QSBS: Small Business, Big Exclusion

Closely Held Businesses Committee

October 14, 2022

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QSBS: Small Business, Big Exclusion

ABA Fall 2022 Tax Meeting

Dallas, TX October 14, 2022

Kevin McGlinchey
Brandon King

Morgan Klinzig
Harrison Richards

Learning Objectives

- After attending the session, the participant will be able to:
  - Understand the mechanics of the Qualified Small Business Stock (QSBS) exclusion
  - Describe what stock is eligible for the QSBS exclusion
  - Better navigate some common problems and issues related to the QSBS exclusion

Agenda

- Background
- QSBS Requirements
- Exclusion Mechanics
- Practical Problems and Insights

Kevin McGlinchey

Kevin is Of Counsel at Ivins, Phillips & Barker, Chtd. Prior to joining IPB in 2020, Kevin served for approximately 20 years in senior in-house legal positions with large portfolio companies of premier global private equity firms, including serving as General Counsel and Corporate Secretary of a multi-billion-dollar US aerospace company and of a major global industrial equipment manufacturer.

During the course of his 25-year in-house career, Kevin has dealt with a full range of corporate legal and compliance matters, including those arising from numerous large-scale M&A transactions, as well as the full range of employment, collective bargaining, executive compensation, and employee benefits matters.

Brandon King

Brandon King is a tax associate in the Seattle office of Wilson Sonsini Goodrich & Rosati, where he focuses his practice on assisting clients of all sizes with transactional tax matters, including drafting agreements, and international and domestic tax planning.

Brandon has a broad background in tax transactional and planning matters, with substantial experience with domestic and international tax planning, transaction assistance, and compliance requirements. He has worked with clients in a variety of industries, including biotechnology, pharmaceutical, medical device, communications, and manufacturing.

Morgan Klinzing

Morgan is an associate at Troutman Pepper. Morgan advises clients on federal and international income tax and private equity matters. Her practice includes advising on mergers, acquisitions, reorganizations, dispositions, capital markets, and restructurings. Morgan has advised private equity sponsors, as well as their portfolio companies and other strategic clients, on the tax aspects of investments, acquisitions, and divestitures. She is also involved in the formation of private equity and hedge funds.

Morgan is an adjunct tax professor at Temple University Beasley School of Law, vice chair of the Partnership Committee of the Tax Section of the American Bar Association, an elected member of the Philadelphia Bar Association's Tax Council, and treasurer of the Philadelphia Tax Conference. Additionally, Morgan is a frequent speaker on a variety of transactional tax matters and has lectured at several major conferences and forums.

Harrison B. Richards

Harrison is an associate at Ivins, Phillips & Barker, Chtd. His practice focuses on a range of federal income, estate and gift tax planning matters, and employee benefits issues.

Harrison earned his J.D., *magna cum laude* and Order of the Coif, from the Northwestern Pritzker School of Law and received a B.S. in Economics, *magna cum laude*, from Brigham Young University. As a student, Harrison interned with the Commercial Law Development Program at the U.S. Department of Commerce, working on commercial-law reform in the Middle East. Prior to law school, Harrison worked at a leading economic consulting firm where he applied economic analysis to the law in high-stakes litigation disputes across finance, antitrust, and employment issues.

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Agenda

Background

QSBS Requirements

Exclusion Mechanics

Practical Problems and Insights

Special Tax incentives for Small Business Corporations

- There are several tax incentives designed to encourage investment in small businesses
- Section 1244: ordinary losses on investments in qualified small businesses
- Section 1045: gain deferral from the sale of stock in qualified small businesses
- Section 1202: gain exclusion on the sale of stock in small businesses

What is the QSBS Exclusion?

- Currently, the QSBS exclusion permits an eligible taxpayer to exclude up to 100% of their gain on the sale of QSBS from income
- This carries important considerations for small businesses seeking capital contributions and entrepreneurs who plan to exit through sale

Historical Statutory Limits on Exclusion

- The Tax Cuts and Jobs Act made the QSBS exclusion a more powerful tax planning tool
    - Increased the exclusion to 100% for QSBS acquired after September 27, 2010
- Previously, the QSBS was a less potent planning tool because not all gain was excluded (and remaining gain was taxed higher than capital gains)
    - Exclusion for QSBS issued from August 10, 1993 to September 27, 2010 ranges from 50% to 75%

