Equity Rollovers in M&A Transactions Involving Section 1202 Qualified Small Business Stock (QSBS)

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Many M&A transactions are structured to include a rollover of some percentage of the target company's equity. These equity rollovers usually involve an exchange of the target company stock for buyer stock or LLC interests. Structuring a tax-free equity rollover is almost always a key planning objective for rollover participants. The article Rollover Equity Transactions 2021 addresses tax and business issues associated with the usual rollover transaction.

In contrast to the usual situation, a key planning priority for rollover participants who hold qualified small business stock (QSBS) and have met all of Section 1202's eligibility requirements should generally be to trigger a taxable sale transaction so that the participants can claim Section 1202's gain exclusion.[1] As discussed below, consideration should be given as to whether the rollover should be structured as a taxable sale of QSBS even in situations where the rollover participants lack the five-year holding period required for claiming the Section 1202 gain exclusion.[2]

The key takeaway from this article for target company stockholders and advisors should be that additional tax planning is required if there is an equity rollover involving QSBS. This tax planning requires a familiarity with Section 1202 and in some cases Section 1045.

Section 1202 background information.

Section 1202 provides an above-the-line exclusion from taxable income on gain from the sale of QSBS, subject to certain limitations.[3] To qualify for Section 1202's gain exclusion, a stockholder must have held QSBS for at least five years. Stockholders with a holding period of less than five years who sell their QSBS have the option under Section 1045 of preserving their Section 1202 gain exclusion by purchasing replacement QSBS with the sale proceeds and holding that replacement QSBS until their combined holding period for the original and replacement QSBS exceeds five years.[4] In

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either case, a taxable sale is required in order to trigger the right to claim Section 1202's gain exclusion.

When a taxable rollover of QSBS should be considered.

It is important to understand why a taxable rollover of QSBS often makes sense. A taxable rollover of QSBS locks in the benefits of the Section 1202 gain exclusion. By triggering a taxable sale and claiming Section 1202's gain exclusion, rollover participants are treated as having purchased the replacement buyer equity with a stepped-up fair market value tax basis rather than a carryover basis. In contrast, if target company QSBS is exchanged for buyer equity in a tax-free Section 721 contribution in exchange for an LLC/LP interest, the ability to claim the Section 1202 gain exclusion is permanently lost. There is no "sale" of the target company QSBS and the exchange terminates QSBS status for the contributed stock and the replacement LLC interest. If target company QSBS is exchanged for non-QSBS in a Section 351 exchange or Section 368 reorganization, the future ability to claim the Section 1202 gain exclusion with respect to the built-in Section 1202 gain remains, but what happens if Section 1202 is revoked before the replacement stock can be sold? What happens if the second exit is an asset sale rather than stock sale? The risk is that the Section 1202 gain exclusion can be lost. Even where the target company QSBS is exchanged for buyer QSBS, there is the risk that the Section 1202 gain exclusion won't be available for some reason down the road.

Two situations where a tax-free rollover of some target company QSBS might be desirable are (i) where the aggregate sales proceeds attributable to the rollover equity would exceed the rollover participant's Section 1202 gain exclusion cap (generally $10 million), or (ii) where the rollover participant's aggregate Section 1202 gain exclusion is well below the exclusion cap and the rollover involves the exchange of target company QSBS for the buyer's QSBS in a tax-free exchange (i.e., Section 351 exchange or Section 368 reorganization). With respect to the second situation, the rollover participant might want to roll over target company QSBS for buyer QSBS in a tax-free transaction because it defers gain and opens the door for the possibility that the QSBS will further appreciate,

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allowing the holder to claim a greater Section 1202 gain exclusion.[5] If the original exchange was a taxable transaction followed by a reinvestment in QSBS, a subsequent sale of the replacement QSBS won't have the benefit of a tacking of the original QSBS' holding period, which opens the door to the possibility that the holder won't have satisfied the five-year holding period requirement when the replacement QSBS is sold. But on the flip side, there is always the risk discussed above that the stock will lose its QSBS status after the initial exchange or that tax laws change, with the end result being that the participant loses the opportunity to take advantage of the gain exclusion.

