Primer on Qualified Small Business Stock

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What is the QSBS Exclusion?

- Qualified Small Business Stock (“QSBS”) code and regulations were promulgated in 1993 and designed to encourage investment in emerging companies by providing income tax incentives to founders, investors and employee shareholders of qualified small businesses.
- Subject to the requirements under IRC §1202, a non-corporate shareholder may exclude part or all of their gain upon the sale of their stock.
- Excluded gain is not subject to Federal income tax (0% tax rate).
- The value of the QSBS gain exclusion has varied significant since 1993, and only more recently has the gain exclusion become much more valuable.

How Much Gain is Excluded?

The amount of eligible gain is the **greater of**:

- $10 million, or
- 10 times adjusted basis
  - The adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.

The amount of eligible gain that may be excluded from tax depends on when the stock was acquired at original issue:

- 50% exclusion for stock acquired between 8/11/1993 and 2/16/2009
- 75% exclusion for stock acquired between 2/17/2009 and 9/27/2010
- 100% exclusion for stock acquired after 9/27/2010

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Key QSBS Requirements

- "Original issuance" of common or preferred C corporation stock directly to non-corporate shareholder in exchange for money, other property (not stock), or as compensation for services
- Business must have less than $50 million of gross assets at original issue of stock
- Corporation must use at least 80% (by value) of its assets in an active qualified trade or business
- Stock held for more than five years from date of issuance
- Stock meets the active business requirements and is a C corporation for "substantially all of the taxpayer's holding period"

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Original Issuance of C-corporation Stock

Issuances that do Qualify:

- Most tax-free transactions, including transfers by gift, at death, in § 351 contributions or in § 368 reorganizations (subject to certain limitations on the gain exclusion)
- Transfer of QSBS from Partnership to Partner
- Stock acquired through the exercise of options or warrants, or through the conversion of convertible debt
- Stock conversions

Issuances that do <u>NOT</u> Qualify:

- S-Corporation stock
- Secondary purchased shares
- Certain redemption transactions

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Disqualifying Redemption Transactions

- Certain redemption transactions that take place shortly before or after an issuance of new stock can remove the QSBS status of the newly issued stock.
- The redemption transactions are tested over a four-year period beginning two years before the issuance at the individual shareholder level and a two-year period beginning one year before the issuance at the corporate level.
- As a general rule of thumb, *de minimis* redemptions, or redemptions where the amount paid is less than $10,000, will not negate the original issuance requirement.

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1202(h)(4): *Reorganizations Involving Nonqualified Stock*

- **IRC §1202(h)(4)(A)**
  - If QSBS is exchanged for non-QSBS, then such stock will be treated as QSBS (*i.e.* will not lose QSBS status) and the holding period will tack
- **IRC §1202(h)(4)(B)**
  - Excludible gain is limited to gain at the time of exchange (unless exchanged stock is also QSBS)
- **Example**:
  - John's stock is worth $5 million at the time of the merger into non-QSBS
  - John sells P stock for $7 million
  - Gain on the QSBS at time of merger is excludible under §1202, BUT the exclusion is limited to the pre-merger gain (*i.e.*, post-merger gain of $2 million is not excludible)

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Different Flavors of Original Issuance

Type	QSBS Qualification Test	QSBS Holding Period Test
Stock Options	Upon date of exercise [1]	5 years from the date of exercise
Restricted Stock	Upon 83(b) election [2] or vesting date	5 years from the date of 83(b) election or vesting date
Restricted Stock Units (RSUs)	Upon vesting date	5 years from the date of vesting
Convertible Preferred Stock	Upon date of preferred investment [3]	5 years from the date of preferred investment
Convertible Debt	Upon date of conversion [4]	5 years from the date of conversion

[1] In the case of unvested options, the company must allow early exercise of unvested options and taxpayer must also make an 83(b) election within 30 days of exercise. Note that incentive stock options (ISOs) must be converted to non-qualified stock options (NQSOs) to make an 83(b) election available for regular tax purposes.

[2] Election within 30 days of restricted stock grant or option exercise into restricted stock.

[3] *See* IRC § 1202(f).

[4] *See* IRC § 1202(i)(1)(A).

$50 Million Aggregate Gross Assets Limit

- For purposes of §1202, aggregate gross assets is the sum of the amount of cash and the aggregate adjusted bases of all other property. Any property that was contributed to the corporation will have an adjusted basis equal to the FMV of the property at the time of contribution.
- The $50 million limit is tested at the original issuance of the stock, so stock will not lose its QSBS status because the corporation subsequently exceeds the $50 million limit.

