High Tech Tax Institute – 2021

PANEL DISCUSSION

IRC Section 1202 – Don't Overlook this Old Rule

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AGENDA

I. Introduction of Topic
II. Overview of IRC Section 1202
III. IRS Overview, including Hot Topics/Issues of IRS
IV. Individual Planning for Execs and Employees & Investors
V. Proposed Tax Law Changes Impact

I. A Little QSBS History….And Why Do We Care?

- The rules were added to the IRC in 1993
- Very little guidance provided by the IRS in this area, several PLRs and several court cases (the cases are fairly dated), one set of regs.
- From a federal tax perspective, not much interest until the LT capital gain rates increased from 15% to 20% in 2013. Then a lot more interest when the exclusion was adjusted to 100% for shares issued after September 27, 2010.
- Reason to care: Gain exclusion is generally $10 mil per stock issuance (in some cases higher) which is roughly a $2.4 mil federal tax savings.

II. QSBS General Requirements

- Domestic C-Corporation Stock Acquired at Original Issuance
- Qualified Small Business
- Active Business Requirement
- Five-Year Holding Period

QSBS General Requirements (cont'd)

- C-corporation Stock Acquired at Original Issuance after August 10, 1993
  - In exchange for money or other property (generally property determinations in accordance with Section 351 and case law)
    - Repurchases – important to evaluate, may disqualify shares
  - Stock received for services treated as issued/received when included in recipient's gross income in accordance with Section 83.
  - Exercise of options or warrants, conversion of convertible debt, Conversion of SAFEs
  - Gross asset test at time of exercise/conversion
  - Holding period begins at time of exercise/conversion

QSBS General Requirements (cont'd)

- Stock Received in Exchange for QSB Shares
    - Corporate transactions (§ 368/§ 351)
      - QSB exchanged for stock of another corporation
    - Does other corporation qualify as QSB?
  - Other corporation does not qualify as QSB, then newly exchanged stock only QSBS to extent of gain that would have been recognized at the time of the § 368/§ 351 transaction

QSBS General Requirements (cont'd)

- Aggregate Gross Assets
  - At all times on/after date of enactment and before the issuances of stock being tested do not exceed $50 million
  - Immediately after issuance aggregate gross assets do not exceed $50 million
  - Corporation to submit to IRS and shareholder any reports required by IRS (to date IRS has not required any reporting)
  - Aggregate Gross Assets = Cash + Adjusted Tax Basis of all other property of the corporation
    - If appreciated property is contributed to the corporation, then basis is fair market value at the time of contribution
  - Aggregation rules for parent-subsidiaries

QSBS General Requirements (cont'd)

- Active Business and Eligible Corporation:
  - At least 80% of assets (value) used in active conduct of qualified trade or business.
  - 80% test must be met during "substantially all" of the holding period of the shares ("substantially all" not defined but 80% is commonly used)
  - Working capital considered 100% business asset during first two year of existence, then 50% thereafter
  - No service businesses (ex. engineering, architecture, accounting, banking, insurance, farming, financing, leasing, production/extraction for which a deduction under Section 613, operating hotel/restaurant or similar business)

QSBS General Requirements (cont'd)

- Five-Year Holding Period
    - Begins on original issuance date/exercise/conversion
  - Tacking of holding period
    - Example QSBS exchanged for stock that is also QSBS
    - Partners can receive QSBS treatment for original shares acquired by the partnership, but it gets complicated.

Gain Exclusion (Federal & some States)

- Greater of $10 million (less any amounts previously excluded) or 10 times adjusted basis
- If stock acquired before September 27, 2010, be mindful of treatment as an AMT preference item and limitation on exclusions:
    - 50% Exclusion - Stocks acquired at original issuance from the domestic C corporation after Aug. 10, 1993 and before Feb. 18, 2009 qualify for 50% gain exclusion; **however**, there is a federal Alternative Minimum Tax preference addback of 7% of the excluded gain.
    - 75% Exclusion - Stocks acquired at original issuance from the domestic C corporation after Feb. 17, 2009 and before Sept. 28, 2010 qualify for 75% gain exclusion; **however**, there is a federal Alternative Minimum Tax preference addback of 7% of the excluded gain.
    - 100% Exclusion – Stocks acquired at original issuance from the domestic C corporation after Sept 27, 2010 or later qualify for 100% exclusion for both regular tax and AMT.

