Rolling QSBS Gains Under Section 1045? Don't Ignore Working Capital

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Categories:

Qualified Small Business Stock (QSBS)
Section 1045 Rollover Planning
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Our QSBS tax planning group at FBT Gibbons regularly assists taxpayers with Section 1202 planning/substantiation and Section 1045 rollovers into replacement qualified small business stock (QSBS).[1] Section 1045 permits taxpayers to roll proceeds from a sale of QSBS into replacement QSBS – something akin to a like-kind exchange transaction. Rolling over QSBS sales proceeds is deceptively straightforward on paper. One issue that does surface is dealing with the "working capital" of corporations issuing replacement QSBS. The working capital "risk" shows up down the road—taxpayers can jeopardize qualification for Section 1202's capital gain exclusion if a QSBS issuer's balance sheet holds too much cash and investment assets for too long.

Section 1202 includes an "active business requirement" providing that at least 80% by value of a corporation's assets must be used in start-up, research and development and commercialization of products and services associated with qualified activities (the "**80% Test**"). In order to qualify for a Section 1045 rollover election, the 80% Test must be met during the first six months after issuance of replacement QSBS. The applicable period extends to include the taxpayer's entire holding period for the replacement QSBS if the taxpayer later claims Section 1202's gain exclusion,

Under Section 1202(e)(6), a corporation's money and cash management investments can qualify as "working capital" and count towards satisfying the 80% Test, which is particularly important for corporations issuing replacement QSBS under Section 1045. Few newly-organized corporations engaging in start-up or R&D activities immediately spend all of the money received in exchange for their issuance of replacement QSBS. For some period after incorporation, the principal assets for most of these corporations will consist of working capital in the form of money and invested money (i.e., cash management assets). Section 1202(e)(6) confirms that this works for purposes of Section 1202 so long as the corporation can justify that its money and investment assets are credibly earmarked for

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future working capital needs. As discussed below, the problem arises two years down the road if working capital remains too much of the corporation's overall value.

Here are some issues that we recommend taxpayers monitor and document with respect to a corporation's working capital.

1. Substantiate that a corporation's cash and investments assets qualify as "working capital."

A critical aspect of substantiating the right to make a Section 1045 election on the tax return reporting capital gain on the sale of QSBS, and later claiming Section 1202's gain exclusion, is justifying that the money and investment assets held by the corporation issuing the replacement QSBS investments qualifies as working capital under Section 1202(e)(6). "Working capital" is not defined by tax authorities for purposes of Section 1202(e)(6) but should reasonably be interpreted to include funds needed for a corporation's current and/or future qualified activities, including operating and capital expenses. These expenses can include money required for start-up, R&D and commercialization of products and services. Section 1202(e)(6) confirms that working capital can include not only money held by a corporation but also investment assets that will be used to fund company operations and capital investments.[2]

- ***Have a business plan and budget***. We believe that it is important for taxpayers who are organizing a corporation for the purpose of accepting rollover money to have a budget and business plan in place that persuasively substantiates the need for 100% of the invested funds. The same holds true if the taxpayer is investing in an existing affiliated corporation's QSBS. On the other hand, there is probably something of a presumption that a QSBS issuer had a need for the invested funds if the taxpayer was willing to invest in the stock of an unaffiliated corporation.
- ***Document use of QSBS cash sales proceeds***. If the replacement QSBS issuer is incorporated by the taxpayer to start or acquire a business, be prepared to show (i) how you

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plan to use the QSBS cash sales proceeds within the first two years as working capital, and (ii) that investment assets are held for cash management. Section 1202(e)(6)(B) provides that the taxpayer must be prepared to substantiate that investment assets intended to qualify as "working capital" must reasonably be expected to be used within two years as working capital. There is specific no guidance on what investment assets would qualify as "working capital," except for a reference in Section 1202(e)(5) confirming that the scope of investment assets qualifying as working capital can include corporate stock and securities. Presumably, any investment asset customarily held for cash management purposes should qualify.

- ***Avoid loans to shareholders or affiliates***. The IRS may consider loans to taxpayers or their affiliated entities as evidence that the funds are not needed as working capital. The IRS might make the same argument regarding holding equity in the taxpayer's affiliated entities. The Tax Court would likely employ a facts and circumstances analysis to determine what falls within the scope of working capital.

2. Keep the working capital narrative current (budgets, minutes, hires, R&D, pipeline, etc.).

Prussian General Carl von Clausewitz was quoted as saying "no plan survives first contact with the enemy." The same can be said about a start-up's initial budget and business plan. Something almost always changes after activities commence that alters, often dramatically, a start-up's current and/or future working capital needs. In some cases, the corporation may not have the same future working capital needs described in the original budget and business plan. If that occurs, it is important to act quickly to preserve the corporation's continuing compliance with the 80% Test by moving those assets off of the corporation's balance sheet, even if that means distributing excess funds as a taxable dividend distribution. Since the 80% Test discussed above runs throughout a taxpayer's QSBS holding period, a taxpayer later claiming QSBS benefits must be prepared to substantiate that the corporation

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needed substantially all of its money and investment assets as working capital throughout the applicable QSBS holding period. Exactly how to meet this substantiation requirement on a continuous basis represents a challenge, but thoughtful contemporaneous narratives accompanying updated budget and business plans should be helpful.

