# Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms

Author: Scott W. Dolson

*Published October 12, 2023*

Frost Brown Todd ATTORNEYS

frostbrowntodd.com

The combination of 21% corporate income tax rate and the possibility of qualifying for Section 1202's gain exclusion has made operating a business through a C corporation an attractive choice.[1] This "Guidebook is a resource for family office and private equity firm ("PE Firm") professionals navigating through the issues associated with ownership of minority and majority investments in qualified small business stock ("QSBS").

This Guidebook is a resource backed by a series of articles and blogs authored by Scott Dolson addressing planning issues relating to Sections 1202 and 1045. References to applicable articles previously published on the Frost Brown Todd website are included throughout this Guidebook. Additional information regarding QSBS planning and the firm's tax planning group can be found at the Frost Brown Todd website.

## Index for this Guidebook

*Click below to jump to specific sections.*



## Key Takeaways from this Guidebook

- **Section 1202's Gain Exclusion and the Cap.** Section 1202 provides for a 100% exclusion from federal income taxes when QSBS held for more than five years is sold in a taxable sale, subject to a gain exclusion cap of $10 million per stockholder per issuing corporation or, if greater, 10 times the aggregate tax basis of QSBS held by a stockholder.[2] If the gain exclusion applies to the taxable sale of QSBS issued after September 27, 2010, there is

no capital gains tax, no 3.8% net investment income tax and no alternative minimum tax. Many states, with a few noteworthy exceptions, follow the federal treatment (see Section A).

- **$10 million cap.** If five stockholders hold a corporation's QSBS, each of those stockholders has at least a $10 million potential Section 1202 gain exclusion. A stockholder who holds QSBS in five corporations has at least a $10 million potential gain exclusion in each corporation. If a fund with 20 partners acquires and later sells QSBS, there is the potential for the pass through of at least a $200 million gain exclusion ($10 million per partner) (see Section P).
- **10X Aggregate tax basis cap.** If stockholders fund a newly-formed C corporation for $45 million for the purpose of acquiring the stock or assets of a qualified business, the potential Section 1202 gain exclusion cap is $450 million (10 times the $45 million tax basis) (see Section P).

- Section 1045 Rollover Planning.
  - **Less than five-year holding period.** A stockholder who sells his QSBS *before* achieving the required five-year+ holding period has two options if he want to defer gain recognition and potentially qualify for Section 1202's exclusion: (i) under Section 1045, he can reinvest sale proceeds in other QSBS investments, or (ii) he can exchange his QSBS for stock (either QSBS or non-QSBS) in Section 351 nonrecognition exchange or Section 368 tax-free reorganization (see Section M).
  - **Recognized Gain in Excess of Section 1202 Exclusion Cap.** If a stockholder sells QSBS for $20 million, he can claim the $10 million gain exclusion (assuming no higher cap applying the 10X gain exclusion cap) and benefit from nonrecognition treatment on the remaining $10 million in otherwise taxable gain by funding a corporate start-up or reinvesting funds into Replacement QSBS (see Section B).
  - **M&A Rollover Transaction.** In order to preserve the QSBS status of stock in a M&A rollover transaction, the rollover can be structured (i) to include retention of the stockholder's target company QSBS, (ii) to involve exchanging target company QSBS for buyer stock in a Section 351 nonrecognition exchange or (iii) to include exchanging target company QSBS for stock in a Section 368 tax-free reorganization. The QSBS status of the target company's stock is forfeited if QSBS is exchanged for partnership equity (e.g., LP/LLC interests) in a Section 721 nonrecognition exchange (see Section L).
- Tiered QSBS Structures.
  - **C corporation.** If a stockholder forms a C corporation by exchanging money for stock, and the C corporation in turn acquires QSBS of another corporation, the language of Section 1202 supports the conclusion that the upper-tier corporation's stock can qualify as QSBS (see Section L). This opens the door for an issuer of QSBS to be used as an acquisition vehicle in stock and asset acquisitions of businesses engaged in qualified activities.
  - **Partnership Carried Interest.** Section 1202 limits a partner's gain exclusion to the "interest" held on the date the partnership acquired QSBS, which has caused some to conclude that holders of carried interests (i.e., profits interests) in a partnership owning QSBS won't share in Section 1202's gain

exclusion. A more favorable interpretation of the rules is that that the term "interest" for purposes of Section 1202 should include a partner's right, to a share of future appreciation, as embodied in applicable governing agreement (see Section K).

- **Navigating the $50 Million Limit.** Stockholders who are looking to take advantage of Section 1202's gain exclusion must navigate Section 1202's requirement that QSBS cannot be issued once a corporation has passed $50 million in aggregate gross assets, or in connection with an acquisition, the value of the target business. While this eligibility requirement can be limiting, provisions setting forth how aggregate gross assets should be calculated, and in particular, the parent-subsidiary "look-through" rule, presents potential opportunities for acquiring the stock of target companies with asset values exceeding $50 million (see Section L).
- **Qualified Trade or Business.** Section 1202's excluded activity categories include healthcare, financial services, consulting, engineering and brokerage businesses (see Section G). Many businesses engaging in activities that provide products or services to or perhaps involve Section 1202's categories of excluded activities can be carefully structured so as to permit stockholders to take advantage of Section1202's benefits.

## About the Author

**Scott W. Dolson** | Tax, Benefits & Estates
Partner | Louisville, KY | 502.568.0203 | sdolson@fbtlaw.com

Scott assists with tax planning for business formations, ownership arrangements, LLC agreements and M&A transactions, equity compensation arrangements and general corporate law matters. He has developed a national practice handling Section 1202 and 1045 issues while helping clients secure and maximize Section 1202's generous tax benefits.

## Tax Planning & QSBS Services

Frost Brown Todd's QSBS practice is focused on maximizing the gain exclusion allowable under Section 1202 or successfully navigating Section 1045's requirements. An important part of our work involves making sure that our clients are eligible to claim Section 1202's gain exclusion or election to reinvest proceeds under Section 1045. Another key part of our QSBS work is making sure that our clients are in the best position possible if the IRS challenges their return positions. Here is a nonexclusive list of our tax planning services:

- Helping clients navigate through the choice of entity decision and whether to operate their business through a C corporation and seek eligibility for claiming the Section 1202 gain exclusion.
- Assisting clients in efforts to meet the eligibility requirements for claiming the Section 1202 gain exclusion.
- Assisting clients in preparing for a potential IRS audit by gathering the information and documentation necessary to establish that they have met each of Section 1202's eligibility requirements.

DOWNLOAD BROCHURE

# QSBS Guidebook for Family Offices and Private Equity Firms

## A. A brief introduction to Section 1202 and QSBS

### Section 1202.

Section 1202 is an Internal Revenue Code provision that applies to certain C corporation stock issued after August 10, 1993. Assuming all of Section 1202's eligibility requirements are satisfied, a stockholder selling QSBS issued after September 27, 2010, is eligible to exclude 100% of gain realized from federal income taxes up to the applicable cap amount.[3] Many states also follow the federal treatment of QSBS.

The per-stockholder gain exclusion is capped at a minimum of $10 million per issuing corporation. If a corporation issues QSBS to 10 stockholders, each stockholder has the potential to exclude at least $10 million of gain from a taxable sale or exchange of QSBS. If a stockholder holds QSBS issued by three separate C corporations, that stockholder has the potential for three separate minimum $10 million gain exclusions. If a stockholder has contributed property or money to a corporation in exchange for QSBS, there are circumstances where the stockholder will be eligible to exclude more than $10 million of gain from an issuing corporation by applying Section 1202's "10X" gain exclusion cap. For example, a stockholder purchasing $4 million in preferred stock (QSBS) from a corporation has an aggregate tax basis of $4 million in his QSBS and a potential $40 million gain exclusion. A stockholder can also expand the standard $10 million gain exclusion cap by gifting QSBS to other taxpayers, each of whom will have their separate $10 million gain exclusion.[4]

Individuals, trusts and pass-thru entities (LLC/LPs/S corporations) are eligible to claim Section 1202's gain exclusion. C corporations are not eligible to claim Section 1202's gain exclusion. Partnerships and S corporation pass through Section 1202's gain exclusion to owners on their Schedule K-1s. Subject to Section 1202's rules regarding who is eligible to claim Section 1202's gain exclusion, each equity owner of a pass-thru entity would be entitled to take advantage of a separate $10 million per-issuer gain exclusion cap.

The various stockholder and issuing-corporation level requirements for stock to qualify as QSBS are discussed below. No election or filing is required at the time of issuance for stock to qualify as QSBS. Section 1202's gain exclusion must be properly claimed on the tax return for the year QSBS is sold.

Although Section 1202 was enacted to encourage investments in domestic (US) start-ups, the statute's benefits should also be available to family offices and PE Firms acquiring majority interests in certain closely-held companies. Buyers structuring a transaction with an eye towards taking advantage of Section 1202's gain exclusion will generally form a C corporation to purchase the target company's equity or assets. A key point is that Section 1202 doesn't require the corporation issuing QSBS to be a start-up. So long as the corporation issuing QSBS passes the $50 Million Test (discussed below), an issuer of QSBS can purchase the assets of an existing business. A second key point is that the drafters of Section 1202 contemplated that the corporation issuing QSBS might engage in its business activities through one or more controlled corporate subsidiaries.[5] Section 1202 doesn't require that the subsidiary be newly-formed by the parent corporation issuing QSBS. These facts support the argument that a buyer can organize a C corporation that issues QSBS, and uses the infused capital and debt to acquire the stock of an operating company. See Section L below for a more detailed discussion of this issue.

Although Section 1202 explicitly requires that the corporation issuing QSBS must be a domestic (US) C corporation, the statute doesn't restrict the ability of the domestic corporation to own foreign assets, engage in business activities outside of the United States, or hold the equity of foreign corporations or pass-thru entities. Finally, Section 1202

does not explicitly address the effect of holding joint venture interests (LPs/LLC interests) on Section 1202 eligibility issues, but there is no reason to assume that silence should be taken as a negative.[6]

### Qualified Small Business Stock (QSBS)

QSBS must be "stock" for federal income tax purposes that is originally issued by a domestic (US) C corporation and that meets all of Section 1202's eligibility requirements. QSBS can be voting or nonvoting common or preferred stock. Entities such as partnerships and LLCs that have elected to be taxed as a corporation can issue "stock" for federal income tax purposes. Stock options and warrants are not "stock" for federal income tax purposes. Debt securities and SAFE instruments might potentially qualify as "stock" if the instruments have more equity-like than debt-like characteristics, but stockholders who are looking for certainty should acquire originally-issued "stock." Stock issued to service providers that is subject to a "substantial risk of forfeiture" under Section 83 (e.g., time and/or performance vesting) can qualify for Section 1202's gain exclusion, but, unless a Section 83(b) election is filed, the stockholder's holding period won't commence until the stock vests.

### QSBS Strategies for Family Offices and PE Firms

Experience has shown that some family offices focus on minority investments in QSBS of start-ups and closely-held businesses. The sections below addressing "*Best practices for minority investments in QSBS*" (Section I) and "*Tips for structuring family offices and PE Firm ownership arrangements for investment in QSBS*" (Section K) focus on family offices making minority QSBS investments. Although less common, there are family offices and PE Firms focusing on issuing QSBS in connection with acquiring majority ownership positions. The sections below addressing "*Structuring family office and private equity ownership arrangements*" "*Structuring the acquisition of business assets*," "*Structuring business sales*," and "*Dealing with equity rollover arrangements in M&A transactions*" focus on planning issues associated with acquiring or selling majority ownership positions.

