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How to turn startup profits into 100% tax-free gain under the qualified small business stock rules

Successful startups can pay off big for those who get in on the ground floor, and the qualified small business stock (QSBS) provisions of Code Sec. 1202 can turn that big payoff into tax-free gain. However, time may be of the essence: under current law, the 100% exclusion won't apply for QSBS *acquired* after 2013. This *Practice Alert* provides an overview of the principal rules and opportunities.

Overview. Noncorporate taxpayers may exclude from gross income 100% of any gain realized on the sale or exchange of QSBS held for more than five years if the QSBS is acquired after Sept. 27, 2010 and before Jan. 1, 2014. (Code Sec. 1202(a)(4)) The exclusion is less than 100% for QSBS acquired during earlier periods. For example, it's 75% of gain for QSBS acquired after Feb. 17, 2009 and before Sep. 28, 2010. Excluded gain is subject to a cumulative and annual dollar limitation. (Code Sec. 1202(a)(4), Code Sec. 1202(b)(1) , Code Sec. 1202(b)(2))

Additionally, there's a temporary alternative minimum tax (AMT) break. Normally, there is an AMT preference for a portion of gain from the sale or exchange of QSBS that is excluded from gross income for regular tax purposes under Code Sec. 1202. However, the preference doesn't apply to QSBS acquired after Sept. 27, 2010 and before Jan. 1, 2014. (Code Sec. 1202(a)(4)(C))

A noncorporate taxpayer's net capital gain that is adjusted net capital gain is taxed at a rate of 20%, 15%, or 0%. (Code Sec. 1(h)(1), Code Sec. 1(h)(1)(C)) Net capital gain attributable to "section 1202 gain" (as well as collectibles gain) is taxed at a maximum rate of 28%. (Code Sec. 1(h)(1)(E), Code Sec. 1(h)(4)) Section 1202 gain is the excess of (1) the gain that would be excluded from gross income on the sale of certain QSBS under Code Sec. 1202, if the percentage limitations of Code Sec. 1202(a) didn't apply, over (2) the gain actually excluded under Code Sec. 1202. (Code Sec. 1(h)(7))

For tax years beginning after Dec. 31, 2012, a 3.8% surtax applies to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over the threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case). (Code Sec. 1411(a)(1), Code Sec.

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1411(b)) MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income under Code Sec. 911a)(1)) (net of the deductions and exclusions disallowed with respect to the foreign earned income). (Code Sec. 1411(d))

Qualifying as QSBS. Stock qualifies as QSBS only if it meets all of the following tests. (Code Sec. 1202(c), Code Sec. 1202(d), Code Sec. 1202(e))

(1) It must be stock in a C corporation (that is, not S corporation stock) originally issued after Aug. 10, '93.

(2) As of the date the stock was issued, the corporation was a domestic C corporation with total gross assets of $50 million or less (a) at all times after Aug. 9, '93, and before the stock was issued, and (b) immediately after the stock was issued. Gross assets include those of any predecessor of the corporation, and all corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.

> O**bservation:** This $50 million limitation means that the company must be relatively small when it begins life, but if all the conditions are met, the Code Sec. 1202 exclusion is available no matter how large it grows.

(3) In general, the taxpayer must have acquired the stock *at its original issue* (either directly or through an underwriter), either in exchange for money or other property or as pay for services (other than as an underwriter) to the corporation.

(4) During substantially all the time the taxpayer held the stock:

... The corporation was a C corporation;

> **Caution:** It is common for startup businesses to initially elect to be S corporations, mainly so that they can pass through to their shareholders losses that they anticipate incurring in their early years of operation. However, the decision to make an S election for a startup should be carefully considered if the shareholders anticipate taking advantage of the QSBS gain exclusion. If the S election results in the corporation not being a C corporation during "substantially all" of a given shareholder's holding period for the stock, the

QSBS gain exclusion won't be available to that shareholder. Note that neither Congress nor IRS has given any indication as to what is "substantially all" of a shareholder's holding period for this purpose.

... At least 80% of the value of the corporation's assets were used in the "active conduct" of one or more qualified businesses (see below); and

... the corporation was not a foreign corporation, domestic international sales corporation (DISC), former DISC, regulated investment company (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), financial asset securitization investment trust (FASIT), cooperative, or a corporation that has made (or that has a subsidiary that has made) a Code Sec. 936 election.

Active conduct of a qualified business. For purposes of the rule requiring 80% of the value of assets to be used in the active conduct of a qualified business, all of the following are treated as used in the active conduct of a qualified business:

(A) Assets used in certain activities relating to *future* qualified businesses, without regard to whether the corporation has any gross income from these activities at the time this rule is applied. Those activities are (a) Code Sec. 195(c)(1)(A) startup activities, (b) activities that result in paying or incurring qualifying research and experimental expenditures under Code Sec. 174, and (c) activities relating to in-house research expenses. (Code Sec. 1202(e)(2))

(B) Assets held to meet the "reasonably required working capital needs" of a qualifying business, and assets held for investment that are reasonably expected to be used within two years to finance research and experimentation in a qualified business or to finance increases in the working capital needs of such a business. (Code Sec. 1202(e)(6)) But, after the corporation has been in existence for at least two years, no more than 50% of its assets may qualify as being used in the active conduct of a qualified business because of these rules. (Code Sec. 1202(e)(6))

Observation: Under Reg. § 1.537-2(b)(4), earnings and profits accumulated "to provide necessary working capital" for a business are not subject to the accumulated earnings tax. The *Bardahl* formula has been applied to calculate "necessary working capital." Although neither Congress nor IRS has indicated that these rules have application for Code Sec. 1202 purposes, it would appear that the reg and other rules that have been developed to interpret the reg, including the *Bardahl* formula, have application for purposes of computing "reasonably required working capital needs."

