QUALIFIED SMALL BUSINESS STOCK: A RARE PLANNING OPPORTUNITY

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Internal Revenue Code Section 1202, which allows exclusions of certain gains on dispositions of qualifying stock, can offer huge tax benefits. Exclusions of gain can amount to hundreds of millions of dollars, and the exclusion can be "multiplied" by the creation of trusts and other entities that hold qualifying stock. This article provides an explanation of the rules for qualification, and then discusses how to maximize the tax benefits.

To qualify for qualified small business stock (QSBS) benefits, the stock must be issued from a U.S. C corporation (see Code Section 1202 (c)(1) and (d)(1)). In addition, the stock must have been issued after August 10, 1993. Although the statute speaks of "partial exclusion," in the case of C corporation stock acquired after September 27, 2010, taxpayers may exclude up to 100% of eligible gain under Code Section 1202(a)(4). A 100% exclusion from tax is rare, especially considering how the benefit can be "multiplied" with the planning discussed in this article.

The next QSBS threshold requirement is that the issuing corporation cannot have more than $50,000,000 in gross assets at any time before, and including the time immediately after, the issuance of the QSBS. For this purpose, "gross assets" include assets of any predecessor entity. Generally, the definition of "gross assets" means the amount of cash and the aggregate adjusted tax basis of all assets. However, in the case of contributed property, the contributed property must be taken into account based on its fair market value at the time of contribution under Code Section 1202(d)(2)(B). As explained below, this "fair market value" rule is what allows QSBS benefits that can exclude substantial gains.

To qualify for QSBS treatment, the stock must have been held by any taxpayer other than another C corporation. This means partnerships, S corporations, trusts, and individuals can qualify. In addition, the taxpayer recognizing the gain must have acquired the stock at original issue from the corporation in exchange for cash, property other than stock, or qualifying services to the corporation. There are qualifications for stock acquired in exchange for other stock and situations involving redemptions that are beyond the scope of this article, but see Code Section 1202(f) and 1202(c)(3).

The issuing C corporation must also meet an "active business" test. At least 80% (by value) of the corporation's assets must be used in the active conduct of a "qualified trade or business" as defined by Code Section 1202(e)(1)(A). For example, many service businesses, such as medical practices, law practices, banking, farming, and most hospitality businesses are excluded. Finally, the QSBS must be held by the taxpayer for more than five years before its sale.

Unfortunately, as a result of the *Cutler* case,[1] California does not recognize QSBS treatment. This means that if the QSBS gain is California source income, California will tax the gain. If the amount to be realized is large enough, a change in residence which (i) is bona fide and (ii) occurs long enough in advance of the sale may save a great deal in California income taxes.

If all of the above requirements are met, Code Section 1202(b)(1) defines the permissible QSBS exclusion. This is where there is a frequently missed opportunity. Although Code Section 1202(b)(1)(A) specifies a $10,000,000 exclusion (reduced by the amount of eligible gains excluded in prior years from the same corporation), Code Section 1202(b)(1)(B) provides an alternate, and frequently more beneficial, rule. This provision allows the exclusion of "[ten] times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year."

> [T]he qualified small business stock rules of Code Section 1202 can offer huge tax benefits, but its requirements and planning opportunities are not widely known.

When you consider one prime area for QSBS benefits, technology start-ups, the potential of how these rules work becomes apparent. Let's say an inventor has developed valuable intellectual property which they contribute to a C corporation, along with some cash contributed by investors. In the case of the inventor, the likelihood is that they have no income tax basis in their contributed IP. Therefore, at first glance, it would seem like they are stuck with "only" a $10,000,000 gain exclusion. However, due to the "fair market value" rule discussed above, that is not the case at all!

Let's say that for economic purposes, in negotiating the terms of their capital contribution with the cash investors, it was agreed that the investors will contribute $10,000,000 in cash in exchange for 25% of the corporation's stock. That means that the corporation's post money valuation would be $40,000,000, below the $50,000,000 QSBS gross asset limitation. If the inventor received the remaining 75% of the stock, that means that the implicit valuation of the IP the inventor contributed would be 75% times $40,000,000, or $30,000,000. Because of the "fair market value" rule of contributed property discussed above, the inventor's IP capital contribution will, for purposes of 1202, afford them $30,000,000 of "basis" for Section 1202 exclusion purposes.

Bear in mind that this "basis" is just for purposes of determining the 1202 gain exclusion. The inventor still has little income tax basis in their stock, but for purposes of computing the 1202 gain exclusion, they use the $30,000,000 fair market value for their contributed property as the means of calculating their exclusion. Under the ten-times basis rule of Code Section 1202(b)(1)(B), this means our inventor has a potential $300,000,000 of qualifying gain exclusion! The actual calculation is not quite this favorable, since the taxable gain on the zero income tax basis IP must be backed out—in this case, $30,000,000. So the net result for our inventor is they can benefit from a $270,000,000 gain exclusion.

