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Section 1202 and S Corporations

With the corporate tax rate reduced from 35% to 21%, we have experienced a heightened awareness that Section 1202 allows business founders and investors to exclude millions of dollars of otherwise taxable gain when they sell qualified small business stock (QSBS) if all of the taxpayer level and issuer level qualification requirements are met.

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.

Advanced Section 1202 Planning – Dealing With the Problem of S Corporations

Two basic requirements of Section 1202 are that:

- Only C corporations can issue QSBS.
- The issuer of the QSBS must remain a C corporation during substantially all the taxpayer's QSBS holding period.

Business owners and investors who are aware of these two basic requirements might assume that there is no way to take advantage of Section 1202's benefits if a business is operating through an S corporation. In fact, there are several ways for S corporation shareholders to access the benefits of Section 1202. These planning ideas and the several challenges presented by S corporations are discussed below.

Is there any relief if an issuing C corporation was converted to an S corporation for a short period during a taxpayer's QSBS holding period?

The issuing C corporation must remain a C corporation during "substantially all" of a taxpayer's QSBS holding period. What constitutes "substantially all" of a taxpayer's holding period for QSBS is not defined in Section 1202. Arguments can be made that "substantially all" could mean as much as 95% or as little as 51% of the time, but 80-95% is probably a reasonable standard to live by

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for Section 1202 purposes. In the context of operating as a C corporation versus S corporation, the substantially all requirement could provide potential relief where, for example, QSBS is issued by a C corporation and the issuer converts to an S corporation for a one year period during the taxpayer's five or six-year QSBS holding period.

Don't convert an S corporation to a C corporation with the expectation of taking advantage of Section 1202's gain exclusion with respect to previously issued stock

A basic requirement for QSBS status is that the issuing corporation must be a C corporation at the time QSBS is issued. Stock is issued by an S corporation won't transform into QSBS if the corporation terminates its S corporation election and becomes a C corporation.

One possible advanced planning idea involves the situation where an S corporation issues stock and then subsequently converts to a C corporation. Generally, if the issuer of stock is an S corporation, stock issued by the S corporation does not and will never qualify to be QSBS. But there is an argument that if stock issued by an S corporation and that S corporation subsequently converts to a C corporation, there will be a point in the future where the corporation has been a C corporation (and a business satisfying all of other "qualified small business" requirements) for "substantially all" of the taxpayer's holding period.[1] At that point, the taxpayer could exchange the former S corporation stock for C corporation stock in an "F" reorganization or "E" reorganization. The planning idea would be that the original issuance requirement would no longer be tested at the time of the original issuance (when the corporation was an S corporation), but rather at the time of the exchange of stock for stock in the reorganization.[2] The holding period for the QSBS would likely be held to commence when the stock is exchanged in the reorganization, although there isn't any guidance addressing that point.

An S corporation converted into a C corporation can issue QSBS for new consideration in the form of cash, property or services

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An S corporation that has converted into a C corporation can issue new QSBS, but only for new consideration in the form of services, cash or other property. The corporation must be a "qualified small business" to issue QSBS, so make sure that all of the Section 1202 requirements are satisfied.

Does it work to terminate an S corporation election and then issue additional shares to the former S corporation's shareholders?

As mentioned above, an S corporation can terminate its election and issue QSBS as a C corporation if all of the Section 1202 requirements are satisfied. So, what if an S corporation election is terminated followed by the issuance of additional stock to the existing shareholders for new additional consideration (based on a reasonable valuation of the business) in the form of cash, property or services? Can these newly-issued shares qualify as QSBS?

There doesn't appear to be any specific prohibition on this approach to placing new QSBS in the hands of the company's historic S corporation shareholders. Although this approach is not specifically addressed in any Section 1202 tax authorities, it certainly seems prudent to only issue additional shares to existing shareholders for reasonable new consideration, whether that new consideration is cash, other property or additional services. Shares issued as part of a stock split of shares issued while the corporation was an S corporation are unlikely to qualify as QSBS. Shares issued for inadequate consideration also appear vulnerable to attack by the IRS as a Section 1202 tax avoidance scheme.

