

## A "PATH" to Substantial Tax Savings: Qualified Small Business Stock

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In the early 1990s, Congress enacted the qualified small business stock ("QSBS") rules to incentivize equity investments in certain corporations. The QSBS rules reduce the effective federal income tax rate on the gain realized upon the sale of qualifying stock held by an eligible stockholder for more than 5 years. The maximum amount of gain that can be taken into account under the QSBS rules with respect to an eligible stockholder's stock in any single issuing corporation generally is the greater of \$10 million or 10 times the stockholder's applicable tax basis in such stock.

The effective federal income tax rate applicable to gain that is subject to the QSBS rules has varied significantly over the years. Depending on its year of issuance, qualifying stock generally could be eligible for a 50%, 75% or 100% exclusion from federal income taxation. In late 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") permanently extended the 100% exclusion from federal income taxation that previously had been in effect, including an exemption from the alternative minimum tax (still subject, however, to the preexisting "greater of \$10 million or 10 times tax basis" limitation). The PATH Act's QSBS provision has a retroactive effective date. As a result, the 100% exclusion from federal income taxation applies to qualifying capital gains from the sale or exchange of QSBS acquired after September 27, 2010 and held for more than 5 years. For stock acquired on or before this date, the QSBS rules still may apply, but with the less favorable exclusion percentages and the application of an add-back to taxable income under the alternative minimum tax rules.

Since most states generally follow the federal rules for determining a taxpayer's taxable income, a sale or exchange of QSBS typically also can result in reduced state income taxation, with California currently being one exception.

### Overview of QSBS Exclusion Percentages

The various applicable exclusion percentages (depending on the year of the QSBS's issuance), along with the resulting effective federal income tax rates, are summarized in the following chart:

Date QSBS Issued	Exclusion	QSBS Effective Tax Rate	Non-QSBS Effective Tax Rate
Aug. 11, 1993– Feb. 17, 2009	50%	16.88%	23.8%
Feb. 18, 2009– Sept. 27, 2010	75%	9.42%	23.8%
Sept. 28, 2010– on	100%	0%	23.8%

In the case of the 50% and 75% Exclusion scenarios in the above chart, (i) the QSBS Effective Tax Rates take into account the special 28% tax rate under the QSBS rules (plus the 3.8% net investment income tax) applicable to the remaining 50% or 25% (respectively) of taxable QSBS gain, and (ii) the alternative minimum tax add-back applicable to the 50% or 75% of non-taxable QSBS gain.

The QSBS Effective Tax Rates do not apply to gain realized in excess of the "greater of \$10 million or 10 times stock basis" limit, which

excess is subject to tax under the regular non-QSBS rules. The Non-QSBS Effective Tax Rate in the above chart assumes a 20% long-term capital gain rate and additional net investment income tax of 3.8%.

## Overview of QSBS Requirements

Even if stock was issued in a year in which the QSBS rules were in effect (whether at the 50%, 75% or 100% exclusion rates), numerous other requirements must be satisfied for a stockholder to qualify for the benefits of the QSBS rules. The following provides a general overview of the principal QSBS requirements. Note that special rules may apply in a number of circumstances that are not addressed in this summary (including, for example, rules relating to stock received in tax-free reorganizations or stock received by gift, death or distribution).

### Eligible Stockholders; Holding Period Requirement

Only non-corporate stockholders, including individuals, estates and trusts, qualify for the benefits of the QSBS gain exclusion rules. A non-corporate investor that owns an interest in a flow-through entity partnership (including an LLC taxed as a partnership) also may be eligible for the exclusion with respect to such investor's share of the gain from the sale of QSBS held by the flow-through entity, provided that certain special rules are satisfied. An otherwise eligible stockholder also must have held the QSBS for more than 5 years to be eligible for the exclusion.

### Qualified Small Business Stock

Stock generally is QSBS only if the stockholder acquired the stock at original issue from a domestic C corporation that is a qualified small business in exchange for money or property (other than stock) or as compensation for services to the corporation (other than as an underwriter).

