GODFREY & KAHN S.C.

MEMORANDUM

TO: Tim Keane, Golden Angels Investors

FROM: Godfrey & Kahn, S.C.

DATE: October 20, 2016

RE: Failing to qualify for Section 1202 has serious tax consequences

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A. Summary

An owner of C corporation stock may be able to exclude up to 100% of the gain on sale from tax if such C corporation stock meets the definition of "qualified small business stock" ("QSBS") under § 1202 of the Internal Revenue Code of 1986, as amended (the "Code").[1]

This memorandum is designed to help you ensure that your stock qualifies for the partial or full exclusion for capital gain for QSBS under § 1202. The discussion begins with an analysis of the benefits § 1202, namely a reduction in the tax rate applicable to gain on the sale of QSBS held for more than five years. Next, the strict requirements for stock to qualify as QSBS are summarized. Finally, common mistakes that we have observed small businesses and/or their shareholders make that cause some or all of the shareholders to be ineligible for the § 1202 exclusion are outlined and analyzed with numerical examples.

B. Section 1202 offers a partial or total exemption from tax for certain capital gains

Section 1202 exempts from tax a specified percentage of a taxpayer's gains from the sale of QSBS provided the taxpayer held the QSBS for more than five years (among other requirements discussed below). The applicable exemption percentage may be 50%, 75%, or 100%,[2] depending on the taxpayer's stock acquisition date because Congress has repeatedly changed the amount of the § 1202 exemption with varying effective dates. Additionally, special modifications to the capital gains tax rate[3] and alternative minimum tax ("AMT") adjustments (because § 1202 gain has historically been an AMT tax preference item)[4] interact with the applicable exemption percentage for each taxpayer to determine the taxpayer's effective tax rate reduction.

The table below summarizes the interaction of § 1202, AMT, and other Code provisions.

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[1] All references to Section or § are to the Code, unless otherwise provided.

[2] § 1202(a)(1), (3), and (4).

[3] § 1(h)(4) imposes a 28% rate on § 1202 gains, as opposed to the 20% rate applicable to most other capital gains.

[4] § 57(a)(7).

Date of Stock Acquisition	§ 1202 Tax Exemption Percentage	§ 1202 Capital Gain Rate[5]	Effective Capital Gains Rate[6]	Effective NII Tax Rate[7]	Effective AMT Tax Rate	AMT rate savings vs. 23.8% regular capital gain rate[8]
On or after Aug. 11, 1993 But before Feb. 17, 2009[9]	50% [10]	28%	14%	1.9%	14.98% [11]	6.92%
On or after Feb. 17, 2009, But before Sept. 27, 2010[12]	75%	28%	7%	0.95%	8.47% [13]	14.38%
On or after Sept. 27, 2010[14]	100%	28%	0%	0%	0% [15]	23.8%

For example, assume that individual X acquired $1 million of Y corporation stock in 2011 and Y stock is a capital asset in X's hands. If the Y stock is not QSBS and X sells it in 2017 for $6 million, then X realizes a gain of $5 million. In that case, X could potentially owe taxes of $1.19 million ($5 million gain * 23.8% capital gains rate). However, if the Y stock were QSBS in X's hands, then X's entire § 1202 gain on the sale would be excluded and X would owe no taxes. Thus, X would have tax savings of $1.19 million.

[5] § 1(h)(4) provides that section 1202 gain is subject to a special 28% rate.
[6] §§ 1202(a)(1); 57(a)(7). For example, for purposes of § 1202(a)(1), the remaining 50% of taxable capital gain is subject to a 28% capital gains tax rate resulting in an overall 14% effective tax rate (50% * 28% capital gain tax rate = 14%).
[7] § 1411(a)(1) imposes a 3.8% tax on net investment income ("NII"), which includes net capital gains. However, net capital gains excluded under § 1202 are not subject to the 3.8% tax. Thus, if 50% of the NII is excluded, then the effective NII rate is 50% * 3.8% = 1.9%. And, if 75% of the NII is excluded, then the effective NII rate is 25% * 3.8% = 0.95%.
[8] The normal long term capital gain rate is 20% under § 1(h), plus an additional 3.8% under § 1411(a).
[9] § 1202(a)(1).
[10] This table does not include the tax savings under § 1202(a)(2) for a "qualified business entity" under § 1397C that is an "empowerment zone business." The savings are generally similar to the 50% tax exemption 1993-2009 row, except the exemption is 60% instead of 50%, which means that the effective capital gains rate is 11.2% (40% of 28%) instead of 14% (50% of 28%) and the NII rate is 1.52% (40% of 3.8%) instead of 1.9% (50% of 3.8%).
[11] For alternative minimum tax purposes, 7% of the excluded § 1202 gain is added back to determine AMT taxable income resulting in an effective tax rate of 14.98%: 28% AMT capital gain rate * (50% unexcluded gain + (7% * 50% excluded gain)) = 14.98%.
[12] § 1202(a)(3).
[13] For alternative minimum tax purposes, 7% of the excluded § 1202 gain is added back to determine AMT taxable income resulting in an effective tax rate of 8.47%: 28% AMT capital gain rate * (25% unexcluded gain + (7% * 75% excluded gain)) = 8.47%.
[14] § 1202(a)(4).
[15] § 1202(a)(4)(C) provides that the AMT add back provision in § 57(a)(7) "shall not apply."

