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Qualified Small Business Stock

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Conference Reference Materials

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The California Lawyers Association
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Qualified Small Business Stock: An Explanation and Exploration

Presented by



Christopher Karachale
Hanson Bridgett LLP



Tracy Hom
Realize CPA

Outline of Topics

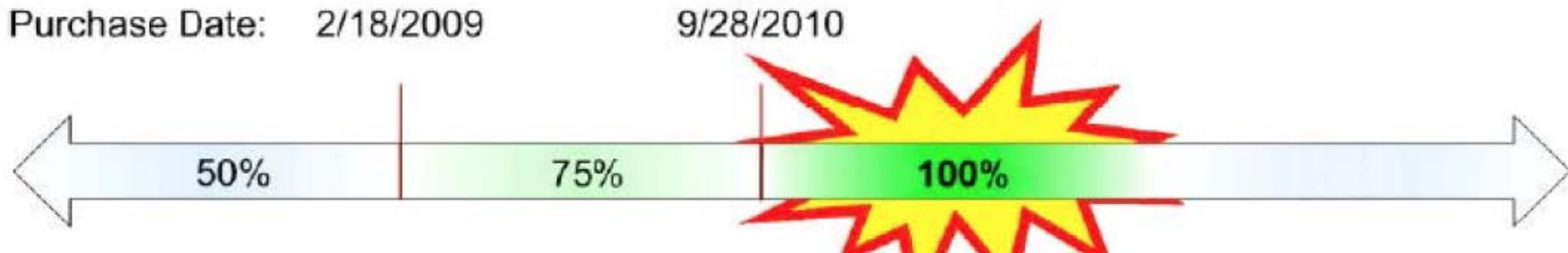
1. Introduction.
2. What is qualified small business stock (“QSBS”).
3. Exclusion from gain under IRC § 1202.
4. Gain rollover under IRC § 1045.
5. Review of case law and administrative guidance.
6. Questions.

QSBS Advantages

- For sales of QSBS acquired on or after September 28, 2010, IRC § 1202 provides generally that no tax will be imposed on the greater of \$10 million of gain or 10 times a shareholder's basis in the stock, provided the shareholder has held the stock for five years.
- Since “qualified small businesses” include tech start-ups and many other Silicon Valley companies, it is imperative for business and tax advisors to understand and be able to counsel their clients on the significant tax savings associated with QSBS.

QSBS Exclusion Amount

Exclusion of Gain from Sale of QSBS



- In pre-100% exclusion years, IRC § 57(a)(7) treated the excluded gain as an AMT preference item subject to tax at a 7% rate, while the taxable gain was subject to tax at the 28% collectibles rate under IRC § 1(h)(4).
- Gain exclusion limited to the greater of \$10 million of gain or 10 times a shareholder's basis. IRC § 1202(a)(1).

QSBS Exclusion Amount - Example

Tony formed a C corp on December 1, 2010 meeting the qualified small business requirements. His initial contribution was \$100. He sells the corporation on January 1, 2016 for \$15 million. He can exclude \$10 million of gain. The balance is subject to tax at long-term capital gains rates + NIIT.

Tony formed the same C corp but his initial contribution was \$2 million worth of machinery. He sells the corporation on January 1, 2016 for \$15 million. He can exclude all the gain (10 x his basis).

QSBS Definition

- QSBS is stock in a C corporation that is a “qualified small business” where a shareholder receives such stock at “original issuance” in exchange for money or other property, or as compensation for services rendered to the corporation. IRC § 1202(c).
 - Stock acquired through the exercise of options or warrants, or through the conversion of convertible debt can be QSBS, but only at the time of exercise or conversion. H.R. Rep. No. 103-111, at 834 (1993).

Restrictions on Redemptions

- Stock acquired by a shareholder is not QSBS if corporation redeems:
 - any stock from the particular stockholder (or a related person) within 2 years of the issuance of the stock. Treas. Reg. § 1.1202-2(a)(1).
 - more than 5 percent (by value) of its own stock within 1 year of the issuance. Treas. Reg. § 1.1202-2(a)(2).
- Redemptions of a shareholder's stock are permitted (and won't cause a company's other shares to lose their potential QSBS status) in the case of *de minimis* redemptions, termination of services, death, disability or mental incompetency, or divorce of a shareholder. Treas. Reg. § 1.1202-2.

