Section 1202: A Big Deal for Small Business: QSBS

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Section 1202 was enacted in 1993 as an incentive for taxpayers to start and invest in certain small businesses.

Currently, the statute provides an exclusion from income for any gain from the sale or exchange of "qualified small business stock" (QSBS) acquired after the effective date of the statute and held for more than five years.

However, the amount of gain that is excludible from income depends on when the QSBS was originally issued. The gain exclusion is 50% for QSBS issued before February 18, 2009, and 75% for QSBS issued between February 18, 2009 and September 27, 2010.

The Creating Small Business Jobs Act of 2010 increased the exclusion to 100% of the total gain for all QSBS issued after September 27, 2010.

Despite this additional incentive, many businesses shied away from planning for QSBS because only the stock of C corporations qualified. Unless business founders had planned from inception to use the sale of stock as an exit strategy, founders were reluctant to voluntarily impose "double taxation" (i.e., income taxes at both the corporate level and the shareholder level) on the corporation's taxable income.

Planning for QSBS became important for many more enterprise founders due to the reduction of the corporate rate to 21% under the 2017 tax legislation. Now is the ideal time to review the fundamentals of QSBS treatment and the particulars of section 1202.

I. Overview of Section 1202

A. Basic Mechanics

Section 1202 allows a taxpayer to exclude 100% of the eligible gain realized from the sale or exchange of QSBS issued after September 27, 2010 and held for more than five years. QSBS must be issued by a "qualified small business" and generally be acquired by the taxpayer at original issuance, either in exchange for cash or other property (not including stock) or as compensation for services rendered to the corporation (other than services an underwriter of the stock).

B. Limitations on Gain Exclusion

The statute limits the per-issuer amount that can be excluded to "eligible gain," which is the greater of:

1) $10 million reduced by any amount the taxpayer excluded from sales or exchanges of QSBS from the same issuer in prior years, or
2) 10 times the aggregate adjusted basis of the QSBS issued by the corporation disposed of by the taxpayer during the taxable year, as measured on the original issue date.

Because the limitation references the higher amount of the two measurements, the potential total gain excluded from gross income may exceed $10 million. Because a corporation qualifying for the provision could have up to $50 million in assets upon inception, the maximum amount of gain eligible for exclusion could reach $500 million under the ten-times-basis limitation.

C. The "Qualified Small Business"

A "qualified small business" is a domestic C corporation (C-Corp) that meets three threshold requirements:

1) The aggregate gross assets of the corporation, including any predecessor corporation, did not exceed $50 million at all times on or after August 10, 1993, and prior to issuance.
2) The aggregate gross assets of the corporation immediately after issuance (including amounts received upon issuance) did not exceed $50 million.
3) The corporation agrees to submit reports to the Secretary and its shareholders as the Secretary may require.

Upon satisfying these requirements, the corporation must also satisfy the "active business" test to be eligible for QSBS treatment. The active business test provides:

1) The corporation uses at least 80% of its assets (as measured by fair market value) in the active conduct of a "qualified trade or business" (the "80% test"); and

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2) The corporation is a C-Corp that is not a domestic international sales corporation (DISC) or former DISC, regulated investment company (RIC), real estate investment trust, real estate mortgage investment conduit, or cooperative.

For purposes of the 80% test, assets used in the active conduct of a qualified trade or business include:

(1) assets used in startup activities, research and development, and in-house research;
(2) assets held for reasonably required working capital needs;
(3) assets held for investment that are reasonably expected to be used within two years to finance research and development or increases in the working capital needs of the business, limited to 50% of the corporation's total assets after the corporation has existed for two years; and
(3) computer software rights leading to the production of section 543(d)(1) royalties.

D. Defining a "Qualified Trade or Business"

A "qualified trade or business" (QTB) is defined in section 1202(e)(3). This definition gained significant attention when the 2017 tax legislation "borrowed" and modified part of it to define and limit businesses eligible to take the deduction for qualified business income (QBI) under the new section 199A. Rather than identifying what a QTB is, section 1202(e)(3) sets forth what a QTB is *not*, namely:

1) 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 in which the principal asset of such trade or business is the reputation or skill of one or more of its employees;
2) Any banking, insurance, financing, leasing, investing, or similar business;
3) Any farming business (including the business of raising or harvesting trees);
4) Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or section 613A (i.e., oil or gas properties subject to depletion); and

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5) Any business of operating a hotel, motel, restaurant, or similar business.

