A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock

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Under IRC § 1202, 100% of gain on the sale of QSBS acquired after September 27, 2010, is generally excluded from tax. Also, gain on the sale of QSBS is no longer included as an alternative minimum tax preference item. This article is one of a series of posts addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Code. We also discussed the impact of the reduction of corporate rate from a maximum of 35% to a flat 21% and the elimination of the corporate alternative minimum tax. We predicted that while these benefits will not in most cases tip the scales in favor of the C corporation over a pass-through entity, there will certainly be increased interest in C corporations.

IRC § 1202 has been around for years, but has not received a lot of attention. This inattention has resulted in large part from IRC § 1202's complicated qualification rules, not to mention the planning uncertainties associated with a required five-year holding period. These problems continue to apply, but if C corporations are being considered on their own merits, understanding how to qualify for the additional benefits of QSBS are an important part of choice of entity planning.

If stock acquired after September 27, 2010, qualifies as QSBS and the five-year holding period is satisfied, then the holder can sell the stock and exclude 100% of the gain up to the greater of (i) $10 million in the aggregate for all sales of such issuer's QSBS by the holder, or (ii) 10 times the aggregate adjusted tax basis of the QSBS of such issuer and disposed of by the holder during the tax year. IRC § 1202 has rules regarding the allocation of the $10 million per-issuer limit between spouses. A sale for IRC § 1202 purposes might be a direct sale by the holder, the redemption of QSBS by the issuing corporation, or a liquidating distribution by the issuing corporation (usually following the sale of its assets).

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The amount of gain excluded by IRC § 1202 is not subject to the 3.8% Medicare tax and is not subject to the alternative minimum tax (for QSBS issued after September 27, 2010). The gain may also be excluded from state and local taxes if the taxing jurisdiction follows federal income tax laws.

The following discussion works through both the general eligibility requirements and pitfalls associated with obtaining and keeping QSBS status and obtaining the benefits of IRC § 1202, and the IRC § 1045 rules relating to the rollover of Section 1202 gain.

1. There are rules regarding what entities can issue QSBS.

An eligible issuer of QSBS is a domestic C corporation that is not (i) a domestic international sales corporation (DISC) or former DISC, (ii) a corporation with respect to which an election under IRC § 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, (iii) a regulated investment company (RIC), (iv) real estate investment trust (REIT) or real estate mortgage investment conduit (REMIC) or (v) a cooperative. Neither an S corporation nor a tax partnership (multi-member LLC) can issue QSBS. The issuer must remain a C corporation during substantially all of a taxpayer's holding period for the QSBS.

2. There are rules regarding who can take advantage of IRC § 1202's benefits.

As a practical matter, the benefits of QSBS are available to any taxpayer other than a C corporation. QSBS can be issued to a limited liability company, other partnerships, trusts or S corporations. IRC § 1202 has rules that address the handling of QSBS' benefits among a pass-through entity's owners.

3. QSBS must generally be acquired by the holder at "original issue" for cash, certain other property or services.

This requirement means that shares of QSBS must be acquired directly from the issuer in exchange for money or other property (other than stock), or as compensation for services performed for the issuing corporation.

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If founders desire their stock to qualify for QSBS treatment, they should be careful to document their cash or property (tangible or intangible) contributions to the issuer in exchange for the QSBS. If intangible assets or goodwill is used to pay for QSBS, make sure that it qualifies as "property" for purposes of IRC § 351(a).

QSBS can be issued upon the exercise of nonqualified incentive options or non-compensatory options or warrants or through the conversion of convertible debt. The holding period will commence and the determination of whether the issuing corporation is a qualified small business will be made at the time of the issuance of the QSBS, not when the convertible debt instruments, options or warrants were issued.

QSBS can be preferred stock, convertible preferred stock or common stock. There are no restrictions regarding voting rights. An issuing corporation can issue an unlimited number of rounds of QSBS so long as the corporation continues to meet the qualified small business requirements (discussed below) at the time of issuance.

4. The original holder of QSBS must generally be its ultimate seller.

In general, the original purchaser of QSBS must be the seller claiming the IRC § 1202 exclusion. There are limited exceptions to this rule for QSBS acquired by gift, at death or as a distribution from a pass-through entity (partnerships, S corporations, regulated investment companies or common trust funds).