## B. A brief introduction to Section 1045

Section 1045 allows stockholders to sell QSBS ("Original QSBS") and reinvest proceeds in replacement QSBS ("Replacement QSBS") on a nonrecognition basis (similar to a like-kind exchange. If Replacement QSBS is later sold, Section 1202's gain exclusion can be claimed if all eligibility requirements are met. Plus, a stockholder's holding period for Original QSBS carries over into Replacement QSBS for the purposes of meeting Section 1202's five year+ holding period requirement.[7] As might be expected, most investments in Replacement QSBS occur when a stockholder's Original QSBS holding period doesn't exceed five years, but the right to reinvest proceeds isn't limited to those circumstances. Section 1045 reinvestment strategies are also employed by stockholders whose aggregate sales proceeds exceed Section 1202's gain exclusion cap. For purposes of calculating the amount of Section 1202 gain exclusion is available to a taxpayer, Sections 1045 and 1202 do not aggregate the gain excluded from the sale of Original QSBS and Replacement QSBS. For example, there are no tax authorities suggesting that a stockholder should not be able to exclude $10 million of gain when Original QSBS is sold, roll over excess proceeds into Replacement QSBS, and exclude an additional $10 million when the Replacement QSBS is sold.

Family offices sometimes use Section 1045 to redeploy proceeds from the taxable sale of Original QSBS on a pre-tax basis into one or more investments in Replacement QSBS. The challenge is that Section 1045 requires that the reinvestment occur within 60 days after the sale or exchange of the Original QSBS. A possible strategy employed by both family offices and PE Firms to cope with requirement that reinvestment in Replacement QSBS occur within 60 day rule is to reinvest Original QSBS sales proceeds into the Replacement QSBS of a newly-formed corporation organized for the activity of searching for and acquiring a qualified small business. This strategy is supported by a

reference in Section 1202(e)(2) to start-up activities under Section 195(c)(1)(A), a provision which includes within its scope engaging in the active conduct of searching for a business acquisition opportunity.[8]

A detailed discussion of Section 1045 strategies and planning issues can be found in several articles on the Frost Brown Todd website.

## C. A short history of Section 1202 and QSBS

Section 1202 became law during 1993. Only stock issued on or after August 11, 1993, can qualify as QSBS. Legislative history states that Section 1202 was designed to provide "*targeted relief for investors who risk their funds in new ventures [and] small businesses.*" The gain exclusion was intended to "*encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.*" In connection with increasing the gain exclusion to 100% during 2010, the legislative history noted that the "*increased exclusion and the elimination of the minimum tax preference for small business stock will encourage and reward investment in qualified small business stock.*"[9] Not surprisingly, Section 1202 has historically received strong support from the angel investor and venture capital communities.

Past legislative handouts circulated by the Angel Capital Association supported passage of a 100% gain exclusion (this mission was accomplished in 2010), reducing the investment holding period from five to two years (not yet achieved), simplifying the determination of whether a business was a qualified small business (definitely not yet achieved) and allowing a taxpayer's holding period for his LLC interests to tack onto his QSBS holding period in connection with partnership incorporations (a great idea for those seeking the gain exclusion but not yet achieved).

In past years, the National Venture Capital Association (NVCA) proposed that the size threshold for qualified small businesses be increased from $50 million (which was pegged in 1993) to $100 million, that the "substantially all" standard and the method of verifying Section 1202 qualification be reformed, and that the Section 1045 rollover period be expanded from 60 to 180 days.[10] The NVCA asserted that a purpose of its lobbying efforts includes spurring the growth of larger venture capital funds financing the nation's startups.

Some academics have voiced skepticism about the economic justification for the QSBS gain exclusion. Professor Victor Fleisher has written of QSBS that "*a better name would be the 'angel investor loophole.' Angel investors and venture capitalists, of course, argue that these are precisely the type of start-ups that tend to create new jobs, and thus they should be encouraged, not taxed. Perhaps the low tax rate encourages angels to put more money into start-ups instead of index funds. On the other hand, it is not clear that the tax break is necessary to encourage investment that would not otherwise take place . . . Tax is not a first-order consideration.*"[11] Adam Looney of the Urban-Brookings Tax Policy Center argued in a blog focusing on wealthy taxpayer's use of C corporations that the QSBS gain exclusion "*has little justification on economic grounds, accrues almost entirely to the highest-income taxpayers, and will prove costly with a 20 percent corporate rate; it should be repealed.*"[12]

During 2021, legislation was proposed that would have provided that the 75% and 100% QSBS exclusion percentages would not apply to taxpayers with adjusted gross income of at least $400,000, and that the baseline 50% exclusion provided for Section 1202(a)(1) would remain available for all eligible taxpayers. This amendment to Section 1202 included in the Build Back Better legislation was not enacted. The subsequent Inflation Reduction Act passed in August 2022, did not amend Sections 1202 or 1045. Legislation was introduced during Spring, 2023 that would expand the scope of business entities eligible to issue QSBS beyond C corporations, reduce the holding period from five to three years, and treat convertible debt and SAFE instruments as "stock" for purposes of Section 1202.[13] While the NVCA and others support this legislation, it seems unlikely that any amendments (positive or negative) to Section 1202 will make it through the current Congress.

## D. Why has Section 1202 previously flown under the radar screen?

Section 1202 has been around since 1993 and has gone through several amendments over the years. Given the potential for a significant gain exclusion, an obvious question is why the provision has somewhat languished in obscurity, out of sight among many business owners and professionals, and in particular, the further away you are from Silicon Valley. For the period beginning in 1993 and ending in 2017, there are at least some plausible answers. Section 1202's percentage gain exclusion was 50%, then 75% and 100% only beginning in 2010, with remaining gain taxed at a highly unfavorable 28% rate. Corporate tax rates were only reduced from 35% to 21% beginning in 2018. Until the gain exclusion was increased to 100%, the blended tax rate wasn't significantly better than the historically generous 15% capital gains rate. Also, operating a business through a C corporation with its high corporate tax rates and the always present threat of double taxation of distributions (in contrast to pass-through tax treatment of LLCs and LPs), presented a less than favorable choice. There are several additional reasons why the pursuit of Section 1202's gain exclusion might not be attractive. Section 1202 has a number of eligibility requirements, including a five-year holding period before a stockholder can qualify for claiming the gain exclusion. Some PE Firms work with C corporations, foreign investors and tax-exempt investors who won't benefit from holding QSBS because they have separate exemptions from tax on capital gains. Other buyers routinely acquire businesses that exceed Section 1202's $50 million aggregate gross assets limit, regardless of how aggressively the $50 Million Test is calculated. Finally, Section 1202 planning is complicated. The general lack of experienced professionals with QSBS planning experiencee likely qualifies as an additional factor working against pursuing Section 1202's benefits.

As noted above, the 2017 Tax Act changed the landscape significantly by lowering the corporate rate from 35% to 21%. Beginning in 2018, there has been a noticeable upswell in interest by investors seeking minority investments in QSBS and by buyers pursuing the gain exclusion by acquiring businesses through C corporations.

## E. Who qualifies for 1202's gain exclusion?

Section 1202 provides an exclusion from gain for non-corporate taxpayers filing US federal income tax returns. Many states follow the federal income tax treatment of QSBS. Notably, California is among the states that do not recognize the gain exclusion, which has generated significant interest in Delaware and Nevada non-grantor trust planning and push-back from California.

C corporations selling QSBS cannot claim the gain exclusion. Individuals, trusts and estates are potentially eligible to claim the gain exclusion. S corporations and LLCs and LPs taxed as partnerships can pass the gain exclusion through to owners, and LLCs/LPs taxed as partnerships can distribute shares of QSBS to members/partners. Section 1202 has an original issuance requirement which means that most stockholders holding QSBS are founders, employees and investors who acquired their stock directly from the issuing corporation for money, property (excluding stock) or services. QSBS that is gifted or transferred upon the death of the holder retains its status in the hands of the recipient.

Nonresident foreign stockholders and tax-exempt investors fall into the category of stockholders who have separate exemptions from US taxation of capital gains, and for that reason do not require or benefit from Section 1202's gain exclusion. Some investors look to IRAs as a funding source, but IRAs don't seem to mix well with QSBS. When an IRA sells stock, the IRA is exempt from tax on any resulting capital gains regardless of whether the stock is QSBS. And when the proceeds are distributed out of IRA, the proceeds are taxed as ordinary income, regardless of whether the proceeds arose from the sale of QSBS. Compare this result to a situation where an individual holds QSBS directly and sales proceeds are eligible for Section 1202's gain exclusion.

The fact that certain investors won't benefit from QSBS may complicate the choice-of-entity decision. For example, C corporation investors may be opposed to converting a partnership into a C corporation. The C corporation isn't

eligible to claim Section 1202's gain exclusion and might be concerned that a buyer will reduce the purchase price if the deal is structured as a stock sale rather than an asset sale.[14] Tax-exempt and foreign investors often invest through C corporation blockers, so structuring the operating company itself as a C corporation might not materially affect them. However, there are some foreign investors who may look to invest in a pass-thru (e.g., LP/LLC) operating company in order to take advantage of favorable tax treaties.

One of Section 1202's several eligibility requirements is that a corporation's aggregate gross assets cannot exceed $50 million prior to the issuance of stock being tested for QSBS eligibility or immediately after the issuance of the QSBS (the "50 Million Test"). If a newco C corporation is organized and funded to purchase business assets or stock, the $50 million limitation will generally equate to the valuation of the acquired assets/stock (but see the discussion of the $50 Million Test below). Once the initial QSBS is issued to founders, financial investors and employees, the acquired company's value can grow to greatly exceed $50 million without adversely affecting the QSBS status of previously issued stock (of course, that's the goal of structuring a deal to allow for the issuance of QSBS). Although the $50 Million Test places a limit on the size of a company acquired with Section 1202 in mind, there are obviously many operating companies that fall below this size cap. As discussed below, how the $50 Million Test is calculated can create planning opportunities to acquire the stock of companies whose enterprise value exceeds $50 million.

Finally, if the anticipated holding period for the equity of the business is less than five years, operating as a C in hopes of benefiting from Section 1202 may not make sense unless there is a solid expectation that stock exchanges governed by Sections 351 or 368 or a reinvestment of proceeds under Section 1045 represents viable options.[15]

## F. A brief primer on Section 1202's eligibility requirements[16]

The following is a brief introduction to the various requirements that must be satisfied before a stockholder is eligible to claim Section 1202's gain exclusion:

### Issuing Corporation Eligibility Requirements

- QSBS can only be issued by a domestic (US) C corporation. A domestic (US) LLC or LP that has made an election to be taxed as a corporation (a check-the-box election) can issue QSBS. An S corporation cannot issue QSBS.
- The stock of a corporation that, is or has been, a domestic international sales corporation (DISC) or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit (REMIC) or cooperative cannot qualify as QSBS.
- The corporation that issuing QSBS must maintain its status as a "qualified small business" for "substantially all" of a stockholder's QSBS holding period. This means that during that period, the corporation must be a C corporation and engage in the active conduct of one or more qualified business activities, using at least 80% of its assets (by value) (the "80% Test") in the pursuit of such activities. A qualified business activity is one that isn't excluded under Sections 1202(e)(3) or 1202(e)(7). The activities and assets of controlled subsidiaries are taken into account for purposes of this test. Section 1202(e)(3) provides that the term "qualified trade or business" means "*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 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 the business of 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*."