C. The tax code imposes strict requirements to qualify for the Section 1202 exemption

In order for stock in a corporation to qualify for the exemption in § 1202(a), the following requirements must be satisfied:

- Five year holding period – the taxpayer must have held the stock for at least five years.[16]

- Shareholder other than a corporation – the taxpayer claiming the § 1202 exclusion must not be a corporation.[17]

- Acquisition at original issuance for cash or services – the taxpayer must have acquired the stock at its original issuance (directly or through an underwriter) either (i) in exchange for money or other property (not including stock)[18] or (ii) as compensation for services provided to the corporation (other than services as an underwriter).[19] However, this requirement is waived in certain cases. For instance, if QSBS is transferred by gift or at death, the donee or heir, respectively, steps into the donor or decedent's shoes for purposes of the § 1202 original issuance requirement and five year holding period.[20]

- Domestic C Corporation – the stock must be in a corporation created or organized in the U.S. or any State that is taxed under subchapter C of the Code. [21] That is to say, a domestic corporation that pays corporate-level taxes, as opposed to an S corporation.

- Gross Asset Test – The aggregate gross assets of the corporation prior to and immediately after the taxpayer acquires the stock must not exceed $50 million.[22] For this purpose, aggregate gross assets includes the amount of cash and the combined adjusted bases of other property held by the corporation.[23] However, the adjusted basis of any property contributed to the corporation is determined as if the basis of such contributed property were equal to its fair market value at the time of contribution.[24]

- Qualified Active Business – The corporation must have conducted a "qualified trade or business," which is defined in the negative to exclude the following types of businesses:
    - any business involving performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset of the business is the reputation or skill of its employee(s),
    - any banking, insurance, financing, leasing, investing, or similar business,

[16] § 1202(a)(1).
[17] § 1202(a)(1).
[18] § 1202(c)(1)(B)(i).
[19] § 1202(c)(1)(B)(ii).
[20] § 1202(h).
[21] § 1202(d)(1); § 7701(a)(4).
[22] § 1202(d)(1)(A).
[23] § 1202(d)(2)(A).
[24] § 1202(d)(2)(B).

- any farming business (including the business of raising or harvesting trees),
- any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
- any business of operating a hotel, motel, restaurant, or similar business. [25]

Additionally, the corporation must be an "eligible corporation," which is also defined in the negative to exclude the following types of corporations: (i) a DISC, (ii) a corporation that has a § 936 election in effect or one of its subsidiaries has a § 936 election in effect, (iii) a regulated investment company, REIT, or REMIC, or (iv) a cooperative.[26]

- 80% of assets by value used in a qualified active business – At least 80% of the corporation's assets must have been used in the active conduct of one or more qualified trades or businesses during "substantially all" of the taxpayer's holding period for the shares.[27] For this purpose, the following rules apply:
  - Assets used for research and experimental expenditures under Section 174 in conjunction with a future qualified business are treated as used in the active conduct of a qualified business without regard to whether the corporation had any gross income from such activities at the time of the determination.[28]
  - Any assets either (i) held as part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (ii) held for investment but reasonably expected to be used in a qualified trade or business by the corporation within two years to finance research and experimentation or increases in the corporation's working capital needs, are treated as used in the active conduct of a trade or business.[29] However, after the corporation has been in existence for two years, no more than 50% of its assets may qualify as eligible working capital or investment assets under this rule. In other words, after two years, up to 70% of the corporation's total assets may consist of working capital and/or investment capital and the corporation would still meet the active business test (50% under this working capital/investment capital rule plus 20% from the general requirement that only 80% of the corporation's assets must be used in a qualified trade or business).
  - The corporation may not have held real estate assets in excess of 10% of the value of the corporation's total assets if such real estate was not used in the active conduct of the corporation's trade or business.[30] For this purpose, owning, dealing in, or renting real property is not a qualified, active trade or business.[31]
  - The corporation may not have held portfolio stocks or securities in excess of 10% of the value of the corporation's total assets (in excess of liabilities) if such

