Section 1202 Qualification Checklist and Planning Pointers

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A basic checklist of qualification requirements to help business owners and tax professionals considering structuring or restructuring a business to take advantage of IRC § 1202, or trying to confirm whether their stock is QSBS.

IRC § 1202's qualification requirements are complex and business founders and investors seeking to take advantage of its benefits should work with their tax professionals to ensure that they satisfy all of the qualification requirements based on their specific facts and circumstances. Contact Scott Dolson at (502) 568-0203 or sdolson@fbtlaw.com if you need help with qualification issues or an opinion regarding whether there is "substantial authority" for taking the tax return position that stock qualifies as QSBS. This article is one of a series of blog posts addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Code.

Section 1202 Checklist

- **Who can issue QSBS**. Only a domestic C corporation can issue QSBS. Stock issued by an S corporation cannot be QSBS. An S corporation can convert into a C corporation and then issue QSBS. An S corporation could contribute its assets to a new C corporation in exchange for QSBS. Tax partnerships (e.g., LLCs tax as partnerships) can contribute their assets to a C corporation (by conversion, merger or exchange), and the stock issued by the C corporation in connection with the conversion can be QSBS.
- **Who can hold QSBS**. A C corporation cannot hold QSBS. An individual, trust, partnership (including an LLC taxed as a partnership), single-member LLC, S corporation, regulated investment company or common trust fund can hold QSBS. There are special rules applicable to pass-through entities holding QSBS.

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- **The QSBS must be issued in exchange for cash, services or property**. Satisfaction of this requirement should be documented. Property would include contributing LLC interests to a C corporation in an IRC § 351 exchange. Stock does not qualify as consideration for the issuance of QSBS. There are a couple of exceptions to these rules. QSBS can convert into other stock of the same issuer and retain its QSBS status. Partnerships holding QSBS can distribute the QSBS to partners. Subject to specific rules, QSBS can be exchanged in an IRC §§ 351 or 368 transaction for the stock of another corporation.
- **The original holder of QSBS must generally be the ultimate seller of the QSBS**. Generally, the taxpayer who was originally issued QSBS must continue to hold and sell the QSBS in order to take advantage of IRC § 1202. There are exceptions for gifted QSBS, QSBS transferred at death, and QSBS transferred by a partnership to its partners.
- **Five year holding period requirement**. Only gain from QSBS held for more than five years can qualify for the benefits of IRC § 1202. IRC § 1045 deals with the rollover the proceeds from the sale of QSBS with less than a five-year holding period into other stock, potentially allowing the taxpayer to ultimately qualify for the benefits of IRC § 1202. Subject to an exception where QSBS is exchanged in a tax-free exchange or reorganization under IRC §§ 351 or 368, the issuing C corporation must remain a qualified small business during substantially all of the taxpayer's holding period for the QSBS.
- **Only a C corporation with aggregate gross assets not exceeding $50 million can issue QSBS**. Aggregate gross assets generally means the amount of cash and the aggregate adjusted bases of other property held by the corporation. For purposes of this test, property contributed to the C corporation is valued not at its adjusted tax basis but its fair market value. So, those considering converting a tax partnership to a C corporation to take advantage of IRC § 1202 should consider look at the partnership's fair market value, including goodwill, before undertaken the conversion

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from a tax partnership to C corporation. The $50 million requirement only applies before and immediately after the time QSBS is issued; not throughout its holding period.

- **Stock redemptions can interfere with obtaining QSBS status**. Watch out for stock redemptions! Either redemptions of stock from the holder of the QSBS or a related person, or "significant" redemptions (defined in IRC § 1202) from any shareholder(s) can render stock ineligible for QSBS treatment at the time of issuance. Past stock redemptions should be reviewed, and restrictions should be placed on post-issuance redemptions of issuer stock.
- **The "active business requirement" must be continually satisfied while holding QSBS**. QSBS loses that status if the issuing C corporation fails to meet the active business requirements during substantially all of the QSBS's holding period. This requirement is satisfied if at least 80% by value of the corporation's assets are used in the active conduct of one or more qualified trades or businesses. Holding too much non-operating cash or passive investment assets can blow QSBS treatment. There is an exception for cash necessary for working capital purposes or used to finance research and experimentation for a start-up qualified trade or business. For 50% or more owned corporate subsidiaries (by voting rights or value), you look through to the subsidiary's business is determining whether these various requirements are met. Likewise, if you hold 20% of a joint venture operated as a tax partnership, you are attributed 20% of the joint venture's items for determining whether the active business requirement is met. The fact that QSBS status would be lost where a corporation ceased to meet the active business requirement after the holder had achieved the five-year holding period is a good reason to consider triggering a sale soon after the five year holding period requirement is satisfied.
- **Holding too much portfolio stock can blow QSBS status**. A corporation will cease to meet the active business requirement if more than 10% of the value of its assets (in

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excess of liabilities) consists of stock of corporations not qualifying as subsidiaries (i.e., the 50% voting rights or value test).

- **Holding too much non-operating real estate can blow QSBS status**. A corporation will cease to meet the active business requirement if more than 10% of the value of its assets consists of real property not used in its trade or business. For this purpose, rental property is not considered property used in a trade or business.
- **Engaging in business activities that are not considered a qualified trade or business can block qualifying for QSBS status or blow QSBS status during the stock's holding period**. At least 80% of a C corporation's assets must be deployed in a qualified trade or business. IRC § 1202(e)(3) defines a "qualified trade or business", and excluding, among other trade or business activities, many professional activities, consulting, athletics, brokerage services, banking, insurance, financing, leasing, investing, farming, mining, hotels, restaurants and activities where the principal asset of the trade or business is the reputation or skill of one or more of its employees. The issue of whether a business is engaged in a qualified trade or business garners a lion's share of the planning attention for businesses that might, for example, be considered to engage in either software consulting (bad for QSBS status) or development (good for QSBS status).
- **IRC § 1202's benefits are typically limited per-taxpayer to $10 million for each C corporation issuer**. The limitations is actually the greater of $10 million or 10 times the investment in QSBS, but in most cases, the initial investment in QSBS won't exceed $1 million. It is possible to multiply the $10 million limitation by gifting QSBS or transferring QSBS at death to multiple beneficiaries or trusts.
- **Maintaining good records is a critical part of qualifying for QSBS status**. Holders of QSBS should make sure that they have documentation supporting each of the qualification requirements outlined in this checklist, which might in some instances come in the form of written documents or

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certifications from the issuing C corporation.

- **Shareholders counting on the benefits of IRC § 1202 should make sure that management of the issuing corporation is on board with the plan**. Since qualifying for the benefits of IRC § 1202 requires the issuing corporation to satisfy the active business requirement during substantially all of the QSBS' holding period, it is critical that management is both aware of all of IRC § 1202's requirements and agrees to maintain the business in a manner that continues to satisfy the active business requirement.
- **Holders of QSBS should be familiar with the mechanics of a rollover of QSBS sales proceeds under IRC § 1045**. Holders of QSBS sometimes find themselves in the position of being forced to sell their stock prior to achieving the five-year holding period required for qualifying for the benefits of IRC § 1202. Since it is possible to roll the proceeds from the sale of QSBS into other QSBS, these shareholders need to be familiar with the rules of IRC § 1045, and plan in advance for the rollover of the proceeds, as there is only 60 days to accomplish the rollover after the sale of the original QSBS.

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:

- Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- How Section 1202's $50 Million Aggregate Gross Assets Limitation Works
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Advanced Section 1045 Planning

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- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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