Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045

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Section 1045 allows stockholders to reinvest on a pre-tax basis, proceeds from the sale of qualified small business stock (QSBS) into replacement QSBS.[i] As discussed in Part 1 of this article, there are several reasons why stockholders take advantage of Section 1045. Often, holders of QSBS who are selling before satisfying Section 1202's five-year holding period requirement want to reinvest the sales proceeds into replacement QSBS on a pre-tax basis so that they eventually claim Section 1202's gain exclusion by combined holding periods for their original and replacement QSBS. Some stockholders may have reached Section 1202's gain exclusion cap ($10 million for holders of low tax basis stock) with respect to their original QSBS investment and want to reinvest excess sales proceeds on a pre-tax basis into replacement QSBS. Other stockholders want to invest in start-ups and see Section 1045 as a useful tool for selling one QSBS investment and replacing it on a pre-tax basis with another QSBS investment.

This is one in a series of articles and blogs addressing planning issues relating to QSBS and the workings of Sections 1202 and 1045. During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the federal corporate income rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202's generous gain exclusion. Legislation proposed during 2021 sought to curb Section 1202's benefits, but that legislation, along with the balance of President Biden's Build Back Better bill, has stalled in Congress, perhaps permanently. More background information regarding qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code is available on our website.

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This is a two-part article. The first installment introduced Section 1045 and focused on Section 1045 as a planning tool. This second installment looks at the nuts and bolts of securing the benefits of Section 1045. A separate article focuses on the overall options available when dealing with the good news-bad news situation when QSBS is sold before satisfying Section 1202's five-year holding period requirement: Are You Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?

Reinvesting Original QSBS sales proceeds into Replacement QSBS.

Proceeds from the sale of Original QSBS can be reinvested into Replacement QSBS under Section 1045, provided the reinvestment occurs during the 60-day period beginning on the sale date of the Original QSBS. If an election is made under Section 1045, the holding period for the Original QSBS is tacked onto the holding period for the Replacement QSBS. A stockholder can reinvest proceeds into the stock of an unaffiliated corporation, or a new or existing corporation owned or controlled by the stockholder. If possible, it is important to obtain representations and covenants from an unaffiliated corporation issuing Replacement QSBS that each of Section 1202's eligibility requirements are satisfied, that the issuing corporation's management will endeavor to maintain eligibility under Section 1202 during the stockholder's entire holding period for Replacement QSBS, and that management will cooperate with the stockholder's efforts to document Section 1202 eligibility.

QSBS proceeds must be reinvestment in "stock" (for federal income tax purposes), which generally excludes the purchase of convertible debt as Replacement QSBS and makes the reinvestment of proceeds into SAFE instruments a risky proposition, as there is no guarantee that the IRS will agree that a particular issuer's SAFE instrument qualifies as equity (stock) for federal income tax purposes.

Although the language of Section 1045 isn't 100% clear on the issue, it does appear possible for a stockholder to pool Original QSBS sales proceeds with other investors in a limited partnership or

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limited liability company that purchases the Replacement QSBS, but the LP or LLC must acquire the Replacement QSBS within 60 days after the stockholder sell the Original QSBS. Further, each stockholder reinvesting through a partnership should make sure that the stockholder's share of the partnership's investment in the Replacement QSBS at least equals the Original QSBS proceeds being rolled over under Section 1045.

What are the requirements for electing Section 1045's gain deferral?

In order to qualify for Section 1045's deferral of gain recognition, the following requirements must be satisfied:

- All of Section 1202's eligibility requirements must have been met with respect to the stockholder's original QSBS (referred to in this article as "Original QSBS") at the time of sale, excluding satisfying the five-year holding period requirement. Some of these eligibility requirements apply at a specific point in time and other eligibility requirements apply during a stockholder's entire Original QSBS holding period. As discussed in Part 1 of this Article, the fact that a stockholder has reached Section 1202's gain exclusion cap doesn't prevent the stockholder from reinvesting the excess proceeds in Replacement QSBS.
- At the time of sale, the stockholder must have held the Original QSBS for at least six months.
- There must be a "sale" (for federal income tax purposes) of the Original QSBS. A sale can include the complete liquidation of the issuing corporation or a stock redemption if the redemption is treated as a sale under Section 302.
- Replacement QSBS must be purchased during the 60-day period beginning on the date of the sale of the Original QSBS. The proceeds from the sale of the Original QSBS are not required to be traced to the purchase of Replacement QSBS. A stockholder can purchase a pickup truck with proceeds from the Original QSBS sale and use other funds to purchase

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the Replacement QSBS. A stockholder can purchase more than one corporation's Replacement QSBS. The corporation issuing Replacement QSBS can be unrelated to the stockholder, or, as discussed below, a corporation organized by the stockholder for the purpose of issuing Replacement QSBS.