Also, Section 1202(e)(7) provides that the "*ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.*" Determining whether business activities fall within the scope of one of these excluded categories is a significant aspect of Section 1202 planning. Typically, most software, biotech, sales and manufacturing businesses qualify for Section 1202's gain exclusion. Companies that provide goods or services to healthcare companies or other excluded categories often qualify so long that they don't directly engage in the excluded activity (e.g., bill patients for a healthcare professional's services versus provide software that assists in analyzing radiology slides). In some cases, companies will engage in both qualified and disqualified activities, requiring a determination whether at least 80% by value of the corporation's assets are used in the qualified activity.

While Section 1202 requires that an issuer of QSBS be a domestic (US) corporation, the statute doesn't suggest that the corporation's assets must be on US soil or that its subsidiaries must be domestic (US) corporations. Given the fact that the drafters of Section 1202 could easily have referred to a domestic (US) subsidiary if they had so chosen, we believe that it is reasonable to conclude that a subsidiary for purposes of the 80% Test and the active conduct requirement can be either a domestic or non-domestic subsidiary. While Section 1202 does address how minority and majority ownership of corporate stock should be considered, the statute is silent regarding the impact on satisfying the 80% Test presented by operating through joint ventures. Treasury Regulations issued under Section 355 provide useful guidance suggesting that it is possible for a parent corporation to be engaging in the active conduct of a business through joint venture interests. Passive investments in LLCs and LPs would count against meeting the 80% Test.

Beginning two years after the formation of a corporation issuing QSBS, any cash or working capital associated investment assets in excess of 50% by value of the corporation's assets won't count towards satisfaction of the 80% Test. Excess cash not required for working capital needs or reinvestment should be distributed out of the corporation or paid out as compensation or fees, not only because excess cash counts against satisfying the 80% Test but also because of the risk posed by the accumulated earning tax.

- A corporation will not be considered a qualified small business during any period where the corporation's minority stock and securities positions exceeds 10% of the value of the corporation's assets. During any period the corporation fails this test, it would count against the requirement that the corporation be a qualified small business for "substantially all" of a stockholder's QSBS holding period. For purposes of this requirement, both the stock of majority-owned subsidiaries and investment assets that represent parked working capital are excluded from calculation of the 10% limit. The value of the corporation's assets should include the value of un-booked goodwill and other intangible assets. The value of any minority stock and securities positions also counts against satisfaction of the 80% Test.
- A corporation's will not be considered a qualified small business during any period where the corporation's holdings of real property not used in the active conduct of its business exceeds 10% of the total value of the corporation's assets. During any period the corporation fails this test, it would count against the requirement that the corporation be a qualified small business for "substantially all" of a stockholder's QSBS holding period. Although there are no tax authorities interpreting this requirement, it seems reasonable to assume that

commercial office space used by the business would not be considered excluded investment property so long as the facility was used solely by company engaging in the active conduct of a permissible business activity. But spending $5 million purchasing and renovating a building for the purpose of operating a business valued at $2 million would likely be pushing the envelope if the arrangement were challenged by the IRS. The value of the corporation's real property holdings falling within the scope of this provision also counts against satisfaction of the 80% Test.

- In connection with an issuance of stock that is intended to qualify as QSBS, a corporation must not have made one or a series of stock redemptions triggering Section 1202's "anti-churning" redemption restrictions. Stock redemptions during the two-year period beginning a year prior to the issuance of QSBS could potentially trigger the loss of QSBS status. And with respect to a particular stockholder who is issued QSBS, any redemption from the stockholder or a related person during a four-year period starting two years prior to the QSBS issuance could potentially trigger the loss of QSBS status. Treasury Regulations have been issued under Section 1202 addressing this requirement.
- At any time prior to the issuance of QSBS and immediately after the issuance, the "aggregate gross assets" of the corporation must not exceed $50 million. No additional QSBS can be issued by a corporation that has failed the $50 Million Test, but failing the $50 Million Test doesn't adversely affect the status of previously issued QSBS. For most successful start-ups, founder stock and early-stage investor and employee stock issuances will be issued early enough to avoid a $50 Million Test problem, but at some point the amount of capital raised through equity or debt financing may push the corporation's balance sheet (particularly the amount of cash raised and on the balance sheet) over the $50 million mark. Generally, "aggregate gross assets" means the sum of a corporation's cash plus the adjusted tax basis of its assets, but if assets were contributed to the corporation in a tax-free exchange (e.g., Section 351 nonrecognition exchange or Section 368 tax-free reorganization), those assets must be included in the computation taking into account their contributed fair market value. The assets of a corporate stockholder that holds more than 50% of the issuing corporation's stock and the assets of majority owned subsidiaries are included in the computation.[17] Typically, a corporation fails the $50 Million Test as a result of adding too much cash to the balance sheet, but increases in FFE, inventory and receivables also conspire to push the "$50 Million Test asset balance sheet" over the $50 million mark. Companies that are converted from partnerships to corporations with a high initial fair market value may go over the $50 million mark quickly because assets contributed into a corporation in a Section 351 nonrecognition exchange are booked for purposes of the $50 Million Test at their fair market value rather than their adjusted tax basis.

### Stockholder Level Eligibility Requirements

- A C corporation cannot claim Section 1202's gain exclusion, so QSBS stockholders generally fall into one of the following taxpayer categories: individuals, pass-thru entities (partnerships or S corporations) or trusts. Generally, foreign stockholders do not pay US taxes on the sale of US domestic stock so they do benefit from owning QSBS. Likewise, US tax-exempt stockholders such as Section 501(c) entities and tax-exempt retirement accounts (e.g., IRA & 401k accounts) do not pay taxes on the sale of US domestic stock so they do not benefit from owning QSBS.

- QSBS must be "stock" as defined for federal income tax purposes. Stock issued to service providers that is subject to time or performance vesting is not "stock" unless and until the stock vests or a Section 83(b) election was properly filed. Compensatory or non-compensatory warrants and options are not "stock" until exercised. SAFE instruments and debt instruments are generally not stock and should be avoided if the holder wants to start the clock on Section 1202's five year holding period requirements.[18] Voting and nonvoting common and preferred stock qualify as "stock" for Section 1202 purposes.
- With limited exceptions (e.g., receipt as a "gift" for federal income tax purposes, receipt pursuant to a transfer at death, via a distribution from a partnership to a partner, or via a Section 351 or Section 368 stock-for-stock exchange), a stockholder must have acquired his shares of QSBS directly from the issuing corporation in an original issuance in exchange for money, property or services. QSBS purchased from a stockholder isn't QSBS in the hands of the purchaser. QSBS can be distributed by a partnership (for tax purposes) to a partner, but stock distributed by an S corporation to its stockholders will lose its QSBS status. QSBS contributed to a Partnership loses its QSBS status if it is retained and sold by the Partnership.
- A stockholder must have a holding period that exceeds five years when the QSBS is sold in order to be eligible to claim Section 1202's gain exclusion.[19] There are circumstances such as a rollover of QSBS sales proceeds under Section 1045 or an exchange of Original QSBS for Replacement QSBS under Sections 351 or 368 where the holding period for the Original QSBS is tacked into the holding period for the Replacement QSBS. The holding period of QSBS transferred by gift or upon death is tacked onto the recipient's holding period.
- QSBS must be sold or exchanged in a taxable transaction in order to trigger a stockholder's eligibility to claim Section 1202's gain exclusion. A taxable sale or exchange for federal income tax purposes can include a stock sale, a cash-out merger, a redemption of stock by the issuing corporation (treated as a taxable sale under Section 302) or the receipt by a stockholder of proceeds distributed as a part of a corporation's complete liquidation. The distribution of QSBS by an S corporation to a stockholder as part of the complete liquidation of the S corporation should be treated as a sale of the QSBS, triggering the right to claim Section 1202's gain exclusion.
- During a stockholder's holding period for his QSBS, the stockholder must not have established any offsetting short positions with respect to the QSBS.
- There are no required tax elections or reporting requirements for stock to be treated as QSBS when issued or when sold, but Section 1202's gain exclusion must be properly claimed and reported on a stockholder's tax return for the year of the sale.

## G. A brief primer on Section 1045's eligibility requirements

A taxpayer selling QSBS that has been held for at least six months has the option of reinvesting up to 100% of the sales proceeds into Replacement QSBS during the 60-day period following the sale. In order to be eligible to elect Section 1045 rollover treatment for sale proceeds, the following requirements must be met:

- The original stock must be QSBS.
- The stockholder must have a six month holding period for the Original QSBS prior to its taxable sale.
- A taxable sale of the Original QSBS must have occurred.

- The taxpayer must acquire Replacement QSBS within 60 days after the closing of the taxable sale of the Original QSBS.
- The corporation issuing the Replacement QSBS must be a "qualified small business" under Section 1202 and remain so for at least six months after the issuance of the Replacement QSBS.

One issue that arises frequently is whether in connection with an installment sale, the period for reinvestment of sale proceeds runs only from the closing date of the sale of the Original QSBS, or runs from each payment day when there are deferred payments. There are arguments supporting both positions. Obviously, the approach with the least risk would be completing a reinvestment in Replacement QSBS within 60 days after the closing date of the taxable sale.

## H. Dealing with Section 1202's gain exclusion cap

Under Section 1202, each taxpayer has a cap on the amount of gain that can be excluded under Section 1202 with respect to each corporation issuing QSBS. The gain exclusion cap typically is the greater of $10 million per stockholder per issuing corporation, or 10 times the sum of the cash and fair market value of property contributed by the taxpayer in exchange for QSBS (the "10X Cap"). It is possible to take advantage of both the $10 million and 10X Cap, but that occurs only when the issuer's stock is sold over two or more calendar years. Typically, founders and early-stage employees tax advantage of the $10 million gain exclusion cap because they don't have any tax basis in their founder or employee stock and investors sometimes have contributed sufficient cash or property to take advantage of the 10X Cap.