For holders of target company QSBS with less than a five year holding period at the time of the closing of the M&A transaction, the right to a tax-free rollover of proceeds into replacement QSBS under Section 1045 would be lost if the target company QSBS is exchanged for a partnership interest (i.e., LLC/LP interest) or non-QSBS. But if a rollover participant does not want to roll proceeds over into replacement QSBS under Section 1045, a tax-free rollover into an LLC/LP interest or non-QSBS will generally be the best approach.

How to structure a taxable rollover of QSBS.

A taxable rollover of target company QSBS can be structured as an all cash transaction, followed by the rollover participants' purchase of buyer equity. A taxable rollover can also be accomplished by structuring the rollover as a taxable exchange of target company QSBS for buyer equity.

While it is easy to trigger a taxable exchange when exchanging QSBS for buyer stock (just structure the exchange to avoid satisfying Section 351's control requirements or to fail the Section 368 reorganization requirements), it is more difficult to avoid a tax-free exchange where QSBS is exchanged for an LLC interest (Section 721's requirements don't include Section 351's 80% control requirement). If buyer LLC interests are involved in the exchange, the best approach might be to structure and document the taxable QSBS rollover as a sale of 100% of the target company QSBS, followed by a reinvestment of the sales proceeds into buyer LLC

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interests.

Some Section 1202 rules to keep in mind during the M&A planning process.

Target stockholders sporting a five-year holding period for their QSBS should keep several rules in mind during a sale process:

- in order to take advantage of Section 1202's gain exclusion, QSBS must be sold. A sale can be structured as a sale or redemption for cash, or a taxable exchange of QSBS for buyer equity or other property;
- if target company QSBS is exchanged for buyer QSBS in a Section 351 exchange or Section 368 reorganization, the replacement QSBS will include the holding period for the original QSBS;
- if target company QSBS is exchanged for buyer non-QSBS in a Section 351 exchange or Section 368 reorganization, when the replacement non-QSBS is sold, if the rollover participant has a five year holding period for the replacement non-QSBS (for this purpose taking into account the holding period for the original QSBS and the holding period for the replacement stock), the rollover participant will be able to claim the Section 1202 gain exclusion in an amount equal to the gain deferred at the time of the exchange of buyer non-QSBS for the target company QSBS, and additional gain would be taxable at capital gains rates. Section 1202(h)(4)(D) provides that the Section 1202 rules with respect to a Section 351 exchange apply only if the corporation issuing stock (either QSBS or non-QSBS) to the rollover participants controls the target company within the meaning of Section 368(c) immediately after the exchange;
- it appears that if target company QSBS is exchanged for buyer QSBS in a tax-free exchange, a subsequent loss of QSBS status for the buyer stock would cause the rollover participant to lose the opportunity to claim any Section 1202 gain exclusion. This result appears to be the case in spite of the fact that in connection with a taxable exchange of QSBS coupled with a Section 1045 election, or a taxable sale of

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target company QSBS followed by a reinvestment of the proceeds in buyer QSBS coupled with a Section 1045 election, Section 1045 provides that the buyer only needs to satisfy the active business requirement under Section 1202(c)(2) for a period of six months after the exchange; and

- the exchange of QSBS for buyer LLC (a partnership for tax purposes) interests may be a tax-free exchange under Section 721, but the exchange will end the stock's QSBS status and the rollover participant won't be able to claim the Section 1202 gain exclusion with respect to the buyer LLC interests received in the exchange.

Planning strategies shift when target company stockholders lack a five-year holding period for QSBS.

One obvious strategy when target stockholders don't have a five-year holding period for QSBS is to postpone the closing of a sale until the five-year holding period requirement has been satisfied. If postponing the sale is not possible, then target company stockholders might consider these planning options:

- exchanging QSBS for buyer QSBS in a tax-free transaction. This strategy works whether the rollover is taxable or tax-free under Section 351 or Section 368. If the rollover is taxable, a rollover participant will need to make an election under Section 1045. All of the target company stockholders holding QSBS can reinvest their sale proceeds in QSBS and make an election to defer gain under Section 1045;
- exchanging target company QSBS for buyer non-QSBS in a tax-free exchange under Section 351 or tax-free reorganization under Section 368. When the replacement non-QSBS is sold, if the rollover participant has a five year holding period for the replacement non-QSBS, taking into account the holding period for the original QSBS, the rollover participant will be able to claim the Section 1202 gain exclusion in an amount equal to the gain deferred at the time of the exchange of buyer non-QSBS for the target company QSBS, and additional gain would be taxable at capital gains