[25] § 1202(e)(3)(A) to (E).
[26] § 1202(e)(4).
[27] §1202(c)(2)(A); § 1202(e)(1).
[28] § 1202(e)(2).
[29] § 1202(e)(6).
[30] § 1202(e)(7).
[31] Id.

portfolio stocks or securities were not used in the active conduct of the corporation's trade or business.[32]

There is no guidance on when the 80% of assets used in qualified active business requirement must be determined (constantly, annually, average over holding period, etc.) or on what basis (valuations, balance sheets, board resolutions, etc.).

D. Common pitfalls that prevent small business owners from being able to take advantage of the Section 1202 exclusion

Tax practitioners have identified the following as common pitfalls that cause certain investors in small business corporations to become ineligible for the § 1202 exclusion.[33]

1. Redemptions of shareholders may cause all stock not to be QSBS

Given that the § 1202 exclusion is designed to incentivize new business investment, the Code has two provisions designed to prevent the exclusion from applying when newly issued stock is simply a replacement of a prior investment.[34] Under the first provision, stock is not QSBS if at any time during the four-year period beginning two years before the stock was issued, "the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or a person related to the taxpayer (within the meaning of section 267(b) or 707(b))."[35] Redeemed stock exceeds a "de minimis amount" only if (i) the amount paid for it is more than $10,000 and (ii) more than 2% of the stock held by the taxpayer and related persons is acquired.[36] Among many other relationships, related persons include: siblings, spouses, ancestors, and lineal descendants, a partnership and a person owning 50% or more of the partnership interests, fiduciaries of trusts and grantors or beneficiaries of those trusts, and two partnerships in which the same person owns 50% of or more of interests.[37]

For example, stock issued on July 1, 2016 cannot be QSBS if the corporation redeemed more than a de minimis amount of stock from the shareholder after June 30, 2014 and before July 1, 2018. A redemption of more than a de minimis amount of stock taints all of the stock that is not redeemed, so none of it is QSBS.

Under the second provision, stock is not QSBS, if during the two-year period beginning one year before the stock was issued, the corporation repurchased stock in one or more transactions (i) each of which involves a repurchase of more than $10,000 of stock where more than 2% of all outstanding stock by value is repurchased and (ii) the sum of all repurchases during the two-year period have a value, at the time of redemption, in excess of 5% of the aggregate value of all the corporation's stock at the beginning of the two-year period.[38] For

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[32] § 1202(e)(5)(B).
[33] A few of the examples below were inspired by material that appeared in business magazines. *See* Tony Nitti, *Tax Geek Tuesday: Reminding You That the Gain on That Sale of Stock May Be Tax Free*, FORBES, November 23, 2015.
[34] § 1202(c)(3).
[35] Treas. Reg. § 1.1202-2(a)(1).
[36] Treas. Reg. § 1.1202-2(a)(2)
[37] § 267(b); § 707(b).
[38] Treas. Reg. § 1.1202-2(a), -2(b)

example, if the aggregate value of a corporation's stock is $10 million on July 1, 2016, stock issued on July 1, 2017 is not QSBS if more than $500,000 of stock is redeemed from any shareholder during the period from July 1, 2016 through June 30, 2018.

2. Large rounds of venture capital financing may cause the corporation to fail the qualified active business test or the gross asset test

The qualified active business test requires that during "substantially all of the taxpayer's holding period" at least 80% (by value) of the corporation's assets must be used in active conduct of a one or more qualified trades or businesses.[39] Subject to the allowances for working capital and financing research and experimentation discussed above, this means that if more than 20% of a corporation's assets become cash or other non-qualified assets immediately after a venture capital round of financing or at any other time, such corporation may fail this "substantially all" test. Congress and the IRS have not given any guidance as to what is deemed "substantially all" of a taxpayer's holding period for this purpose. Thus, it may be advisable for corporations and their (potential) shareholders to exercise an abundance of caution and avoid potentially violating the test by holding too much cash or other non-qualified assets at any time.

Additionally, in order for stock to qualify as QSBS, the aggregate gross assets of the corporation cannot exceed $50 million at either (i) any time prior to the taxpayer's stock acquisition date and (ii) immediately after the taxpayer's stock acquisition date.[40] Thus, if a corporation never exceeded $50 million in gross assets through June 30, 2016, but received a cash investment from a venture capital firm on July 1, 2016 of $50,000,001 (or any lesser amount that pushed the corporation's aggregate gross asset value over $50 million), then

- Any shareholders who acquired stock on or after July 1, 2016 would be ineligible for the § 1202 exclusion;
- But any shareholders who acquired stock on or before June 30, 2016 would remain eligible for the § 1202 exclusion.