One strategy that should be considered is first acquiring the assets or equity of a target company in a Partnership and later converting the Partnership to a C corporation when the value of the business has increased sufficiently for stockholders to benefit from the 10X Cap.[20] For example, if the buyer forms a Partnership or acquires the equity of a Partnership for $10 million and converts the Partnership to a C corporation in a Section 351 nonrecognition exchange when the business is valued at just under $50 million, the potential gain exclusion when the business is sold for more than $550 million is $500 million, with the first $50 million of gain taxed at capital gains rates, the next $500 million eligible for Section 1202's gain exclusion and gain in excess of the $500 million of excluded gain taxed at capital gains rates. A potential downside of this strategy of growing asset value in a Partnership before converting to a C corporation is that the holding period for QSBS doesn't commence until the conversion occurs, which can be a problem given Section 1202's requirement that a stockholder's holding period for QSBS must exceed five years. Another issue is that since property contributed in a Section 351 nonrecognition exchange is valued at fair market value for purposes of the $50 Million Test, careful attention must be paid to not exceeding a $50 million value for the property contributed in the Section 351 nonrecognition exchange. In situations where the $50 Million Test becomes an issue, it might be possible exclude certain assets from those contributed in connection with the C corporation's formation. Also, if a partnership is incorporated when the asset value approaches $50 million and later sells for (only) $100 million, the first $50 million won't qualify for Section 1202's gain exclusion. Incorporating when the Partnership was valued at substantially less than $50 million would have achieved a better result under the circumstances. Another strategy for a stockholder who has a substantial anticipated QSBS gain is to acquire additional QSBS for a substantial money contribution in advance of the sale. Under Section 1202(b)(1)(B), the aggregate adjusted tax basis of QSBS would include both QSBS with holding periods that exceed five years and QSBS with a shorter holding period.[21]

If a Partnership acquires QSBS, each partner has his own separate minimum $10 million gain exclusion cap (or 10X Cap), so long as the partner held equity on the date the Partnership acquired the QSBS. For example, there is the potential for a $200 million gain exclusion if a Partnership with 20 equal partners invests in QSBS or acquires a business through a C corporation. Presumably, if a pass-thru entity acquires QSBS in consideration of contributed

money or property, each equity owner's 10X gain exclusion amount would be based on such equity owner's share of the pass-thru entity's money or property paid as consideration for the QSBS (i.e., the equity owner's share of the tax basis of the pass-thru entity in the QSBS). Assuming the 10X gain exclusion amount would be allocated as outlined in the preceding sentence, holders of a profits interest (carried interest) on the date the pass-thru entity acquired the QSBS would not benefit from the 10X Cap but could still claim Section 1202's gain exclusion based on the $10 million cap.

Section 1202(b)(1)(B) defines the 10X gain exclusion cap as being "*10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.*" This provision only refers to the aggregate adjusted tax basis of a stockholder's QSBS, and doesn't distinguish between QSBS with different holding periods. If a stockholder is holding more than $10 million in QSBS but doesn't have sufficient aggregate tax basis in his QSBS to take advantage of the 10X Cap, one possible strategy would be for the stockholder to acquire additional QSBS through making additional contributions of money or property, which should result in an increase in the stockholder's aggregate QSBS tax basis. This strategy should work regardless of whether there is an expectation that the holding period for the additional QSBS would exceed five years when the business is sold. The additional stock must be QSBS when issued. Although Section 1202 is silent on the issue, we believe that it would be prudent for a stockholder to be able to establish that there was a bona-fide business purpose (i.e., for reasons other than "stuffing" the corporation to further benefit from Section 1202) for the contribution of the money or property in exchange for the issuance of the additional QSBS.

If the 10X Cap isn't available because insufficient money or property has been contributed to the corporation, but the issuing corporation's value has increased to the point where the per-stockholder potential gain exceeds $10 million, stockholders should consider gifting QSBS to other taxpayers, including non-grantor trusts (e.g., Delaware asset protection trusts).[22] Another strategy would be to reinvest excess proceeds (i.e., proceeds in excess of the gain exclusion cap) into Replacement QSBS under Section 1045. For example, if a stockholder has a $15 million gain when QSBS is sold, the stockholder could claim a $10 million gain exclusion and reinvest some or all of the proceeds into Replacement QSBS under Section 1045 (subject to Section 1045's somewhat complicated rules regarding the ordering of gain deferral). Finally, if a stockholder's Original QSBS is exchanged for QSBS of a buyer, Section 1202 doesn't appear to link the Original QSBS and the Replacement QSBS, opening the door for potentially multiplying the gain exclusion cap by selling some of the original target company QSBS and subsequently selling buyer stock received in exchange for original target company QSBS -- in this scenario, the buyer stock would be subject to a separate gain exclusion cap as stock of a different issuing corporation.

## I. Best practices for minority investments in QSBS

There are family offices throughout the United States who are either considering or have implemented a plans to focus on multiple QSBS investments (usually preferred stock investments). Professionals working with these family offices often develop a working knowledge of QSBS issues, and ideally surround themselves with tax professionals with a deep understanding of QSBS planning. Below are several key issues to consider when making minority investments in QSBS.

### The investment must be in "stock" for federal income tax purposes

Only investments treated as "stock" for federal income tax purposes qualifies as QSBS. QSBS can be voting or nonvoting preferred (including convertible preferred) or common stock. Section 1202 allows for the conversion of convertible preferred stock to common stock, as the statute specifically provides that the common stock issued upon conversion of one class of stock into anotherr retains its QSBS status and continues the holding period that commenced when the original QSBS was issued. Stock that is subject to substantial risk of forfeiture under Section 83

(i.e., subject to vesting requirements and non-transferable) is not treated as "stock" or QSBS until the stock vests, unless a Section 83(b) election is made when the stock in connection with the stock's issuance. Investments in convertible debt, SAFE instruments, stock options or warrants should generally be avoided if the focus is on obtaining Section 1202's benefits, as none of those investments are irrefutably treated as "stock" for Section 1202 purposes, and the expectation should be that the holding period for Section 1202 purposes (i.e., for purposes of meeting the five year+ holding period requirement) won't commence until stock is treated as have been issued).

### Pre-investment and ongoing due diligence associated with minority investments in QSBS

The additional due diligence associated with an investment in preferred or common QSBS should focus on obtaining a comprehensive set of representations and warranties from the issuer with respect to facts relevant to whether the corporation is a qualified small business, along with determining that management's level of commitment to obtaining the benefits of Section 1202 for its stockholders is fully aligned with the expectations and goals of the family office investor. In addition, the issuing corporation should be asked to covenant that it will provide periodic financials and other information upon request, use at least commercially reasonable best efforts to preserve the QSBS status of the investor's stock to the extent that the eligibility requirements are at the issuing-corporation level, and to further covenant that the issuing corporation will provide reasonable assistance in the investor's efforts to document satisfaction of issuing corporation level eligibility requirements down the road when the investor's stock is sold. Obviously, the extent to which many issuing corporations will be willing to provide these representations, warranties and covenants will differ from corporation to corporation and may depend on the importance of a particular investor's money is to the corporation. Companies that issue QSBS may balk at providing an unqualified covenant that no actions will be taken that might result in the termination of its investors' QSBS status. Management must deal with the concern that there might be a decision down the road that would benefit the company overall but would terminate QSBS status. For example, the business might have the opportunity to acquire activities that are excluded under Section 1202, putting the corporation at risk of failing the 80% Test.

## J. Best practices for majority investments in QSBS

An important first step for positioning family offices and PE Firms to maximize Section 1202's benefits is to ensure that both business professionals and outside tax and business advisors are sufficiently versed in the workings of QSBS (Sections 1202 and 1045). The next steps involve thoughtful consideration of how best to structure the ownership and compensation arrangements at the family office and PE Firm levels, taking into account Section 1202's eligibility requirements and who qualifies for and doesn't qualify for claiming Section 1202's gain exclusion. Beyond those buyer-structural issues, the focus turns to establishing and maintaining best practices for acquiring, owning and selling qualified small businesses (issuers of QSBS):

- Developing and implementing a process for identifying potential acquisition targets that fit within Section 1202's requirements, including by activity and size (i.e., targets that satisfy the $50 Million Test), would function well operating as a C corporation, and would be well received by potential buyers as an stock purchase (i.e., not asset purchase) opportunity.
- Determining with respect to each M&A opportunity (i) whether the target engages in qualified business activities under Section 1202, (ii) how well the business will function as a C corporation, (iii) whether the $50 Million Test will restrict the ability to issue QSBS, (iv) given the nature of the business and the industry it operates within, whether a future stock sale is predictable, and (v) how to properly structure the ownership group and the purchase arrangement. Post-acquisition, the focus shifts to maintaining QSBS status, possibly structuring equity

compensation arrangements, if necessary, increasing the potential gain exclusion cap through gifting, and properly structuring a sale process with an eye toward maximizing Section 1202's gain exclusion.

- Developing a plan for acquiring target companies through newly-organized C corporation holding companies or C corporation operating companies, including addressing leverage buy-out structuring issues and the rollover of target stockholder equity in a manner that maximizes the potential beneficial treatment under Section 1202.
- Structuring operating company's equity plan with an eye towards spreading the benefits of Section 1202 among the operating company's service providers.
- Including in the ongoing plan for owning an operating company that has issued QSBS, steps for maintaining qualified small business eligibility.
- Addressing QSBS related issues in connection with structuring the sale of operating companies that have issued QSBS.

### Can purchasers of majority stock positions in QSBS take advantage of Section 1202's gain exclusion?

A buyer that wants to purchase a business and at the same time position itself to take advantage of Section 1202 can form a new C corporation, cause the corporation to issue QSBS in exchange for money, and undertake an asset purchase. A more complicated question is whether the family office can take advantage of Section 1202's benefits if it acquires a majority position in the stock of a business engaged in qualified activities. There are no tax authorities that expressly address this issue. One of the requirements of Section 1202 is that a stockholder must have acquired QSBS as an original issuance for money, property (not stock) or services. There are limited exceptions to this rule in Section 1202, but in general, stock purchased from a stockholder will not qualify as QSBS in the hands of the purchaser. But this rule clashes with several provisions in Section 1202 that expressly confirm that a corporation issuing QSBS can hold a majority interest in the stock of a subsidiary. Section 1202(d)(3) provides that "*all corporations which are members of the same parent-subsidiary controlled group shall be treated as 1 corporation for purposes of this subsection.*" The subsection referenced, Section 1202(d), addresses the definition of a qualified small business. Section 1202(e)(5) provides a "*look-thru in case of subsidiaries" and states that "for purposes of this subsection, stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct Its ratable share of the subsidiary's activities.*" The subsection referenced, Section 1202(e), provides the requirements for satisfying Section 1202's active business requirement. Neither Section 1202(e)(3) nor Section 1202(e)(5) state that a subsidiary must be created by the parent corporation issuing the QSBS. The requirement that QSBS be originally issued stock is found in Section 1202(c)(1), which addresses the stock of the corporation issuing QSBS - a subsidiary is not the issuer of QSBS and Sections 1202(e)(3) and 1202(e)(5) explicitly ignore the subsidiary's stock when consolidating the parent and subsidiary for purposes of determining whether Section 1202 eligibility requirements are met.

Although the issue isn't entirely without doubt, it appears that the better argument based on the language of Section 1202 is that a buyer should be able to take advantage of Section 1202 if the buyer forms a C corporation to act as the acquiror. The IRS could argue that there is no bona-fide business purpose other than tax avoidance for the formation of a C corporation to acquire the stock of the target company (i.e., when stock purchased directly won't qualify as QSBS but stock purchased through a C corporation buyer does qualify under the parent-subsidiary rules). A buyer must be prepared to establish that there were bona-fide (non-tax) business reasons for using a C corporation to serve as the acquiror.

## K. Tips for structuring the ownership of QSBS by family offices and PE Firms

Family offices and PE Firms rarely structure their ownership of QSBS as direct investments by individuals and trusts. The typical investment vehicle serving as the stockholder is a limited partnership (LP) or limited liability company (LLC), in either case taxed as a partnership for federal income tax purposes (LPs/LLCs are referred to as "Partnerships" in this Guidebook). For that reason, it is important to understand the issues associated with the ownership of QSBS through Partnerships.

