Excluding Gain On The Sale Of Qualified Small Business Stock

By William E. Sigler

The reduction in the maximum capital gain rate for non-corporate taxpayers to 20% in 1997 and then 15% in 2003 dampened interest in the exclusion of gain on the sale of qualified small business stock ("QSBS") under Section 1202 of the Internal Revenue Code. For 2013, the top rate on capital gain did go back up, but only to 20%, and then just for taxpayers in the 39.6% income tax bracket. The capital gain rates were given their own brackets in the Tax Cuts and Jobs Act of 2017 ("TCJA"), but the change was not sufficient, by itself, to generate enthusiasm for QSBS.

The use of Section 1202 has been further complicated by the deduction for certain types of business income earned through pass-through entities made available by the TCJA under new Section 199A. However, business founders and investors are beginning to take another look at Section 1202 now that they may be able to exclude all of the gain on the sale of their QSBS. The increased focus on the potential for excluding all of the capital gain from income upon exit is also influencing choice-of-entity decisions.

The Exclusion

Section 1202 excludes a percentage of the eligible gain recognized by a non-corporate taxpayer on the sale or exchange of QSBS held for more than five years. The excluded percentage is as follows:

- 100% for QSBS acquired after September 27, 2010
- 75% for QSBS acquired after February 17, 2009 and before September 28, 2010
- 50% for all other QSBS

The eligible gain during any year is the greater of ten times the taxpayer's basis in the stock issued by the corporation and disposed of during the year or $10 million reduced by any gain excluded in prior years on dispositions of the corporation’s stock.

Most taxpayers to whom Section 1202 applies are subject to a lower effective tax rate than would have been the case had Congress not provided the partial gain exclusion for QSBS. However, taxpayers are not entitled both to the partial gain exclusion under Section 1202 and to the reduced capital gain rates that otherwise would be available. Instead, the taxable portion of the gain is taxed under the normal rules and subject to a maximum rate of 28% on capital gains. In some cases, the gain is also a preference for alternative minimum tax (“AMT”) purposes. This results in effective tax rates as follows:

Date of QSBS Issuance	Regular Tax	AMT
After September 27, 2010	0%	0%
After February 17, 2009 and before September 28, 2010	7%	8.47%
All other dates	14%	14.98%

QSBS Requirements

To qualify as QSBS, the following requirements must be satisfied at the time of issuance:

- The stock must be issued after August 10, 1993.
- The stock must be issued for money or property (not including stock), or as compensation for services provided to the issuing corporation (other than services performed as an underwriter for such stock).
- The issuing corporation must be a domestic C corporation.
- The aggregate gross assets of the issuing corporation at all times on or after August 10, 1993 and immediately following the issuance must not exceed $50 million.

In addition, the following requirements must be met during substantially all of the taxpayer’s holding period:

- The corporation must be a domestic C corporation.
- The corporation must not be a DISC, former DISC, Section 936 corporation, RIC, REIT, REMIC, FASIT or cooperative and must not have a Section 936 subsidiary.
- The corporation must be engaged in a qualified trade or business.
- The corporation must satisfy an active business requirement.

A qualified trade or business is any trade or business other than those 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 other trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees. The term also excludes any banking, insurance, leasing, financing, investing, or similar business; any farming business (including the business of raising or harvesting trees); any business involving the production or extraction of products of a character for which percentage depletion is allowable; or any business of operating a hotel, motel, restaurant or similar business.

To satisfy the active business requirement, at least 80% (by value) of the corporation’s assets (including intangible assets) must be used by the corporation in the active conduct of a qualified trade or business. If in connection with any future trade or business, a corporation uses assets in certain startup activities, research and experimental activities, or in-house research activities, the corporation is treated as using those assets in the active conduct of a qualified trade or business. Assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within two years to finance future research and experimentation, are treated as used in the active conduct of a trade or business. If a corporation has been in existence for at least two years, only 50% of these working capital assets will qualify as used in the active conduct of a qualified trade or business. In addition, certain rights to computer software are treated as assets used in the active conduct of a trade or business.