Agenda

Background

QSBS Requirements

- The stock must be
  - Issued after September 27, 2010 by a C corporation
  - Acquired at original issuance
  - In exchange for money or other property
  - Held for five years
- The corporation must
  - Satisfy the active business requirement
  - Have aggregate gross assets not exceeding $50 million

Exclusion Mechanics

Practical Problems and Insights

QSBS Requirements

- An eligible shareholder may exclude gain* from the sale of stock that was held for more than five years and which was originally issued from a qualified small business
  - *Up to 100% of gain if issued after Sept. 27, 2010

Eligible Shareholder

- An eligible shareholder is
  - An individual
  - A trust
  - A pass-thru entity
- A permitted pass-thru entity is
  - Partnership
  - S corporation
  - Regulated investment company
  - Common trust fund
- C corporations are not eligible shareholders

Special Rules for Pass-Thru Entities

- An individual qualifies for the QSBS exclusion on stock held by a pass-thru entity if
  - The stock is QSBS in the hands of the pass-thru and was held for more than five years; and
  - Taxpayer held an interest in the pass-thru entity from the date the stock was acquired through when the stock was disposed
- Basis is the taxpayer's proportionate share of adjusted basis
- Taxpayer's proportionate share of adjusted basis cannot exceed their proportionate share when QSBS was acquired
  - For example, if taxpayer is a 10% interest holder in Year 1 and a 50% interest holder in Year 5, taxpayer's share of adjusted basis is 10% for purposes of section 1202

Holding Period for Stock and Redemption Disqualification

- QSBS must be held for more than five years from the date of issuance to qualify for exclusion
  - For pass-thru entities, both the entity and the interest holder must satisfy this requirement
  - Holding period is tacked in certain tax-free exchanges or transfers
- Certain redemption transactions disqualify QSBS from the exclusion
  - QSB purchases any of its stock from the taxpayer or related parties two years before or two years after the issuance of the stock
    - Related parties include immediate family, lineal descendants, and ancestors as well as related corporations and partnerships
    - *See* sections 267(b) and 707(b)
  - QSB purchases its own stock with an aggregate values exceeding 5% of its total value between one year before and one year after the issuance of the stock
    - 5% is determined at the point one year before the issuance of the stock

Original Issuance

- The taxpayer must acquire stock "at its original issue" from a qualified small business in exchange for money or other property or as compensation for services
  - Stock acquired in exchange for other stock does not qualify
- Original Issuer
  - The stock cannot be purchased from a third party, except an underwriter
  - Stock devised or gifted may qualify for QSBS (discussed later)

Date of Issuance

- Stock issued after September 27, 2010 is eligible for a 100% exclusion
- Stock issued after August 10, 1993 and on or before September 27, 2010 may qualify for a more limited exclusion
  - The portion of the section 1202 gain not excluded on these sales is subject to a capital gains rate of 28% under section 1(h)(4)
  - This is higher than the current capital gains rate

Qualified Small Business

- In order to be considered QSBS, the stock must have been issued by a "qualified small business" (QSB)
- A QSB is a domestic C corporation engaged in certain active trades or businesses whose assets are worth less than $50 million at all times prior and immediately after the issuance
- A domestic C corporation is not
  - A DISC or former DISC
  - A regulated investment company, real estate investment trust, or REMIC
  - A cooperative
- The corporation must be a QSB as of the date of issuance of the QSBS

Active Business

- At least 80% of the corporation's assets (by value) are used in the active conduct of a qualified trade or business
  - Includes: assets held for reasonably required working capital, start-up activities (section 195(c)(1)(A)), research and experimental expenditures (section 174), and in-house research expenses
  - No more than 10% of total assets may consist of real property not used in the active conduct of a trade or business (ownership, dealing in, and renting real property are not active trades or businesses for this purpose)
- Qualified business excludes various professional services, hospitality, brokerage and extractive industries
  - However, a "specialized small business investment company" is an active trade or business
- Recent PLRs suggest the Service takes a narrow view on disqualified businesses
  - *See e.g.*, PLR 20221006 (filling prescriptions is not the provision of medical services); PLR 202114002 (brokers are "mere intermediar[ies]"); PLR 202125004 (creating medical products is not medical services); *but see* CCA 202204007 (providing website to match lessors with lessees with income based in part on commissions from leasing activities is a "brokerage" service)

$50 Million Assets Limitation

- Aggregate gross assets of the business must be below $50 million at all times on or after October 10, 1993, until immediately after the issuance of the QSBS
  - This is not indexed to inflation
- Aggregate gross assets is defined by the amount of cash and aggregate adjusted basis of property held by the corporation
  - Includes amounts received in exchange for the issuance of the QSBS
  - Contributed property: adjusted basis is the fair market value at the time of the contribution
- Parent-subsidiary aggregation applies