Family office investment in QSBS. Ownership of family office Partnerships generally consists of a combination of trusts and/or individuals representing the family's wealth and family office professionals or their affiliated entities who hold profits (carried) interests or co-invest alongside the family. There might be an upper-tier partnership that holds and manages the carried interests. Typically, a family office would make a minority (usually preferred stock) investment in QSBS through the Partnership. If the plan is to acquire a majority interest in a business and then operate it through a C corporation, the structure generally involves the formation of a corporation owned by the Partnership that either becomes the holding company of the target company (if the transaction involves the purchase of C corporation stock, the assets of target company, or the membership interests of an LLC holding the target company assets. The C corporation might also be partially owned by target company equity owners who roll over equity in a Section 351 nonrecognition exchange.

When a family office is focusing on investing in QSBS, there are several issues discussed below that should be considered when structuring its Partnership arrangement.

- *The family office Partnership must hold "stock" for federal income tax purposes*. Holders of convertible debt, options and warrants in a corporation are not treated as holding QSBS for Section 1202 purposes until the instrument is converted into stock. SAFE instruments, although they are touted as being equity for federal income tax purposes, enjoy an uncertain tax status, are they equity, debt or a hybrid instrument? If the adopted strategy Is to take advantage of Section 1202's gain exclusion, the safe approach is to acquire preferred or common stock.
- *Dealing with Section 1202's rule regarding the sharing of the gain exclusion among partners*. Section 1202 limits a partner's sharing of gain exclusion associated with QSBS held by the Partnership to the smallest "interest" held by the partner during the Partnership's period of QSBS ownership.[23] If a taxpayer wasn't a partner on the date the Partnership acquires its QSBS, the smallest ownership during the Partnership's holding period for the partner would be a zero interest. This rule has several ramifications.

First, holders of convertible debt, options and warrants in a Partnership purchasing QSBS will not share in Section 1202's gain exclusion if the conversion of their instrument occurs after the Partnership acquired the QSBS -- they do not have the necessary "interest" in the Partnership.

Second, if a partner/member acquires or increases his "interest" after the Partnership acquires the QSBS, that partner/member won't share in the allocation of Section 1202 gain exclusion with respect to the additional interest. How this rule would function if a partner's interest increases because of the redemption of another partner's interest is unclear. If a partner's interest decreases after the Partnership acquires QSBS because the Partnership issued additional equity, this would most likely result in a reduced allocation of Section 1202's gain exclusion to the partner when the Partnership sells the QSBS. The gain allocated to the new interest would not qualify for Section 1202's gain exclusion. Applying the rules outlined above, if a member/partner has a 5% share of gain on the date QSBS is acquired, is the member's/partner's share of gain limited to 5% under all circumstances? One possible interpretation would be that if a partner held a 5% equity interest on the date the QSBS was acquired, the partner's share of Section 1202's gain exclusion would be capped under all circumstances to 5% of the aggregate possible gain exclusion. If the same

reasoning used to analyze the "interest" of a profits interest holder was applied to this question, there are arguments that a member's/partner's "interest" under the applicable LLC/LP agreement on the date the QSBS was acquired by the Partnership result in an share exceeding 5%. It seems obvious that a member/partner would not increase his share of Section 1202's gain exclusion if he purchased an additional five Units either from the Partnership or another member/partner. But if "interest" is interpreted to mean that the member/partner has five Units out of whatever number of Units are outstanding from time-to-time, then if a Partnership starts with 100 Units and 50 Units are redeemed, the member's/partner's share of gain would increase from 5% to 10%, but has his interest increased or did he always have that economic right? Definitive answers to these questions are likely to remain elusive so long as the IRS fails to issue regulations interpreting Section 1202.

- *Allocating Section 1202's gain exclusion; carried interests.* If a Partnership acquires and later sells QSBS, only those members/partners who owned their interests on the day that the Partnership acquired the QSBS will share in Section 1202's gain exclusion. With respect to Section 1202's gain exclusion, members/partners share In the gain exclusion to the extent of their respective "interests" on the date the Partnership acquired the QSBS.[24] If a reinvestment of QSBS sales proceeds is being elected, members/partners share in the gain exclusion to the extent of their respective "capital interests" on the date the Partnership acquired the QSBS. There isn't a clear definition of what an "interest" in the Partnership means for purposes of Section 1202. Some commentators assume that the reference to "interest" in Section 1202 means a "capital interest" as referenced in Section 1045. Other commentators reach the opposite conclusion, noting that the reference to "interest" in Section 1202 must mean something different than "capital interest" or the drafters of Section 1202 would have used the term in a consistent fashion. Clearly a capital interest can be distinguished from a "profits interest" (carried interest) as defined in Revenue Procedure 93-27.[25] If "interest" in Section 1202 means a "capital interest," then a pure profits interest (carried interest; promote) wouldn't share in Section 1202's gain exclusion. The issue for a holder of a profits interest is how to interpret Section 1202(g)(3)'s limitation on sharing in Section 1202's gain exclusion. Section 1202(g)(3) provides that, with respect to QSBS sold by a Partnership, the gain exclusion offered by Section 1202(a) by way of Section 1202(g)(1) "*shall not apply to any amount to the extent such amount exceeds the amount to which paragraph (1) would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired*" (emphasis added). Language found in Section 1045's regulations has been cited by some as authority for the conclusion that holders of carried interests don't share in Section 1202's gain exclusion. But a reading of Section 704 and Treasury Regulation Section 1.704-1(b)(3) supports the position that the economic rights of the holder of a carried interest set forth in an LP/LLC agreement constitutes the partner's interest. The "interest" of the holder of a carried interest existed when the Partnership's QSBS was acquired, with the only variable being whether the QSBS appreciated post-acquisition. Assuming that argument prevails, the holder of a profits interest would be eligible to claim Section 1202's gain exclusion with respect to his entire share of gain attributable to the sale of QSBS.

  The reference in Section 1045's regulations to "capital interest" makes it clear that a stockholder who is issued a profits interest when QSBS is issued won't share be eligible to reinvest proceeds under Section 1045.[26]

- *Original stock issuance requirement.* If a Partnership holds QSBS, the Partnership (i.e., not its partners) must acquire the QSBS as an original issuance from the issuing corporation for money, property (other than stock) or services. The Partnership may hold investments in multiple corporations issuing QSBS. Section 1202's eligibility

requirements and gain exclusions apply separately to each corporation's QSBS. Section 1045's regulations make it clear that while QSBS can be contributed tax-free to a Partnership tax-under Section 721, the stock loses its QSBS status in the process. A Partnership will generally contribute property or money in exchange for the issuance of QSBS. At the Partnership level, members/partners may have contributed money, property or services to the Partnership in exchange for their Partnership equity interests. When the Partnership sells QSBS, the members'/partners' right to claim Section 1202's gain exclusion is discussed above.

As discussed above, a member/partner sells his Partnership interest, the purchaser does not share in Section 1202's gain exclusion with respect to any allocation of tax items with respect to the sale of previously acquired QSBS. One exception to the general rule that transfers (e.g., sales) of a Partnership's equity interest won't carry with it the right to share in Section 1202's gain exclusion appears to be transfers of Partnership interests by gift or upon death of the partner.[27] If QSBS is gifted or transferred at death, the recipient steps into the shoes of the previous stockholder with respect to QSBS status and the prior stockholder's holding period for the QSBS. Presumably, the same treatment would hold true when a Partnership interest is transferred by gift or upon death.[28]

- *QSBS held by the Partnership must be sold.* Section 1202 requires that QSBS must be sold (for federal income tax purposes) before a stockholder is eligible to claim Section 1202's gain exclusion. When QSBS is held by a Partnership, either the Partnership must sell the QSBS or the QSBS must be distributed to one or more members/partners who in turn may then sell the QSBS. Gain on the sale of QSBS passes through to members/partners on their Schedule K-1s just as any capital gains from the sale of Partnership assets. The right to claim Section 1202's gain exclusion applies at the member/partner level, but the amount of the gain exclusion is determined based on each member's/partner's interest in the Partnership (discussed below). The election under Section 1045 to investment QSBS sales proceeds can be claimed at either the Partnership or member/partner level as outlined in detailed Treasury Regulations.[29]

  Even if a Partnership is holding QSBS, a sale or redemption of a member's/partner's Partnership interest does not trigger the right to claim Section 1202's gain exclusion. If the plan is to redeem an interest in the Partnership, one, one possible way to unlock Section 1202's benefits would be to distribute the appropriate shares of QSBS to the member/partner in exchange for his Partnership interest, followed by a purchase by the Partnership of the QSBS. Alternatively, the member/partner could sell the QSBS to a third party and claim Section 1202's gain exclusion, subject to meeting all of Section 1202's eligibility requirements.

- *Section 1045 issues.* Section 1045 permits stockholders to sell QSBS and reinvest the proceeds in Replacement QSBS on a tax-free basis. Under Section 1045's regulations, when the Partnership sells QSBS, either the Partnership or individual partners can elect to reinvest proceeds in Replacement QSBS. Section 1045's regulations explicitly provide, however, that partners share in the right to invest QSBS proceeds based on their smallest "capital interest" during their holding period for their Partnership interest. This means that under Section 1045, the holder of profits interest issued on the same day as the Partnership acquired QSBS would be treated as having no share of the proceeds for purposes of Section 1045.

  PE Firm investment in QSBS. Many of the same issues discussed above would apply to the structuring of ownership of C corporations by PE Firms and their funds.

## L. M&A issues - structuring the acquisition of an operating company

### The Role of The C Corporation

The fact that the issuer of QSBS must be a domestic (US) C corporation has been discussed throughout this Guidebook. Stockholders can be a pass-through entity taxed as a partnership (LLC/LP), an S corporation, trusts or individuals, or a combination of the above, but only domestic (US) C corporations can issue QSBS (an LLC or LP that has checked the box to be a corporation would qualify as a C corporation for this purpose). An issuer of QSBS should remain a domestic (US) C corporation for a stockholder's entire holding period and generally must be a domestic (US) C corporation when the QSBS is sold. An issuer of QSBS can meet Section 1202's active conduct requirement through the ownership of one or more corporate subsidiaries. Section 1202(e)(5) provides that for the active conduct requirements, there is a pro rata look-thru to the activities of a more than 50% (voting or value) owned subsidiary. If an investment in stock doesn't meet the subsidiary definition, the ownership interest does not count towards satisfaction of Section 1202's active conduct requirement (i.e., it is treated as a passive investment asset). Presumably, a corporation would be treated as engaged in the active conduct of a qualified business if that ownership was through a 100% owned LLC that was disregarded for federal income tax purposes. There are no Section 1202 tax authorities addressing whether a corporation can be considered to be engaging in the active conduct of a qualified business through a joint venture or ownership interest in an LLC. There are tax authorities under Section 355 which suggest that the ownership of at least a 33.33% interest in a LLC should be sufficient, hopefully coupled with an active role in management of the joint venture or LLC. Having greater than a 50% ownership interest (by vote or value) in an LLC or joint venture would align the arrangement with Section 1202(e)(5) and should provide the taxpayer with a strong argument if the structure were challenged by the IRS.