Hot Topics & Examples

Hot Topics:

- Maximizing the 10x Basis Exclusion
  - General presumption – maximum exclusion is 10 mil.
  - The rule is the greater of $10 mil (cumulative limit) or 10x cost basis of the shares (annual limit)
  - In many cases the 10x cost basis, especially with Tech companies, is generally a small number.
  - Special basis rule for the contribution of appreciated property – FMV is used as basis rather than cost basis.
  - Reminder – FMV for contributed appreciated assets also applies for the $50 mil test

Hot Topics (cont'd)

<u>10x Basis Example:</u>

- A, an individual, forms a partnership in 2015 with other investors, significant development work over the next year occurs within the partnership, then converts to a C corp via Section 351 (2016)
- §409A value at the time of conversion indicates the value of A's partnership interest is $8 mil and cost basis is $0.
- In 2021, more than five years post-conversion to C corp, A sells all of A's shares for $75 mil, which results in a gain of the same amount.
- The 10x QSBS exclusion is $80 mil, however only $67 mil of gain can be offset because the $8 mil of appreciation at the time of the conversion is deemed basis for purposes of Section 1202

Hot Topics (cont'd)

- Reorganizations/Incorporations
  - Contribution of appreciated property – basis for purposes of QSBS equals FMV
  - Reorganizations – exchange of old QSBS for new QSBS in a tax-free reorganization results in carryover basis, holding period, and QSBS status going forward.
  - Reorganizations – exchange of old QSBS for new non QSBS shares results in continued QSBS status, but gain is capped based on FMV at the time of the reorganization.
  - Section 351 roll overs in an acquisition can qualify if structured correctly

Hot Topics (cont'd)

- Reorganizations/Incorporations Example:
  - A holds QSBS shares with current FMV of $5 mil, zero cost basis, holding period of 4 years, which are exchanged for shares in a domestic C corp via triangular merger with consideration being $1 mil cash and $4 mil of shares of the buyer.
  - The $1 mil is boot and taxable at the time of the transaction (assuming the 5-year holding period is not met)
  - The shares received are not taxable currently, carryover basis and tacked holding period.
  - The buyer is not a QSBS corp
  - Assume A holds the shares for another 2 years and sells for $12 mil - $4 mil of gain qualifies for the QSBS exclusion, the rest is taxable.
  - If the buyer was a QSBS at the time of the exchange, then A can exclude $10 mil of the gain.

Hot Topics (cont'd)

- Recapitalizations
  - Technically, a reorganization under §368.
  - §1202(h)(4) provides that in the case of a transaction described in §368 results in the receipt of shares which would not qualify as QSBS, then the QSBS status is retained, but gain is capped.
  - §1202(h)(3) provides that rules similar to §1244(d)(2) shall apply. §1244 relates to losses on small business stock.
  - §1244(d)(2) and the underlying regulations appear to provide relief for recaps and F reorgs, but its subject to interpretation.
  - Some risks that a recap could result in future appreciation not qualifying as QSBS.

Hot Topics (cont'd)

- Redemptions:
  - Anti churning provision to prohibit shareholder from converting non-qualified shares into QSBS shares
  - Section 1202 does not define redemptions – interplay with Section 302 and 301….buy back could be a dividend, but also subject to 1202 redemption rules
  - First anti churning rule – <u>existing shareholder redeems</u> shares, then purchases new shares. From the date of the issuance, the redemption must be outside a 4-year period beginning on the date 2 years before the issuance of such shares
  - Second anti churning rule – <u>Significant Redemptions</u>
    - Similar testing window but 2 years instead of 4 years
    - Significant redemption is defined as one or more purchases of stock with an aggregate value exceeding 5% of all stock based on the value at the beginning of the testing period.
    - If a significant redemption, then shares issued during the 2-year window do not qualify.
    - Companies that have experienced rapid growth over a short period are particularly impacted because the denominator is the value of all shares 1 year earlier.

III. IRS Overview – Erika Reigle, IRS

- IRS Hot Topics

- Issues

IV. Tips for Executives, Employees, Investors

- Exercise stock options early [Sec. 1202(d)(1)]
- Make 83(b) elections timely [within 30 days, Sec. 1202(a)(1)]
- Maximize exclusions
  - Stacking through gifts[Sec.1202(h)(2)]
  - State conformity [CA disallows, some (MA) modifies, most allows (NY, CO)]
  - QSBS stock with different basis[Sec.1202(b)(1)]
  - Going IPO through a SPAC [Sec. 1202(h)(4)(B)]
- Section 1045 rollover (held for >6 months, within 60 days, SAFE?)