An S corporation can contribute assets to a newly-formed C corporation in exchange for QSBS

One strategy for giving existing S corporation shareholders access to Section 1202's benefits is to have the S corporation contribute assets to a new or existing C corporation in exchange for QSBS. So long as the exchange of assets for stock qualifies for a tax-free exchange under Section 351, the S corporation can successfully make the exchange and hold QSBS on behalf of its shareholders. The C corporation issuing QSBS would need to meet all of the qualified small business requirements under Section 1202.

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The S corporation should not distribute the QSBS to its shareholders because a distribution would trigger a deemed sale transaction. The S corporation should hold the QSBS until it is sold sometime after the five-year QSBS holding period requirement is satisfied. The S corporation's shareholders would benefit from the Section 1202 gain exclusion on a pro rata basis with their ownership of S corporation stock. While in many instances the exchange for QSBS would involve a newly-formed C corporation, the exchange could take place with an existing C corporation, so long as the exchange meets Section 351's 80% control requirement.

Under Section 1202, appreciated property contributed in exchange for QSBS is deemed to be contributed for Section 1202 tax basis purposes at the properties' fair market value at the time of contribution rather than its historic tax basis used for other purposes. This special Section 1202 rule is important for three reasons. First, if the aggregate fair market value of the contributed assets (plus the adjusted tax basis of any assets already held by the C corporation) exceeds $50 million, the C corporation won't be a qualified small business and the stock issued won't be QSBS. Second, the spread between the tax basis and fair market value of the assets at the time of the deemed contribution won't qualify for the Section 1202 gain exclusion, instead, the gain would generally qualify for long-term capital gains treatment. For example, if the tax basis of the contributed assets is zero but the fair market value of the assets is $2 million, and the QSBS is later sold for $20 million, then only $18 million of the gain can potentially qualify for the Section 1202 gain exclusion. On a happier note, for purposes of the gain exclusion cap found at IRC § 1202(b)(1)(B), the 10X contribution limit is based on the fair market value where assets are contributed, so in preceding example, the entire $18 million would qualify for the Section 1202 gain exclusion (10 times $2 million = $20 million of potential gain exclusion).

Potentially significant tax issues arise if there is a desire to distribute earnings out of the C corporation. Dividends or interest payments from the C corporation will be treated as passive income, which could trigger the termination of the S corporation under IRC § 1362(d)(3) and the payment of a 25% additional tax on the excess net passive income under Section 1375 if the S corporation has any

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accumulated earnings and profits.

A non-tax problem with a contribution of assets to a newco C corporation is that the plan requires an actual transfer of assets, contracts and liabilities in exchange for QSBS. This asset transfer may be an issue for some businesses and certainly at the least an annoyance in terms of dealing with EIN numbers, benefit plans, contracts and licenses. One way of potentially reducing this pain is to undergo an "F" reorganization as the first step in the restructuring (discussed below).

It may be useful to undergo an "F" reorganization restructuring prior to contributing assets to a C corporation

If an S corporation has contracts, licenses, permits or other business assets that would be adversely affected by their contribution to a C corporation (think in terms of what steps would be needed if someone purchased the assets of the business), then one approach that is likely to the impact of the restructuring would be to first have the S corporation restructure in a transaction qualifying as an "F" reorganization.[3]

An F reorganization can be structured to involve the following steps: (1) the formation of a new holding company; (2) the contribution of stock of the S corporation to the new corporation in exchange for the stock of the new corporation (which in the F reorganization carries on the life and status of the old S corporation); and (3) the making of a qualified S corporation subsidiary election for the old S corporation. Once this F reorganization is completed, the S corporation can be converted into a single member LLC. When this restructuring is completed, the membership interest in the single member LLC can be contributed to a newly-formed C corporation in exchange for QSBS (assuming all Section 1202 requirements are satisfied). As outlined in the previous section, the holding company (now the successor the old S corporation) becomes the QSBS shareholder and holds QSBS for the benefit of its stockholders until the QSBS is sold down the road.

A benefit of the F reorganization restructuring prior to the contribution of assets in exchange for QSBS is that the assets,

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contracts and licenses of the old S corporation remain in the same entity by operation of law, which can help avoid the asset transfer and contract assignment issues discussed above.