### Can a C corporation be formed and issue QSBS for the purpose of acquiring the stock of a target corporation?

A C corporation that issues QSBS should be able to purchase assets for the purpose of engaging in qualified business activities. But can a C corporation that issues QSBS acquire the stock of a target company for the purpose of satisfying Section 1202's active conduct requirement through ownership of a corporate subsidiary? One of the requirements of Section 1202 is that stock must generally be an original issuance in the hands of the stockholder claiming the gain exclusion. Stock purchased from another stockholder is not stock originally issued to the holder. At the same time, however, Section 1202 expressly contemplates that a corporation that has issued QSBS can operate its business and satisfy Section 1202's active conduct requirement through subsidiaries. Neither Section 1202 nor any other tax authority requires that a subsidiary be originally created by the corporate parent. Absent tax authorities taking a contrary position, it appears reasonable to conclude that if there are bona-fide business reasons for forming a C corporation (and issuer of QSBS) as an acquisition vehicle, the C corporation can not only purchase assets or an LLC/LP interest, but also the stock of a target business. The IRS could argue that there is no business purpose for using a corporation as the acquisition vehicle other than to facilitate the issuance of QSBS, but in reality, parent/subsidiary ownership arrangements are common and employed for a number of non-tax reasons in the M&A and business world.

### Dealing with Section 1202's $50 Million Test

Section 1202(d) provides that a corporation cannot issue additional QSBS once its "aggregate gross assets" have previously exceeded $50 million or exceed $50 million as a result of the issuance of stock being vetted for QSBS eligibility (the "$50 Million Test"). The $50 Million Test doesn't take liabilities into account. If the $50 Million Test is passed when QSBS is issued, the fact that the company's later fails the $50 Million Test won't affect the QSBS status of previously issued stock. But no additional QSBS can be issued once the corporation has failed the $50 Million Test.

The $50 Million Test is generally calculated by adding the corporation's cash plus adjusted tax basis of other assets. An exception is that assets that are contributed to the corporation on a tax-free basis are valued for purposes of the $50 Million Test at their contributed fair market value. Liabilities are excluded from the computation. The $50 Million Test with its FMV rule can affect how long owners wait before incorporating partnerships using a Section 351 nonrecognition exchange. There are additional rules that require the inclusion in the calculation of aggregate gross assets the assets of corporate stockholders and majority owned subsidiaries.

The $50 Million Test can be a significant hurdle for buyers hoping to undertake their purchase through a C corporation that issues QSBS. If a target company's value is less than $50 million, it should be possible to avoid failing the $50 Million Test by purchasing the business through a shell C corporation that issues QSBS to the buyer-group prior to or in connection with acquisition transaction. If the value of the target company's assets is approaching $50 million, care should be taken to structure the transaction and influx of cash and property to keep the issuing corporation and its subsidiary, if applicable, below the $50 million mark until all desired QSBS has been issued.

If the buyer group wants to issue QSBS but the value of the target company's assets exceeds $50 million, there are several possible strategies:

- The purchase transaction could be structured so that the buyer C corporation acquires less than $50 million in target company assets. One approach to accomplishing this would be to split the business into two separate activities housed in two C corporations or exclude certain assets from the acquisition and instead lease or license those assets.
- Another approach might be to first organize the buyer corporation, undertake the start-up of an activity or acquisition of a business, and issue QSBS (common stock) when the corporation clearly passes the $50 Million Test. Later, when a target company is identified, the acquisition can be structured so that the capital is contributed into the corporation as a capital contribution, in consideration of the issuance of preferred stock or debt, or a combination of these three approaches. The second business acquired might cause the buyer corporation to fail the $50 Million Test, but that shouldn't affect the QSBS status of previously issued common stock.
- Another approach might be to organize the buyer corporation, issue QSBS and undertake the start-up activity of searching for acquisition candidates. Later, when a business is purchased, the additional assets could result in the buyer corporation failing the $50 Million Test, but the stockholders could take the position that the QSBS status of the previously issued stock should not be affected by the subsequent acquisition. Again, the additional capital necessary for the acquisition could be infused through combinations of capital contributions, issuance of preferred stock, debt or a combination of these approaches, all of which paves the way for the initial QSBS (the common stock) issuance to reap the benefits of future appreciation and Section 1202's gain exclusion. Using this approach, assuming the $50 Million Test applicable to the initial QSBS issuance doesn't take into account the target company's assets and that all of the necessary QSBS was issued when the corporation was initially organized, it might be possible for the target company's assets to exceed $50 million.
- One unanswered question is how Section 1202's concept of "immediately after the issuance" should be interpreted to apply in these situations. The issue would be whether "immediately after the issuance" should include or exclude a target company acquisition that might occur months after commencement of the search process. Since there are no direct Section 1202 tax authorities, the Tax Court would likely look at how the phrase

"immediately after the exchange" is used elsewhere in the Internal Revenue Code. For example, Treasury Regulation Section 1.351-1(a)(1) states that the phrase "immediately after the exchange" does not require a simultaneous exchange between two or more persons, and may include a "situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Two tests that the IRS and courts have used to determine whether two events should be combined are the "mutual interdependence test" (where steps are so interdependent that the legal relationships created by one transaction would be fruitless without the completion of the entire series of transactions) and the "binding commitment test" (where transactions are aggregate with other transactions if there is a binding commitment for the parties to undertake the other transaction). The IRS has taken the position in a series of Revenue Rulings that two transactions should be stepped into one when the parties involved had a prearranged plan to carry out a number of steps, even if the parties had no binding commitment or obligation at the outset to consummate the subsequent steps. Courts also traditionally consider as relevant the length of time between two transactions and whether any parts of the first step are functionally related to the second step. Here the question would be whether the initial formation of the buyer corporation for the purpose of undertaking a search process and a subsequent closing of a purchase should be stepped together applying the "mutual interdependence test" and the "binding commitment test," or whether there can be sufficient separation between these steps to avoid this result. In reaching a determination, the Tax Court is likely to focus on all of the facts and circumstances surrounding the steps leading to the issuance of the QSBS and the subsequent acquisition of the business.

- Another approach might apply in situations where a buyer corporation is organized to acquire the stock of a target corporation either as a purchase transaction or by means of a Section 351 stock for stock and cash exchange. In connection with the acquisition, the buyer corporation would issue stock to the buyer group. The question is whether this stock could qualify as QSBS where the consideration paid for the target corporation exceeds $50 million but the "aggregate gross assets" of the acquisition parent and target company are less than $50 million. Section 1202 adopts a "look through" concept where for purposes of the $50 Million Test, the aggregate gross assets of the subsidiary are combined with those of the parent as though they are a single corporation. Section 1202(d)(3)(A) provides that "*all corporations which are members of the same parent-subsidiary controlled group shall be treated as 1 corporation for purposes of this subsection [Section 1202(d)].*" The value of the stock of the corporate subsidiary should be ignored when undertaking this computation. There is no authority under Section 1202 suggesting that in connection with the look-through and combination of parent and subsidiary assets, you should step-up the value of the subsidiary's assets. This approach could result in a calculation of aggregate gross assets immediately after the acquisition where the aggregate gross assets pass the $50 Million Test but the acquisition price for the target company's assets substantially exceeds $50 million. For example, it wouldn't be at all unusual for a software or pharma company to have a $100 million+ valuation, but at the same time have little or no assets on the balance sheet other than unrecognized goodwill. Contrary to the wording of Section 1202, the IRS might nevertheless argue that the language of Section 1202(d)(3)(A) should be interpreted to require a step-up in the basis of the target corporation assets for purposes of the $50 Million Test. The IRS might also argue that there is no valid business purpose for organizing a buyer corporation to purchase the stock of the target corporation rather than directly purchasing the stock of the target corporation, other than tax avoidance (i.e., to position the buyer's stockholders to benefit from Section 1202's gain exclusion). We note,

however, that employing a corporate holding company to acquire a target corporation is a commonly used structure for asset protection, financing, governance and other non-tax benefits.

### Does Section 1202's "anti-churning" rules impact the structuring of business acquisitions?

One common acquisition method (the leveraged buyout) is for the buyer corporation to purchase some target company stock in combination with the acquisition of the balance of the stock indirectly through a redemption of stock by the target company, with funds obtained through borrowing at the target company level. Section 1202 limits the ability of QSBS to be issued in close proximity to stock redemptions. Although there are no tax authorities addressing the issue, the anti-churning rules should be triggered by a leveraged buyout (LBO) structure because it is the stock of the target company, not the buyer corporation (issuer of the QSBS) that is redeemed in the LBO.

### Dealing with Target Company Stockholders Who Hold QSBS (including structuring rollover equity arrangements)

Sooner or later a buyer will run into a target company whose stockholders are holding QSBS. Adding QSBS to the planning equation adds complexity and requires an understanding of what selling stockholders are looking for if they hold QSBS. Generally, target stockholders will strongly prefer a taxable stock sale if they have held their QSBS for more than five years. In some cases where a target stockholder's gain will exceed the applicable gain exclusion cap (often $10 million), the stockholder will want to trigger at least $10 million of taxable gain and might be inclined to roll over additional shares in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization. Where the target stockholders have held their QSBS for less than five years, they will be particularly interested in structuring a transaction governed by Sections 351 or 368. Under Section 1202(h)(4), if the holder of QSBS can exchange that stock for either QSBS or non-QSBS in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, the holding period for the Original QSBS continues and when the replacement buyer stock is sold, the target company stockholders could be eligible to claim Section 1202's gain exclusion. If the buyer stock is QSBS, the target company stockholders could be eligible to claim Section 1202's gain exclusion on all of their eventual gain, subject to Section 1202's gain exclusion cap. If the buyer stock is non-QSBS, the target company stockholders could be eligible to claim Section 1202's gain exclusion on the gain that was deferred when the nontaxable exchange took place.

From a buyer's standpoint, structuring the acquisition of a company as a stock purchase results in the loss of an inside tax basis step-up in the target company's assets. This result is unfavorable to the buyer from a tax standpoint as it means that there will be no 15-year amortization of purchased goodwill. The significant tax benefits to the target stockholders of a stock sale, particularly where QSBS is involved, may allow the buyer to reduce the overall purchase consideration. Where a buyer insists on asset purchase, the target corporation will pay corporate income taxes at a 21% rate and, assuming the target corporation is liquidated, its stockholders should be able to claim Section 1202's gain exclusion in connection with the corporation's complete liquidation.

If a part of the acquisition transaction includes a rollover of equity, target company stockholders holding QSBS are likely to negotiate for an equity rollover governed by Sections 351 or 368 unless they can shelter most or all of their gain using Section 1202's gain exclusion. The target stockholders' request that the buyer structure a transaction that requires the use by the buyer of a corporation may be denied where the buyer intends to exchange LP/LLC interests for target company stock. This transaction can be structured as a nontaxable exchange under Section 721, but the partnership interest received in the exchange will not qualify for Section 1202's gain exclusion.

As mentioned above, if the target owners hold QSBS with a holding period exceeding five years, the parties should consider whether the best result would be a fully taxable exchange, triggering the target company stockholders' right to claim Section 1202's gain exclusion. Whether a fully taxable exchange would be attractive to a target stockholder usually depends on whether the aggregate gain in the taxable exchange would exceed the stockholder's Section 1202 gain exclusion cap.

