to be used within two years for R&D or working capital needs are treated as assets used in active business
 - If corporation is more than two years old, not more than 50% of the corporation’s assets may qualify for this exception.

Pass-Through Entity Rules

A taxpayer may own QSBS through a partnership, S corporation, regulated investment company, or common trust fund if the following requirements are satisfied:

- All eligibility requirements with respect to QSBS are met;
- The entity held the qualifying stock for more than five years; and
- The taxpayer sharing in the gain held the interest in the pass-through entity at the time the taxpayer acquired the qualifying stock and at all times thereafter.
 - Carried interest?

Section 1045 – Rollover of Gain on Sale of Qualified Small Business Stock

- Section 1045
 - Permits taxpayers to defer recognition of gain generated by selling QSBS (if any) by rolling the gain over to another QSBS.
 - Taxpayer cannot be a corporation and must have held the QSBS for at least 6 months.

Section 1202 – Exclusion of Gain on Sale of Qualified Small Business Stock

Corporate Transactions

Redemptions

- Redemptions from Taxpayer or Related Person
 - Stock will not be QSBS if at any time during the 4 year period beginning 2 years before issuance of stock, stock is redeemed from the taxpayer or a related person.
 - De-minimis exception: purchase price must exceed \$10,000 and more than 2% of the stock held by taxpayer and related persons must be acquired.
- Significant Redemptions
 - Stock issued by a corporation is not QSBS if during the 2 year period beginning 1 year before the date of issuance, corporations repurchases stock with aggregate value exceeding 5% of the aggregate value of all stock determined as of the beginning of the 2 year period.
 - De-minimis exception: purchase price must exceed \$10,000 and more than 2% of outstanding stock must be acquired.

QSBS in M&A

- Total enterprise value must be less than \$50 million.
- New corporation must be formed to acquire existing corporation to meet “original issue” requirement.
 - Business of subsidiary is attributed to parent corporation.
 - Must be corporate subsidiary.
 - Treatment of majority-owned partnership subsidiary is unclear.
 - Stock of new “buyer” corporation should be issued to buyer at or close to closing to qualify as being engaged in business for “substantially all” of the taxpayer’s holding period.

QSBS in M&A (cont'd)

- Rollover Equity to Sellers:
 - If target is a C corporation, rollover equity can be QSBS only if target stock was QSBS.
 - If acquisition corporation stock is not QSBS, gain exclusion is limited to value as of transaction date.
 - If target is an LLC, rollover equity can be QSBS, but “basis” for purposes of gain exclusion is fair market value of as of date of acquisition.
 - No exclusion for “built-in-gain” on acquisition date.

Capital Contributions to Existing Issuers

- New stock issued
 - New holding period begins.
 - Must meet \$50 million gross asset test at, and at all times before new investment.
 - Additional investment counts as basis for purposes of 10x basis gain exclusion limitation.
- No new stock issued
 - No new holding period.
 - No new testing for QSBS qualification.
 - Additional investment does not count as basis for purposes of gain exclusion limitation.
- Deemed new issuance for 100% owned subsidiary?

Entity Conversions

- S Corp to C Corp
 - Does not create QSBS for S corp owners – not QSBS on original issuance.
- Partnership (LLC) to C Corp
 - Can create QSBS for existing owners
 - QSBS status tested on conversion
 - Holding period begins on conversion
- LLC taxed as a C corporation may qualify as QSB and its membership interests may qualify as QSBS

Employee Equity Grants

- Options – QSBS qualification measured, and holding period begins on exercise, not grant.
- Restricted Stock - QSBS qualification measured, and holding period begins upon vesting, not grant.
- Restricted Stock with 83(b) Election - QSBS qualification measured, and holding period begins upon effective date of 83(b) election (i.e., grant date).

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Transfers / Estate Planning

Transfers of QSBS

- If QSBS is received by gift, the transferee is treated as having acquired the stock in the same manner as the transferor and having the same holding period.
 - Gratuitous transfer to family member
 - Gratuitous transfer to trust (revocable or irrevocable)
 - Sale to intentionally defective grantor trust?
- Transfer to partnership (e.g., family limited partnership)
 - QSBS status is terminated
 - Partnerships must acquire QSBS upon original issue

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State Tax Considerations

State Tax Considerations of QSBS

- States, generally:
 - No income tax or no capital gains tax
 - Based on Federal AGI (so QSBS exclusion built-in)
 - Based on Federal Gross Income
 - With state-level QSBS exclusion
 - Without state-level QSBS exclusion
- For example:
 - Connecticut – based on Federal AGI
 - Massachusetts – based on Federal Gross Income, but has state-level QSBS benefits
 - New York – based on Federal AGI

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Documentation

Documentation

- Keep records of QSBS purchase to support Section 1202 qualification.
 - Section 1202 qualification
 - Holding period
 - Tax basis
- Seek certification from the issuer
 - C corporation
 - <\$50 million gross assets
 - Active business
- Seek covenants from the issuers
 - Maintain active business qualification
 - Avoid passive assets, real estate etc.

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Questions ?