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# Tax Bulletin

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**Qualified Small Business Stock: Reaping the Tax Benefits**

**Introduction**

In the summer of 1993, Congress added a new section to the Internal Revenue Code, Section 1202, as part of its long-range plan of stimulating investment in smaller businesses that traditionally have found it difficult to compete for capital. In general, Congress intended that, commencing on August 12, 1998, Section 1202 would exempt from federal income taxation up to 50% of any gain realized from the sale of "qualified small business stock", as defined in great detail under Section 1202 ("QSB Stock").

In 1997, Congress took yet another step toward stimulating investment in smaller businesses by enacting Section 1045 of the Internal Revenue Code. In enacting Section 1045, Congress complemented Section 1202 by providing further benefits to holders of QSB Stock. Effective as of August 6, 1997, Section 1045 allows certain investors to defer the tax on - or "roll over" - their gains from the sale of QSB Stock if they promptly reinvest the sale proceeds in other QSB Stock.

While many investors celebrated the enactment of Sections 1202 and 1045, others initially questioned the utility of these provisions, particularly in light of the restrictions placed on companies seeking to issue QSB Stock. Perhaps in response to these questions, the Treasury recently promulgated regulations that ease some of the restrictions imposed on companies seeking to issue QSB Stock. As a result, investors increasingly are availing themselves of the benefits afforded by Sections 1202 and 1045. This Tax Advisory summarizes these benefits, as well as the basic mechanics for securing them, particularly in light of the regulations promulgated by the Treasury.

**The Benefits Afforded to Investors in QSB Stock**

***50% Gain Exclusion Under Section 1202***

As a general principle, a non-corporate investor may exclude from federal taxable income 50% of any gain realized from the sale of QSB Stock held for more than five years. Because long-term gain from the sale of QSB Stock is still subject to federal income taxation at a maximum rate of 28% (and not the lower 20% rate currently in effect with respect to most other types of assets), the effect of the

50% exclusion, if fully applicable, is to yield a maximum tax rate of 14% on the gain realized from the sale of QSB Stock.

The 50% exclusion, however, may be subject to limitations, some of which can potentially reduce or eliminate the exclusion in its entirety. First, with respect to each issuer of QSB Stock, the amount of gain that an investor is eligible to exclude generally is limited to the greater of:

- $10,000,000, reduced by the amount of gain attributable to the issuer's stock already excluded by the investor in prior tax years; and
- 10 times the aggregate adjusted basis of all of the issuer's QSB Stock disposed of by the investor during the current tax year.

Second, and often more importantly, investors who seek to avail themselves of the 50% exclusion with respect to QSB Stock must consider the potential application of the alternative minimum tax. In particular, under current law, 42% of any gain excluded under Section 1202 is treated as an item of tax preference for purposes of the alternative minimum tax. As a result, an investor who sells a significant amount of QSB Stock during a particular year may be required to pay the alternative minimum tax in that year. Under these circumstances, the investor effectively will pay a tax of up to 19.88% on the gain realized from the sale of QSB Stock - virtually the same tax that the investor would have paid upon the sale of non-QSB Stock.

***Rollover of Gain Under Section 1045***

Because the alternative minimum tax effectively may yield a tax of close to 20% on long-term gain attributable to the sale of QSB Stock, many investors have questioned whether they really can derive significant benefits from investing in such stock. An affirmative answer may be found in Section 1045.

Section 1045, amended earlier this year, provides that, for any sale of QSB Stock after August 5, 1997, an investor may elect to defer the tax on - or "roll over" - the gain from the sale if, prior to the sale, the stock was held for more than six months and the investor purchases other QSB Stock during the 60-day period beginning on the date of the sale. Thus, under Section 1045, investors can effectively shift their positions in issuers of QSB Stock without attracting federal income taxes.