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QSBS Requirements

Exclusion Mechanics

- Determine the amount of eligible gain
- Apply the per-issuer limitation
- Apply the exclusion amount

Practical Problems and Insights

Calculating the QSBS Exclusion

- **Determine the Amount of Eligible Gain**
  - Gain from the sale of QSBS held for more than five years
  - Basis in stock from contributed property is the fair market value at the time of contribution
- **Apply the Per-Issuer Limitation**
  - The limitation is the greater of
    - $10 million reduced by the amount of eligible gain previously taken into account by the taxpayer under section 1202 for stock issued by this corporation or
    - Ten times the aggregate adjusted basis of the stock issued by the corporation and disposed of by the taxpayer
- **Apply the Exclusion Amount**
  - 100% for stock acquired after September 27, 2010

Example QSBS Exclusion Calculation

Facts

- A contributes property with a fair-market value of $500 in exchange for X stock
- A's property has a basis of $100
- More than five years later, A sells X stock to B for $10,000
- A has not previously sold any stock

Calculation

- **Determine the Amount of Eligible Gain**
  - A's section 1202 gain is $9,500 ($10,000 - $500)
  - Note: A's total gain is $9,900 ($9,500 section 1202 gain and $400 capital gain)
- **Apply the Per-Issuer Limitation**
  - A's limitation is $10 million
  - The greater of
    - $10 million ($10 million - $0 of previous exclusions)
    - $5,000 (10 x $500)
- **Apply the Exclusion Amount**
  - 100% for stock acquired after September 27, 2010
  - Therefore, A excludes $9,500 ($9,500 x 100%) from income under section 1202

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Example QSBS Exclusion Calculation

Facts

- A, an unmarried individual, contributes $2 million in exchange for X stock
- In Year Six, A sells ½ of his X stock to B for $15 million
- In Year Seven, A sells ¼ of his X stock to C for $7.5 million
- In Year Eight, A sells the remaining ¼ of his X stock to D for $2 million

Calculation

- **Determine the Amount of Eligible Gain**
    - Year Six: $14 million
    - Year Seven: $7 million
    - Year Eight: $1.5 million
- **Apply the Per-Issuer Limitation**
    - Year Six: $10 million (greater of $10 million or $10 million [10 x $1 million basis])
    - Year Seven: $5 million (greater of $0 [$10 million - $10 million] or $5 million [10 x $500,000 basis])
    - Year Eight: $ 5 million (greater of $0 or $5 million)
- **Apply the Exclusion Amount**
    - Year Six: $10 million (and $4 million capital gain)
    - Year Seven: $5 million (and $2 million capital gain)
    - Year Eight: $1.5 million

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- Entity Structuring
- Tax-Free Transactions and Gifts
- Acquisitions
- Redemptions

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Entity Structuring and QSBS

- QSBS applies parent-subsidiary aggregation for determining the QSB asset calculation
- There is no brother-sister aggregation
- As a result, separating lines of business into separate corporations is preferred

Entity Structuring and QSBS

- Section 1202 does not define "stock" for purposes of the section
- Qualified preferred shares and other forms of stock are not excluded by statute and are generally "stock" for tax purposes
  - Can QSBS be issued to family members without losing voting control?
  - Beware of disqualifying redemption dangers when involving family members