Beyond this statutory description, scant guidance exists – perhaps because of the relative obscurity of the QSBS statute – to help taxpayers determine whether an activity is a QTB. Two private letter rulings and one tax court case comment on the subject. In PLR 201436001, a pharmaceutical research and clinical testing company was a QTB because it did not "offer value to customers primarily in the form of services … [or] individual expertise."

Likewise, in PLR 201717010, a health care technology company providing laboratory reports was a QTB because the company never offered a patient a "diagnosis or treatment recommendation," but rather only issued the reports. In *Owen v. Commissioner*, the Tax Court concluded that a corporation's principal asset did not include the reputation or skill of one or more employees even though the court acknowledged that the success of the corporation was attributable to its owners.

Otherwise, practitioners may need to look to other guidance defining these terms, such as section 448 and the regulations thereunder.

E. Holding QSBS in a Pass-Thru Entity

Section 1202(g) permits taxpayers to hold QSBS through any partnership, subchapter S corporation, RIC, or common trust fund. Generally, however, a transfer of originally issued QSBS to a pass-thru entity will cause the QSBS to cease to be treated as QSBS. For example, if QSBS is transferred to a partnership in exchange for a partnership interest, gain realized on the disposition of the stock by the partnership would not be eligible for exclusion under section 1202(a).

Any QSBS held via pass-thru entity will enjoy the same treatment as QSBS held directly to the extent the pass-thru entity meets all requirements otherwise applicable to an individual holder of QSBS.[21] Taxpayers must hold the interest in the pass-thru entity for at least five years, as well; for instance, a taxpayer may not acquire an interest in a partnership that has held QSBS for ten years, then sell the interest two days later and receive QSBS treatment. Disallowance of QSBS treatment would likewise apply if the aforementioned hypothetical taxpayer received a distributive share of partnership income attributable to the sale of QSBS shortly after acquisition of a partnership interest.

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F. Allowable Transfers and Entity Conversions

Section 1202(h) allows for transferees to receive QSBS that retains its character as QSBS in certain permitted transfers. The list of permitted transfers generally reflects a policy of blessing certain QSBS dispositions that provide for carry-over basis treatment. For instance, if a taxpayer holds QSBS through a tax partnership from first issuance, distribution of the QSBS from the partnership to the taxpayer in a non-recognition transaction will allow the taxpayer to tack the partnership's QSBS eligibility and holding period to her own. If a taxpayer gifts or bequeaths QSBS, the recipient of the QSBS will also be allowed to tack QSBS eligibility and holding period.

Tax-deferred incorporations and reorganizations enjoy similar treatment: any successor stock received in exchange for QSBS will also retain its character and holding period. If a taxpayer holds QSBS and exchanges it for non-QSBS in a section 351 or section 368 transaction, the non-QSBS received will be treated as QSBS to the extent of the built-in gain on the date of the reorganization.

For example, assume Acme Corp. issues QSBS to Tom Taxpayer in 2012, and Tom Taxpayer has a basis of $1 per share. In 2018, after meeting all applicable requirements imposed by section 1202 for the entirety of Tom Taxpayer's holding period, Acme Corp. merges with Widget Corp. Assume that the adjusted basis of Acme Corp. stock in the hands of Tom Taxpayer remains $1, but Widget Corp. values Acme Corp.'s shares at $11 per share. Unlike Acme Corp., the stock of Widget Corp. is non-QSBS. Under section 1202(h)(4)(B), the Widget Corp. stock that Tom Taxpayer received in exchange for his Acme Corp. stock is treated as QSBS to the extent of the $10-per-share built-in gain at the time of the merger. If Tom Taxpayer sells his Widget Corp. stock when it appreciates to $26 per share, he will enjoy a section 1202(a) exclusion for $10 per share of his gain but will not be able to apply section 1202(a) to the remaining $15 per share of his gain.

