Planning for Tech Entrepreneurs

Qualified Small Business Stock (QSBS)

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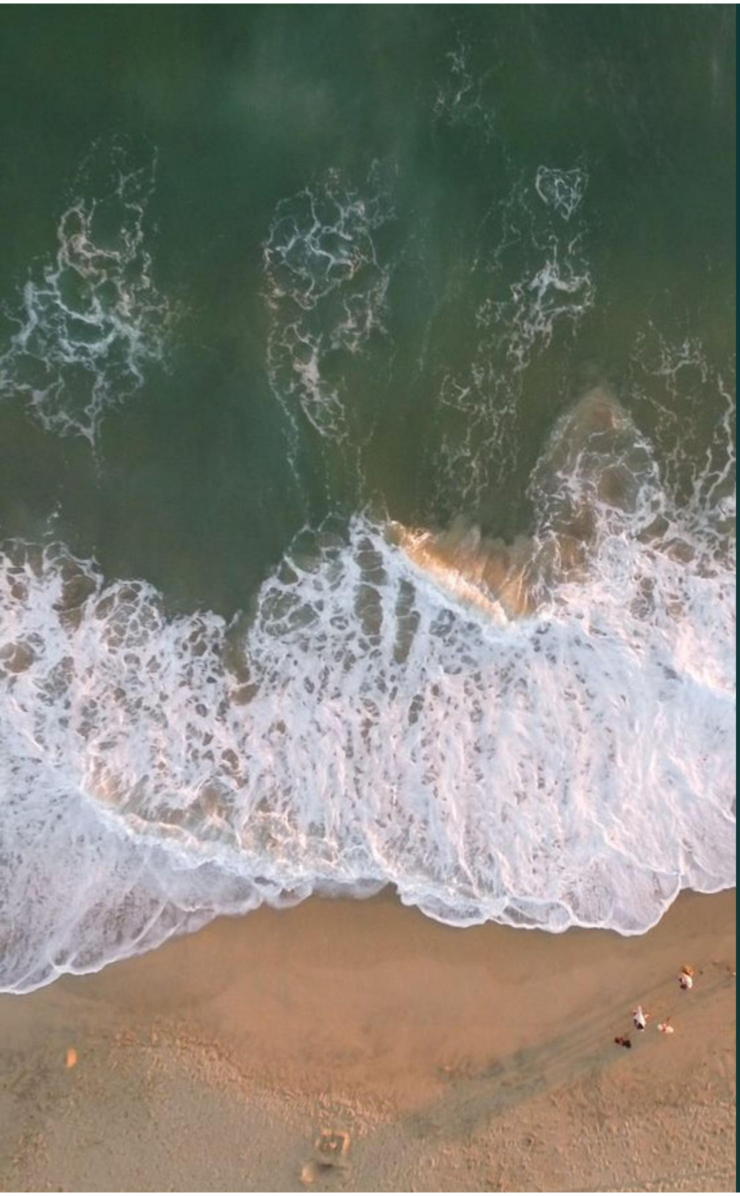

Agenda

A Little QSBS History….And Why Do We Care?

- The statute was added to the IRC in 1993. Regulations effective Dec. 31, 1997 deal with limited issues.
- Very little other guidance has been provided by the IRS in this area, several PLRs and several court cases.
- The original 50% exclusion was also a tax preference addback under AMT so the overall benefit was limited.
- Not much interest until the long-term capital gain rate increased from 15% to 20% in 2013. Then a lot more interest in late 2015 when shares issued after 9/27/2010 were allowed a 100% exclusion.
- The exclusion is generally $10 million per stock issuance (in some cases higher) which is roughly a $2.4 million federal tax savings.

QSBS General Requirements

- Domestic C-Corporation Stock Acquired at Original Issuance
- Qualified Small Business
- Active Business Requirement
- Qualified Trade or Business
- Five-Year Holding Period

QSBS General Requirements

C-corporation Stock Acquired at Original Issuance after August 10, 1993

- In exchange for money or other property (generally property determinations in accordance with §351 and case law)
- Repurchases – important to evaluate, may disqualify shares
- Stock received for services treated as issued/received when included in recipient's gross income in accordance with §83
- Exercise of options or warrants, conversion of convertible debt, conversion of SAFEs
  - Gross asset test at time of exercise/conversion
  - Holding period begins at time of exercise/conversion