- Replacement QSBS must be "stock" for federal income tax purposes. Voting and nonvoting common and preferred stock all are eligible to qualify as QSBS. Convertible debt is unlikely to qualify as "stock" for federal income tax purposes. SAFE instruments are often characterized and treated by holders and issuing companies as "stock" for federal income tax purposes, but there are no tax authorities directly supporting that position. If the IRS challenges a taxpayer's characterization, a stockholder would have the burden of proving that the SAFE instrument has a preponderance of equity-like features and qualifies as equity under Section 385. It may be risky to purchase a SAFE instrument as Replacement QSBS, because Section 1045's tax deferral would be lost if it was determined that reinvestment into "stock" did not occur during the 60-day period.
- A corporation issuing Replacement QSBS must satisfy Section 1202(c)(2)'s active business requirements for a period of at least six months after issuing Replacement QSBS. The significance of this requirement is that a stockholder would defer gain on the sale of Original QSBS even if the corporation issuing the Replacement QSBS ceased after six months to be a qualified small business. But if the corporation issuing the Replacement QSBS ceases to be a qualified small business, the opportunity to claim Section 1202's gain exclusion with respect to the Replacement QSBS is lost. Whether a corporation has met the active business requirements will be of particular importance where the corporation issuing Replacement QSBS is organized by the stockholder selling Original QSBS. The "Active Business Test" and "80% Test" are discussed in detail below.

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- A stockholder must make an election to reinvest proceeds under Section 1045 on a timely filed tax return for the year in which the Original QSBS was sold.
- A stockholder making the Section 1045 election should maintain comprehensive documentation supporting that: (a) both the stockholder and the corporation issuing the Original QSBS met Section 1202's eligibility requirements; (b) the Original QSBS was held for at least six months; (c) the Original QSBS was sold, and the proceeds reinvested during the 60-day window; and (d) the corporation issuing the Replacement QSBS was a qualified small business for at least six months after issuance of the Replacement QSBS.

Reinvesting QSBS sales proceeds into a newly-organized corporation

We frequently work with stockholders who sell their Original QSBS before satisfying Section 1202's five-year holding period requirement. Some of these stockholders do reinvest their QSBS proceeds into minority investments into someone else's Replacement QSBS. But for many stockholders, the idea of sourcing substantial minority investments during a short 60-day window isn't attractive for a variety of reasons. In some cases, the stockholder elects to fund an existing controlled corporation. More frequently, the stockholder funds a newly-incorporated C corporation (Newco) with an amount equal to some or all of the Original QSBS sales proceeds. Newco can be organized to engage in the de novo creation of a business or to seek and (hopefully) acquire the assets or equity of an existing active qualified business. Section 1202(e)(2)(A) provides that assets are considered to be used in the active conduct of a qualified trade or business if a corporation is engaged in start-up activities of the nature described In Section 195(c)(1)(A). Section 195(c)(1)(A), which separately governs the deductibility of certain start-up expenditures, includes within its scope engaging in typical activities of a business start-up and references the creation and acquisition-related activities. Section 1202(e)(2) confirms that it isn't necessary for a corporation to have any gross income to be considered as

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engaging in qualifying start-up activities.

Whatever reinvestment approach is chosen, a critical requirement for achieving a successful Section 1045 reinvestment is that the proceeds from the sale of the Original QSBS must be reinvested into the Replacement QSBS during the 60-day period after sale of the Original QSBS. Efforts should be made to fully document issuance of the Replacement QSBS during this 60-day period, including depositing the reinvested proceeds into the bank account of the corporation issuing the Replacement QSBS.

A corporation must meet Section 1202's active business requirements for at least six months after issuing Replacement QSBS

Section 1045(b)(4)(B) requires that the corporation issuing Replacement QSBS must meet Section 1202(c)(2)'s active business requirement for at least six months after issuance of Replacement QSBS. In order to meet these requirements, the corporation must be a C corporation and remain a C corporation during the six-month period. Second, the corporation must also satisfy Section 1202's other issuing-corporation level eligibility requirements, including the $50 million test (at the time of issuance), the Active Business Test and the 80% Test (discussed below). If the stockholder eventually sells the Replacement QSBS with the intention of claiming Section 1202's gain exclusion, the must have satisfied Section 1202(c)(2)'s active business requirement for substantially all of each of (i) the first six months after issuance of the Replacement QSBS (to meet Section 1045's requirements) and (ii) the stockholder's combined holding period for the Original QSBS and Replacement QSBS (to meet Section 1202's requirements).[ii]

If Original QSBS sales proceeds are reinvested into minority investments in Replacement QSBS, the key for the stockholder is to obtain from the corporation issuing the Replacement QSBS representations necessary to document that the issuing corporation has met all of Section 1202's eligibility requirements through the date of issuance, including the 80% Test. Ideally, the stockholder will also obtain covenants that management of the

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issuing corporation will use at least commercially reasonable efforts to cause the issuing corporation to continue satisfying Section 1202's eligibility requirement until the Replacement Stock is sold.