G. Section 1045: QSBS Rollovers

Section 1045 allows a taxpayer to "roll over" gain on the disposition of QSBS into QSBS of a different issuer, provided the QSBS is held for more than six months prior to disposition and the rollover occurs within 60 days. If the taxpayer does not purchase "replacement" QSBS with a fair market value equal to or greater than the "relinquished" QSBS, the taxpayer will recognize "boot" in the form of capital gain, similar to the treatment of a section 1031 exchange. For purposes of determining the five-year QSBS

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holding period, the taxpayer's holding period in the "relinquished" QSBS will count toward the holding period of the "replacement" QSBS.
For example, assume Tina Taxpayer has a $100,000 adjusted basis and a three-year holding period in her Acme Corp. QSBS. Tina then sells her Acme Corp. QSBS for $1 million. Within 60 days of her original sale, Tina purchases Widget Corp. QSBS for $850,000. Tina takes a $100,000 carry-over basis in her Widget Corp. QSBS and recognizes $150,000 of capital gain. To avoid recognition of capital gain entirely, Tina could have reinvested the remaining $150,000 into Widget Corp. QSBS or the QSBS of a different issuer. Tina's three-year holding period in the Acme Corp. QSBS carries over to her new Widget Corp. QSBS. Thus, Tina would only need to hold her Widget Corp. QSBS for two additional years to qualify for gain exclusion from the sale or exchange of the Widget Corp. QSBS.

II. Traps for the Unwary

A. Put Options as Dispute Resolution

Section 1202(j) prohibits the application of Section 1202(a) to exclude gain from the sale of QSBS from a taxpayer's gross income if the taxpayer holds an "offsetting short position" with respect to the QSBS. Although the statute was clearly designed for taxpayers who actively seek out strategies to mitigate their economic risk of loss for QSBS holdings, no statutory or regulatory exception exists for the common dispute resolution strategy of allowing shareholders to possess a put option for their stock that would allow the shareholder to exit by compelling a sale to either another shareholder or the corporation itself. Practitioners who are not mindful of section 1202(j) could inadvertently trigger its application by attempting in good faith to set up a method for the corporation to avoid a crippling impasse between its principals.

B. Failure to Monitor Assets or Spend Working Capital

As described above, section 1202(e) measures the "active business requirement" by examining how the corporation uses its assets. Section 1202(e)(1)(A) requires the corporation to use 80% of its assets in the active conduct of a qualified trade or business. While section 1202(e) provides a list of exceptions, failure to meet the requirements of section 1202(e) could result in a tax disaster. Corrective action may cure such a failure, but any rescue attempt must be completed quickly to allow the taxpayer to meet the "substantially all" requirement in section 1202(c)(2)(A). Because no bright-line standard exists for measuring "substantially all of the taxpayer's holding period" for QSBS, time is of the essence for taxpayers and their advisors to discover and

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remedy any facts or circumstances causing less than 80% of assets to be used in a qualified trade or business.

III. Interplay with the 2017 Tax Legislation

The 2017 tax legislation cut the statutory income tax rate on C-Corps from 35% (the maximum rate in a graduated rate provision) to a 21% flat rate, making the C-Corp a significantly more attractive choice of entity. Other changes in the tax act also favored C-Corps, such as the limitation on a non-corporate taxpayer's deduction for state and local income, property, and sales/use taxes, which is not applicable to C-Corps. The introduction of tax incentives for investment in qualified opportunity zones (QOZs) might be the second most important aspect of the 2017 tax legislation to favor planning for QSBS treatment. In brief, Congress provided for the deferral and partial forgiveness of capital gain that is reinvested into a QOZ and the exclusion from gross income of all subsequent appreciation, provided certain conditions have been met. Depending on Treasury's reconciliation of the incentives in section 1202 with the incentives in section 1400Z-2, seizing the tax advantages of QSBS could become even more compelling if the QSBS also satisfies the requirements to be treated as QOZ stock. In that case, adroit tax planning could result in the permanent exclusion from taxation of gain on the sale of the QSBS, provided forthcoming regulations do not prohibit the technique. The overlap of the QSBS and QOZ systems will require detailed rules, which are unlikely to be a part of the initial wave of QOZ guidance expected in the coming months.

IV. Conclusion

Section 1202 did not receive much attention from the tax community at large because of the relative unattractiveness of C-Corps, but with the passage of the 2017 tax legislation, now is the ideal time for practitioners to review the inner workings of the statute. Despite existing statutory and administrative ambiguity, taxpayers can obtain significant benefits from issuing QSBS, especially if they work closely with their tax advisors to avoid traps for the unwary. In the current environment, the cost-benefit analysis in the choice of entity decision will favor C-Corps more frequently when QSBS treatment applies. Although shareholders, accountants, and lawyers will need to jointly navigate the setup and operation of a corporation issuing QSBS, the reward at the end of the journey is well worth the complexity, and the tax advantages may become even more enticing if Treasury promulgates taxpayer-favorable regulations under section 1400Z-2.

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