Does it work to liquidate an S corporation and contribute its assets to a newly-formed C corporation in exchange for QSBS?

On paper this strategy appears to work, but generally triggers an immediate tax event. The liquidation of the S corporation is treated as a deemed sale of its assets. This treatment could trigger a substantial up-front tax liability, with no guarantee that there will be a successful sale of QSBS down the road as the reward. Also, the IRS could attack the plan by invoking step-transaction or liquidation-reincorporation arguments, or other similar anti-tax avoidance arguments. But the up-front tax cost of liquidation would seem to reduce the risk that the IRS will focus this planning idea.

There are potentially significant additional tax problems with the S corporation liquidation strategy. If the S corporation holds depreciable assets, gain on the deemed sale of these assets will be taxed at ordinary income rates.[4] If the S corporation has built-in gains at the time of liquidation, the liquidation will trigger a corporate level tax on the built-in gains.[5]

One side benefit of the deemed asset sale is the tax basis of the assets will equal the value assigned to them in the taxable liquidation. When the high basis assets are then contributed to the new C corporation, the holders of the newly-issued QSBS may benefit from the provision that allows taxpayers to exclude from income 10X the aggregate adjusted basis of QSBS issued and disposed of by the taxpayer during a taxable year. For example, if a taxpayer contributes assets to a newly-formed C corporation in a transaction governed by Section 351 with a tax basis of $2 million, the taxpayer can ultimately shield $20 million of QSBS gain from tax. Business owners must weigh the immediate tangible tax cost triggered by liquidating the S corporation against the potential future benefits of Section 1202's gain exclusion.

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Business owners should also consider that there may be non-tax issues associated with distributing assets out in an S corporation liquidation and recontributing them to a newly-formed C corporation. A true liquidation may trigger contract assignment issues, license and permit issues and potentially expose the owners to the business' liabilities and obligations. An alternative approach that avoids some of these issues is to convert the S corporation into an LLC under state entity laws. Another approach would be to merge the S corporation into a newly-formed LLC. Both approaches would include the termination of the S corporation election. In both cases, the LLC would first default to partnership classification, and a check-the-box election could then be made to treat the LLC as an association taxable as a C corporation, resulting in a deemed Section 351 exchange with the issuance of QSBS in the exchange. Don't try these approaches without the help of experienced tax advisors.

Closing Remarks

The details of advanced Section 1202 planning are not commonly understood. Founders, investors, advisors, and return preparers engaging in advanced planning should consider seeking the advice of tax professionals who regularly handle QSBS issues. In particular, taxpayers and other participants in the planning process should want to know whether there is substantial authority for tax return positions. Finally, taxpayers and other participants in the planning process should also seek advice regarding potential penalties and the IRS's disclosure rules.

Business owners and professionals who want to learn more about IRC §§ 1202 and 1045 planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- The 21% Corporate Rate Breathes New Life into IRC § 1202.

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Visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] See IRC §§ 1202(c)(1)(A) and 1202(c)(1)(2)(A).

[2] Reorganizations governed by Section 368(a)(1)(E) (recapitalizations) or (F) (mere changes in identity, form, or place of organization of one corporation).

For "F" reorganizations, see IRC § 1202(h)(3) and Treasury Regulation § 1.1244(d)-3(d)(1). Because Section 1244 stock status is tested "at the time of the exchange" of equity in the "F reorganization", QSBS status would also presumably be tested at the time of the exchange in a reorganization under Section 1202.

For "E" reorganizations, see IRC §§ 1202(h)(3) and 1244(d)(2) and Treasury Regulation § 1.1244(d)-3(c)(1). ("If, pursuant to a recapitalization described in section 368(a)(1)(E), common stock of a corporation is received by an individual or partnership in exchange for stock of such corporation meeting the requirements of section 1244 stock determinable at the time of the exchange, such common stock shall be treated as meeting such requirements.") (emphasis added).

[3] IRC § 368(a)(1)(F) reorganization is a mere change in identity, form, or place or organization of one corporation.

[4] See Section 1239.

[5]See Section 1374.

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