Satisfying the Active Conduct Test and the 80% Test

As discussed above, Section 1045's benefits are not available unless for substantially all of the first six months after issuance of Replacement QSBS, at least 80% (by value) of the assets of the corporation issuing the Replacement QSBS were used in the active conduct of one or more qualified trades or businesses (referred to in this article as the "80% Test").[iii] In order for a stockholder to claim Section 1202's gain exclusion if the Replacement QSBS is sold, the 80% Test will need to have been satisfied for substantially all of the combined holding period for the Original QSBS and Replacement QSBS. Further, if challenged, the stockholder will also need to be able to show that the business of the start-up was actively conducted from day one and at least for the first six months to meet Section 1045's requirements (referred to in this article as the "Active Conduct Test") and continues to meet the requirements for claiming Section 1202's gain exclusion.

Application of the Active Conduct Test to a stockholder-controlled start-up. Section 1202(c)(2) provides that stock is not QSBS unless the corporation meets the "active business requirements" of Section 1202(e). Section 1202(e)(2) provides that engaging in start-up activities described in Section 195(c)(1)(A) can be treated as the active conduct of a trade or business for purposes of Section 1202(e). The activities referenced in Section 195(c)(1)(A) include engaging in de novo start-up activities and activities associated with the acquisition of an active trade or business (discussed below). There are no tax authorities under Sections 1202 or 1045 confirming that there is an explicit "Active Conduct Test" (i.e., a requirement of any specific level of activity before a start-up meets the "active conduct" requirement of Section 1202(e)) separate from the 80% Test, or a roadmap for satisfying the Active Conduct Test. That being said, we believe that it is reasonable to conclude that reinvesting Original QSBS proceeds into a controlled corporation

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and then failing to engage in a minimal level of activity would encourage the IRS to argue that reinvestment of Original QSBS proceeds into the controlled start-up was a "sham" on the basis that the corporation failed the Active Conduct Test and/or the 80% Test.

In *John P. Owen*, T.C. Memo 2012-21, a taxpayer organized a corporation and reinvested Original QSBS proceeds in a start-up jewelry business. Unfortunately, taxpayer invested only 8% of the corporation's capital in jewelry inventory, and over the course of two years, made only a couple of sales to related parties. Basically, the taxpayer bought jewelry and put it in a drawer for several years. At trial, the taxpayer argued that the reason there was so little jewelry purchase and sale activities was because he needed time to learn the retail jewelry business before diving into purchasing inventory. Not surprisingly, the taxpayer failed his credibility test. The Tax Court supported its decision with the determination that the taxpayer had not satisfied the 80% Test. The court not surprisingly concluded that the taxpayer had not acted in good faith and imposed a 20% accuracy-related penalty.

Treasury Regulation Section 1.355-3 and Proposed Treasury Regulation Section 1.355-3 address in detail what the "active conduct of a trade or business" means for purposes of Section 355. The regulations provide that the issue of whether a business is "actively conducted" is an "all the facts and circumstances" test. We believe that if the Tax Court determines that Section 1202(c)(2) imposes an Active Conduct Test separate from the 80% Test, the Tax Court would likely apply a version of the "reasonable man" test to determine whether the corporation's level of activities, as undertaken through stockholder(s), management, employees and contractors, rise to the level of activities that would be expected for a start-up engaged in similar activities under similar circumstances (excluding the influence of Sections 1045 and 1202). If the activities fall short of a reasonable level of activity based on the specific facts and circumstances, the risk is that the Tax Court will reach a conclusion similar to the one reached in the *John P. Owen* case.

Application of the 80% Test to a stockholder-controlled start-up. As mentioned above, Section 1045's benefits are not available

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unless the issuing corporation satisfies the 80% Test (at least 80% [by value] of the assets of the corporation issuing the Replacement QSBS are used in the active conduct of one or more qualified trades or businesses) for substantially all of the first six months after issuance of Replacement QSBS. Section 1202(e)(2)(A) provides that assets used in connection with start-up activities described in Section 195(c)(1)(A) are treated as being used in the active conduct of a qualified business. The activities referenced in Section 195(c)(1)(A) which could be permissible for a stockholder-controlled start-up include either engaging in de novo start-up activities or engaging in activities associated with the acquisition of an active business (discussed below).

Since the taxpayer has the burden of proof if challenged by the IRS, we believe that a stockholder investing in Replacement QSBS should be prepared to establish that each dollar used to purchase the Replacement QSBS was necessary to fund the corporation's start-up activities (what this means is discussed below). We believe that for every stockholder-controlled start-up, the starting point for proving satisfaction of the 80% Test should be the development of a contemporaneously prepared comprehensive business plan and budget. Only dollars that are required pursuant to the business plan and budget should be contributed into the start-up.