It should be noted that QSBS treatment extends to more than just common stock. It can apply to preferred stock as well. There are no restrictions on voting rights, and an issuer can have multiple rounds of qualifying QSBS stock, as long as each issuance qualifies. Each separate issuance has its own holding period. In the case of warrants or SAFEs (simple agreements to issue equity), the QSBS requirements would have to be satisfied on the date the equity was actually issued, not at the time of the grant of the warrant or the SAFE.

Valuations are important in maximizing QSBS benefits. In the example above, the valuations were derived as a result of arm's length negotiations between the IP inventor and the cash investors. The IRS usually respects valuations determined in arm's length negotiations between unrelated parties. In cases where valuations may be an issue, an appraisal should be obtained, and special care should be taken to make sure there are no conflicting valuations (such as 409A valuations) that are inconsistent with the valuation for QSBS purposes.

Based on the huge potential benefits, we wanted to stress the importance of record keeping and keeping strong proof of qualification for QSBS treatment, especially since the IRS can challenge QSBS qualification many years after the fact.

If QSBS treatment is desired, the qualifying factors should be documented, and the records preserved. As one example, suppose an otherwise qualifying incorporation and stock issuance is going to be modified. Say one investor contributed $10,000,000 for a 25% stake, and it is decided another investor will take half that investment—$5,000,000 for a 12.5% stake. The second investor should not simply buy half of the stock of the first investor, because then the second investor fails the "original issuance" test. They should make a separate capital contribution with newly issued stock from the corporation. This would start a new holding period for such newly issued stock.

Not many litigated cases deal with attacks on QSBS treatment, but when the potential benefits are so large, advisors should counsel their clients to be very careful. In the authors' experience, many of the record-keeping requirements for QSBS treatment are overlooked.

For example, for each purchase of stock, proof of the date the stock was purchased, the amount paid, proof of payment (such as a canceled check or wire transfer), a copy of the stock certificate, proof that the corporation was engaged in the active conduct of a qualifying business, and proof that the corporation met the $50,000,000 gross asset test should all be documented.

Many times, we have had situations where someone wishes to sell QSBS ten years after they received it, and there is difficulty proving all of the QSBS requirements are met so long after the fact. Code Section 1202(d)(1)(C) imposes a requirement for the corporation to "submit such reports to the Secretary and to shareholders as the Secretary may require." Again, when the potential benefits are so great, extra care in monitoring compliance is warranted.

In those circumstances where someone makes a contribution of high fair market value but low-income tax basis property that qualifies for QSBS treatment, the benefit of QSBS treatment can greatly exceed the $10,000,000 exclusion that many people believe is the QSBS limit. However, in either case, the benefit of QSBS treatment can be multiplied with proper planning.

For example, although generally, the seller of QSBS stock must be the original holder of such stock, certain transfers to non-grantor trusts (trusts that are separate taxpayers from the original holder) can qualify for QSBS treatment. *See* Code Section 1202(h)(2)(A), which allows transfers by gift to continue to qualify for QSBS treatment. Such transfers involve an analysis of federal estate and gift tax rules to see if they make sense. But as a simple example, assuming a QSBS shareholder has a $10,000,000 gain exclusion and a potential $20,000,000 gain, a gift of $10,000,000 of stock to a children's trust would allow both the individual and the trust to claim the $10,000,000 exclusion.

There is sometimes tension between using a C corporation, as opposed to a pass through entity, like an LLC, to operate a new business. The C corporation does not permit the use of operating losses to offset the shareholders' taxable income; subject to the passive loss rules of Code Section 469, the LLC structure allows the use of operating losses. But the LLC does not permit QSBS treatment.

However, if QSBS treatment is desired, and assuming the more than five year holding period can be met post-incorporation, the LLC can be incorporated as a C corporation if all the tests of Section 1202 are met. A good valuation is critical under this approach, since with an operating business, the IRS can argue that the business has goodwill and might try to argue the $50,000,000 gross assets test has not been met. Bear in mind that although for 1202 purposes any goodwill would be valued at its fair market value (not its low-income tax basis), under 1202 the inherent taxable gain (the difference between the low-income tax basis in the goodwill and its higher fair market value) would be subtracted from the total amount that can be excluded under the QSBS rules.

Finally, there is one other possible benefit under the QSBS rules. Except in California, if a taxpayer has qualifying QSBS but cannot meet the more than five-year holding period test, as long as they have a holding period of more than six months, they can defer the gain on their QSBS if they make a qualifying rollover of such stock into another qualified small business under Code Section 1045. The statute allows sixty days beginning on the date of sale of the QSBS to make a qualifying rollover purchase. In practice, this may be difficult for clients to accomplish if they have a large gain.

The rules of Code Section 1202 are very nuanced, and the technical requirements for satisfying the tests and, more importantly, proving the tests have been satisfied, are complicated. However, given the huge potential benefits, counsel should be alert to possible planning opportunities available to their clients.

ENDNOTE

(1) *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247 (2012).

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