A holder of QSBS should not contribute the stock to a family LLC or limited partnership or trust or to an LLC organized to manage the sale of the issuer's stock – any of these steps will result in the seller being someone other than the original holder and generally disqualifies the QSBS under IRC § 1202.

5. QSBS must be held for more than five years to qualify under IRC § 1202 treatment.

In most cases, the start date for this five-year holding period will be straightforward. If the holder of an incentive option is exercising the option, or a note holder is converting convertible debt, the holding

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period will start on the date the QSBS is issued. If service provider stock is subject to vesting requirements when issued, the date of issuance of the QSBS will be the date of issuance if an IRC § 83(b) election is made or when the restrictions lapse.

If all of the requirements of IRC § 1202 are satisfied, QSBS can be exchanged for other QSBS in a tax-free transaction under IRC §§ 351 or 368. If the stock received in exchange for QSBS is not QSBS, then IRC § 1202(h)(4)(B) generally allows for a tax-free rollover of the amount of built-in gain at the time of the exchange. That limitation does not apply, however, if the replacement stock is issued by a corporation that is a qualified small business.

For example, shareholders holding QSBS can utilize IRC §§ 351 or 368 to form a new holding company owning all of the stock of the qualified small business. Under IRC § 1202, the activities of the 100% owned qualified small business should be imputed to the new holding company and the holding company stock received in exchange for the QSBS should also be QSBS with a holding period that includes the holding period of the exchanged QSBS. But if additional activities are undertaken in the holding company or subsidiary, those activities could disqualify the qualified small business classification.

After QSBS stock has been held for at least six months, it is possible under IRC § 1045 to roll over the built-in gain into other QSBS or non-QSBS under certain circumstances. See the discussion of IRC § 1045 below

6. The corporation issuing QSBS must be a qualified small business.

Immediately prior to and immediately after issuance of QSBS, the issuing corporation must not have aggregate gross assets in excess of $50 million (this includes the cash or property contributed in connection with the current stock issuance). Be careful that the subscription payments made in connection with the issuance of QSBS don't push the aggregate gross assets over the $50 million threshold.

"Aggregate gross assets" means the amount of cash and the adjusted tax bases of other property held by the issuing

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corporation. IRC § 1202(d)(3) provides that the gross assets of certain subsidiaries are counted towards the $50 million threshold. Contributed property is valued for purposes of the $50 million test at the property's fair market value at the time of contribution. QSBS can be issued in connection with the incorporation of a partnership, but be careful that the fair market value of the contributed assets doesn't cause the corporation to exceed $50 million threshold. If the partnership's assets are added to those of other contributors or to an existing corporation, the corporation's other assets will also be counted towards the $50 million threshold. Note that there are other tax implications of the incorporation of a partnership that should be addressed.

If a corporation is a qualified small business when QSBS is issued, it won't affect the QSBS status of previously issued shares if the issuer subsequently ceases to be a qualified small business. But once a corporation's aggregate gross assets exceed $50 million, the corporation cannot issue QSBS, even if its aggregate gross assets dip below $50 million in the future.

7. An issuing corporation must meet the active business requirements of IRC § 1202 during substantially all of the holding period for QSBS.

IRC § 1202(e)(1)(A) requires that a corporation issuing QSBS must satisfy an "active business requirement" which is defined to mean that at **least 80% (by value)** of the corporation's assets are used in the **active conduct of one or more qualified trades or businesses** .

IRC § 1202(c)(2)(A) provides that stock in a corporation will not be QSBS unless the corporation meets the active business requirements (including engaging in a qualified trade or business) during substantially all of the taxpayer's holding period for such stock. There is no specific guidance on what "substantially all" means, but for those taxpayers seeking QSBS status, the safest approach is for the corporation to continually satisfy the active business requirement.

Obviously, identifying whether a business is a qualified trade or business is a critical aspect of achieving QSBS status. In a recent article, we focused on what constitutes an **active trade or**

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business for purposes of IRC § 1202. Generally, any trade or business that **does not involve** the performance of services in certain fields (e.g., law practice, accounting practice, medical practice, brokerage service), or operating a business involved in banking, investing, leasing, insurance, farming, oil and gas extraction, or operating a hotel or restaurant will be an active trade or business for the purposes of IRC § 1202. If the primary business function of a trade or business involves developing or manufacturing a product, it is likely it will meet the active trade or business requirement. Otherwise, an active trade or business analysis may be necessary to determine if the trade or business falls under a disallowed category.