Typically, a start-up's initial assets will be limited to the cash reinvested as payment for Replacement QSBS. We believe that Section 1202(e)(2)(A) supports the conclusion that cash properly earmarked to pay for any start-up activities should apply towards satisfaction of the 80% Test, including funds for payment of reasonable compensation.[iv] Section 1202(e)(6) provides that assets held to fund a corporation's working capital needs count towards satisfying the 80% Test, provided that no more than 50% of the corporation's assets can qualify towards the 80% Test by virtue of being cash and investment assets (that are reasonably expected to be used within two years to fund a corporation's working capital needs) after a start-up has operated for two years.[v] We also believe that funds earmarked for the acquisition of equipment, supplies, plant, inventory and any intangible assets, or for other documented reasonable and necessary capital

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investments, should count towards satisfying of the 80% Test. Our reasoning is that since the value of tangible and intangible assets generally count towards satisfaction of the 80% Test if those assets are used in a qualified business activity, it is reasonable to conclude that cash earmarked by a start-up to purchase those assets should also qualify towards satisfaction of the 80% Test.[vi] This issue is discussed in more detail below.

For purposes of the 80% Test, it isn't clear constitutes a reasonable period to measure cash earmarked for start-up expenditures and the corporation's working capital needs, but the reference to two years in Section 1202(e)(6) suggests that a stockholder should be able to qualify cash towards satisfying the 80% Test if the cash is earmarked by the budget to be used during the start-up's initial two years of operation. What falls within the scope of a start-up's working capital needs is discussed below.

There are a couple of additional critical points that should be considered when planning to reinvest QSBS proceeds into a de novo start-up. First, whether a stockholder intends to engage in start-up activities or acquire an active business, care should be taken to not roll over proceeds beyond the amount that can be shown as required to adequately fund the corporation's start-up activities. If the corporation is holding excess cash, the IRS would likely argue that any cash not required for the start-up's activity should count against satisfaction of the 80% Test. Second, a stockholder who is intending to fund two or more activities should consider using separate corporations for each activity. Engaging in multiple activities in a corporation that has issued QSBS can cause problems if those activities prove to be incompatible and later cannot be split-up on a tax-free basis.[vii]

Application of the 80% Test to a start-up engaged in searching for and acquiring the assets or equity of an existing active qualified business. Some stockholders selling Original QSBS would rather purchase an active business than create a new business from scratch. We believe that stockholders do have the option under Sections 1045 and 1202 to organize a corporation for the purpose of searching for and acquiring the assets or equity of a qualified active business.

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As discussed in the preceding section, a critical eligibility requirement for stockholders organizing a new corporation as a vehicle for acquiring Replacement QSBS is satisfying the 80% Test for at least six months after the date Replacement QSBS is purchased. For purposes of determining whether the corporation has satisfied the 80% Test, Section 1202(e)(2)(A) provides that assets (in this case the cash) earmarked for use in connection with the corporation's start-up activities described in Section 195(c)(1)(A) are treated as being used in the active conduct of a qualified business. Section 195(c)(1)(A), which itself exists to address the deductibility of certain start-up expenditures, includes within its scope both the creation of an active business and investigating the creation or acquisition of an active business. As discussed below, we believe that the combination of Sections 1202(e)(2)(A), 195(c)(1)(A) and 1202(e)(6) supports the conclusion that the assets that fall within the scope of Section 1202(e)(2)(A)'s exception to the active business requirement include assets that are earmarked for the creation, investigation and acquisition of an active business, including cash earmarked for funding the corporation's capital investment and operating cash needs.

Section 1202(e)(2) does not specifically address how to determine what assets are eligible for inclusion when calculating whether a corporation's assets should apply towards satisfying the 80% Test. The assets that qualify for inclusion in calculating the 80% Test will differ based on a start-up's business plan. Section 195(c)(1)(A) expressly references cash used to fund the investigation of potential acquisitions. Based on this express reference, any cash property earmarked for that effort should count towards satisfying the 80% Test. In addition, Section 1202(e)(6) provides that cash and investment assets earmarked to fund the working capital needs of an active qualified business should also qualify as assets included in the 80% Test calculation.

If the start-up's activity is searching for and acquiring an active business, we believe that assets that should qualify as working capital includes cash required to fund anticipated day-to-day working capital needs of the acquired business over at least a two-year period based and perhaps longer depending on the business plan. Since there is no requirement under Section 1202 that a

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business must be created from scratch, a reasonable conclusion is that both acquired business assets and cash earmarked for acquiring business assets should count towards satisfying the 80% Test.[viii] This position is further supported by Section 1202(e)(2), which refers to the activities described in Section 195(c)(1)(A) — the referenced activities are those associate with the creation and acquisition of active business. Section 195's legislative history refers to the activity of acquiring assets.[ix] Further support can be found in the language of Section 195(c)(1)(A)(ii), which refers to "creating an active trade or business." We note, however, that there are no tax authorities which parse through what should be included and excluded in categorizing assets for purposes of the 80% Test.