#### *"Acquired at Original Issue" Requirement*

The tax benefits of the QSBS exclusion are available to stockholders (including service providers and founders) that acquire shares of stock from the issuing corporation. As previously described, the stock must be acquired from the corporation in exchange for money or property (other than stock) or as compensation for services (other than as an underwriter). For this purpose:

- **Conversion of debt; exercise of warrants or options into C corporation stock.** The receipt of options, warrants, phantom stock rights or debt from a C corporation does not qualify as a receipt of stock for purposes of the QSBS rules. However, the conversion of debt into C corporation stock and the exercise of investor warrants or employee stock options are treated as acquisitions of stock at original issue.
- **Conversion of an LLC or partnership to a C corporation.** If a partnership (including an LLC taxed as a partnership) is converted into a C corporation, C corporation stock issued in the conversion to members or partners of the LLC or partnership should be treated as the acquisition of stock at original issue if the conversion is appropriately structured. However, the QSBS rules would only apply to the portion of any gain that is attributable to appreciation in value of the C corporation stock that occurs after the conversion transaction.
- **Conversion of an S corporation to a C corporation.** To be QSBS, the applicable shares must have been issued by an eligible domestic C corporation, not an S corporation. If an S corporation converts into a C corporation, the conversion will not cause shares that were issued by the S corporation to become eligible for QSBS treatment. However, shares of stock issued by the C corporation after this conversion may qualify as QSBS, provided that all the other QSBS requirements are satisfied with respect to such newly-issued shares.

#### *"Qualified Small Business" Requirement*

For stock to qualify as QSBS, the issuing corporation must be a qualified small business. For this purpose:

- The issuer must be an eligible domestic C corporation at the time the stock is issued and during substantially all of the applicable stockholder's holding period for the C corporation shares being sold. Accordingly, shares issued by an S corporation would not satisfy this requirement. In addition, DISCs, RICs, REITs, REMICs, FASITs, cooperatives and certain other special types of corporations are not eligible corporations.
- The aggregate gross assets of the issuer must not have exceeded \$50 million at any time from inception up to the time immediately after the issuance. For this purpose, an issuer also shall be deemed to own a proportionate amount of the assets of its subsidiaries

(as determined under the QSBS rules). The amount of an issuer's aggregate gross assets generally will be equal to the sum of the issuer's cash plus the aggregate adjusted tax basis of the other assets held (or deemed held) by the issuer, as determined under the QSBS rules; provided, however, that the tax basis of any property contributed to the issuer (immediately after such contribution) is deemed to be its fair market value at the time of the contribution.

- The issuer must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses during substantially all of the applicable stockholder's holding period. For this purpose:
  - ▶ Certain types of businesses are expressly excluded from being "qualified trades or businesses." For example, any trade or business involving the performance of services in the fields of health, law, engineering, consulting, financial services and many other types of service businesses will not qualify. In addition, hotel, restaurant, oil, gas, banking, investment, farming and certain other types of businesses will not qualify.
  - ▶ Research and start-up activities in connection with a future qualified trade or business generally may be treated as the active conduct of the qualified trade or business, regardless of whether these activities have generated any gross income.
  - ▶ In addition to assets clearly used in the active conduct of a qualified business, the following assets also may be counted as used in the active conduct of the business: (1) assets held for working capital needs; and (2) assets held for investment that are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or to finance increases in the corporation's working capital needs. If a corporation has been in existence for at least 2 years, however, no more than 50% of the assets of the corporation will qualify as used in an active trade or business by reason of the rules described in (1) and (2).
  - ▶ A corporation shall be deemed to own a proportionate amount of the assets, and conduct a proportionate amount of the activities, of its subsidiaries (as determined under the QSBS rules).
  - ▶ There are limitations on the amount of portfolio stock and real estate that a corporation may hold and still be considered engaged in the active conduct of a qualified trade or business.
  - ▶ An otherwise eligible corporation that is licensed to operate as a "specialized small business investment company" (or SSBIC) under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993) is deemed to satisfy the active business requirements.
- The issuer must submit any reports that the IRS requires. Currently, the IRS has not created any reporting requirements for QSBS issuers.

## Redemptions

In order to truly incentivize new investment in corporations, the QSBS rules provide that certain redemptions by the issuing corporation of its stock before or after the issuance of the corporation's stock may disqualify such stock from QSBS status.

More specifically, stock cannot be QSBS if, within two years before or after the issuance of such stock, the issuing corporation purchased any of its own stock from the taxpayer or from a person related to the taxpayer. Similarly, stock cannot be QSBS if, within one year before or after the issuance of such stock, the issuing corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding five percent of the aggregate value of all of its stock as of one year before the issuance.

## Purchase of Replacement QSBS

A stockholder may be able to defer the recognition of taxable gain from the sale of QSBS if replacement QSBS is acquired within 60 days from the date of the sale. Provided that the 60-day time limit (and other applicable requirements) are satisfied, a stockholder seeking this rollover treatment must make an election on or before the due date, including extensions, for filing the stockholder's tax return for the tax year in which the QSBS is sold. The rollover election, once made, can only be revoked with the written consent of the IRS, which requires the submission of a request for a private letter ruling.

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