Since it is possible to lose QSBS treatment even after stock has been held five years if the corporation ceases to meet the active business requirements, holders should consider selling their QSBS after five years to lock in IRC § 1202 treatment.

8. The ownership of stock of subsidiaries is taken into consideration in determining whether a corporation meets the active business requirement.

IRC § 1202(e)(5)(A) provides for a look-through if a corporation is engaging in a business through a subsidiary. IRC § 1202(e)(5)(C) defines "subsidiary" to mean a corporation where the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock. If the corporation owns a subsidiary meeting the definition, then the assets and business of that subsidiary must be factored into the determination of whether the corporation is satisfying the active business requirements. Under IRC § 1202(e)(5)(B), a corporation will fail the active business requirement if more than 10% of its net assets consists of stock or securities in corporations that are not subsidiaries, exclusive of stocks and securities held as working capital.

9. The ownership of interests in joint ventures and LLCs is taken into consideration when determining whether a corporation meets the active business requirement.

IRC § 1202 doesn't specifically address a corporation's ownership of partnerships. Presumably, if a corporation owns a 20% interest in a

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partnership engaged in a qualified trade or business, the value of the partnership interest would count towards satisfying the corporation's 80% (by value) asset requirement. But if the partnership engages in business activities or holds assets that don't meet the active business or qualified trade or business requirements, then the corporation's pro rata share of the value of the disqualified real estate holdings, investment assets, and business activities that aren't a qualified trade or business are likely to count for IRC § 1202 purposes. While this result seems logical, there doesn't appear to be any guidance confirming how partnership items pass through for IRC § 1202 purposes.

10. How disregarded entities owned by issuing corporations are treated for purposes of the active business requirement.

Although it isn't addressed specifically in IRC § 1202, its seems reasonable to conclude that the existence of disregarded entities held by a C corporation will be ignored for all purposes of determining qualification under IRC § 1202.

Besides the basic issue of making sure that at least 80% of the issuer's assets are involved in an active trade or business, there are additional aspects of meeting the requirement that need to be considered:

11. Holding too much cash, investment assets or real estate can kill the potential for QSBS treatment.

A corporation will fail the 80% (by value) asset test if its aggregate investment assets (assets such as stock investments and cash, less cash qualifying for the working capital exception), **plus** non-trade or business real estate assets, **plus** disqualified trade or business assets add up to more than 20% of the value of the corporation's assets.

IRC § 1202(e)(7) provides that a corporation is not engaged in an active conduct of a trade or business if more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business. The ownership of, dealing in, or renting of real property is not treated as the active conduct of a trade or business.

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IRC § 1202(e)(6)(A)(A) provides that assets (cash or investment assets) can be treated as being used in a qualified trade or business if they are (i) held for the reasonably required working capital needs of a qualified trade or business or (ii) held for investment if it is reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business. But for periods after the corporation has been in existence for at least two years, in no event may more than 50% of the assets of the corporation qualify as used in the active conduct of a qualified trade or business as a result of this provision.

12. Favorable treatment for start-up companies.

IRC § 1202(e)(2) provides special dispensation for a corporation engaged in start-up activities and research and development activities associated with the future undertaking of a qualified trade or business. QSBS can be issued during this start-up period before the corporation actually starts engaging in an active trade or business, regardless of whether any income has been generated from the activity at the time of issuance.

13. Redemptions of stock by the issuing corporation in close proximity to the issuance of QSBS will destroy QSBS status.

IRC § 1202(c)(3) provides that stock does not qualify as QSBS if (i) the issuing corporation purchased stock from the holder or a related person at any time during the four-year period beginning two years before the issuance of the stock, or (ii) during the two-year period beginning on the date one year before the issuance of the stock, the issuing corporation made one or more purchases of its stock with an aggregate value exceeding 5% of the aggregate value of all of its stock as of the beginning of such two-year period. This rule prevents an issuing corporation from redeeming and reissuing stock that will qualify for QSBS treatment.