Section 1202(e)(6) contemplates that a high percentage of a start-up's assets can consist of cash during the first two years of its operations. Even after the second anniversary of the corporation's existence, up to 50% of a corporation's assets can be held in the form of cash and investment assets (parking cash required for the business) without causing those assets to count against satisfying the 80% test. Based on the authority cited below, we believe that based on Section 1202(e)(6), if the corporation's activities involve the acquisition of business assets, a good argument can be made that the working capital needs of the business encompasses the capital required to acquire assets necessary for the operation of the active business.

What falls within the "required working capital needs" of a business for purposes of Section 1202(e)(6) is not defined by tax authorities specifically addressing the workings of Section 1202. The United States Supreme Court defined "working capital" broadly to include cash contributed for the purpose of funding the acquisition of property.[x] The Meriam Webster online dictionary defines "working capital" to mean the excess of current assets over current liabilities and all capital of a business except that invested in capital assets. The definition does not limit the scope of working capital by reference to the working capital's intended use. Investopedia states in its discussion of "What Is Working Capital?" that a positive net working capital "indicates that a company can fund its current operations and invest in future activities and growth." Cash used to

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acquire assets of an active business should fall within the scope of investment in future growth and funding for the acquisition of property. Based on the above, funds earmarked for the acquisition of business assets should count towards satisfaction of the 80% Test.

Does Section 1045 apply when the search for an active business target results in a stock purchase?

In some cases, the search for business to acquire culminates in the purchase of a target corporation's stock rather than its assets. There are no tax authorities addressing the Section 1202 consequences arising out of organizing a Newco that ultimately purchases stock. Section 1202(e)(5) does provide that a corporation can be deemed to engage in an active business for purposes of the 80% Test by virtue of the activities of its subsidiary. We note that the availability of this look-through treatment does not hinge on whether the subsidiary was created de-novo or acquired by the parent holding company.

The IRS could take argue that the business purpose or step transaction doctrine is applicable in situations where Newco purchases stock. The IRS would claim that the formation of Newco was merely for tax avoidance purposes because the target corporation's stock could have been purchased directly by Newco's stockholders, and if structured in that manner, the acquiring stockholders would not be purchasing Replacement QSBS. But the IRS would need to overcome the fact that M&A transactions are often structured using a corporate holding company to purchase stock. Parent-subsidiary structures are commonly used for a number of bona-fide business reasons, including asset protection planning, governance issues, regulatory issues, equity and debt financing, and equity compensation arrangements.

One further potential IRS argument relates to Congress' authorization in Section 1202(k) for the IRS to promulgate Section 1202 anti-abuse rules that can include rules regarding "shell corporations." Weighing against this argument would be the fact

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that not only are there bona-fide business reasons for adopting a parent-subsidiary entity structure, but Section 1202 expressly contemplates that a corporation issuing QSBS might have a subsidiary, and Section 1202 does not limit the subsidiary to one which is created de novo. Finally, and perhaps most persuasively, Section 1202 was enacted in 1993, and no regulations addressing anti-abuse rules have been promulgated by the IRS during the preceding 28+ years, which raises the question of whether Section 1202(k) has any import in the absence of those regulations.

There are a number of instances in the Internal Revenue Code where the acquisition of the stock of a subsidiary that becomes part of an affiliated group is treated the same as an asset acquisition, including "covered transactions" under Treasury Regulation Section 1.263(a), and in connection with the treatment of investigatory expenses when a corporate taxpayer acquires the stock of subsidiary that becomes a member of the acquiring company's consolidated group. In the context of Section 1202, we believe that there isn't a logical reason why the purchase of assets of an active business by a new corporation would qualify the acquiring corporation as an active business while the purchase by the new corporation of the stock of a corporation engaged in an active business would not qualify. Of course, stockholders reinvesting Original QSBS proceeds into a new corporation should purchase active business assets if they want to avoid potential scrutiny by the IRS.

The importance of a start-up's business plan and budget

Any stockholder who organizes a new corporation in connection with making a Section 1045 election should document the intent to grow an active business and invest 100% of the reinvested sales proceeds in operating expenditures and capital investments that qualify towards satisfying the 80% Test. We believe that developing a contemporaneous business plan and budget and then actively pursuing start-up activities are the best defense against any IRS argument that the start-up was organized for tax avoidance purposes. Original sales proceeds in excess of the amount required

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by the budget should not be contributed into the start-up, as those funds may count against satisfying the 80% Test.

