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The Year of Qualified Small Business Stock?

By Robert W. Wood • Wood & Porter • San Francisco

When Congress passed amendments to Section 1202 affecting Qualified Small Business Stock (QSBS) in 2010's Small Business Act, it increased the exclusion from 75 percent to 100 percent. The QSBS provisions are full of details and requirements. Yet to those who have never plowed the fertile fields of QSBS lore, the tweaked 100-percent exclusion law seemed deceptively simple.

Tax Holiday

If you bought qualifying stock between September 27, 2010, and December 31, 2010, and you managed to hold it for more than five years, you'd be in for a treat: Congress promised that when you sell, you would pay zero federal income tax. Although long-term capital gain rates may be 15 percent now, it seems unlikely they will remain at that level for five years. Besides, zero percent is better than any alternative.

That is an amazing benefit, but there was little time in the remaining three months of 2010 to take advantage of it. Now one can take advantage of this benefit for an additional year through the end of 2011. The latter was effected by the 2010 Tax Relief Act.

Many investors and stock issuers were rushing to close deals in late 2010. Many more probably could not collect themselves to even attempt to act by the end of 2010. Thus, the impact of this extension may be enormous. Many more taxpayers can be expected to use it.

Not Your Father's QSBS

There's considerable history to the QSBS provision during which the size of this benefit has grown. The QSBS exclusion started as a 50-percent exclusion in 1993. It grew to a more generous 75-percent exclusion in 2009. Finally, the exclusion grew to 100 percent for QSBS

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purchased after September 27, 2010, and before January 1, 2011, if held more than five years. The new law even eliminates the alternative minimum tax preference for these sales.

This investor benefit was ideal for companies that were looking for funding. It was also ideal for investors who were looking for tax-free gains. The 75-percent and then 100-percent exclusion simply made it more attractive. Like speed dating, companies and investors were trying to find each other and to close their stock transactions by the end of 2010, since year-end would usher out this promised 100-percent tax holiday. That was a tall order in the few months remaining in 2010. Fortunately, Congress gave both sides of the equation more time.

The promise of tax-free sales proceeds five years hence is alluring, a siren's song. But be wary, as the rules can be unforgiving. Here are the bare bones.

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QSBS Defined

To qualify as QSBS, stock must be:

- issued by a C corporation having no more than $50 million of gross assets when the stock is issued;
- issued by a company using at least 80 percent of its assets by value in an active trade or business (excluding personal services, finance, farming, restaurants, hotels, *etc.*);
- issued after August 10, 1993;
- held by a noncorporate taxpayer; and
- acquired by the taxpayer on original issuance.

Companies able to meet these criteria can be expected to do their best to attract investors before the end of 2011. The issues can make for curious representations and warranties to prospective investors. Companies that qualify for this tax-free deal are saying so, marketing themselves as a rare tax-free investment.

One suspects that due diligence will be at a premium. If it isn't, it should be, for it is important to make sure the investment as teed up is truly tax-free. It can be difficult to say that stock today qualifies. It can be even more difficult to say that it will remain qualified more than five years hence.

Those new to the QSBS characterization question may think—as most clients seem to—that the QSBS question is mechanical and easily resolved. It would be hard for me to count the number of investors who have told me with authority that their QSBS was certified as such.

Upon investigation, I may find that vaunted certification to which the investor is referring may take the form of a full-blown legal opinion, a sentence or two in the offering materials, or a brief e-mail from the investor's own accountant saying the stock should hopefully qualify. You'll need lawyers and accountants to verify that everything is in order whether you're an individual investor, an investment partnership (beware special partnership rules) or a company seeking to get investor dollars in the door.

Full legal opinions are best, but by their very nature, they are likely to contain carve-outs and qualifications that may provide less than 100-percent certainty.

What's Active?

One of the issues that can prove nettlesome is determining precisely what qualifies as an active business. The company must use at least 80 percent of its assets (measured by value) in the active conduct of one or more qualified businesses. "Qualified" excludes service businesses; oil and gas; banking or investing; and motels or similar businesses. Beyond those prohibited categories, though, the main issue is whether the business is active.

Fortunately, start-up and research-and-development operations, including in-house research activities, are considered used in an active trade or business. In fact, that is so even if they haven't yet generated any income. Assets held for working capital needs can also be treated as used in the active conduct of a qualified business.