Qualified Small Business

- **General Requirement:** Shares of QSBS must be stock in a C corporation that is a “qualified small business” meeting the “active business test” during “substantially all of the taxpayer’s holding period for such stock.”
- Two requirements for a corporation to be a qualified small business:
 - Gross Assets Test
 - Active Business Test

Gross Assets Test

- A C corporation is a qualified small business if, at the time the shares are issued, its gross assets are not greater than \$50,000,000. IRC § 1202(d).
 - **Calculation of \$50,000,000:** the amount of cash and the aggregate adjusted bases of other property held by the corporation, over the aggregate amount of short-term indebtedness of the corporation, cannot exceed \$50,000,000.
 - **Ownership of subsidiaries:** Where a corporation owns more than 50% of the vote or value of a subsidiary, that subsidiary's assets are attributed to the parent corporation in calculating whether the parent corporation has exceeded the \$50,000,000 gross assets test.

Active Business Test

- During substantially all of the taxpayer's holding period for such stock, at least 80% of the assets of the corporation must be used in the active conduct of one or more "qualified trades or business." IRC § 1202(e)(1).
- Generally, a qualified trade or business is any trade or business "other than one involving the performance of services" where "the principal asset of the trade or business is the reputation or skill of one or more of its employees." IRC § 1202(e)(3).

Qualified Trade or Business

- IRC § 1202(e)(3) states that certain trades or businesses cannot be “qualified trades or businesses”:
 - health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services;
 - banking, insurance, leasing, financing, investing, or similar business;
 - farming business; and
 - any business of operating a hotel, motel, restaurant or similar business.

Qualified Small Business - Example

Tony and his daughter Kallista open a restaurant and incorporate as a C corp. They hold their respective shares for 5 years and then sell. QSBS exclusion applicable? Probably not. IRC § 1202(e)(3)(E).

Tony and Kallista start developing computer software that provides tax return preparation tips. They incorporate and sell after five years. QSBS exclusion applicable? Probably since their business is not selling a service, rather software.

Active Business Test

- **Start Up Expenses:** If, in connection with any future qualified trade or business, a corporation uses assets in certain start-up activities, research and experimental activities or in-house research activities, the corporation is treated as using such assets in the active conduct of a qualified trade or business. IRC § 1202(e)(2).
- **Working Capital:** Assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within two years to finance future research and experimentation, are treated as used in the active conduct of a trade or business provided 50% of those assets are actually used w/n two years. IRC § 1202(e)(6).

Rollover of Gain for QSBS: IRC § 1045

- Where taxpayer has held QSBS for six months, he can defer (rather than exclude) gain on the sale of that QSBS, provided the he purchases “replacement” QSBS within 60 days of the sale of the original QSBS. IRC § 1045(b)
 - A taxpayer will recognize taxable gain to the extent the amount realized on the sale of the original QSBS exceeds the cost of the replacement QSBS.
 - Any gain not recognized (because of the valid rollover) reduces the shareholder's cost basis in the replacement QSBS.

QSBS Rollover – Example

Tony has held QSBS with a basis of \$1,000 for 1 year. He sells the QSBS for \$5 million and reinvests \$3 million in a new qualified small business within 60 days.

He recognizes \$1,999,000 of long-term capital gain and his basis in the replacement QSBS is \$1,000. Tony is able to defer gain on the remaining \$3 million in proceeds from the stock sale.

Ownership of QSBS through Other Entities

- Gain from the disposition of QSBS held by an LLC, partnership, trust, or S corporation is eligible for the exclusion, provided that:
 - all eligibility requirements with respect to qualified small business stock are met;
 - the stock was held by the entity for more than five years; and
 - the owner of the entity held his interest in that entity on the date the entity acquired the stock and at all times thereafter and before the disposition of the stock. IRC § 1202(g).

Tax-Free Transfers of QSBS

- Where QSBS is transferred by gift or at death, the transferee is treated as having acquired the QSBS in the same manner as the transferor. IRC § 1202(h)(1)
- When QSBS is transferred for other stock in an IRC § 368 reorganization (or an IRC § 351 exchange) the transferor treats the new stock received as QSBS, even if the new stock is not actually in a qualified small business. IRC § 1202(h)(4)

Tax Planning with QSBS

- Consider gifting to family members or nongrantor irrevocable trusts
- Caution clients about moving QSBS from one entity to another
- Caution clients about hedging their positions in QSBS
- Consider current entities that are currently structured as non-C corporations

***Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd*, 479 Fed.Appx. 775 (9th Cir. 2012)**

- Taxpayer owned options of a C corporation which were converted to options of Intel after a merger in 2001. Two years after the merger, the taxpayer exercised his Intel options and sold the Intel stock.
- The taxpayer sought to exclude 50% of the gain under IRC § 1202(a)(1) by arguing that the Intel options acquired in the merger retained the QSBS character of the original corporation under an equivalent provision of IRC § 1202(h).
 - The taxpayer was unable to show that original corporation was a “qualified small business” under IRC § 1202(d)
 - The taxpayer simply sold shares of Intel (after immediately exercising the options). The QSBS rules only apply to stock, not options held for 5 year.