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Qualified Trade or Business

- **Does <u>NOT</u> Include**:
  - any trade or 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 trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees;
  - any banking, insurance, financing, leasing, investing, or similar business;
  - any farming business (including raising or harvesting trees);
  - any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A; and
  - any business of operating a hotel, motel, restaurant, or similar business.

PLRs Addressing Qualified Trades or Businesses

- **PLR 201436001** involved a taxpayer that was engaged in the pharmaceutical industry by assisting clients in the commercialization of experimental drugs. The IRS ruled that the taxpayer was not performing a health-related service using individual expertise but was rather akin to a manufacturer of parts.
- In **PLR 201717010**, a taxpayer that analyzed and summarized test results gathered from technology which detects certain diseases was not performing services in the field of health. The ruling emphasized that the reports did not diagnose or recommend treatment.

Brokerage Services & CCA 202204007

- **In 2021**, the IRS issued **PLR 202114002** which ruled that an insurance broker was not engaged in brokerage services because in addition to providing their normal services, the taxpayer also performed administrative services for its clients. The ruling defined the traditional broker as a mere intermediary. This ruling was very taxpayer favorable and narrowed the definition of brokerage services.

- **In January 2022**, the IRS released **CCA 202204007** which defines brokerage services quite broadly. In the CCA, the taxpayer runs a website that connects lessees with lessors renting real property. The lessees and lessors use the website to execute the lease agreement. All future lease payments are made through the website as well. The taxpayer collected a fixed fee from the lessors for posting their property as well as collecting a percentage of the lease payments for facilitating the lease transaction. The IRS ruled that the taxpayer was engaged in brokerage services because despite holding itself out as an advertiser and performing additional services like maintaining the lease payments, it was acting as an intermediary by bringing buyers and sellers together. The IRS also ruled that the service being performed by a software did not change their analysis because the nature of the services being provided is the same as if it were performed by an individual.

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Active Business Requirement: *IRC §1202(e) Tests*

- **<u>Portfolio Stock or Securities – IRC §1202(e)(5)(B)</u>**. Corporation will fail active business requirement if more than 10% of the value of its assets (in excess of liabilities) consist of stock or securities in other corporations which are not subsidiaries of such corporation (other than working capital assets described in IRC §1202(e)(6)).

- **<u>Real Estate Holdings – IRC §1202(e)(7)</u>**. A corporation will fail active business requirement during any period during which more than 10% of the value of its assets consists of real property which isn't used in the active conduct of a qualified trade or business. The ownership of, dealing in, or renting of real property "shall not be treated as the active conduct of a qualified trade or business."

Active Business Requirement: *IRC §1202(e) Tests*

- **<u>Working Capital – IRC §1202(e)(6)</u>**. Working capital shall be treated as used in the active conduct of a qualified trade or business if —
  - The assets are held as part of the reasonably required working capital needs of a qualified trade or business of the corporation, or
  - 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.
- However, after a corporation has been in existence for two years or more, in no event may more than 50% of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of the above.

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S to C Corporation Conversion

- Many founders like the single level of taxation that an S corporation provides.
- If an S corporation converts into a C corporation, stock issued while the corporation was an <u>S corporation will not qualify</u> for the QSBS exclusion.
- If the corporation issues additional stock as a C corporation, that stock will qualify as QSBS provided that the other QSBS requirements are satisfied.
- Tax reform legislation passed in 2017 reduced the top tax rate of C corporations to 21%, therefore reducing the tax penalty relative to pass-through entities.

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LLC to C Corporation Conversion

- The founder can qualify for the QSBS exclusion if entity was formed as a LLC (taxed as a partnership) and later converts the LLC into a C corporation.
- The C corporation stock will be considered "issued" as of the date of the conversion, but the basis in the stock for QSBS gain exclusion purposes will be the fair market value of the LLC interests at the time of conversion, as opposed to the basis of the LLC interests.*
- The maximum QSBS gain exclusion can be increased significantly by virtue of the "10 times" basis rule.**

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* **Assumes a tax-free incorporation pursuant to IRC §351 with basis determined pursuant to §1202(i).**

** **§1202(b)(1)(B).**

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QSBS Planning: *Conversion from LLC*

1. Form LLC – losses flow-through; benefit from 199A deduction until 2025

2. Convert LLC to C-Corporation at least 5 years before sale (and before gross assets exceed $50 million) – possibly increase exclusion amount above $10 million (*i.e.*, expect basis to be greater than $1 million)

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QSBS and Pass-Thru Entities: *IRC §1202(g)*

- An individual taxpayer's allocable share of gain from the sale of QSBS held by a partnership, LLC, trust or S corporation is eligible for the exclusion if the following requirements are met:
  - All eligibility requirements for QSBS are met;
  - The stock was held by the entity for more than 5 years; and
  - The owner of the entity interest owned such interest when the entity acquired the stock and at all times thereafter before the disposition of the stock by the pass-through entity.
  - Partner, member or shareholder cannot exclude gain to the extent that the partner's, member's or shareholder's share in the entity's gain exceeded the partner's, member's or shareholder's interest in the entity at the time the entity acquired the stock.