However, there are limits on the amount of portfolio stock and real estate a corporation can hold and still be considered engaged in the active conduct of a qualified trade or business.

Original Insurance

Quite apart from the active business rule, another fundamental requirement is that you buy your stock directly from the corporation, not from a third party. The stock must be newly issued, requiring purchasers to inject fresh money into the company for new stock. To counteract someone qualifying for the tax-free benefit based on an old investment that is cashed out to make way for the new, the law includes a series of redemption rules to ferret out prior stock ownership.

Redemption Rules

Detailed rules cover redemptions of stock. There is a natural tendency for taxpayers to want to surrender their existing stock so they can be issued newly minted "tax-free" stock thereafter. Accordingly, if you or a related person had stock redeemed by the same company within two years before you buy your new stock, you don't qualify.

The same rule applies for two years after you acquire your stock. That totals four years spanning the time of your investment when a company stock repurchase from you or related persons will disqualify you from tax-free treatment. The "related person" rule covers your brothers and sisters (either whole or half blood), your spouse, ancestors and lineal descendants.

Plus, even outside these relationships, some stock redemptions that occur within one year before or one year after your stock purchase will also disqualify your investment. The one-year period that is scrutinized on either side of the issuance is in some ways broader. The two years before and two years after rule applies to redemptions from related persons.

But other redemptions up to one year before or after your investment can disqualify you when made from nonrelatives if they are "significant." "Significant" is defined as a redemption of more than five percent by value of the company's stock.

However, it may seem easy enough to determine if you or a person related to you was an investor in the company and had their stock redeemed during a four-year window of scrutiny. It may be more difficult to assess whether your tax-free treatment could be eliminated based on a "significant" redemption that has nothing to do with you or your family. Furthermore, the timing can be problematic. One must not only worry about what the company did up to a year *before* you buy your stock, but also what the company might do for a year *after* your purchase.

For that reason, investors may wish to consider requiring the issuing company to agree that it hasn't made a "significant" redemption for the one year period before the investment. Obtaining a covenant from the company that it agrees it will not make a significant redemption for a year after your stock issuance would also seem appropriate.

Importance of State Law

Bear in mind you still may face state taxes when you sell your shares unless your state conforms to the federal tax law. In some states, the state tax issues affecting QSBS can be important and can be more difficult than the federal. A good example is California. California has its own spin on what constitutes California QSBS and for how the rules should be interpreted. Perhaps predictably, a short description of California's version of QSBS is that California requires virtually everything to be in California (for example, including 80 percent or more of the company's assets, and even 80 percent or more of the company's payroll).

At this writing, California has not conformed to the 100-percent exclusion offered by the federal government. In fact, California never conformed to even the prior law 75-percent exclusion either. However, an exclusion of 50 percent is nothing to sneeze at, particularly given California's high tax rates and its lack of capital gain rates.

Veterans of disputes with California's primary income tax agency, the Franchise Tax Board, are likely to know that these disputes are generally far harder to resolve than disputes with the IRS. If one has a lack of success administratively with the Franchise Tax Board, one can proceed to the five-member California State Board of Equalization. That body hears California state tax cases (including income, franchise, property and sales and use taxes).

If one cannot gain satisfaction there, one can proceed to California Superior Court, the general civil trial courts in California, for a trial *de novo.* Some say that virtually every QSBS claimed on a California income tax return is examined by the Franchise Tax Board. Indeed, it seems to have a penchant for finding a way to treat the QSBS—which may be perfectly fine for federal income tax purposes—as not qualifying in California. In any case, disputes are common.

Conclusion

Taking advantage of qualified small business stock benefits can be considerably more painstaking than it might appear on the surface. Nevertheless, clients like the benefit for obvious reasons. Most are even comfortable that the promise of a tax-free benefit five years out into the future will not be taken away by Congress, notwithstanding our changeable economic and political climate.

One should compare the benefits of the QSBS exclusion with the capital gain tax that would otherwise apply. With the 15-percent federal capital gain rate prevailing for 2011 and 2012, the QSBS exclusion may not look as compelling as it would in a higher-rate environment. That is once again where state taxes often enter into the mix.

In any case, with eligibility through December 31, 2011, it seems likely many will seek to qualify for this tax-free bonanza before the end of 2011.