Application of the Section 1202(c)(3)'s "substantially all" requirement in the context of a Section 1045 rollover

Section 1045(b)(4)(B) provides that for purposes of determining whether there is a successful rollover of proceeds under Section 1045, only the first six months of the stockholder's holding period for the Replacement QSBS is taken into consideration. Section 1202(c)(2) provides that stock will not be treated as QSBS unless the corporation meets the active business requirements of Section 1202(e) during "substantially all" of the stockholder's QSBS holding period. The potential combination of these requirements creates two separate applicable holding periods for applying the "substantially all" test.[xi] For Section 1045 purposes (i.e., for determining whether the rollover of funds is tax-deferred under Section 1045), the corporation issuing Replacement QSBS is only required to satisfy the active business requirements of Section 1202 for substantially all of the first six months of a stockholder's holding period for Replacement QSBS. The active business requirement includes the ongoing satisfaction of the 80% Test and the requirement of Section 1202(e)(5) that the corporation is an "eligible corporation." Separately, in order to claim Section 1202's gain exclusion, the corporations issuing the Original QSBS and the Replacement QSBS must meet the active business requirements for substantially all of the stockholder's combined holding periods for his Original QSBS and Replacement QSBS.

Can you invest funds before they are required for use in the active business?

Unlike the typical start-up where funds are raised approximately as needed, a start-up funded with Section 1045 rollover proceeds often receives this "investor" money before those funds are immediately required by the business. A common question asked by stockholders reinvesting QSBS sales proceeds is whether those

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proceeds can be invested prior to their use in the business issuing the Replacement QSBS. Section 1202(e)(6) provides some guidance, suggesting that funds set aside for reasonable working capital needs of a business can be invested in investment assets, so long as the proceeds from those investment assets are reasonably expected to be used within two years to finance research and experimentation or fund increases in the working capital needs. We believe that it is reasonable to assume based on Section 1202(e)(6)'s guidance, that rollover funds can be invested short-term, so long as the requirements of Section 1202(e)(6) are met with respect to funds earmarked for working capital needs and funds earmarked for start-up and capital expenditures are available as per the business plan and budget of the business.

While there is no explicit prohibition on funds being loaned out of the corporation on a short-term basis, we believe that this could complicate efforts to establish that funds were properly earmarked for uses by the start-up that qualify towards meeting the 80% Test. Obviously, any funds that are diverted to uses that are outside of the scope of the start-up's creation or acquisition of a qualified business activity would not count towards satisfying the 80% Test. In the past, we have been asked by stockholders whether changes in the use, intended use or timing of the use of rollover proceeds might have on meeting the 80% Test. Our response is that the answer depends on the specific facts and circumstances surrounding the course of events. We believe that these changes in circumstances would be analyzed based on asking what the reasonable management of a similarly situated start-up would do when motivated by bona-fide business purposes (to the exclusion of tax avoidance purposes). There are numerous bona-fide circumstances where unexpected internal and external events intervene to change best-laid plans outlined in a start-up's initial budget and business plan, and we believe the mere fact that a start-up has experienced one or more of these issues should not be reason alone for assuming the start-up has failed the 80% Test.

Is there a required holding period for Replacement QSBS before Section 1202's gain

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exclusion can be claimed?

A stockholder must have at least a five-year holding period for QSBS at the time of sale in order to be eligible to claim Section 1202's gain exclusion. Section 1223(13) provides that a stockholder's holding period for Replacement QSBS includes the holding period for the shares of Original QSBS with respect to which the stockholder claimed Section 1202's gain exclusion. So, a stockholder who had a four-year holding period for Original QSBS could reinvestment proceeds into Replacement QSBS, and after one year the stockholder would have a five-year holding period for the Replacement QSBS.

While the situation described above is clear, what about the situation where that stockholder reinvests proceeds into replacement QSBS, undertakes de novo start-up activities, reaches the determination that his start-up has failed after 16 months of effort, and then completely liquidates the issuer of the Replacement QSBS? A complete liquidation of a corporation is treated under Section 331 and Treasury Regulation Section 1.331-1(a) as a sale of stock, with amount received in the liquidation as full payment in exchange for the stock, which means that a complete liquidation satisfies Section 1202's "sale" requirement. But is there an argument that a deeded sale of Replacement Stock within two years of the issuance of that Replacement Stock violates that anti-churning rule found in Section 1202(c)(3)(A)? Section 1202(c)(3)(A) generally provides that stock issued to a stockholder is not QSBS if other stock of the corporation was redeemed from that stockholder within a two-year period before or after the issuance. The headings in Section 1202(c)(3) and Treasury Regulation Section 1.1202-2 reference "redemptions" of stock. Section 317(b) provides that stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a stockholder in exchange for property. Revenue Ruling 80-101 confirms the distribution of property in complete liquidation of a corporation meets Section 317(b)'s general definition of a redemption. So, based on the preceding authority, there appears to be an argument that, in the example outlined above, the stockholder's replacement QSBS should lose its QSBS status because it was "redeemed" within two

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years after its date of issuance by virtue of the complete liquidation.[xii] But is this a correct reading of how Section 1202(c)(3)(A) applies in the situation outlined above? There certainly is an argument based on one reading of Section 1202 that it does, so a stockholder who wants to avoid this argument would be prudent to maintain active start-up activities for a at least a two-year period.[xiii] But as discussed in the paragraph below, Sections 1202 and 1045 can be also read to reach a different conclusion, and one that we believe is more consistent with the view that Congress did not intend the scope of Section 1202(c)(3) to apply to a complete liquidation of the issuer of Replacement QSBS.