The redemption rules are subject to exceptions for *de minimis* redemptions and redemptions triggered by a termination of the services of an employee or director, or by death, divorce, disability

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or mental incompetence.

14. Navigating through and around the $10 million individual taxpayer limit.

IRC § 1202 limits the amount of gain that a taxpayer may exclude from taxable income with respect to QSBS to the greater of (i) $10 million per issuing corporation, reduced by the aggregate amount of eligible gain taken for a tax year into account by the taxpayer for prior years attributable to dispositions of such corporation's QSBS (in the case of a married taxpayer filing separately, this limit is $5 million), or (ii) 10 times the taxpayer's aggregate adjusted bases of QSBS issued by the corporation and disposed of by the taxpayer during the taxable year. For purposes of this 10X basis limit, the adjusted basis of any stock is determined without regard to any addition to basis after the date on which such stock was originally issued.

The typical taxpayer will be limited to a $10 million individual taxpayer cap on Section 1202's gain exclusion. Where the value of QSBS is expected to exceed this $10 million limit, the original holder can structure a workaround. While in most instances the original purchaser of QSBS must sell the stock in order to take advantage of IRC § 1202, IRC § 1202(h)(2) treats transferees who acquire QSBS by gift or at death as having acquired the stock in the same qualifying manner as the original purchaser. The planning opportunity centers around making lifetime gifts of QSBS. There isn't any language in IRC § 1202 that divides the $10 million limitation between transferors and multiple transferees of QSBS, leading to the conclusion the transferor and each transferee by gift of QSBS has a separate $10 million limitation. A holder should be able to gift QSBS directly to individuals or to grantor trusts. So long as the holder has donative intent, it seems possible that the holder could gift QSBS to family LLCs or grantor retained annuity trusts (GRATs).

Another workaround is to take advantage of the separate 10X basis limitation. IRC § 1202(i) provides that a taxpayer can contribute appreciated property to a C corporation in exchange for the issuance of QSBS, and that (i) the holding period for the QSBS issued in the exchange commences on the date of issuance and (ii) the basis of the QSBS received in the exchange is not less than the

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fair market value of the property exchanged. This provision suggests that a viable planning opportunity is to operate a business as an LLC taxed as a partnership or sole proprietorship until the fair market value of its assets approach $50 million, and then exchange the assets for QSBS in an IRC § 351 incorporation. The exchange would result in the taxpayer(s) having an initial basis for Section 1202 gain exclusion calculation purposes approaching $50 million, with the potential aggregate Section 1202 exclusion of $500 million. Assuming the contributed property had a zero tax basis, the first $50 million in gain would be excluded from the benefit of Section 1202's gain exclusion.

The exchange of appreciated LLC assets for QSBS can occur as a result of a conversion of an LLC to a C corporation under state law or the filing of a check-the-box election by the LLC. Although operating the business initially in partnership form increases the potential Section 1202 gain exclusion, the fact that the five-year holding period doesn't commence until the exchange can be a critical negative factor.

15. Planning issues for PE firms and others created by holding QSBS through an LLC (including determining the share of Section 1202 to be allocated to the LLC's carried interests).

Taking advantage of IRC § 1202 may be of increased interest to investors in private equity funds and investors making co-investments with PE firms and funds. Some of these investments will undoubtedly be made through LLCs taxed as partnerships. If an LLC (taxed as a partnership) is the original purchaser of QSBS, IRC § 1202(g)(1)(B) provides that gains from the sale of the QSBS will be passed through to the LLC's members if the LLC has satisfied the five-year holding period requirement.