Section 1045 Deferral

- Ability to sell QSBS held for more than 6 month and uses *all* proceeds to purchase other QSBS within 60 days beginning on the date of sale
  - Proceeds not used to purchase QSBS, gain recognized
  - Basis in QSBS purchase price less unrecognized gain
  - Original QSBS holding period counted
  - Timely election
  - Gain cannot be ordinary income
  - Possible for partnership to rollover, specific requirements

V. Proposed Tax Law Considerations:

- House Ways and Means Proposed Changes
  - Retains 1202 rules for Taxpayers with $400k or less of AGI
  - Eliminates the 75% and 100% exclusion for Taxpayers with AGI above $400k
  - Retains 50% exclusion for all Taxpayers
  - Effective for sales occurring after September 13, 2021

Comparison of Section 1202 and 1244 Stock Rules

	Section 1202 Stock	Section 1244 Stock
Objective of provision	Allows full or partial exclusion of gain from the sale of stock.	Allows ordinary loss treatment for stock dispositions or worthlessness.
Eligible stock	Stock must be issued by a corporation that on the date of issuance qualifies as a small business corporation (a domestic C corporation with cash and other assets totaling $50 million or less, based on adjusted basis, at all times from August 10, 1993, to immediately after the stock is issued).	Stock must be issued in exchange for money or other property (other than stock and securities). Stock issued for services rendered or to be rendered to the corporation does not qualify. The cancellation of debt in exchange for stock qualifies unless the debt is evidenced by a security or arises from the performance of personal services.
Eligible shareholder	The shareholder must acquire the stock in an original issue in exchange for money or other property or as compensation (although certain tax-free transfers and exchanges also qualify). Transfers of stock by a shareholder to an employee or third party in connection with performance of services are not a purchase even if stock is considered to have been transferred by the corporation [Reg. 1.1202-2(c)].	The stock must be issued to an individual or a partnership. Reg. 1.1244(a)-1(b) provides that only the individual or partnership to whom the stock was originally issued is entitled to ordinary loss treatment under IRC Sec. 1244. An individual who acquires the stock by purchase, gift, devise, or any manner other than directly from the corporation or its agent may not claim a Section 1244 ordinary loss.
Eligible corporation	At least 80% of the value of the corporation's assets must be used in a qualified trade or business during substantially all of the taxpayer's holding period for the stock, and the corporation cannot be a DISC, RIC, REIT, REMIC, or cooperative. A qualified trade or business excludes: 1. health, engineering, architecture, accounting, law, etc.; 2. banking, insurance, financing, leasing, investing, etc.; 3. farming; 4. production of products subject to percentage depletion; and 5. hotels, motels, restaurants, or similar businesses.	The corporation cannot have capital receipts in excess of $1 million on the date the stock is issued. A separate determination is made each time new stock is issued. The first year the capital receipts exceed $1 million and the corporation issues stock is known as the *transitional year*. All stock issued in years before the transitional year may be Section 1244 stock, while none of the stock issued in years after the transitional year can be Section 1244 stock. In the transitional year, the corporation can designate which shares are to be Section 1244 stock. Otherwise, the regulations provide the operative rules.
Is an S corporation eligible?	Stock issued by an S corporation does not qualify as QSBS. However, an S corporation, partnership, or other pass-through entity can own QSBS.	Stock issued by an S corporation can be Section 1244 stock. However, only an individual or a partnership can own Section 1244 stock.

	Section 1202 Stock	Section 1244 Stock
Gain or loss limitation	Gain eligible for exclusion in a tax year is limited to the greater of: 1. 10 times the taxpayer's aggregate adjusted basis in the QSBS that is sold, or 2. $10 million reduced by the eligible gain taken into account in prior tax years for dispositions of stock issued by the corporation ($5 million for married filing separate status). This limitation is a lifetime per corporation limitation—it applies to the cumulative gains from dispositions of stock of a specific QSBC.	The annual maximum deduction is $50,000, although married taxpayers filing joint returns are limited to $100,000 annually, regardless of which spouse owns the stock. The $100,000 limitation applies whether one or both spouses sustains a Section 1244 loss. If both spouses sustain separate losses the same year, the limit is $100,000. In the case of a partnership, the limitation applies at the partner level. Gains and losses in the same year are not netted together before applying the annual dollar limitation.
Other rules	Gain generally does not qualify for the exclusion if: 1. at any time during the four-year period beginning two years before the issuance of the stock, the issuing corporation purchased (directly or indirectly) any of its stock from the taxpayer or a related person; or 2. during the two-year period beginning one year before the issuance of the stock, the issuing corporation made one or more purchases of its stock with an aggregate value exceeding 5% of the aggregate value of all its stock at the beginning of the two-year period. A corporation will not be treated as a qualified trade or business for any period during which more than 10% of the total value of its assets consists of stock or securities in another corporation that is not a subsidiary, or real property that is not used in the active conduct of a qualified trade or business.	During the five most recent tax years ending before the date the loss was sustained by the shareholder (or the life of the corporation, if less than five years), the corporation must have derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. If the company's deductions (other than NOLs and special dividend received deductions) exceed gross receipts for the five-year period, the gross receipts test does not apply. Even if the gross receipts test is passed (or the corporation qualifies for the exception noted in the preceding sentence), the corporation must have been an operating company for the five-year testing period. It must not have been a holding or investment company.