NEAL GERBER EISENBERG

Qualified Small Business Stock Overview

August 27, 2020

While we generally advise our clients to structure their investments through limited liability companies, limited partnerships, and to a lesser extent, S corporations, some of our clients are forced to invest in C corporations, which are subject to double taxation. Occasionally, we meet a potential client who structured their operations as a C corporation without considering whether another structure would have been advantageous. Our goal in these situations is to make lemonade out of lemons, by looking for potential tax advantages that are available to those who invest in C corporations.

Certain equity investments in small business C corporations are afforded preferential tax treatment under three sections of the Internal Revenue Code:

- Section 1202 provides taxpayers with an exclusion for certain gains recognized with respect to stock of a "qualified small business corporation."
- Section 1045 allows a taxpayer to rollover any gains realized on the sale of stock of one qualified small business corporation into the stock of another qualified small business corporation, and, thus, defer payment of tax on such gains.
- Section 1244 permits taxpayers to treat losses with respect to stock of small business corporations as ordinary in character instead of capital in nature.

Sections 1045 and 1202 mitigate some of the effects of "double-taxation" of C corporations by reducing effective shareholder-level tax rates. Similarly, section 1244 also mitigates some of the effect of using the corporate form by permitting shareholders to treat investment losses as ordinary in character. As discussed below, each of these sections has its own requirements that must be met in order for a taxpayer to obtain the benefits provided by that section. Many small business corporations do not qualify under each of the sections.

The following is a brief overview of each of these provisions. Note, however, that depending upon the facts of a specific situation, certain exceptions, limitations, and additional requirements may apply. *Therefore, this memo should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents of this memo are intended solely for general purposes, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. The memo is not intended and should not be considered as a solicitation to provide legal services. However, the memo or some of its content may be considered advertising under the applicable rules of the supreme courts of Illinois and certain other states.*

Exclusion of Gain From Qualified Small Business Stock

Under the right circumstances, taxpayers other than corporations generally can exclude from their gross income 100 percent of the gains from the sale or exchange of qualified small business stock held for more than five years, subject to certain limitations discussed below. Although the corporation does not need to be "small" at the time of sale, the amount of gain that can be excluded by a taxpayer with respect to the stock of any one corporation is limited to the greater of $10 million or ten times the taxpayer's aggregate adjusted bases in the stock.

REQUIREMENTS

In order for stock to qualify as "qualified small business stock:"

- the underlying corporation must have been a "qualified small business" as of the date that the stock was issued;
- the stock must have been acquired by the taxpayer directly from the corporation or through an underwriter at the corporation's original issue date of the stock (*i.e.*, not a repurchase) for money, property, or services;
- the stock must have been of a C corporation and issued originally after August 1993; and
- the underlying corporation must have been engaged in an "active business" during substantially all of the time during which the taxpayer held the stock.

QUALIFIED SMALL BUSINESS REQUIREMENT

A "qualified small business" is a domestic C corporation, which (i) had aggregate gross assets less than or equal to $50 million from August 1993 until the issuance of its stock, (ii) had aggregate gross assets less than or equal to $50 million immediately after the issuance of its stock, and (iii) agrees to report any information to the Internal Revenue Service and its shareholders that the Internal Revenue Service may require. "Aggregate gross assets" is the sum of cash and the aggregate adjusted bases of other property held by the corporation. The adjusted basis of property contributed to a corporation is the fair market value of the property at the time of the contribution. If the corporation is a member of a parent-subsidiary controlled group, then all members of the group are treated as a single corporation for purposes of the $50 million aggregate gross asset limit. Corporations are generally treated as part of a parent-subsidiary controlled group if at least 50 percent of the stock (by vote or value) is owned by other members of the group.

ACTIVE BUSINESS REQUIREMENT

A corporation satisfies the "active business" requirement if: (1) at least 80 percent (by value) of the business assets are used in a qualified trade or business (*i.e.*, not professional services, finance, farming, natural resource extraction, or hotels); (2) the corporation is an "eligible corporation;"[1] (3) less than 10 percent of the value of the corporation's net assets is stock of an unrelated corporation; and (4) less than 10 percent of the corporation's assets consist of real property that is not used in the active conduct of a qualified trade or business.