(C) The rights to computer software which produces active business computer software royalties as defined in Code Sec. 543(d)(1). (Code Sec. 1202(e)(8))

A corporation will be treated as failing to meet the active business requirement for any period during which: (1) more than 10% of the value of its assets in excess of its liabilities consists of stock or securities in other corporations which are not subsidiaries of the corporation, other than working capital assets; or (2) more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified business (for this purpose, owning, dealing in, or renting real property is not considered to be the active conduct of a qualified business). (Code Sec. 1202(e)(5)(B), Code Sec. 1202(e)(7))

Note that a corporation will be treated as meeting the active business requirement for any period during which it is a specialized small business investment company (SSBIC). (Code Sec. 1202(c)(2)(B)(i))

Qualified business. For QSBS purposes, a qualified business can't be (Code Sec. 1202(e)(1), Code Sec. 1202(e)(3)):

- A business involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services.

  Observation: Note that the rule in the first bullet is limited to service businesses, while the rule in the second, below, is not so limited.

- A business whose principal asset is the reputation or skill of one or more employees.

  Observation: There is no other instance in which either the Code or the regs use the term "principal asset" in the context of an intangible human quality like "reputation" or "skill." And, the relevant Congressional Committee reports do

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not add any insight as to Congress's intent regarding this language. Thus, it is quite unclear which trades or businesses will fail the qualified business test as a result of this language, or which more-specific characteristics of any given trade or business are indicative of it failing this test.

- A banking, insurance, financing, leasing, investing, or similar business.
- A farming business (including the raising or harvesting of trees).
- A business involving the production of products for which percentage depletion can be claimed.
- A business of operating a hotel, motel, restaurant, or similar business.

Dollar limit on eligible gain. For each tax year, for each corporation in which the taxpayer sells or exchanges QSBS, the amount of gain eligible for the exclusion can't exceed the greater of:

(1) $10 million ($5 million for married persons filing separately), less the total amount of eligible gain (i.e., gain on the sale or exchange of QSBS held for more than five years) taken into account under the Code Sec. 1202(a) rules by the taxpayer with respect to dispositions of stock issued by the corporation in all earlier tax years, or

(2) 10 times the taxpayer's total adjusted basis in QSBS of the corporation disposed of by the taxpayer in the tax year. (Code Sec. 1202(b)(1))

Illustration 1: Anderson, a single taxpayer, acquires 10,000 shares of QSBS in Corp A on Nov. 15, 2013 at $10 per share, for a total cost of $100,000. This is the only QSBS he has ever owned. Anderson sells all 10,000 Corp A shares in 2020 for $20.1 million ($2,010 per share). The maximum gain eligible for exclusion is the greater of (1) $10 million; or (2) $1 million, i.e., 10 times his $100,000 total basis in the 10,000 shares. Thus, on his 2020 individual return, Anderson can exclude $10 million of the gain.

Observation: The balance of Anderson's gain should, under current rules, be taxed at a maximum rate of 20% (the 3.8% surtax on net investment income also may apply). The $10 million excess over the excluded gain of $10 million is not treated as section 1202 gain subject to the 28% rate under Code Sec. 1(h)(7), because the current 100% percentage limitation under Code Sec. 1202 does not affect the amount excludible. Rather, the exclusion is capped by the

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dollar limitation of Code Sec. 1202(b)(1). This result is supported by an example at page 149 of S. Rpt. 105-174 to P.L. 105-206 (the Internal Revenue Service Restructuring and Reform Act of 1998 ('98 RRA).

Observation: The limit in (1) is expressed as a dollar cap of $10 million ($5 million for separate filers) and also is a cumulative cap with respect to dispositions of stock of the same corporation. By contrast, the limit in (2) does not have a dollar cap-instead, the limit is based on the basis in the QSBS shares-and is an annual limit. Thus, by stretching out sales of QSBS of the same corporation, a taxpayer may be able to exclude more than $10 million of gain.

Illustration 2: Baker, a single taxpayer, acquires 10,000 shares of QSBS in Corp B on Dec. 15, 2013 at $500 per share, for a total cost of $5 million. This is the only QSBS he has ever owned. Baker sells 5,000 Corp B shares in 2020 for $12.5 million ($2,500 per share). His entire profit of $10 million ($12.5 million minus $2.5 million cost) is excluded. In 2021, he sells his 5,000 remaining Corp B shares for $12.5 million. His $10 million profit for 2021 also will be excluded. The maximum gain eligible for exclusion for 2021 is the greater of: (1) zero ($10 million less the $10 million he excluded in 2020); or (2) $25 million, i.e., 10 times his $2.5 million basis in the 5,000 shares he sells in 2021.

Observation: Obviously an investor in Baker's situation would spread out sales only if he thought his QSBS shares would remain at the same price or appreciate in value.

Other rules. The complex QSBS requirements include anti-abuse provisions (Code Sec. 1202(c)(3)), special rules for taxpayers or related parties that take certain short positions in the stock (Code Sec. 1202(j)), stock held by passthroughs (Code Sec. 1202(g)), and gifts and bequests (Code Sec. 1202(h)).

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