

Why Section 1202 and QSBS is Important *for Founders, Employees & Investors*

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Introduction

The purpose of today's presentation is to review (1) the benefits of qualified small business stock and (2) what is required to qualify as qualified small business stock ("**QSBS**").

The benefits of QSBS are significant. At a high level, a taxpayer who sells QSBS potentially will not have to pay federal (and in some cases state) income tax on any gain of up to \$10 million (or ten times the taxpayer's basis, if greater) from such sale. This benefit is virtually unmatched throughout the federal income tax code.

Unfortunately, one problem we have found is that founders do not realize that these benefits exist until it is too late to take the appropriate steps to qualify for them. For example, generally, at the time stock is issued, the company must be classified as a C Corporation for income tax purposes to qualify. There is some ability to later restructure some entity forms into a C Corporation in a manner for founders to qualify but with limitations. It is not possible to qualify and receive any real benefits near or immediately prior to a sale of the company.

There are also other events that disqualify a company's owners from receiving the benefit such as stock buybacks of certain types or certain amounts.

We routinely deals with these issues and will provide an overview today of the benefits and qualification requirements of QSBS.

General Overview

- Choice of Entity Decision
- What is the Benefit?
- Who is Eligible for the Benefit?
- What is a “Qualified Small Business”?
- What is “Qualified Small Business Stock”?
- Common Pitfalls that Terminate QSBS Status
- QSBS Held in a Passthrough Entity
- QSBS Where Business Began as a Partnership or S Corporation

Choice of Entity Decision

- Tax Classification of Business Entities
 - C Corporation
 - S Corporation
 - Partnership
 - Disregarded Entity
- Advantages of C Corporations
 - Must be stock of a C Corporation in order for the stock to qualify as QSBS
 - C Corporations are subject to a flat rate of 21% on taxable income.

What is the Benefit?

Date of Stock Acquisition	Section 1202 Exclusion Percentage	Section 1202 Capital Gain Rate	Effective Capital Gains Rate	Effective Net Investment Income Tax Rate	Effective AMT Tax Rate	AMT Rate Savings vs. 23.8% Regular Capital Gain Rate
August 11, 1993 through Feb. 16, 2009	50%	28%	14%	1.90%	14.98%	6.92%
Feb. 17, 2009 through Sept. 26, 2010	75%	28%	7%	0.95%	8.47%	14.38%
On or after Sept. 27, 2010	100%	28%	0%	0%	0%	23.80%

What is the Benefit? - How Much Gain Can Be Excluded?

There is a cumulative and an annual limitation on the amount of gain that may be excluded from the sale of QSBS. Both limitations apply on a corporation-by-corporation and a shareholder-by-shareholder basis. Each year that a shareholder sells QSBS, the total gain that may be excluded is limited to the greater of:

- \$10M reduced by the aggregate amount of gain excluded in prior tax years attributable to stock in the corporation (the “cumulative limitation”), or
- Ten times the aggregate adjusted basis of QSBS the corporation issued that the taxpayer sold during the tax year (the “annual limitation”).

What is the Benefit? - Example

In Year 1 (after 2010), A, an individual, invests \$4M in ABC, Inc., a C Corporation, in exchange for 100 shares of ABC common stock. In Year 6, A sells 50% of his ABC shares for \$20M. If A's ABC shares do not qualify as QSBS, A would have to recognize gain of \$18M and based on current federal tax rates would have to pay federal taxes of \$4,284,000 ($\$18M \times 23.8\%$). If A's ABC shares qualify as QSBS, then A will get to exclude gain up to an amount equal to the greater of (i) \$10M or (ii) 10 times his basis in the stock sold or \$20M. Since A's gain of \$18M is less than his limitation, A's \$18M gain would be excluded pursuant to Section 1202 of the Code and A would owe no taxes on the gain. Tax savings of \$4.284M to A.

Remember State Income Taxes – Some states do not follow Sec. 1202 (e.g., California, Pennsylvania)

Who is Eligible for the Benefit?

- Only non-corporate shareholders such as individuals, trusts and estates are eligible to take advantage of the exclusion.
- Partnerships and S Corporations may qualify depending on their ultimate ownership as we will discuss in more detail later in this presentation.
- Having ineligible (i.e., corporate) shareholders does not eliminate the ability of the eligible non-corporate shareholders to take advantage of the exclusion.
- The exclusion only applies to stock sales. Therefore, if the sale transaction is in the form of an asset sale, the corporation will have to recognize any gain from the asset sale. If the corporation liquidates in short order after the sale, the shareholders may be able to use Sec. 1202 to exclude gain upon the liquidation.
- The stock must have been held for at least 5 years from the original date of issuance.

What is a “Qualified Small Business”?

- Must be a domestic C Corporation
- At all times after 1993 and before issuance of the stock the aggregate gross assets of the corporation must not exceed \$50 million
- Immediately after issuance of the stock, the aggregate gross assets do not exceed \$50 million
 - The “aggregate gross assets” of a corporation means an amount equal to corporation’s cash plus the aggregate adjusted basis of the corporation’s property (with contributed property being deemed to have an adjusted basis equal to its FMV).