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QSBS and Pass-Thru Entities: *IRC §1202(g)* (cont.)

- If entity distributes QSBS to individual partner, the recipient may claim QSBS gain exclusion if the above requirements are met (except for the 5-year holding period). The individual's holding period tacks on to the partnership's holding period.
- What happens if QSBS owned by an individual is transferred to a pass-thru entity? **<u>QSBS status is lost</u>**.
- What happens if an interest in a pass-thru entity that acquired QSBS is transferred (*i.e.*, gifted)? QSBS status for transferee might be retained, but the exclusion is determined by reference to the transferor's interest in the pass-through entity on the date of issuance (§1202(g)(3)).

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Planning Opportunities: *When Holding Period Less Than 5 years – § 1045 Rollovers*

- IRC §1045 allows a taxpayer to defer recognition of gain on the sale of QSBS if replacement stock is purchased within 60 days beginning on date of sale.
- Like a §1031 Exchange
- **Requirements**:
  - Non-corporate taxpayer
  - QSBS that's being sold has been held for at least 6 months
  - Replacement QSBS is purchased within 60 day period beginning on date of sale
  - Affirmative IRC §1045 election

IRC §1045 Rollovers

- Gain is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement stock purchased during the replacement period.
- The basis in the replacement QSBS is the purchase price less unrecognized gain from the sale of the original QSBS.
- The holding period from the original QSBS is carried over to the holding period of the replacement QSBS.
- IRC §1045 can be particularly helpful for a taxpayer who owns stock that would otherwise qualify for the QSBS exclusion except that the taxpayer hasn't held the stock for the required 5-year holding period.

IRC §1045 Rollovers (cont.)

- Interesting what-if cases
  - **Contingent payments?** Likely not eligible for deferral if replacement QSBS isn’t purchased within 60 days of sale
  - **Venture fund investor?** When partnership sells QSBS, each partner may individually purchase replacement QSBS

Late IRC §1045 Rollovers

- **PLR 200521021** involved taxpayers who were permitted to make a late IRC §1045 election. The taxpayers sold QSBS stock and reinvested the proceeds in new QSBS within 60 days. However, the taxpayers' CPAs failed to recognize that the gain could be deferred under IRC §1045. Since the taxpayers had not been audited and the only change to their return would have been the IRC §1045 election and deferral, the IRS granted the taxpayers an extension of time to make the election and allowed them to filed amended returns deferring the gain.

- However, in **PLR200604004**, the IRS denied an extension of time to make an IRC §1045 election because the taxpayers could not demonstrate that they had relied on the advice of the return preparer in failing to make the election.

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Late IRC §1045 Rollovers (cont.)

- In **PLR 200906009**, the IRS denied the request of a taxpayer to make a late IRC §1045 election because the IRS had already commenced an audit of the years in question. Further, the taxpayer sought the late election only after the IRS determined that the taxpayer could not substantiate certain capital loss and zero-gain reporting positions.

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Baylee Beeman focuses her practice on corporate tax matters. Baylee works with the members of Pillsbury's Tax and Corporate groups to provide federal income business tax advice to clients.

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- Advice on a non-profit AI-based healthtech company's corporate formation and tax-exempt status, and corporate agreements (internal and external).
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Kit Ryan focuses his practice on general corporate matters, including capital markets, venture capital financings, mergers and acquisitions, and securities law compliance. Kit is a certified public accountant, and prior to entering the legal profession, he worked as a tax professional. He was also a founder of two startup companies.

- Represented Shield AI, a fast-growing defense technology company, in its $225 Series E financing and most recently in its $200 million Series F financing, which increased its valuation to $2.7 billion.
- Represented Everi, a premier provider of land-based and digital casino gaming content and products, in its $59 million acquisition of certain strategic assets of Video King, in its acquisition of Venuetize and in its $22 million acquisition of certain strategic assets of Intuicode Gaming.
- Represented EMCORE Corporation, a leading aerospace, defense, communications and sensing markets provider, in its $55 million asset acquisition of KVH Industries.

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