IRC § 1202(g)(3) provides that the amount includible in the gross income of an LLC member cannot exceed the amount of the gain exclusion determined by reference to the interest held by the LLC member on the date the LLC acquired the QSBS. This language creates an issue for determining the proper allocation of Section 1202 gain to holders of profits interests (including carried interests). Treasury Regulation § 1.1045-1 provides that in the case of QSBS

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rollovers, the amount of gain that can be deferred by an LLC member is limited by reference to the member's lowest percentage of capital in the LLC at the time of the QSBS's issuance. The IRS could argue that for IRC § 1202(g)(3) purposes, the interest held by an LLC member is limited to the member's initial capital interest. Another approach, however, would be to calculate each LLC member's interest based on how the Section 1202 gain triggered on the sale of the QSBS would be divided among an LLC's members based on their LLC interests on the date of issuance, but first grossing up the capital accounts of LLC members holding profits interests (and carried interests) on the date of the issuance of the QSBS based on the allocation of gains under the LLC agreement, rather than just the pre-allocation initial capital accounts (which for a profits interest would be zero if the QSBS was acquired at or around the same time the profits interests were issued).

16. Potential rollover of QSBS gain under IRC § 1045.

If QSBS has been held for at least six months, IRC § 1045 generally permits a tax-free rollover of gain on the sale of the QSBS if the rollover occurs within 60 days of the sale of the QSBS.

If the proceeds from the sale of QSBS are rolled over into other QSBS and the tacked holding period (the original QSBS holding period plus the replacement QSBS holding period) subsequently exceeds five years, the shareholder can sell the replacement QSBS and take advantage of IRC § 1202 gain exclusion on 100% of the sale price.

If the proceeds from the sale of QSBS are rolled over into other QSBS, IRC § 1045(b)(4)(B) provides that the replacement stock only needs to continue to qualify as QSBS for a period of six months after the QSBS rollover. After six months, the second corporation would be able to convert to an S corporation or otherwise cease engaging in an active business. But if the second corporation does cease to satisfy the active business requirement, only the carried over Section 1202 gain treatment would subsequently qualify for QSBS treatment once the five-year holding period is satisfied. Any additional appreciation of the replacement stock would not qualify for IRC § 1202 treatment.

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Under IRC §§ 1045(b)(5) and 1202(h)(4)(B), Section 1202 gain can also be rolled over in a tax-free transaction under IRC §§ 351 or 368 into non-QSBS. If the shareholder's replacement stock then satisfies the QSBS five-year holding period requirement, the shareholder would be able to claim an IRC § 1202 exclusion for the amount of gain which would otherwise have been taxable if the stock was sold at the time of the rollover from QSBS into non-QSBS.

There are various other requirements that must be satisfied in order to take advantage of IRC § 1045's rollover provisions that should be carefully reviewed and followed in order to qualify for that section's favorable treatment. Also, IRC § 1045 has Treasury Regulations that deal with the rollover of the proceeds from the sale of QSBS held for more than six months by a partnership, or the rollover of QSBS proceeds distributed to partners.

17. Documenting QSBS Eligibility.

Schedule D and the Instructions for Schedule D set forth the IRS' requirements for QSBS eligibility and the related adjustments to capital gains. Because there are so many requirements for QSBS eligibility, it is important for a taxpayer to maintain good records supporting a claim for QSBS eligibility on Schedule D. At the shareholder level, there should be documentation of the eligible consideration paid for QSBS, including the date of purchase and the nature of the consideration paid. With respect to the corporation, a shareholder should ask at the time of the issuance of the QSBS for certification that the company has $50 million or less in aggregated gross assets immediately after the share purchase and that at least 80% of the company's assets are used and will continue to be used in the active conduct of a qualifying active trade or business. If a taxpayer is relying on QSBS treatment as part of making an investment, then an important aspect of the investment decision is the assessment of whether management will take steps to maintain qualified small business eligibility during the investor's entire holding period for his QSBS.

All of the eligibility issues associated with the original issuance of QSBS and the maintaining of QSBS status apply in connection with undertaking an IRC § 1045 rollover, along with satisfying and

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documenting compliance with the rollover requirements themselves.

Although proof of QSBS eligibility and the satisfaction of holding period requirements are not required in connection with the filing of tax returns, the taxpayer needs to be prepared to provide documentation when asked by the IRS during the audit process. If the holder of QSBS fails to gather the necessary documentation and information together at the time of the QSBS' issuance and obtain assurances of cooperation during the QSBS holding period, it may be difficult or impossible to accomplish these things years down the road. Management can become uncooperative and records can be lost or never maintained.

More resources

In spite of the potential for significant tax savings, many experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 and related planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- View all QSBS Resources

Contact Scott Dolson if you want to discuss QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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