### Dealing with Target Company Owners Who Want Their Buyer Rollover Equity to Qualify as QSBS.

Not surprisingly, target company business owners who are rolling equity over often want to walk away from the closing table holding QSBS. If the target company stock is not QSBS, a stock-for-stock exchange will not transform their non-QSBS into QSBS. But if their target company stock is QSBS, the stock received in a stock-for-stock exchange can retain the benefits of QSBS if the exchange is properly structured.

If the acquisition involves a partial purchase and partial rollover of assets for stock of the acquiror, a typical approach would be for the target owners to contribute their assets to the buyer's C corporation in exchange for stock and cash. Generally, the transaction won't be structured as a tax-free reorganization because it won't satisfy the continuity of Interest requirements for a Type C reorganization. An assets for stock and cash exchange could potentially be structured as a Section 351 nonrecognition exchange (with taxable boot) if the buyer forms a C corporation to be the acquiring company issuing stock. This won't happen if the buyer is a large corporation (e.g., a strategic public company buyer). Also, the exchange of assets for a Partnership equity interest and cash may qualify as a partial Section 721 nonrecognition exchange, but the equity received back won't be QSBS. Also, if the target company is a C corporation, an asset sale will trigger tax at the corporate level, any stock received back In the sale won't qualify as QSBS, and the sellers generally will avoid double taxable by undertaking a complete liquidation of the seller C corporation. An asset sale is not generally QSBS-friendly.

As discussed elsewhere in this Guidebook, if the target stockholders are in a position to claim Section 1202's gain exclusion in connection with most or all of their gain on a taxable sale of target company stock, the rollover should be structured as a taxable sale of the rollover equity.

If target company stockholders hold QSBS and some or all of them are being asked to roll over equity into the buyer, and the desire is to avoid triggering gain on the equity rolled over into the buyer and preserve the QSBS status of the target stock, the transaction should be structured in one of three ways:

- target stockholders participating in a "rollover" of equity can retain some or all of their target company equity. While this deal structure is relatively uncommon, it does have the benefit of not affecting either the QSBS status of stock or the ability of holders to claim Section 1202's gain exclusion against any future appreciation In the value of the retained stock.
- target stockholders can participate as part of an overall Section 351 nonrecognition transaction (a purchaser C corporation is formed, with target stockholders exchanging target stock for buyer stock and buyer principals exchange cash for stock). The stock received back may be vested or unvested and may be QSBS or non-QSBS. If the buyer stock is non-QSBS, only the gain not recognized in the exchange would qualify for a future claiming of Section 1202's gain exclusion. Any further appreciation would only qualify for capital gains treatment. In a Section 351 exchange, the target stockholder's holding period for their target company QSBS tacks onto the holding period for the stock received in exchange. So, if a target stockholder has a three-year holding period for his target company QSBS, that three year holding period would tack onto the buyer stock received in exchange and once the target stockholder has achieved a five year holding period, he can sell the buyer stock and claim at least some Section 1202 gain exclusion.
- A rollover can also be structured using a tax-free reorganization if the percentage of stock consideration is sufficient. Depending on which type of reorganization is used/available, the percentage of consideration required to be in stock (versus cash) varies from 40% to 100%.

As mentioned in the section above, a rollover is often structured as a tax-free exchange under Section 721 when the acquiring company is a Partnership, but the exchange of stock (including QSBS) or assets for an interest in a Partnership does not allow the target owners to participate down the road in Section 1202's gain exclusion.

### Additional Transaction Structuring Considerations

Many family office and PE Firm buyers make initial acquisitions of "platform" companies in a particular industry, followed in some cases by one or more "bolt-on acquisitions" (also referred to as an add-on acquisition or a tuck-in acquisition), basically following a strategy of growing an existing business by acquiring one or more smaller target companies. These smaller business acquisitions are generally grouped under the platform company, the idea being that adding the small businesses is one way to increase the value of the overall package when it comes time to sell. But when QSBS is issued in conjunction with the acquisition of a platform company, consideration should be given whether grouping the bolt-on acquisitions under the platform company makes sense from a tax planning standpoint. If the platform company operating under or within the C corporation that previously issued QSBS would satisfy the $50 Million Test and be able to issue additional QSBS, bringing the bolt-on acquisition under the platform company would probably make sense as additional QSBS could be issued to the family office or private equity fund and in connection with the target company's rollover equity.[30] Possibly weighing against operating the two businesses under one holding company would be the functioning of Section 1202's gain exclusion cap. If the bolt-on acquisition is operated through a separate brother-sister C corporation, stockholders would have two separate gain exclusion caps (at least $10 million for each corporation) rather than a single gain exclusion cap. If the platform company has failed the $50 Million Test (e.g., growing accounts receivable, inventory or purchased goodwill) or would fail the test in connection as a result of the acquisition of the additional business assets, consideration should at least be given to operating the target company as a brother-sister corporation rather than as a subsidiary of the platform company.

### Potential Negative Consequences of Structuring the Ownership of Multiple Activities Under the Umbrella of One Issuer of QSBS

Section 1202 does not restrict the ability of an issuer of QSBS to engage in multiple qualified business activities within one C corporation, whether those activities are related or unrelated, so long as the corporation satisfies Section 1202's "80% Test" on an ongoing basis.[31] Although there are no limitations on engaging in multiple activities under the umbrella of a single C corporation (issuer of QSBS), this might not be the best strategy. A stockholder's QSBS must be sold in order to qualify for claiming Section 1202's gain exclusion. But where the corporation issuing QSBS engages in separate activities, situations may arise where there is a reason to sell the assets of only one activity or subsidiary. When the assets of an issuing corporation or subsidiary are sold, or stock of a subsidiary is sold, the sale will trigger a corporate level tax. Instead, a sale of assets or subsidiary stock would trigger tax at the corporate level and if the proceeds are distributed, the distribution may be treated as a taxable distribution unless the sale of assets or subsidiary stock is treated as a partial liquidation under Section 302(e). The best planning strategy to deal with holding multiple activities might be to consider at the outset how to manage or avoid the problem. If possible, consider using brother-sister corporation arrangements when there are two or more incompatible activities. If there are assets such as software that are used in multiple activities, consider whether it would work to hold the software in a separate entity and license it to the multiple operating corporations.

## M. M&A issues - structuring the sale of an operating company

QSBS must be held for more than five years and sold in a transaction qualifying as a taxable sale for federal income tax purposes in order to qualify for claiming Section 1202's gain exclusion. If an opportunity arises to sell QSBS before satisfying the five-year holding period requirement, stockholders have two options, they can (i) exchange their stock for buyer stock (QSBS or non-QSBS) in a Section 368 tax-free reorganization or Section 351 nonrecognition

exchange or (ii) take advantage of Section 1045 by selling their Original QSBS and reinvesting the proceeds in Replacement QSBS. If the five-year mark is approaching, it may be possible to postpone the closing until after the five-year mark has passed by coupling an option or deferred closing with a management arrangement. Care must be taken to structure the transaction properly to minimize arguments that the arrangement represented a completed sale at the outset.

Many M&A transactions include a rollover equity piece where some or all target stockholders are asked to roll over some percentage of their equity into buyer equity. If target stockholders are holding QSBS, these rollover arrangements must be carefully structured to preserve QSBS status, or at the very least, the target stockholders should take into account their loss of QSBS status when considering the overall benefits of the transaction. A taxable rollover may be the preferred choice if sellers ae able to claim Section 1202's gain exclusion.

Deferred payments, escrows and earn-outs are common elements of deals today. Most of these payments are treated as Section 453 installment payments and are a part of the purchase consideration for purposes of claimin Section 1202's gain exclusion. The instructions to Schedule D explain how to report the claiming of Section 1202's gain exclusion when there are installment payments (deferred purchase payments, escrows and earn-outs). A stockholder who has held QSBS for more than five years and anticipates receiving less than $10 million in aggregate consideration should consider electing out of Section 453 installment sale treatment and claiming the gain exclusion with respect to both the upfront and deferred purchase consideration. More difficult planning issues arise if the selling stockholders have not held their QSBS for more than five years and are looking to reinvest sales proceeds under Section 1045. Section 1045 literally states that Replacement QSBS must be purchased within 60 days of the sale date. In some installment sales, little or no consideration is paid at closing and if there is an earn-out, it may be difficult to anticipate how much of the additional purchase consideration will ultimately be earned. All of this renders problematic the requirement that all of the up-front and deferred sales proceeds be reinvested in Replacement QSBS within 60 days of the original sale day. In spite of the literal language of Section 1045 which supports a conclusion that sales proceeds must be reinvested within 60 days of the original sale, there is support in Section 1045's regulations and other tax authorities for the argument that the 60-day period should run from the date installment payments are made. In light of these dueling tax authorities, the conservative approach would be to find a way to obtain the necessary funds and make the reinvestment in Replacement QSBS within the 60-day period following the closing of the sale of the Original QSBS.

## N. Compensation arrangements for family offices and PE Firms holding QSBS

If a family office or PE Firm wants its professionals to be positioned to take advantage of Section 1202's gain exclusion, the compensation arrangement should involve a capital or profits interest (carried interest) if ownership is through a Partnership. And, the service provider should hold the capital or profits interest on the day the Partnership invests in QSBS. As discussed above, there is a lack of consensus among tax professionals whether the holder of a profits (carried) interest shares in Section 1202's gain exclusion. If a Partnership profits or capital interest issued to a service provider is subject to vesting, a Section 83(b) election should be filed.[32]

If services providers hold QSBS directly, a Section 83(b) election should be filed if the stock is subject to substantial risk of forfeiture under Section 83 (vesting), otherwise the holding period won't commence for Section 1202 purposes until the QSBS vests.

A bonus or option arrangement, either at the Partnership level or the issuing corporation level, won't qualify as "stock" (or QSBS) for federal income tax purposes and won't start the holding period running for purposes of claiming Section 1202's gain exclusion. A SAFE instrument or convertible debt instrument typically isn't treated as "stock" for federal income tax purposes but might under certain circumstances qualify as "equity" (stock), applying a debt-versus-

equity analysis. But if the goal is to provide a degree of certainty with respect to qualifying for Section 1202's benefits, a stock grant (whether vested or unvested stock) is the safest approach.

## O. Equity compensation arrangements for businesses issuing QSBS

If a planning goal of management/owners is for employees to benefit from Section 1202's gain exclusion, compensation arrangement should involve a direct issuance of stock (vested, or coupled with a Section 83(b) election). Ownership can also be structured through an upper-tier Partnership owned by employees that in turn is issued QSBS by the C corporation. Section 1202 permits QSBS to be issued for services. Founder stock is often issued for nominal consideration due to the *de minimis* value of business.

As discussed in Section N, a bonus or option arrangement either at the Partnership level or the issuing corporation level, won't qualify as "stock" (or QSBS) for federal income tax purposes and doesn't start the five-year clock running for purposes of claiming Section 1202's gain exclusion. A SAFE instrument or convertible debt instrument isn't generally considered to be "stock" for federal income tax purposes, but could qualify as "equity" (stock) if run through a debt-versus-equity (Section 385) analysis. Nevertheless, a stock grant (whether vested or unvested stock) is the right approach if a key goal is to provide a reasonable degree of certainty with respect to qualifying for Section 1202's benefits.