Indirect Ownership of QSBS

A taxpayer does not necessarily have to own stock directly to benefit from the

QSBS rules. Non-recognition of gain may be possible where the QSBS is owned through a partnership, S corporation, regulated investment company, or common trust fund if the following apply:

- All of the eligibility requirements with respect to QSBS are met;
- The entity held the QSBS for more than five years; and
- A taxpayer sharing in the gain held the interest in the pass-through entity at the time the taxpayer acquired the QSBS and at all times thereafter.

In addition, a partner, shareholder or participant cannot exclude gain received from an entity to the extent that the partner's, shareholder's or participant's share in the entity's gain exceeded the partner's, shareholder's or participant's interest in the entity at the time the entity acquired the stock.

Rollover of Gain from the Sale of QSBS

Section 1045 provides for the deferral of gain from the sale of QSBS held for more than six months where replacement QSBS is acquired. A taxpayer may elect to defer the gain by acquiring new QSBS within 60 days from the sale. The taxpayer seeking the rollover benefits under Section 1045 must make an election on or before the due date (including extensions) for filing the tax return for the tax year in which the QSBS is sold. A Section 1045 election is irrevocable only with the IRS's prior written consent, which must be obtained by submitting a request for a private letter ruling.

Planning Issues

The $50 million limit on gross assets can be a potential problem for larger start-up companies that raise capital through multiple rounds of financings. To stay within this limit, those companies may stagger their financings, so that no single round will put them over the $50 million limit. For example, a company with $5 million of asset basis could consider doing two rounds of financing at $40 million each, staggering them as cash is spent down, rather than completing one $80 million round.

It is also common for investors in start-up companies to participate in multiple financing rounds or for founders to have very low (or zero) basis in the stock issued at formation, but to have a higher basis in stock received through subsequent grants or later purchases of restricted stock. For a partial liquidity event, the order in which different blocks of stock are sold can affect the amount of the available Section 1202 exclusion, depending on the taxpayer's basis in the different blocks of stock and the dates on which the taxpayer acquired each block.

Take a shareholder who holds two equal blocks of stock, half with a zero basis and half with a $1 million basis. If there was a partial exit in which the shareholder sold half of the shares with the higher basis for $11 million first, then $10 million of gain would be excluded. If the shareholder were then to sell the remaining zero-basis stock in a later year, there would be no available exclusion because the $10 million of gain previously excluded would have reduced the available $10 million exemption to zero. In contrast, if the lower basis stock was sold first for $11 million, then $11 million of gain would be recognized and $10 million of gain would be excluded. If the higher basis stock were sold in a later year, then the shareholder could exclude an amount equal to ten times the shareholder's $1 million basis in that block of stock for an additional exclusion of $10 million.

It is not uncommon for a partnership to become a corporation for tax purposes at the time venture capital money is invested in the entity. For purposes of the $50 million test, the assets deemed contributed to the corporation are valued at their fair market value, so it may be that the stock deemed issued will not qualify. In order to qualify the original founder's stock, it may help to incorporate prior to bringing in the venture capital money.

Another issue involves the impact of the rule treating all corporations that are members of the same parent-subsidiary controlled group as a single corporation on the ability of an S corporation to hold QSBS, as well as the effect of that ownership on the qualification of the subsidiary's stock as QSBS in the hands of other shareholders. For example, if an S corporation with $75 million acquires more than 50% of the stock of a newly formed C corporation, can the stock of the C corporation qualify as QSBS given that the $50 million test is failed when treating the S corporation and the C corporation as a single corporation?

One of the most difficult problems from a practical standpoint is determining whether at the time of sale stock that was formerly acquired qualifies as QSBS. If a company is not performing a QSBS analysis on a regular basis, because it is not clear that it will ever become relevant, then it is, at least, necessary to maintain all of the information necessary to perform the analysis. This includes tax returns, monthly financial statements, audited financial statements, stock ledgers, etc. If possible, investors should require investee companies to test and document the status of stock as QSBS.

The requirements for establishing a QSBS investment and maintaining its qualification can be very simple in many situations and quite tricky in others. Considering that business founders and investors may be able to exclude all of the gain on the sale of their QSBS, this time is well-spent.

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