Qualified Small Business Stock

David A. Sussman

April 2016

Purpose of Favorable Tax Treatment

- Stimulate investment in start-up companies.
- Allows investors to receive favorable income tax treatment of the capital gain earned on early stage investments.
- Favorable income tax treatment consists of (i) full or partial gain exclusion or (ii) rollover of gain.

Overview of Discussion

- First, discuss the rules for gain exclusion.
- Second, discuss the rules for tax-free rollovers.
- Third, discuss the definition of "qualified small business corporation stock."

Exclusion of Gain – IRC 1202

- Under IRC Section 1202, a taxpayer, other than a corporation, may exclude some or all of the gain on the sale or exchange of *qualified small business stock* (“QSBS”).
- The amount of the exclusion depend on when the QSBS was acquired and whether the issuer is in an “empowerment zone” (certain geographic areas designated by HUD or USDA).
- There is no exclusion for gain attributable for periods after 12/18/2018.

Exclusion of Gain

- Noncorporate taxpayers can exclude from gross income 50% of any gain from the sale of QSBS held for more than 5 years.
- The exclusion is 75% for QSBS acquired after 2/17/2009 and before 2/28/2010.
- The exclusion is 100% for QSBS acquired after 9/27/2010 and ***thereafter****.
- The exclusion is 60% for QSBS issued by a corporation in an empowerment zone.

*Prior to the Protecting Americans from Tax Hikes Act of 2015, the 100% exclusion only applied to QSBS acquired after 9/27/2010 through 12/31/2014.

Limitations on Exclusion

- For any one taxpayer, the maximum amount of eligible gain with respect to the stock of a single issuer that may be subject to the partial exclusion is no more than the greater of:
  - $10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer under §1202 in prior taxable years with respect to stock of the same issuer; or
  - 10 times the aggregate adjusted bases of QSBS of that issuer disposed of by the taxpayer during the taxable year.

DuaneMorris

Limitations on Exclusion – Example

B and C each purchases QSB stock in X corporation for $500,000. B also purchases QSB stock in Z corporation for $2,000,000. X corporation and Z corporation are unrelated. B and C sell all of their stock. All of the requirements of §1202 are met. All transactions are assumed to be subject to the 50% exclusion.

- B sells her X corporation stock for $12,000,000. Of B's gain, up to $10,000,000 is subject to §1202. Therefore, assuming a 50% exclusion, B excludes $5,000,000 of gain from gross income with respect to the sale of the X corporation stock. B recognizes a gain of $6,500,000.
- C sells his X corporation stock for $11,500,000. Of C's gain, up to $10,000,000 is subject to §1202, and, assuming a 50% exclusion, C excludes $5,000,000 from gross income. Therefore, C recognizes gain of $6,000,000.

Exclusion Not Available

- Stock issued to a taxpayer cannot qualify for the exclusion if the issuing corporation redeems its own stock from the taxpayer or persons related to the taxpayer, within the four-year period beginning two years before the issue date. 2% de minimis exception applies.
- Stock will also not qualify for the exclusion if the issuing corporation engages in a “significant redemption,” which occurs if the corporation, within a two year period beginning one year before the issuance of the stock, redeems stock with an aggregate value exceeding 5 percent of the aggregate value of all the corporation stock. 2% de minimis exception applies.

Tax Rate

- A taxpayer is not entitled to both the gain exclusion for QSBS and the reduced capital gain rates.
- Generally, the 28% rate will apply to the gain which is not excluded under IRC 1202.
- Note that a portion of the excluded gain may be treated as a preference item for the purposes of the Alternative Minimum Tax (n/a to stock acquired between 9/27/10 and 1/1/14).

DuaneMorris

Rollover of Gain – IRC 1045

- Taxpayers other than corporations may elect to “roll over” capital gain from the sale of QSBS held for more than six months into new QSBS stock.

Rollover of Gain – Requirements

Provided that:

- The taxpayer is not a corporation;
- The taxpayer sells the stock;
- The taxpayer has held the QSBS stock more than six months at the time of the sale; and
- The taxpayer elects to apply the provisions of IRC 1045.

Then:

- Gain is recognized only to the extent that the amount realized exceeds the cost of the replacement QSBS purchased during the 60-day period beginning on the sale date.

Qualified Small Business Stock

- Stock in a subchapter C corporation issued after August 10, 1993.
- As of the date of issuance, the corporation is a "***qualified small business.***"
- Taxpayer acquired the stock at its original issuance in exchange for money or property (not stock) or in exchange for services (other than as an underwriter).
- During substantially all of the taxpayer's holding period of the stock, the corporation is a C corporation and meets the "***active business test.***"

Qualified Small Business

- The aggregate gross assets of the corporation (or any of its predecessors) must not have exceeded $50,000,000 at any time on or after August 10, 1993 and before the issuance of the stock for which preferential treatment is sought.
- Immediately after the issuance, the aggregate gross assets of the corporation — including amounts received by the corporation in the issuance — must continue to be no more than $50,000,000.

Active Business

- The corporation is an ***eligible corporation*** and uses at least 80% of its assets, measured by value, in the active conduct of one or more "***qualified trades or businesses.***"
- For purposes of measuring a corporation's asset values, a parent corporation is deemed to own its ratable share of its subsidiary's assets, and to conduct its ratable share of the subsidiaries activities. A corporation is a subsidiary if the parent owns more than 50% of the combined voting power of all classes of voting stock, or more than 50% in value of all outstanding stock.

Active Business

- An ***eligible corporation*** is a domestic corporation ***other than*** (1) a domestic international sales corporation ("DISC") or former DISC; (2) a corporation for which a 936 election (Puerto Rico tax credit) is in effect for itself or its subsidiaries; (3) a regulated investment company, real estate investment trust, or a real estate mortgage investment conduit (REMIC); or (4) a cooperative.
- No more than 10% of the corporation's assets consist of portfolio stock or securities.
- No more than 10% of the corporation's assets consist of real property not used in the active conduct of the trade or business.

Qualified Trade or Business

Any trade or business ***other than***:

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
- Any banking, insurance, financing, leasing, 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 with respect to which a depletion deduction is allowable for natural resources, oil or gas; and
- Any business of operating a hotel, motel, restaurant, or similar business.

Useful References

- Bloomberg BNA, Tax Management Portfolio, *Small Business Corporation Stock: Special Tax Incentives*, No. 760-3rd.
- Stanislaw, *Tax Planning for Transfers of Business Interests* (WG&L), 2.04[2]

Further information

David A. Sussman, Partner, Newark

dasussman@duanemorris.com

+1 (973) 424-2011

DuaneMorris

Qualified Small Business Stock

David A. Sussman

April 2016