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Who wants (tax-free) $10 Million?

By Michael Shaff

It sounds like a hustle you might hear on a dark street, the chance to get $10 million and not pay any federal income tax on, but it is possible. That prospect should figure into how transactional lawyers advise their clients on choosing the form of entity in which to conduct their business.

Section 1202 of the Internal Revenue Code allows individuals to exclude the gain on the sale of qualified small business stock. There are, as may be expected, a number of hurdles that must be met for corporate stock to be QSBS.

The stock must be held at least five years. IRC Section 1202(a)(1). The exclusion does not accrue ratably. Stock held four years, eleven months and three weeks would not be eligible for the exclusion. There is a rollover of gain election for QSBS held at least six months. IRC Section 1045.

Stock acquired before 2010 is eligible for less than a complete exclusion. Stock acquired between 1993 and Feb. 16, 2009, is eligible for an exclusion of 50% of the gain up to $10 million of gain. IRC Section 1202(a) (3)(A). Stock acquired between Feb. 17, 2009 and Dec. 31, 2010 is eligible for a 75% exclusion. Stock acquired after Dec. 31, 2010, is eligible for the 100% exclusion.

An individual may exclude up to $10 million in gain per issuer. IRC Section 1202(b)(1)(A). The $10 million per issuer exclusion is reduced to $5 million per spouse if the shareholder files a married filing separate income tax return. The $10 million amount is cumulative and takes into account prior sales of the stock of the same issuer.

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An individual may make a gift of QSBS to a family member (other than a spouse) who, as will be discussed below, may also qualify for his or her own $10 million exclusion. While no authority was located authorizing a separate $10 million exclusion for a family member who received stock from the original shareholder, there is no provision that limits a gift or bequest recipient to the original shareholder's $10 million per issuer exclusion limit.

QSBS must be issued by a C corporation. IRC Sections 1202(c)(1) and (d)(1). If stock is originally issued by an S corporation or a foreign corporation, that stock will never be QSBS. If the issuer subsequently becomes a domestic C corporation and sells an existing shareholder stock for subsequent contributions of cash, property or services that newly issued stock could qualify as QSBS.

The shareholder asserting that the stock is QSBS must have acquired it at original issue for cash, other property or services. IRC Section 1202(c)(1)(B). There are exceptions for shareholders who acquired their shares by gift from, or at the death of, a shareholder who held QSBS at the time of gift or death. IRC Section 1202(h). Special rules apply for shareholders who acquired their shares by converting shares of another corporation or on a distribution from a partnership (including an LLC treated as a partnership for income tax purposes). Shareholders who acquired their shares by purchase from another shareholder will not have QSBS. Neither will shareholders of an S corporation that is acquired by a C corporation that qualifies as a "qualified small business" hold QSBS. What constitutes a "qualified small business" is discussed below.

Many tax practitioners have advised clients to organize a start up business as a limited liability company to allow the initial investors to claim the net losses from the new business on their own returns. That may be very good advice — unless the business is expected to be a "qualified small business" (discussed below). It would be unfortunate for the investors to obtain the deduction for some or all of their investment if that deductibility cost them the chance at excluding up to $10 million of gain on the sale of their stock. "Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection 1202(e) and such corporation is a C corporation." IRC Section 1202(c)(2). Section 1202 does not define the term "substantially all" but ninety percent has been identified as "substantially all" in other contexts. *See, e.g.*, Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568. For example, a new business organized as an LLC on July 1, 2020 would really have to convert to C corporation status by Jan. 1, 2021, in order for the stock of the original equityholders to qualify as QSBS by Jan. 1, 2026, the computation being the 60 months that the equityholders held stock in a C corporation engaged in a qualified business divided by the equityholders' 66-month holding period equals 90.9%.