QSBS General Requirements – Original Issuance Domestic C-Corp

STOCK RECEIVED IN EXCHANGE FOR QSB SHARES

- Corporate transactions (§368/§351)
- QSB exchanged for stock of another corporation
- Does the other corporation qualify as QSB?
- If other corporation does not qualify as QSB, then newly exchanged stock only QSBS to extent of gain that would have been recognized at the time of the §368/§351 transaction

QSBS General Requirements – Qualified Small Business

AGGREGATE GROSS ASSETS TEST

- At all times on/after date of enactment and before the issuances of stock being tested do not exceed $50 million.
- Immediately after issuance aggregate gross assets do not exceed $50 million
- Corporation to submit to IRS and shareholder any reports required by IRS (to date IRS has not required any reporting)
- Aggregate Gross Assets = Cash + Adjusted Tax Basis of all other property of the corporation
- If appreciated property is contributed to the corporation, then basis is fair market value at the time of contribution (also basis for the 10x annual exclusion amount)
- Aggregation rules for parent-subsidiaries (more than 50%, domestic or foreign entities)

QSBS General Requirements – Active Business Requirement

ACTIVE BUSINESS TEST

- At least 80% of assets (value) used in active conduct of qualified trade or business
- 80% test must be met during "substantially all" of the holding period of the shares ("substantially all" not defined but 80% is commonly used)
- Working capital considered 100% business asset during first two years of existence, then 50% thereafter

QSBS General Requirements – Qualified Trade or Business

- No professional service businesses

Ex: engineering, architecture, accounting, banking, insurance, farming, financing, leasing, production/extraction for which a deduction under §613, operating hotel/restaurant or similar business)

- Four PLRs issued in this area (five as of 11/5/21, see PLR 202144026)
- Questions exist for hybrid businesses such as Fintech and Healthtech

QSBS General Requirements – Five Year Holding Period

- Begins on original issuance date/exercise/conversion
- Continued QSBS status and tacking of holding period
- Gifts, death, partnership distributions, reorganizations, incorporations
- Partners can receive QSBS treatment for original shares acquired by a partnership, but it gets complicated

Gain Exclusion

Greater of $10 million (less any amounts previously excluded) or 10 times adjusted basis.

- **50% Exclusion** - Stocks acquired at original issuance from the domestic C corporation after Aug. 10, 1993, and before Feb. 18, 2009, qualify for 50% gain exclusion; however, there is a federal Alternative Minimum Tax preference addback of 7% of the excluded gain and the included gain is taxed at 28%.
- **75% Exclusion** - Stocks acquired at original issuance from the domestic C corporation after Feb. 17, 2009, and before Sept. 28, 2010, qualify for 75% gain exclusion; however, there is a federal Alternative Minimum Tax preference addback of 7% of the excluded gain and the included gain is taxed at 28%.
- **100% Exclusion** – Stocks acquired at original issuance from the domestic C corporation after Sept 27, 2010, or later qualify for 100% exclusion for both regular tax and AMT.

Generally, no gain exclusion if taxpayer takes any offsetting short positions with respect to the if stock held for less than 5 years.

Generally, must hold stock for 5 years before attempting to monetize.

§ 1045 Deferral

- Ability to sell QSBS held for more than 6 months and uses proceeds to purchase other QSBS within 60 days beginning on the date of sale
- Proceeds not used to purchase QSBS, gain recognized
- Basis in QSBS purchase price less unrecognized gain
- Original QSBS holding period counted
- Timely election – Code Q, form 8949
- Gain cannot be ordinary income
- Possible for partnership to rollover, specific requirements
- How can a serial entrepreneur use rollovers?

Estate Planning with QSBS

MAXIMIZING THE EXCLUSION (STACKING)

- Generally, one exclusion per taxpayer per stock issuance
- Married filing joint taxpayers - only one exclusion (some debate, but problematic language in the Code)
- Gifting shares - carryover basis, holding period tacks, and new $10 million exclusion
- §1045 rollovers - holding period tack and new $10 million exclusion.
- Most common form of "stacking" is via gifting to non grantor trusts, typically children of the shareholder. Need to be aware of §643(f) and possible combination of multiple trusts
- Ultimate sale of QSBS can happen at the trust level or the beneficiary level if shares are distributed