3. Monitor the shift to the 50% working capital cap at year two.

Section 1202(e)(6) provides that after a corporation has been in existence for at least two years, the amount of cash/investment assets that qualify as good assets for purposes of the 80% Test is limited to 50% of the fair market value (FMV) of all of the corporation's assets. Keeping track of the timeline, use of contributed money and the FMV of all of the corporation's assets is critical when the second anniversary approaches. Each day that the corporation has too much money/investment assets might count against a taxpayer satisfying the requirement that the QSBS issuer was a qualified small business for "substantially all" of the taxpayer's QSBS holding period.[3] Taxpayers potentially faced with an 80% Test issue should consider obtaining an appraisal to substantiate the FMV of the corporation's assets. QSBS issuers can also distribute excess funds, increase reasonable (and deductible) compensation, and expand into additional qualified activities to consume the excess funds. Distribution of excess money would generally be treated as a taxable dividend ineligible for Section 1202's gain exclusion, but that inefficient tax result is generally preferable to failing Section 1202's eligibility requirements.

We have heard from some tax practitioners that a possible solution for the two-year cliff on working capital is to liquidate the QSBS issuer and reinvest the distributed money into new QSBS investments under Section 1045. The plan would be for the taxpayer to start a new two-year clock for purposes of Section 1202(e)(6). Whether this strategy should be expected to work will be fact specific. Treasury Regulation Section 1.331-1(c) provides the following:

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Recharacterization. A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of 'other property.'

If the distribution was recharacterized as a "dividend," then the distribution would not qualify for the necessary "sale or exchange" treatment that would support a Section 1045 election with respect to the gain. Further, taxpayers should also consider the potential assertion by the IRS of the liquidation-reincorporation doctrine and/or no bona-fide business purpose argument. A question that would be asked by the IRS and Tax Court would be whether there is a bona-fide business purpose for the timing of the liquidation and subsequent reinvestment of the proceeds. This strategy may have a better chance of passing muster if there is a bona-fide business reason for the complete liquidation and some or all of the funds distributed in liquidation are reinvested into third-party QSBS rollover investments.

Bottom line: If you' re using Section 1045 to roll into replacement QSBS, treat working capital as a living asset—plan for it, document it, and don't lose sight of the timeline.

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And there's a second excess cash issue—the accumulated earnings tax.

If dealing with the working capital issue wasn't enough, taxpayers also need to be aware of the potential impact of the accumulated earning tax. One benefit of operating in a C corporation is the favorable 21% flat tax rate on the corporation's income. But the distribution of excess working capital can trigger a stockholder-level tax on dividends. In order to discourage the accumulation of unneeded money at the corporation level for the purpose of avoiding double taxation of those revenues, Section 531 and companion provisions impose a 20% additional tax on accumulated earnings in excess of reasonable business needs. Those choosing to

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operate a profitable business in a C corporation need to be familiar with and plan for avoiding the accumulated earnings tax. Planning for avoidance of the accumulated earnings tax is addressed in more detail in the article "*Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide*."

* * *

Our federal tax planning group at FBT Gibbons works extensively with taxpayers seeking the gain exclusion associated with selling QSBS. The work encompasses both Section 1202 planning and substantiation, periodic check-ins to analyze continuing QSBS eligibility during the holding period pre-sale, and rollovers of original QSBS investment proceeds into replacement QSBS investments under Section 1045.

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[1] "Section" refers to sections of the Internal Revenue Code of 1986, as amended.

[2] Section 1202(e)(6) provides that for purposes of the 80% Test:

any assets which— (A) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (B) are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business, shall be treated as used in the active conduct of a qualified trade or business. For periods after the corporation has been in existence for at least 2 years, in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of this paragraph.

[3] Although there is limited guidance on what "substantially all" means for purposes of Section 1202, a survey or related tax authorities suggests that it falls between 80% and 95% of the applicable holding period, with 80% as the overall best guess.

More Tax Planning & QSBS Resources

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- *Planning for the Sale of Qualified Small Business Stock (QSBS)*
- *Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1*
- *Exploring Section 1202's Active Business Requirement*
- *Substantiating the Right to Claim QSBS Tax Benefits | Part 2*
- *Substantiating the Right to Claim QSBS Tax Benefits | Part 1*
- *To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)*
- *Advanced Section 1202 (QSBS) Planning for S Corporations*
- *Finding Suitable Replacement QSBS – A Section 1045 Primer*
- *Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1*
- *Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2*
- *Structuring the Ownership of QSBS – Is There a Role for Roth IRAs?*
- *Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide*
- *Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations*
- *Can Stockholders of Employee Staffing Companies Claim Section 1202's Gain Exclusion?*
- *QSBS Guidebook for Family Offices and Private Equity Firms*
- *Conversions, Reorganizations, Recapitalizations, and Stock Splits Involving QSBS*
- *Navigating Section 1202's Redemption (Anti-churning) Rules*
- *A Section 1202 Walkthrough: The QSBS Gain Exclusion*
- *A SPAC Merger Primer for Holders of Qualified Small Business Stock*
- *Determining the Applicable Section 1202 Exclusion Percentage When Selling QSBS*
- *Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?*

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- *Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*
- *Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*

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