Section 1202's legislative history provides that Section 1202(c)(3) was included to prevent evasion of the requirement that QSBS be newly issued.[xiv] Congress intended for Section 1202(c)(3) to plug a potential loophole that would have otherwise given taxpayers holding non-QSBS the opportunity to combine the redemption of that non-QSBS with an issuance of QSBS soon thereafter. We believe that Congress would not have intended the language of Section 1202(c)(3)(A) to be interpreted as applying to the sale of Replacement QSBS within two years after its purchase. Where a stockholder sells Original QSBS and purchases Replacement QSBS, there is no evasion of the type targeted by Section 1202(c)(3) — the stockholder is not using a redemption to convert non-QSBS into QSBS. Further, Section 1223(13) provides that, except for purposes of Sections 1202(a)(2) and 1202(c)(2)(A), a stockholder's holding period for Replacement QSBS includes the holding period for the applicable Original QSBS. This means that a stockholder's holding period for purposes of Section 1202(c)(3)(A) (the anti-redemption clause) would include not only the holding period for Replacement QSBS but also the holding period for the Original QSBS. Based on this reading of the application of Section 1223(13) to Section 1202(c)(3), the "issuance" date of the Replacement QSBS would be deemed to date back to the issuance date of the applicable Original QSBS. We believe that this is the better reading of the interplay of Sections 1202, 1045 and 1223 and, as previously mentioned, has the added benefit of reaching a result that is consistent with Section 1202's legislative history.

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What happens if events don't go as planned in the original business plan and budget?

This article has emphasized the importance of preparing a business plan and budget detailing the anticipated use of each dollar reinvested in Replacement QSBS in connection with establishing that the 80% Test has been satisfied. But just as important as preparing the original business plan and budget are the post-reinvestment active efforts to meet the Active Conduct Test. Of course, no start-up activities progress precisely as originally anticipated. Sometimes anticipated development plans, expenditures or timelines change dramatically due to internal and/or external events, benchmarks are not met, or there is simply no viable product or service to take to market. A determination of how this might affect satisfaction of the Active Conduct Test or 80% Test, or the claiming of the benefits of Sections 1045 and 1202 will depend on the relevant facts and circumstances. If the evidence shows that the corporation's activities were those of a bona-fide start-up functioning like any reasonable start-up would under similar circumstances, we believe that unexpected and uncontrollable changes in plans, focus, direction or timeline, and for many start-ups, ultimately failure of the start-up's efforts, should not alone affect the corporation's tax treatment under Sections 1045 and 1202. But from a practical standpoint, a stockholder should expect to have a greater challenge satisfying the burden of proof if there are severe disruptions in the start-up's activities and/or the stockholder cannot show reasonable efforts to actively pursue the business plan.

There are no tax authorities prohibiting a stockholder from liquidating a start-up funded with QSBS proceeds after a five-year holding period is achieved (combining the holding period for the Original and Replacement QSBS to reach Section 1202's five-year holding period requirement) and claiming Section 1202's gain exclusion.[xv] The liquidation will trigger a deemed sale of the corporation's assets, which in some cases might consist merely of unspent funds, and in other cases the remaining unspent funds and intellectual property or other assets held by the start-up.[xvi] If

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challenged by the stockholder's own return preparer or the IRS, the burden will be on the stockholder claiming the Section 1045 reinvestment or Section 1202's gain exclusion to establish that the start-up operated for bona-fide business purposes, rather than the primary purpose of avoiding federal income taxes. Further, if a start-up is liquidated within two years after the issuance of Replacement QSBS, there is the potential risk that the IRS will claim that the stock issued by the start-up was not QSBS based on a possible reading of the application of Section 1202(c)(3) discussed above in the section titled "*Is there a required holding period for replacement QSBS before Section 1202's gain exclusion can be claimed?*".

Closing remarks

The details of advanced Sections 1202 and 1045 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, stockholders and other participants in the planning process should want to know whether there is substantial authority for their income tax return positions. Finally, stockholders 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 Sections 1202 and 1045 planning opportunities are directed to several articles on the Frost Brown Todd website:

Using Section 1045 to reinvest QSBS sale proceeds into replacement QSBS

- 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
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock

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- Advanced Section 1045 Planning
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045

Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] References to "Section" are to sections of the Internal Revenue Code. An important aspect of Section 1045 planning is confirming that a stockholder was entitled to claim Section 1202's gain exclusion with respect to the Original QSBS (excluding Section 1202's gain exclusion cap, which doesn't limit a stockholder's ability to roll QSBS proceeds over under Section 1045) and that the Replacement QSBS meets Section 1202's eligibility requirements applicable at the time of issuance.