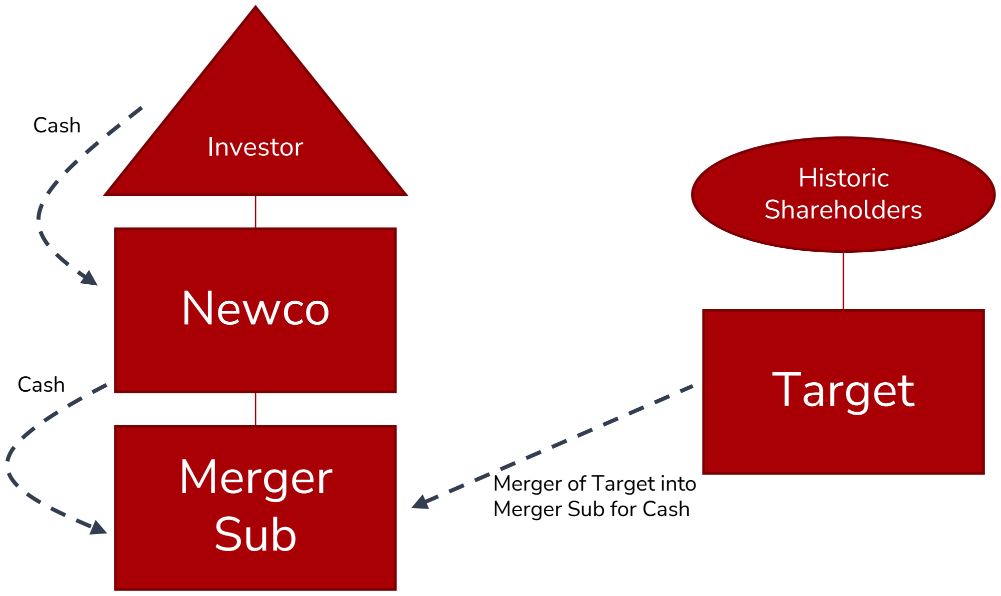
Tax-Free Transactions and QSBS

- QSBS exchanged in a tax-free transaction for other QSBS retains its status and tacks the holding period
  - This includes QSBS distributed from a partnership to a partner
- QSBS exchanged for other stock in a section 351 or section 368 transaction is treated as QSBS
  - Holding period is tacked
  - Applies to successive transfers
- Non-QSBS stock is limited to the gain that would have been recognized had sections 351 or 368 not applied
  - Built-in deferred section 1202 gain

Gift Planning and QSBS

- Gifts are one way in which an individual can qualify for the QSBS without original issuance
  - QSBS may also be acquired by devise
- No authority discusses whether donees share the donor’s per-issuer limitation
  - Section 1202 provides for the treatment of married individuals filing separately but not donees

Acquisitions and the QSBS



Steps

- Investor forms Newco and contributes $49.9m cash
- Newco forms Merger Sub
- Merger Sub merges with and into Target with Target surviving

$50M Test

- Tested “immediately after” the acquisition of stock.
  - Based on cash contributed to Target or basis in Target assets?
  - What if Investor contributes an additional $10m to Newco after the acquisition to pay transaction expenses or fund expansion?
- Application of step transaction versus bright-line end-of-the-day test.
- Impact of liabilities – what if Merger Sub borrows an additional $10m and acquires Target stock for $59.9m?

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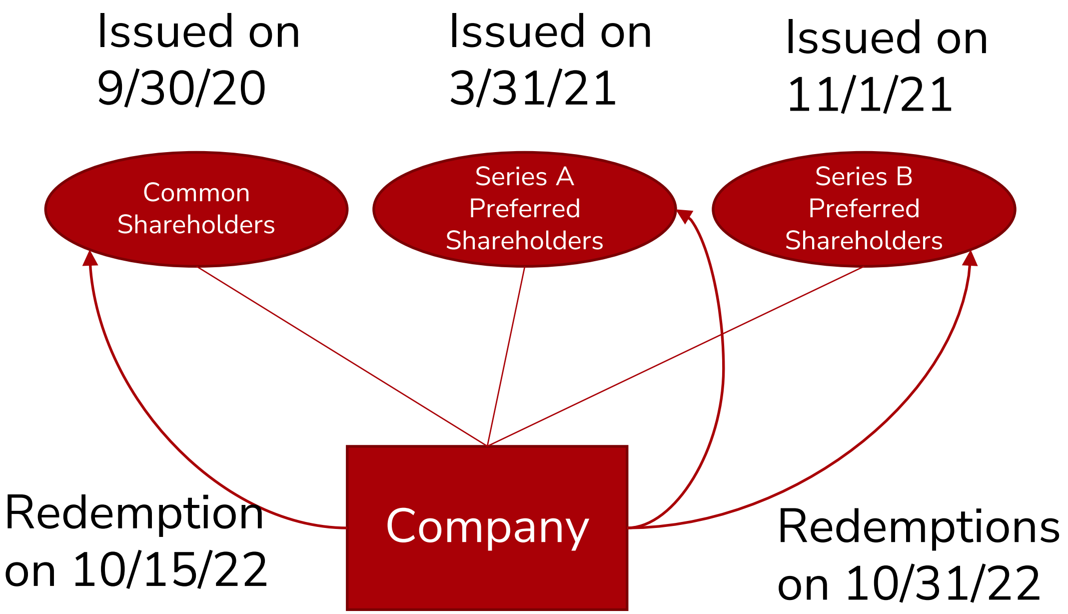
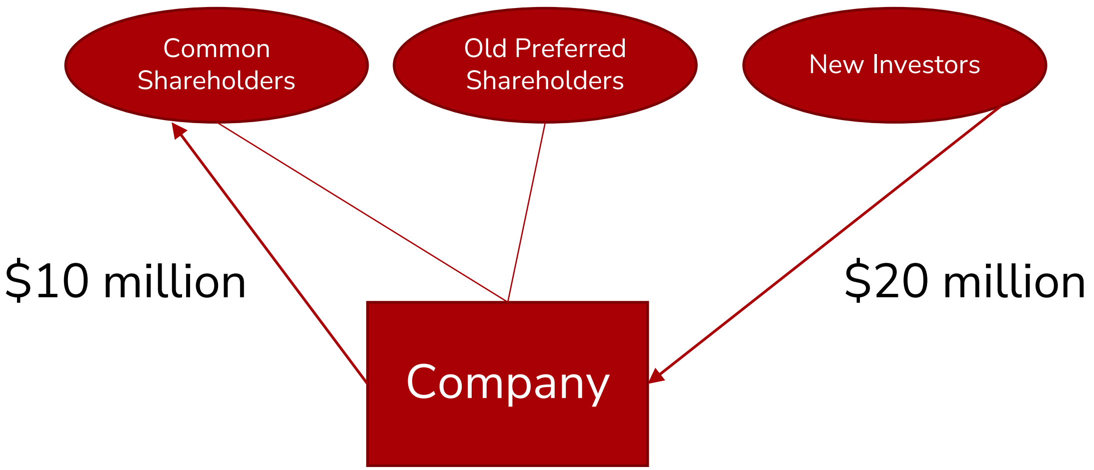
Redemptions and Secondary Sales