Owen vs. Commissioner, T.C. Memo 2012-21

- Taxpayer owned a qualified small business (which sold “prepaid legal service policies”). He sold the business on June 17th and formed a new jewelry business on August 12th, investing \$2 million of sales proceeds with the goal of deferred gain under IRC § 1045.
- In its first two years, the jewelry business only purchased \$150,000 of jewelry and sold \$12,000. The rest in cash.
 - The taxpayer was unable to show that the jewelry business was engaged in an “active trade or business” under IRC § 1202(e).
 - Assets can held for a company’s “reasonably required working capital needs” during the first two years of existence. IRC § 1202(e)(6). Because the taxpayer had only spent 8% of his initial investment after two years, the Tax Court found that the jewelry company was not engaged in active trade or business.

***Holmes v. Commissioner*, T.C. Memo 2012-251, aff'd, 593 Fed.Appx. 693 (9th Cir. 2015)**

- Taxpayer owned two companies, MacroPore and LeonardoMD. He sold more than \$3 million of MacroPore and reinvested proceeds in LeonardoMD, alleging the sales qualified as tax-deferred rollovers under IRC § 1045.
- Tax Court found that MacroPore was not a qualified small business because: The taxpayer was unable to show that original corporation was a "qualified small business" under IRC § 1202(d)
 - The taxpayer provided no evidence he received MacroPore shares at original issuance or that the value of the company was less than \$50 million at the time of the sale; and
 - The taxpayer could not show that MacroPore was engaged in a qualified trade or business.

PLR 201436001 (Sept. 5, 2014)

- The IRS reviewed whether a corporation meets the "qualified trade or business" requirement of IRC § 1202(e)(3) and is a qualified small business.
- The corporation provided products and services in the pharmaceutical industry, working with clients to commercialize experimental drugs. Its business activities consisted specifically of
 - (1) research on drug formulation effectiveness;
 - (2) pre-commercial testing procedures, such as clinical testing; and
 - (3) manufacturing of drugs. In addition, the corporation worked with clients to solve problems in the pharmaceutical industry, such as developing successful drug manufacturing processes.

PLR 201436001 (Sept. 5, 2014) - Continued

- The PLR concludes that the corporation was engaged in a qualified trade or business for purposes of IRC § 1202 because it was not in the business of "offering service in the form of individual expertise."
- Rather, the company created value for its customers using its specific manufacturing assets and intellectual property. According to the IRS, the corporation was "a pharmaceutical industry analogue of a parts manufacturer in the automobile industry."

PLR 201717010 (April 28, 2017)

- The corporation used a patented technology to test for specific diseases, the results of which were analyzed and summarized in laboratory reports for healthcare professionals.
- The company's "sole function is to provide healthcare providers with a copy of its laboratory report."
- PLR concludes that for purposes of section 1202(e)(3), the company is not in a trade or business
 - (i) involving the "performance of services in the field of health," or
 - (ii) whose principal asset is "the reputation or skill of one or more of its employees."

Questions?

Christopher A. Karachale, J.D., LL.M. is a partner at Hanson Bridgett in San Francisco. He advises individuals, businesses, non-profits, and government agencies on a range of tax planning and tax controversy matters at the federal, state, local, and international levels. He also serves as outside general counsel to small and midsized companies in need of corporate and general legal advice.

Christopher's work on federal tax matters ranges from income tax controversies involving individuals and businesses to partnership structuring and corporate mergers and acquisitions. He regularly works with entrepreneurs and start-up companies, and is one of the leading practitioners on qualified small business stock and related section 1202 issues.

Christopher has published extensively, with articles appearing in Tax Notes, the California Business Law Practitioner, and Law360. He also is a frequent speaker on tax issues to audiences in the United States and abroad. Christopher is certified as a legal specialist in taxation law by the California Board of Legal Specialization.

Tracy Hom is a Partner in our San Francisco office. Her tax practice is focused on providing tax consulting and compliance services to high net worth individuals and their related entities including trusts, partnerships and closely held businesses. In particular, Tracy has extensive experience in working with clients involved in all aspects of venture capital and private equity from investors to fund managers as well as their related entities.

Tracy works to provide a comprehensive, thoughtful and personalized approach to her client's tax and financial situations. As an advisor to various family members, Tracy has assisted in planning, implementing and maintaining complex estate planning strategies as well as analyzing the tax and financial implications of various business deal scenarios.

Tracy is a second generation accountant, following in the footsteps of her father who worked in the governmental arena for over 30 years before retiring. She started in public accounting immediately after graduating in 2000 from the University of California, Los Angeles and became a licensed Certified Public Accountant in 2003. In addition, Tracy earned her Masters of Taxation from Golden Gate University in 2010.