OTHER LIMITATIONS

While redemptions in connection with the termination of services of employees and directors, or with the death, disability, incompetence, or divorce of a shareholder, are generally permitted, the IRS will not treat stock as "qualified small business stock" if certain redemption transactions occur shortly before or after the stock issuance because it would violate the original issuance requirement. First, stock will not be treated as qualified small business stock with respect to a particular taxpayer if the issuing corporation purchased more than a de minimis amount of its own stock directly or indirectly from the taxpayer or a party related

1. An "eligible corporation" is any domestic corporation, other than a DISC, a corporation with a section 936 election, a corporation with a subsidiary with a section 936 election, or a RIC, REIT, REMIC, or Cooperative.

to the taxpayer within the four-year period beginning two years before the issue date. Stock acquired by the corporation exceeds a de minimis amount only if the corporation paid more than $10,000 in the aggregate for the stock and acquired more than 2 percent of the stock held by the taxpayer and related persons to the taxpayer.

Second, any stock issued by a corporation (to any taxpayer) will not be treated as qualified small business stock if the issuing corporation made at least one "significant redemption" during the two-year period that begins one year before the date of the stock issuance. There is a "significant redemption" if the amount redeemed has an aggregate value (at the time of the respective purchases) greater than 5 percent of the aggregate value of the underlying corporation's stock at the beginning of the two-year period, and more than a de minimis amount is purchased. Stock acquired by the corporation exceeds a de minimis amount only if the corporation paid more than $10,000 in the aggregate for the stock and acquired more than 2 percent of the outstanding stock.

It should be noted that if the issuing corporation engages in a restructuring or similar transaction that, under the rules of section 304, is recharacterized for federal income tax purposes as a distribution in redemption of its stock, the issuing corporation may run afoul of the foregoing limitations.[2]

Because the redemption provisions are complicated, some examples are warranted. Assume that Founder 1 and Founder 2 form Corporation A on January 1, 2012. Each Founder receives 100 shares of Corporation A stock in exchange for an initial investment of $2,500 each. Each share has a par value of one cent ($0.01). Assume further that Angel Investor 1 acquires 100 newly-issued shares of Corporation A on January 1, 2015 in exchange for $1 million. Because Angel Investor 1 is acquiring one-third of Corporation A for $1 million, assume for purposes of this example that Corporation A is valued at $3 million. On January 1, 2015, Founder 1 and Founder 2 enter into a stock restriction agreement under which each of their 100 shares are treated as unvested and subject to a vesting schedule under which 20 percent of such stock vests annually over five years. Thus, under the stock restriction agreement, each Founder is permitted to retain 100 percent of their stock if they remain with Corporation A for five years (until December 31, 2019). However, Corporation A will redeem at par value: (1) 100 percent if a Founder resigns before December 31, 2015; (2) 80 percent if a Founder resigns before December 31, 2016; (3) 60 percent if a Founder resigns before December 31, 2017; (4) 40 percent if a Founder resigns before December 31, 2018; and (5) 20 percent if a Founder resigns before December 31, 2019.

In Scenario 1, the Founders each stay through December 31, 2019 and Corporation A does not redeem any shares from Founder 1, Founder 2, or Angel Investor 1. In this case, assuming all other requirements are met, all of the shareholders of Corporation A should be eligible to exclude gain on the sale of their Corporation A stock up to the applicable limit.

In Scenario 2, Founder 1 resigns before December 31, 2015 and, as a result, Corporation A redeems all of Founder 1's shares for $1 (100 shares x $0.01 par value). Although Corporation A has redeemed one-third of the shares of the company within one year of issuing shares to Angel Investor 1 (and, thus, within the two-year period beginning one year before the January 1, 2015 issuance of shares to Angel Investor 1), the redemption should not be treated as a "significant redemption" because Corporation A did not pay more than a "de minimis" amount for the shares of Founder 1. As such, Founder 2 and Angel Investor 1 should be eligible to exclude gain (up to the applicable limit) on the sale of their Corporation A stock (assuming all other requirements are met).