In other words, a small business corporation can permanently eliminate its ability to have investors qualify for the § 1202 exclusion by having a venture capital or angel investment round in excess of $50 million (or, more precisely, $50 million less the aggregate gross assets of the corporation) at any time.

3. Contributions of appreciated property in exchange for stock are subject to further limits

For purposes of the requirement that a qualified small business have aggregate gross assets of $50 million or less, aggregate asset value is generally measured as cash plus the adjusted basis of the other assets.[41] However, the basis of any property contributed to the corporation is deemed to be equal to its fair market value ("FMV") for purposes of this gross asset test.[42] This has significant consequences for a shareholder contributing property under § 351.

[39] § 1.1202(c)(2)(A); § 1.1202(e)(1).
[40] § 1202(d)(1).
[41] § 1202(d)(1).
[42] § 1202(d)(2)(B).

For example, shareholder X contributes property with an adjusted basis of $2 million and a FMV of $5 million to Y corporation in exchange for stock, which qualifies as a § 351 contribution. The basis of the contributed property to Y will be $2 million under § 362 for all purposes outside of § 1202. However, for purposes of the § 1202 $50 million gross asset test, the basis of the assets will be treated as $5 million. Thus, if Y's aggregate gross assets prior to the contribution were more than $45 million, Y stock would not be QSBS in X's hands immediately after the contribution.

The contribution rule also affects a shareholder's basis in his QSBS and the calculation of gain on later sale. When a shareholder has contributed property to a qualified small business, the shareholder's basis in her QSBS is also deemed to be the FMV of the contributed property at the time of contribution,[43] even though for all other tax purposes § 358 provides that the shareholder has carryover basis in her stock equal to her adjusted basis in the contributed property.

Following on the example above, when X sells her Y stock, her basis in the stock is treated as being $5 million, as opposed to $2 million. This rule prevents X from converting her $3 million of unrealized appreciation in the contributed property, which would be taxed on sale, into non-taxable § 1202 gain by selling the Y stock after holding it for at least five years.

4. The $50 million gross asset test includes the assets of more than 50%-owned subsidiaries

Corporations that are members of the same parent-subsidiary controlled group must calculate their assets on an aggregated basis.[44] This rule is triggered when a corporate parent owns more than 50% ownership of a subsidiary, not the 80% ownership generally required under § 1563 for treating a chain of corporations as a controlled group.

For example, X corporation owns 53% of Y corporation stock. Individual Z contributes $2 million of cash to X in exchange for X stock. Although X's assets immediately after the contribution are only $40 million, Y has assets with an aggregate basis of $15 million. Given that X owns more than 50% of Y's stock, for purposes of the § 1202 gross asset test, X and Y's assets must be aggregated. Thus, the aggregated assets are $55 million ($40 million plus $15 million), and the X stock that Z receives does not qualify for the § 1202 exclusion.

5. Stock must be acquired at original issuance to qualify for § 1202

Generally, a shareholder must acquire stock at original issuance in exchange for cash or other property or as compensation for services in order for it to qualify as QSBS. Thus, if a shareholder purchases stock from an existing shareholder that stock will not qualify for the § 1202 exclusion. For example, individual X is the sole shareholder of Y corporation, the stock of which qualifies as QSBS in X's hands. Individual Z purchases 50% of Y's stock from X for cash. The stock that Z acquires is not QSBS, even though it was QSBS in X's hands, because Z did not acquire it at original issuance. The 50% of Y stock that X still holds, however, remains QSBS.

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[43] § 1202(i)(1)(B).
[44] § 1202(d)(3)(B).

This strict rule is relaxed a bit, however, in the realm of corporate reorganizations. When a shareholder exchanges QSBS for other stock in a tax-free reorganization, such as a merger under § 368(a)(1)(A) or a stock acquisition under § 368(a)(1)(B), the new stock received by such shareholder qualifies as QSBS and the holding period of the original QSBS given up is tacked to the holding period of the new stock received.[45]

For example, individual X owns all of the outstanding stock of Y corporation and Y stock constitutes QSBS in X's hands. Y merges into Z corporation in a corporate reorganization that qualifies under § 368(a)(1)(A). In the transaction, X exchanges all of his Y stock for Z stock. The Z stock that X receives is deemed to be QSBS with a holding period that includes the period that X held her Y stock.