[ii] Section 1202's eligibility requirements are discussed in detail in Dissecting Section 1202's "Active Business" and "Qualified Trade or Business" Qualification Requirements.

[iii] The percentage applicable to satisfy the "substantially all" requirement is not addressed in Section 1202 tax authorities, but it is likely that it would be determined to fall between 70% and 95% of a stockholder's holding period for his QSBS. For Section 1045, there is a requirement that the corporation issuing Replacement QSBS must meet Section 1202's active business activity requirements during the first six months after a stockholder's acquisition of Replacement QSBS, so it is important where a Section 1045 rollover is involved that the 80% Test is seen as being immediately satisfied based a start-up anticipated use of the reinvested proceeds.

[iv] Section 1202(e)(2)(A) references start-up activities described in Section 195(c)(1)(A), which refers to investigating the creation or acquisition of an active trade or business and creating an active trade or business. Section 1202(e)(2) further provides that the

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determination of whether the corporation qualifies is made without regard to whether it has any gross income from such activities

[v] This provision suggests that during the first two years of a start-up's existence, up to 100% of the start-up's assets could theoretically consist of cash/investment assets earmarked to fund the start-up's working capital needs.

[vi] The 80% Test is described in legislative history of Section 1202 as encompassing "at least 80 percent (by value) of the corporation's gross assets (including intangible assets)." Conference Report to Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), H.R. Rep. No. 103-213, at 524. A reading of Section 1060 and 338(b)(5) (in particular what is included in each of the asset classes referenced in Treasury Regulation Section 1.338-6) confirms that "asset" is broadly defined, and there is nothing in Sections 1202 or 1045 that suggests that funds earmarked for the creation or acquisition of assets across these broad asset classes would not be created against meeting the 80% Test assuming that it can be reasonably established that the assets, once created or acquired, would be used in the conduct of an active qualified business.

[vii] It is not unusual for corporations with two unrelated active business activities to have difficulties maximizing the potential of the two activities in the same corporation and splitting the two corporations up on a tax-free basis in a Section 355 transaction isn't always practicable or possible.

[viii] We note that there is little doubt that equipment, inventory, materials, plant and other assets used in the operation of an active business apply towards satisfaction of the 80% Test. Given that fact, it seems reasonable to conclude that the capital required to acquire some or all of the assets necessary for operation of an active business should also count towards satisfying the 80% Test.

[ix] Committee Report ¶1951.01 (1980 Miscellaneous Revenue Act, PL 96-605) (12/28/80). Section 1202 refers to Section 195 not to specifically define the assets that would be includible in calculating the 80% Test, but rather to define the scope of additional start-up activities that qualify as engaging in an active business for Section

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1202 purposes.

[x] *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950). In United States v. Chi., Burlington & Quincy R. Co., 412 U.S. 401(1973), the United States Supreme Court, in the course of addressed whether funding of a company by States to construct numerous railroad safety improvements qualified as a capital contribution that became a permanent part of the company's "working capital structure."

[xi] Although "substantially all" is not defined In Sections 1202 or 1045, we believe that the available tax authorities suggest that substantially all means somewhere between 70% and 95% of the applicable time period.

[xii] Revenue Ruling 80-101, 1980-1 CB 70.

[xiii] Note that if the decision is made to avoid the possible application of Section 1202(c)(2) by postponing liquidation until the second anniversary date of the acquisition of the replacement QSBS, those involved need to make sure that during that two-year period the corporation continues to satisfy the 80% Test discussed above. In the case of a truly failed start-up, continuing to engage in active start-up activities after the point of "failure" is reached may be more difficult than taking a convincing position that Section 1202(c)(2) doesn't apply to the liquidation of the start-up.

[xiv] Committee Report ¶12,021.095 increased exclusion of gain from the sale of qualifying empowerment zone stock (Community Renewal Tax Relief Act of 2000 (as enacted into law by the Consolidated Appropriations Act, 2001), PL 106-554, 12/21/2000).

[xv] See the discussion above regarding the possible consequences of liquidating within two years of the formation of the issuer of Replacement QSBS in the section titled "**Is there a required holding period for replacement QSBS before Section 1202's gain exclusion can be claimed?**".

[xvi] The complete liquidation of a corporation is treated as a deemed sale of the corporation's assets, and as a deemed sale by its stockholders of their shares. The deemed sale of shares would

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trigger the right of stockholders to claim Section 1202's gain exclusion, assuming all of Section 1202's eligibility requirements have been satisfied.

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