In Scenario 3, the facts are the same as Scenario 2, except that Corporation A redeems the stock of Founder

2. The rules of section 304 are extremely complicated and are beyond the scope of this document.

1 at fair market value, which is determined to be $1 million ($3 million FMV of Corporation A / 300 issued shares x 100 unvested shares held by Founder 1). Corporation A has engaged in a significant redemption because it redeemed Investor 1 for more than 5 percent of the $3 million aggregate value of Corporation A's stock and the purchase amount is more than de minimis because it is greater than $10,000 and more than 2 percent of the outstanding stock. Angel Investor 1 will not be eligible to exclude gain on the sale of the stock issued to him on January 1, 2015 because Corporation A engaged in a significant redemption before December 31, 2015, and, therefore, during the two-year period beginning one year before, and ending one year after, the date of the stock issuance to Angel Investor 1 (*i.e.*, January 1, 2014 to December 31, 2015). If, however, Founder 2 were to sell his or her stock, Founder 2 would remain eligible to exclude gain from the sale of such stock (assuming all other requirements are met) because the significant redemption between January 1 and December 31, 2015 did not occur during two-year period of January 1, 2011 to December 31, 2012 (which began one year before the issuance of stock to Founder 2 on January 1, 2012).

In Scenario 4, the facts are the same as Scenario 3, except that (i) Founder 1, Founder 2, and Angel Investor 1 all acquired their shares on January 1, 2015, and (ii) Founder 1 resigns between January 1 and December 31, 2016, after 20 percent of Founder 1's stock vests on December 31, 2015. Thus, in this scenario, Corporation A redeems 80 percent of Founder 1's shares for $800,000 ($3 million FMV of Corporation A / 300 issued shares x 80 unvested shares held by Founder 1) between January 1 and December 31, 2016. Founder 1 will not be eligible to exclude gain on the sale of his or her 20 vested shares because Corporation A engaged in a prohibited redemption with Founder 1 by paying more than a de minimis amount for shares from Founder 1 during the four-year period beginning two years before, and ending two years after, the date of the stock issuance to Founder 1 (*i.e.*, January 1, 2013 to December 31, 2016). However, because Corporation A did not engage in a significant redemption during the two-year period beginning one year before, and ending one year after, the date of stock issuance to Founder 2 and Angel Investor 1 (*i.e.*, January 1, 2014 to December 31, 2015), Founder 2 and Angel Investor 1 remain eligible to exclude gain from the sale of their stock assuming all other requirements are met.

Rollover of Gain From Qualified Small Business Stock to Another Qualified Small Business Stock

A taxpayer (other than a corporation) may be able to defer gain on the sale of qualified small business stock under section 1045 if certain holding periods and affirmative elections are satisfied, and the taxpayer timely completes a "rollover" by purchasing qualified small business stock in a new qualified small business. In order to qualify, taxpayers must sell the qualified small business stock (*i.e.*, other "exchanges" are not permitted), have held the qualified small business stock for more than six months at the time of sale, and affirmatively elect rollover treatment.

Stock must meet the definition of qualified small business stock under section 1202, discussed above, to qualify for deferred gain "rollover" treatment.

However, even if a taxpayer otherwise qualifies for deferral under the provisions above, the taxpayer must recognize gain to the extent that (i) the amount realized on the sale of qualified small business stock exceeds (ii) the cost of the "new" qualified small business stock purchased during the 60-day period beginning on the date of sale, reduced by any portion of that cost used to shelter the amount realized with respect to the sale of other qualified small business stock.

Losses on Small Business Stock

An individual or a partner in a partnership that recognizes loss on "section 1244 stock" that was originally issued to them by a domestic "small business corporation" for money or property may treat the loss as ordinary in character. The amount of loss on section 1244 stock that will be treated as ordinary in character is limited to $50,000 per year for an individual. For stock to qualify as section 1244 stock, it must be common or preferred stock, have been issued by a domestic small business corporation, have been issued for money or property other than stock or securities, and the corporation issuing the stock must pass a gross receipts test under which more than 50 percent of the corporation's income was derived from "active" sources (*i.e.*, trade or business income, not investment income) during the five tax years before the year in which the loss was sustained. A small business corporation for purposes of section 1244 is one with "capital receipts" (*i.e.*, contributions to capital and paid-in surplus) in exchange for its stock that do not exceed $1,000,000. The "capital receipts limitation" applies to all capital receipts of the corporation, whenever received, and is not reduced for capital distributions.

For more information about how Neal Gerber Eisenberg can serve your business needs, contact **Michael Gray** at **312.269.8086** or email **mgray@nge.com**.