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rates; or

- selling target company QSBS for cash or exchanging target company QSBS for buyer equity in a taxable exchange and reinvesting the proceeds in replacement QSBS. Under Section 1045, an amount equal to the consideration received in the sale of target company equity can be reinvested in replacement QSBS within 60 days of the sale of the target company QSBS.

Confirm and document satisfaction of Section 1202's eligibility requirements, and Section 1045's requirements, if applicable.

In addition to having an understanding of how QSBS is treated in rollover transactions and the M&A sale process generally, potential rollover participants should determine whether their equity is QSBS and the date on which their original QSBS holding period commenced for purposes of determining whether Section 1202's five-year holding period requirement has been satisfied. Finally, rollover participants, along with any target company stockholders claiming Section 1202's gain exclusion or rolling over proceeds under Section 1045 should make sure that they have fully documented the satisfaction of each of Section 1202's eligibility requirements, and Section 1045's requirements, if applicable.

Closing Remarks

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and Section 1045 tax planning. Venture capitalists, founders and investors who want to learn more about QSBS 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
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock

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- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- View our series of blog posts addressing planning issues relating to qualified small business stock (QSBS)

Contact Scott Dolson if you want to discuss any QSBS issues by telephone or video conference.

Finally, we recommend a review of our **QSBS & Tax Planning Services page** for a broader discussion of the general tax and legal consequences associated with equity rollovers.

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[1]If the rollover participant is expected to roll over some or all of the participant's equity into buyer equity, the planning consideration is whether the transaction should be structured to permit the participant to sell target company QSBS and claim Section 1202's gain exclusion, and then reinvest the sales proceeds into buyer equity with a higher cost basis rather than a lower carryover basis in a tax-free exchange. Plus, if the target stockholders roll QSBS over into buyer equity on a tax-free basis, there is always the possibility that a subsequent liquidity event won't be structured to allow for the participant to claim Section 1202's gain exclusion. The planning issue is whether it is best to structure a rollover that takes advantage of Section 1202's gain exclusion rather than hoping that it might be available at some future date.

[2] The rollover participant might want to consider reinvesting an amount equal to the "proceeds" of the taxable sale in replacement QSBS under Section 1045.

[3] The Section 1202 exclusion for a taxable year is limited to the greater of $10 million or 10 times the stockholder's aggregate basis in the QSBS. The limitation is applied to each issuer of QSBS at the stockholder level. As such, every stockholder of QSBS stock may exclude gain of the greater of $10 million or 10 times the stockholder's basis in an issuing corporation's QSBS, and the limitation is not aggregated with QSBS from other issuers.

[4] For purposes of Section 1045, the "proceeds" from the sale of QSBS in a rollover transaction would be an amount equal to the value of the target company equity rolled over into buyer equity.

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There is no tracing of proceeds from the original QSBS into replacement QSBS. If target company QSBS is exchanged in a taxable exchange for buyer equity and the value of the rolled over equity is $1,000, then the rollover participant must roll over $1,000 into replacement QSBS to take full advantage of Section 1045. Under Section 1045, the rollover participant can hold the buyer equity and write a $1,000 check out of a separate account to purchase replacement QSBS within the required 60 day period.

[5] If the buyer's equity is QSBS and the transaction is structured to permit a tax-free rollover of original QSBS for replacement QSBS, it still might make sense to restructure and trigger a sale transaction. Deferring gain recognition (and the Section 1202's gain exclusion claim) opens the door to the possibility that there won't be a qualifying sale of the QSBS in the future, or that the replacement stock might decline in value, which would result in the participant foregoing some capital loss when the replacement QSBS is sold – if the original exchange had been taxable, participants claiming Section 1202's gain exclusion would have started with a higher tax basis in the replacement QSBS.

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