Hot Topics

MAXIMIZING THE 10x BASIS EXCLUSION

- General presumption – maximum exclusion is $10 million
- The rule is the greater of $10 million (cumulative limit) or 10x cost basis of the shares (annual limit)
- In many cases the 10x cost basis, especially with Tech companies, is generally a small number
- Special basis rule for the contribution of appreciated property – FMV is used rather than cost basis
- Reminder – FMV for contributed appreciated assets also applies for the $50 million test

Hot Topics (continued)

10x BASIS EXAMPLE

- A, an individual, forms a partnership in 2015 with other investors. Significant development work occurs within the partnership over a one-year period. Then partnership converts to a C corp via §351 (2016)
- 409A value at the time of conversion indicates the value of A's partnership interest is $8 million and cost basis is $0
- In 2021, more than five years from the date of the conversion to C corp, A sells all of the shares for $75 million, which results in a gain of the same amount
- The 10x basis QSBS exclusion is $80 million, however only $67 million of gain can be offset because the $8 million of appreciation at the time of the conversion is deemed basis for purposes of §1202

Hot Topics (continued)

CARRIED INTERESTS

- Interest must have been issued to the service partner prior to the partnership’s acquisition of the QSBS
- The service partner must have a partnership interest at the time of the purchase
  - §1045 rules require the service partner have a capital account at the time of purchase
- Limitation on the exclusion based on the partnership interest at the time of the acquisition….subsequent increase in capital does not generate additional QSBS
- Decreases in a partnership interest will decrease the allocated QSBS gains as well

Hot Topics (continued)

REORGANIZATIONS/INCORPORATIONS

- Contribution of appreciated property – basis for purposes of QSBS equals FMV
- Reorganizations – exchange of old QSBS for new QSBS in a tax-free reorganization results in carryover basis, holding period, and QSBS status going forward
- Reorganizations – exchange of old QSBS for new non-QSBS shares results in continued QSBS status, but gain is capped based on FMV at the time of the reorganization
- §351 rollovers in an acquisition can qualify if structured correctly

Hot Topics (continued)

REORGANIZATIONS/INCORPORATIONS-Example

- Facts:
  - A holds QSBS shares with current FMV of $5 million, zero cost basis, holding period of 4 years, which are exchanged for shares in a domestic C corp via triangular merger with consideration being $1 million cash and $4 million of shares of the buyer
  - The $1 million is boot and taxable at the time of the transaction (assuming the 5-year holding period is not met)
  - The shares received are not taxable currently, carryover basis and tacked holding period
  - The buyer is not a QSB
  - Assume A holds the shares for another 2 years and sells for $12 million
- Answer:
  - $4 million of gain qualifies for the QSBS exclusion, the rest is taxable
  - If the buyer was a QSB at the time of the exchange, then A can exclude $10 million of the gain

Hot Topics (continued)

REORGANIZATIONS/INCORPORATIONS

- Technically, a reorganization under §368
- §1202(h)(4) provides that in the case of a transaction described in §368 results in the receipt of shares which would not qualify as QSBS, then the QSBS status is retained, but gain is capped
- §1202(h)(3) provides that rules similar to §1244(d)(2) shall apply. §1244 relates to losses on small business stock
- §1244(d)(2) and the underlying regulations appear to provide relief for recaps and F reorgs, but its subject to interpretation
- Some risk that a recap could result in future appreciation not qualifying as QSBS

Hot Topics (continued)

QUALIFIED TRADE OR BUSINESS

- The IRS has issued PLRs in this area:
  - PLR 201436001, PLR 202114002, PLR 202125004, PLR 201717010 (five as of 11/5/21, see PLR 202144026)
- ~~Two~~ Three of the rulings are in the health care area, one in the insurance area, and one in the medical manufacturing area
- In all the rulings, the IRS concluded that the Taxpayer was engaged in a qualified trade or business
- Fintech
  - Is this “banking”, “financing”, or “similar business” under §1202(e)(3)(B)?

Proposed Tax Law Changes

- House Ways and Means Proposed Changes (as of 10/28/21)
- Retains §1202 rules for Taxpayers with $400k or less of AGI (1202 gain is included in AGI)
- Eliminates the 75% and 100% exclusion for Taxpayers with AGI above $400k
- Retains 50% exclusion for all Taxpayers
- Effective for sales occurring **after September 13, 2021**
- Proposed changes would still provide significant benefits

Key Points

- §1202 is still a valuable planning tool even given pending legislation
- The tests are many and fact-specific
- Not an election – missing proper treatment is an overstatement of tax!

QUESTIONS

Let’s start a conversation.

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