Additionally, if a shareholder contributes her existing QSBS to another corporation in a § 351 transfer, then the stock received from the transferee corporation will be deemed QSBS stock, as long as the transferee corporation owns over 80% of the transferred corporation.[46] For example, individual X owns 100% of Y corporation and contributes all of her Y stock, which is QSBS, to Z corporation in exchange for 90% of Z's shares. The Z shares that X receives are QSBS because (i) X's Y stock was QSBS before the contribution and (ii) Y owns more than 80% of Z after the contribution (100% in fact).

Note that the exception for transfers qualifying under §§ 368 or 351 only applies to the built-in gain in the stock at the time of the tax-free reorganization or contribution.[47] All future gains in the stock received do not qualify for the § 1202 exclusion, unless the new corporation in which the shareholder receives stock in the reorganization is also a "qualified small business." For instance, individual X owns Y corporation stock, which is QSBS with a basis of $2 million and a FMV of $8 million. Y merges with and into Z corporation under § 368(a)(1)(A) and X receives Z stock, which would not otherwise qualify as QSBS but for the reorganization. The Z stock in X's hands is QSBS, but when X sells Z stock in the future, X can only exclude a maximum of $6 million of gain, which is equal to the built-in gain in X's Y stock at the time of the reorganization ($8 million FMV - $2 million basis). That is to say, all post-reorganization gain in Z stock is not eligible for the § 1202 exclusion.

6. <u>$10 million or 10 times basis ceiling on the § 1202 exclusion</u>

Note that there is a per-corporation ceiling on each taxpayer's eligible § 1202 gain. In other words, if a taxpayer's gain from sales of QSBS of a particular corporation exceeds a ceiling amount, none of the excess is excluded from gross income.[48] In each taxable year, the ceiling is the greater of

[45] § 1202(h)(4)(A).
[46] § 1202(h)(4)(D).
[47] § 1202(h)(4)(B).
[48] § 1202(b)(1).

i. $10 million ($5 million for married taxpayers filing separate returns), reduced by the taxpayer's § 1202 eligible gain used in prior years[49] or

ii. 10 times the taxpayer's original basis in the stock of the corporation that is sold during the taxable year.[50]

For instance, shareholder X paid $3 million for QSBS in 2015. In 2021 X sells the QSBS for $17 million and realizes a gain of $14 million. The ceiling on § 1202 excluded gain is $30 million (the greater of $10 million or 10 times the $3 million basis). Thus, the entire gain is excluded from both X's taxable gross income and AMT calculation.

However, if all of the same assumptions applied, except for the fact that instead X only paid $300,000 for her QSBS, then the gain would be $16.7 million. In this situation, 10 times X's basis is only $3 million, which is less than $10 million. Thus, the § 1202 exclusion ceiling is restricted to $10 million and $6.7 million of gain must be included in X's taxable gross income and is subject to AMT.

7. Limitation on § 1202 exclusion for partners in partnerships holding QSBS

A partner in a partnership (or member of certain other pass through entities)[51] holding QSBS may qualify for the § 1202 exclusion, but additional limitations particular to the pass-through context apply.[52] The partner must have held her interest in the partnership both (i) at the time the partnership acquired the QSBS and (ii) at the time the partnership sold the QSBS. For purposes of determining the $10 million or 10 times adjusted basis ceiling, the partner's basis is determined to be her proportionate share of the partnership's basis in the stock.[53] Additionally, even if a partner increases her ownership interest in the partnership between the time that the partnership acquires the QSBS and the time it sells the QSBS, the partner's § 1202 gain exclusion is limited based on the partner's original proportionate interest in the partnership, when the partnership acquired the QSBS.[54]

For example, as of January 1, 2011 partner P was a 20% partner in the X partnership. On that date, X bought QSBS for $2 million. By January 1, 2017, P has become a 50% partner in X and on that date X sells all of the QSBS for $3 million. X has a gain of $2 million to allocate to its partners. P is allocated $1 million of gain (50% of $2 million). However, only $400,000 of that gain is eligible for the § 1202 exclusion (20% * $2 million). Additionally, the adjusted basis that would be used for P's $10 million or 10 times adjusted basis § 1202 exclusion ceiling is $400,000 (20% * X's $2 million basis).

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[49] § 1202(b)(1)(A).
[50] § 1202(b)(1)(B).
[51] This discussion also applies to S corporations, regulated investment companies, and common trust funds. the § 1202(g)(4).
[52] § 1202(g).
[53] § 1202(g)(1)(B).
[54] § 1202(g)(3).

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