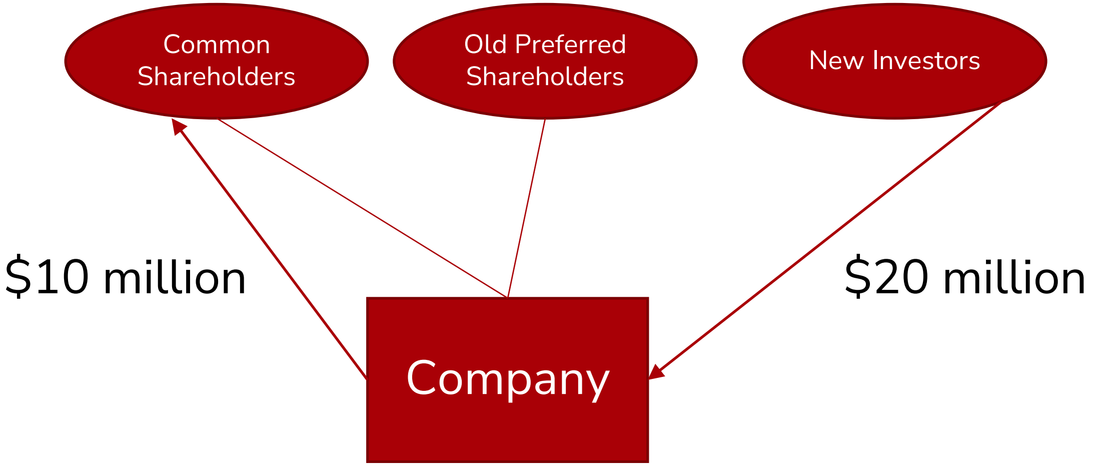
- QSBS treatment may be disqualified if a company makes "significant" redemptions in certain windows around the investment. *See* IRC 1202(c)(3); Treas. Reg. 1.1202-2
- Significant redemptions from any shareholder within 1 year before or after the stock issuance (i.e., a 2-year period) will disqualify all stock issued from being QSBS
- Meaningful redemptions from the specific shareholder within 2 years before or after the stock issuance (i.e., a 4-year period) will cause stock issued to that shareholder to lose QSBS benefits