Although there is no authority directly on point, it should not make a difference if the LLC (i) contributes all its assets to a new C corporation for stock, (ii) merges into a new C corporation under state law, (iii) has all of its issued interests contributed to a new C corporation or (iv) merely elects to be treated as a C corporation by filing a Form 8832. The effect of filing that election is that the LLC is deemed to have contributed all of its assets and liabilities to itself as a corporation in exchange for stock in the, and immediately thereafter, the LLC is treated as having liquidated by distributing the stock of the corporation to the former LLC partners. Treas. Reg. Section 301.7701-3(g)(1) (i).

The code anticipates a shareholder whose shares would not be QSBS because they were acquired when the issuer corporation was an S corporation or LLC might want to have those shares redeemed and use the redemption proceeds to buy new shares from the corporation at original issue. A redemption of stock by the corporation from a particular shareholder will disqualify as QSBS all stock that the shareholder acquired during the period between two years before and two years after the redemption. IRC Section 1202(c) (3)(A). Redemptions of stock aggregating 5% or more of a corporation's stock in any running period beginning one year before the redemption and ending one year after the redemption will cause all stock that the corporation issues during that two-year window as not QSBS. IRC Section 1202(c)(3)(B).

There are a number of requirements for the stock issuing corporation to be a "qualified small business." IRC Section 1202(d)(1). The corporation's gross assets must have a value of $50 million or less at the time of issuance for the stock to be QSBS. Value is the amount of cash on hand and the aggregate adjusted basis of the corporation's assets, which could very well undervalue the corporation's good will and other self-created intangible assets. IRC Section 1202(d)(2)(A). Eighty percent of the issuing corporation's assets by value must be used in the active conduct of a "qualified business." IRC Section 1202(e)(1)(A).

The term "qualified business" is defined as any business except for a long list including (1) 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 one or more of its employees, (2) banking and financial businesses, (3) farming, (4) mining and other extraction business, (5) hotel or restaurant business. IRC Section 1202(e)(3). Real estate must not account for more than 10% of the value of the assets of a corporation engaged in any of the foregoing businesses. The first exception, for services in the enumerated fields, has been interpreted as only the provision of services in those fields and not the development and sale of products in those fields. Priv. Ltr. Rul. 201436001 (Sept. 5, 2014) (testing and production of pharmaceuticals was not the performance of services in the health industry); Priv. Ltr. Rul. 201717010 (Apr. 28, 2017) (company performs test analysis and prepares reports for use by health professionals, held not the performance of services in the health field). The businesses listed in (2) through (5) above are not qualified businesses whether they provide products or services in the listed fields.

The holding period and QSBS status tack on the conversion of one class of stock to another in the same issuing corporation. IRC Section 1202(f). Stock that otherwise would be QSBS that a pass-through entity, such as an LLC or S corporation, acquires at original issue is considered QSBS as to the members of the passthrough entity on the date of acquisition and disposition, but in a ratio no greater than each member's percentage in the pass-through entity on the date that the pass-through entity acquired the QSBS and continuously thereafter. New members in the LLC or S corporation would not be able to treat their allocable portion of the entity's QSBS shares as QSBS in their hands. IRC Section 1202(g). That disqualification would be subject to the exception for transfers on death or by gift — meaning persons acquiring their interest in the LLC or S corporation after it acquired its QSBS would be able to treat as QSBS their portion of the pass-through entity's QSBS shares if those persons had received an interest in the passthrough entity by gift or on death. IRS Section 1202(h). Similarly, even if a member of the pass-through entity holding QSBS had his or her percentage interest in the pass-through entity increase at any point that the pass-through entity held the QSBS stock, the member's share of the entity's QSBS would not increase.

If the issuer corporation is acquired by a larger corporation in a tax-free reorganization, the acquiring corporation's stock would be QSBS in the hands of the target's shareholders to the extent that the target corporation's stock was QSBS as of the date of the reorganization. IRC Section 1202(h).

There are many rules for QSBS but the benefit, at least for federal income tax purposes, is the difference between tax at up to 23.8% and no tax on up to $10 million, potentially a federal tax saving of $2,380,000.

California repealed its analogous section. Cal. Rev. & Tax. Code Section 18152.5(n). Gains on the sale of QSBS by a California resident be subject to tax at rates of up to 13.3%. ■

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