## P. Navigating through potential tax issues associated with operating through a C corporation

As discussed above, the potential tax benefits associated with qualifying for Section 1202's gain exclusion are significant. The 21% corporate tax rate compares favorably with the 37% top individual marginal tax rate. Also, C corporations are not subject to the 3.8% investment income tax. While there certainly are indisputable benefits associated with operating as a C corporation, engaging in business through a C corporation brings with it several tax problems that must be managed.

A C corporation's taxable income is subject to federal income tax at the corporate level. The tax rate was reduced from 35% to 21% rate beginning in 2018. As noted above, this 21% corporate tax rate compares favorably to individual marginal tax rates ranging up to 37%. But unlike a Partnership, the profits of a C corporation are generally subject to double taxation if distributed to shareholders as dividends. It is possible to avoid double taxation by making deductible compensation payments, or by paying deductible license, lease or management fees, but there are limits to how much income can be flushed out of a C corporation in this manner without inviting IRS scrutiny. The IRS might argue that excessive payments do not qualify as reasonable ordinary and necessary expenses.

C corporations that throw off unneeded cash are potentially subject to the accumulated earning tax, a provision that is intended to severely penalize C corporations that fail to distribute excess profits. The personal holding company tax is another possible surtax. The imposition of these additional taxes can often be avoided through careful planning. From a choice of entity standpoint, the best type of business to operate through a C corporation is one that can take full advantage of the 21% corporate tax rate, reinvest profits to grow enterprise value and position stockholders to claim Section 1202's gain exclusion. But with careful planning, even corporations that generate substantial excess cash can operate successfully within a C corporation.

There must be a taxable sale or exchange of stock in order to take advantage of Section 1202's gain exclusion.[33] A significant aspect of QSBS planning is considering whether a future stock sale is a reasonable planning goal, hopefully within a reasonable period after the five-year holding period requirement is satisfied. A plan to take full advantage of Section 1202 will fail if buyers refuse to purchase stock or substantially reduce their offer versus what they would pay

for assets. Unlike purchasers of stock, purchasers of other tangible and intangible assets are able to amortize their purchase consideration over 15 years for goodwill and sometimes over a shorter period for tangible personal property. Finally, if an exit in less than five years is a real possibility, owners should consider whether it is worth pursuing Section 1202's gain exclusion, perhaps taking into consideration whether a nontaxable stock-for-stock exchange (i.e., keeping QSBS status alive) is a reasonably likely scenario.

## Q. Closing remarks

In spite of the potential for extraordinary tax savings, many business owners and otherwise experienced tax advisors are unfamiliar with Sections 1202 and 1045. Given the challenges associated with structuring investments in QSBS and documenting Section 1202 or Section 1045 eligibility, we recommend that family offices and PE Firms learn the basics necessary for making informed business decisions regarding QSBS issues and identify tax advisors who have extensive experience working with QSBS. Business owners and professionals interested in learning more about QSBS planning opportunities are directed to the QSBS articles on the Frost Brown Todd website.

---

[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[2] The functioning of the gain exclusion cap is actually more complicated than this summary. It is possible to take advantage of both the $10 million cap and separately the 10X cap when QSBS of a particular issuing corporation is sold by stockholder over two or more years.

[3] Gain excluded includes capital gains, the 3.8% investment income tax and the alternative minimum tax. This means that approximately $2,380,000 of taxes are excluded at the federal level when a stockholder has a $10 million gain arising out of a qualifying sale of QSBS. This Guidebook focuses on the federal income tax consequences associated QSBS. Many states, but not all, follow the federal treatment of QSBS.

[4] There are arguments for and against the position that each spouse has a separate $10 million gain exclusion. But if there is an opportunity to plan in advance, the prudent course would be to gift stock to a non-grantor trust or taxpayers other than the grantor's spouse.

[5] Other sections of this Guidebook address planning opportunities and tax issues associated with using a buyer corporation to purchase a target company's stock.

[6] Section 1202 doesn't address the extent to which a corporation can engage in the active conduct of a business through the ownership of joint venture interests. The concept of a corporation engaging in the "active conduct of a trade or business" is found in Section 355, which also includes in Section 355(b)(3)(A) the concept that for purposes of determining whether the corporation is engaged in an active conduct of a trade or business, such corporation's affiliated group of corporations is treated as one corporation. Section 355 doesn't explicitly address engaging in an active business through LLC (partnership) affiliates. Nevertheless, in Revenue Ruling 2007-42, the IRS concluded that a corporation that engaged in no active and substantial management functions for an LLC met the active conduct of a trade or business requirement through its "substantial" (33.33%) ownership of an LLC. In 2005, Congress amended Section 355 by adding Section 355(b)(3), which simplifies the active trade or business requirement as it applies to affiliated group. The statute, however, only explicitly addressed corporate affiliated groups. The Treasury Department followed upon the amendment of Section 355 with the issuance of Proposed Regulation Section 1.355-3 dealing with the active business requirement, and such Proposed Regulations do address satisfying the active business requirement through the holding of partnership interests. Proposed Regulation Section 1.355-3(b)(2)(v) provides that a corporate partner in a partnership will be attributed the trade or business assets and activities of that partnership during the period that such corporate partner owns a significant interest in the partnership. Examples (23) and (24) in those Proposed Regulations confirm that holding at least a 33 1/3% interest is deemed to be a significant interest. These proposed regulations "codify" Revenue Rulings 92-17, 2002-42 and 2002-49, and expand those rules to adopt an approach that is consistent with the continuity of business enterprise regulations (Treasury Regulation Section 1.368-1(d)). Treasury Regulation Section 1.368-1(d)(4(iii)(B) provides that a corporation will be treated as conducting a business of a partnership if the corporation owns "an interest in the partnership representing a significant interest in that partnership business" or the corporation has "active and substantial management functions

as a partner with respect to the partnership business." Example (10) confirms that a "significant interest" means owning at least a 33 1/3% interest in a partnership.

[7] See Section 1223(13).

[8] Note that there are no tax authorities addressing the details of how Section 1202(e)(2) functions with respect to start-ups either engaged in creating a new qualified business activity or acquiring assets or equity of a business engaged in qualified activities, or both, but given the language of Section 195's regulations, we believe that it would be an uphill battle for the IRS to argue that Section 1202(e)(2) doesn't encompass both creating and acquiring a qualified small business.

[9] The Protecting Americans from Tax Hikes Act of 2015 made the 100% exclusion under Section 1202 permanent. Gain excluded under Section 1202 is not subject to the 3.8% net investment income tax or the alternative minimum tax.

[10] July 17, 2017, letter from the National Venture Capital Association to Orrin Hatch, Chairman of the Senate Finance Committee.

[11] Victor Fleischer, The New York Times DealBook, "Tax Extenders that Slip Under the Radar" (January 15, 2013).

[12] Adam Looney, The Brookings Institution, Up-Front Blog, "The next tax shelter for wealthy Americans: C-corporations" (November 30, 2017). The blog was focusing on tax law changes proposed as part of the 2017 federal tax legislation.

[13] Legislation introduced on April 20, 2023, by Tennessee Congressman David Kustoff and Texas Senator John Cornyn.

[14] If the transaction is a stock sale, a buyer won't qualify for an inside basis step-up and the opportunity to amortize purchased goodwill over 15 years under Section 197. Plus, buyers generally prefer assets acquisition over stock acquisitions because the risk of assuming unknown liabilities is reduced.

[15] One eligibility requirement of Section 1202 is that QSBS must held for more than five years.

[16] This a merely a summary of Section 1202's eligibility requirements put together as introductory background information. The requirements are not addressed in sufficient detail to be relied upon or used for planning purposes.

[17] The parent corporation can be a C or S corporation.

[18] It may be possible for SAFE instruments and debt instruments (e.g., convertible notes) to actually qualify as "stock" for federal income tax purposes based on a debt versus equity analysis under Section 385 and other tax authorities.

[19] The holding period for QSBS is calculated by excluding the date of issuance and including the date of sale. If QSBS ss issued on January 1, 2023, then Section 1202(a)(1)'s requirement that QSBS be held for more than would be satisfied on January 2, 2028. See Revenue Ruling 66-5, 1966-1 CB 91.

[20] Section 1202 provides that when property is contributed to a corporation in exchange for QSBS, the property is treated as having been contributed for purposes of Section 1202 at its fair market value rather than adjusted tax basis. This treatment is relevant for purposes of the 10X Cap which runs off of fair market value, and also for purposes of calculating whether the corporation has passed or failed the $50 Million Test.

[21] The issuing corporation should have a bona-fide business reason for obtaining the additional funding beyond providing stockholders with additional tax basis for purposes of taking advantage of the 10X Cap.

[22] Nevada is another favored jurisdiction for formation of asset protection (non-grantor) trusts for QSBS and other planning purposes.

[23] Section 1202(g)(3) provides that the amount of gain exclusion available to a member/partner when a Partnership sells QSBS is limited to the amount available to the member/partner by reference to the member/partner's "interest" in the Partnership on the date the QSBS was acquired. Section 1202(g)(3) refers to "**Limitation based on interest originally held by taxpayer**" and provides that "*paragraph (1) shall not apply to any amount to the extent such amount exceeds the amount to which paragraph (1) would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired.*" Treasury Regulation Section 1.1045-1(d)(2) provides that a member/partner's interest is "*smallest percentage interest in partnership capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is sold to reflect any reduction in the capital of the eligible partner including a reduction as a result*

*of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest by the eligible partner, but excluding income and loss allocations.*"

[24] See footnote iii.

[25] Revenue Procedure 93-27, 1993-2 C.B. 343.

[26] Treasury Regulation Section 1.1045-1(d)(1)(ii), (d)(2), (e)(2)(A)-(B).

[27] Treasury Regulation Section 1.1045-1(g)(3)(ii) provides that for purposes of determining who is an eligible partner for Section 1045 purposes, a taxpayer who acquires from an Owner (other than a C corporation) by gift or at death an interest in a Fund that holds QSBS is treated as having held the acquired interest in the Fund during the period the Owner hold the Fund interest.

[28] See Treasury Regulation Section 1.1045-1.

[29] See Section 1045 and Treasury Regulation Section 1.1045-1.

[30] Under the $50 Million Test, a corporation can no longer issue QSBS once its "aggregate gross assets" exceed $50 million. Typically, "aggregate gross assets" means the sum of cash and the adjusted tax basis of other assets, but if assets are acquired in a nontaxable contribution under Sections 108, 351 or 368, the assets are valued at fair market value at the time of contribution for purposes of the $50 Million Test. There are circumstances addressed in Section 1202 where the assets of a parent corporation or subsidiary would be included in the calculation of the $50 Million Test.

[31] Section 1202 has a requirement that at least 80% by value of the issuing corporation's assets be used in undertaking one or more qualified business activities during substantially all of a stockholder's holding period for QSBS.

[32] Under Revenue Procedure 2001-43, 2001-2 C.B. 191, a Section 83(b) election isn't required when a profits interest is subject to substantial risk of forfeiture (vesting) under Section 83, but the safe approach is to file the election to cover the situation where the interest doesn't, in fact, meet the requirements for a profits interest under Revenue Procedure 93-27, 1993-2 C.B. 343.

[33] A stock exchange can include redemptions that are treated as an exchange under Section 302.