Redemptions and Secondary Sales



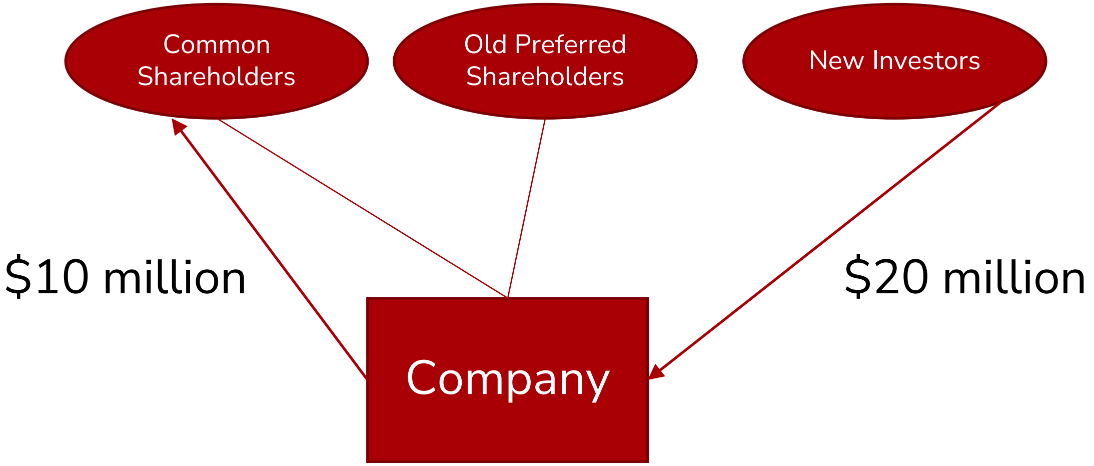
- Company raises money from VC or other investors and wants to provide some liquidity to founders and employee shareholders

Redemptions and Secondary Sales



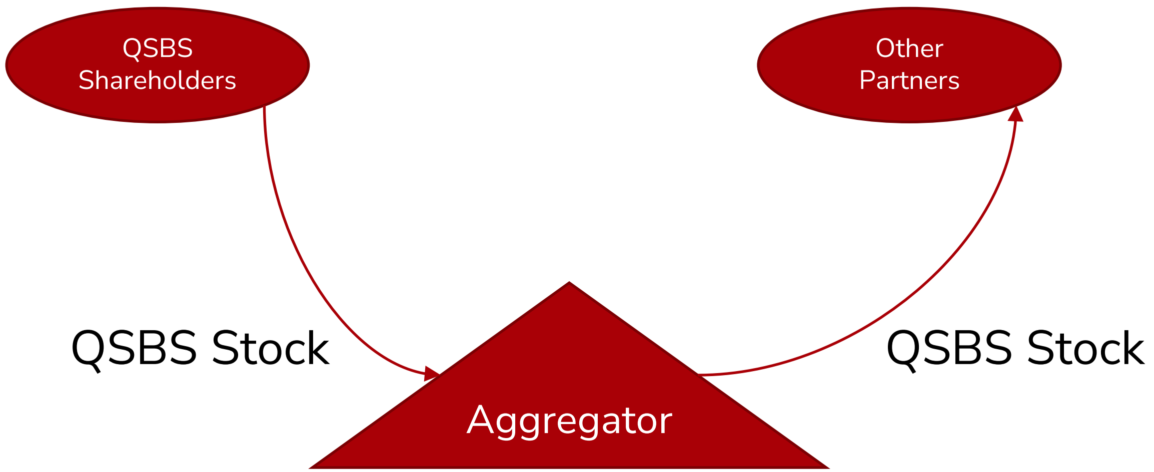
- Investors invest in preferred shares and Company redeems employee stock
- Investors buy common stock from employees and Company recapitalizes investors into new preferred shares
- Investors buy stock from employees and hold common stock

Redemptions and Secondary Sales



- Payment characterization:
  - Capital gain vs. ordinary income
  - 301 dividend vs. 302 sale or exchange treatment
- Significant redemption for QSBS purposes?

Aggregator Entities



- Gain on QSBS held by a partnership or S corporation is excludible if the entity held it for the requisite five-year+ period, and if the partner/shareholder held an interest in the entity when the entity acquired the stock and at all times thereafter
- A partnership can generally distribute eligible QSBS to its partners, and the partner will retain QSBS eligibility, as long as the partner held their interest when the QSBS was acquired
- But, if stock is contributed to a partnership, it is no longer QSBS eligible

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QSBS in the Future

- In September 2021, the House Ways and Means Committee proposed reducing the QSBS from 100% to 75% for taxpayers with incomes over $400,000
  - This would have applied to sales or exchanges occurring after September 13, 2021
- Both the House Ways and Means Committee and the Treasury Department have expressed support for continuing the QSBS exclusion, even if at lower rates
  - The 2021 Treasury Green Book expressed support for the QSBS exclusion
  - In its proposal, Means and Ways reiterated that the 50% exclusion under section 1202(a) “remains available for taxpayers”

Any Questions?

For more information

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