What is “Qualified Small Business Stock”?

- The stock is issued after August 10, 1993
- The stock is issued by a qualified small business
- The shareholder must have received the stock directly from the corporation
- The stock must have been acquired in exchange for cash, property (other than stock but includes partnership interests) or services (other than underwriting services)
- During substantially all of the shareholder’s holding period for such stock, the corporation uses at least 80% of its assets (measured by value) in the active conduct of one or more qualified trades or businesses

What is “Qualified Small Business Stock”?

Special rules in applying the receipt and holding period rules

- Stock received via gift, inheritance or distribution from an entity taxed as a partnership to a partner in the partnership.
 - The recipient will be treated as having acquired the stock in the same manner as the transferor.
 - The recipient will get to tack on the previous owner’s holding period.
- QSBS is converted into other stock of the same corporation.
 - The stock received will be treated as QSBS and will be treated as being held for the period the converted stock was held.

What is “Qualified Small Business Stock”?

Special rules in applying the receipt and holding period rules (Cont.)

- Stock received upon exercise of an option the issuance date is of the exercise of the option.
- The issue date for restricted stock is the date the stock vests or the recipient makes a Section 83(b) election with respect to such stock.

What is “Qualified Small Business Stock”?

Active Conduct of a Qualified Trade or Business Test

A “qualified trade or business” means any trade or business other than:

- a business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any business where the principal asset of the business is the reputation or skill of one or more employee;
- any banking, insurance, financing, leasing investing or similar business;
- any farming business;
- any business involving the production or extraction (mining and oil and gas production); and
- Hotel, restaurant or similar business.

What is “Qualified Small Business Stock”?

Active Conduct of a Qualified Trade or Business Test (Cont.)

- Assets that are held as part of the "reasonably required working capital needs" of a qualified trade or business of the corporation or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in the working capital needs of a qualified trade or business, are treated as used in the active conduct of a trade or business.
- A corporation will fail the active conduction of a qualified trade or business test when 10-percent of the total value of its assets consists of real property that is not used in the active conduct of a qualified trade or business.

Common Pitfalls that Terminate QSBS Status

Redemptions (Taxpayer/Related Persons)

- Any stock a shareholder acquires will not be treated as QSBS if, at any time during the four-year period beginning on the date two years before the issuance of the stock, the corporation purchased (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or from a person related to the taxpayer.
 - De Minimis Threshold - A redemption exceeds a de minimis amount if the aggregate amount paid for the stock exceeds \$10,000 **and** the corporation purchases more than 2% of the stock held by the taxpayer and persons related to the taxpayer. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

Common Pitfalls that Terminate QSBS Status

Redemptions (Significant Redemptions)

- Stock issued by a corporation will not be treated as QSBS if, during the two-year period beginning on the date one year before the issuance of the stock, the corporation redeemed more than a de minimis amount of stock with an aggregate value (at the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of the two-year period.
 - De Minimis Threshold - For these purposes, a redemption exceeds the de minimis threshold if the aggregate amount paid for the stock exceeds \$10,000 **and** more than 2% of all outstanding stock. For each redemption, the percentage of the outstanding stock purchased is determined by dividing the value of the purchased stock at the time of the redemption by the value of all outstanding stock at the time of the redemption.

Common Pitfalls that Terminate QSBS Status

Transfers to Partnerships

- Subject to specific rules, in some cases QSBS can be exchanged for stock in another corporation under transactions under Sections 351 or 368 of the Code.
- There is no similar rule for transfers of QSBS to a partnership under Section 721 of the Code.
- This can be an issue for acquisition transactions involving a rollover where the entity issuing the rollover equity is taxed as a partnership.

QSBS Held in a Passthrough Entity

Owners of a partnership or S Corporation (a “*passthrough entity*”) may exclude their share of any gain recognized by the passthrough entity upon the sale of stock subject to certain requirements and limitations:

- The stock sold must satisfy all of the requirements to qualify as QSBS, including the five-year holding period.
- The partner or shareholder may only exclude gain if the partner or shareholder held an interest in the passthrough entity on the date the passthrough entity acquired the stock and at all times before the sale of the stock.
- The partner or shareholder may only exclude the portion of the gain allocated to the owner based on his or her ownership interest in the passthrough entity on the date the QSBS was originally acquired by the passthrough entity.

QSBS Where Business Began as a Partnership or S Corporation

Company originally formed as a S Corporation

- S Corporation can convert to a C Corporation and then issue QSBS.
 - This will not help stock already outstanding.
- S Corporation can contribute its assets to a new C corporation in exchange for stock in the new C corporation that can qualify as QSBS.

QSBS Where Business Began as a Partnership or S Corporation

Company originally formed as a Partnership

- Partnership can convert to a C Corporation.
 - Unlike the S Corporation, the owners' historical ownership can qualify as QSBS.
- Partnership can contribute its assets to a new C corporation in exchange for stock in the new C corporation that can qualify as QSBS.
- Be aware of the \$50M gross asset requirement when converting a partnership or contributing assets from a partnership or a S Corporation to a new C Corporation.