In order to qualify for the Section 1045 rollover, the replacement stock must be QSB Stock immediately prior to its purchase by the investor, and the issuer of the replacement stock must satisfy the "active business" requirement (discussed below) for at least the 6-month period following the purchase. For this reason, an investor seeking the benefits of a Section 1045 rollover may request representations from the issuer of the replacement stock to the effect that such stock is QSB Stock and that the issuer will satisfy the active business acquirement for at least 6 months.

In the case of a rollover under Section 1045, gain is recognized by the investor only to the extent that the amount realized on the sale of the stock exceeds the purchase price for the replacement stock. To the extent that gain is not recognized, that amount will be applied to reduce the investor's basis in the replacement stock. In general, the investor's holding period for the replacement stock will include the holding period for the stock sold.

**The Requirements for Treatment as QSB Stock**

Central to attaining the 50% exclusion and rollover benefits described above is the status of the stock in question as "QSB Stock". For these purposes, stock will be treated as "QSB Stock" only if all of the following requirements are satisfied:

- the issuer was a "qualified small business" as of the date of issuance (a "QSB");
- the issuer was and has continued to be a domestic C corporation;
- the stock originally was issued on or after August 10, 1993;
- during substantially all of the investor's holding period, the issuer has satisfied the "active business" requirement described below; and
- with certain limited exceptions, the stock was acquired by the investor at original issue in exchange for cash, property (other than stock), or as compensation for services (other than as an underwriter of the stock).

**The QSB Requirement**

An issuer can be a "QSB" only if it is a domestic C corporation that does not have aggregate gross assets in excess of $50 million prior to or immediately after the issuance of the stock in question. In making this determination, a corporation's gross assets generally include its cash and the aggregate adjusted tax basis of any other property held by the corporation (with special rules for any property contributed to the corporation).

**The Active Business Requirement**

In order to satisfy the "active business" requirement, the issuer must use at least 80% of its assets in the active conduct of one or more "qualified trades or businesses." For this purpose, professional services, financial and brokerage services, banking, insurance, and farming businesses, as well as any business involving the production or extraction of products for which depletion deductions are allowable, and any business operating a hotel, motel, restaurant, or similar business are not considered qualified trades or businesses. In addition, special tax-advantaged entities (such as domestic international sales corporations, regulated investment companies, and real estate investment trusts) cannot satisfy the active business requirement.

Furthermore, in order to satisfy the "active business" requirement, an issuer generally cannot own:

- real property not used in the active conduct of a qualified trade or business, if the value of the real property exceeds 10% of the issuer's total assets; or
- stock or securities in other corporations (not including greater than 50% subsidiaries of the issuer) the value of which exceeds 10% of the issuer's total net assets.

Nevertheless, assets used in certain start-up activities, research and experimental activities, or in-house research activities generally are treated as used in the active conduct of a qualified trade or business. Moreover, assets held to meet the reasonable working capital needs of a qualified trade or business or that are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation or increases in the working capital of a qualified trade or business generally are treated as used in the active conduct of such business. Finally, certain royalty-producing rights to computer software are also treated as used in the active conduct of a trade or business.

**The Original Issue Requirement**

As stated above, the investor must acquire QSB Stock at original issue in exchange for cash, property (other than stock), or as compensation for services (other than as an underwriter of the stock). In order to deter efforts to circumvent this original issue requirement, Section 1202 provides that stock acquired by an investor will not be treated as QSB Stock if, at any time during the 4-year period beginning 2 years before the issuance of the stock, the issuer redeems any of its stock from the investor or a related person (the "4-year rule"). Moreover, stock acquired by an investor will not be treated as QSB Stock if, at any time during the 2-year period beginning 1 year before the issuance of the stock, the issuer redeems stock with an aggregate value exceeding 5% of the aggregate value of all of its stock as of the beginning of the 2-year period (the "2-year rule").

**Regulatory *De Minimis* Exceptions**

Recognizing the somewhat rigid and potentially restrictive nature of the 4-year and 2-year rules, the Treasury recently finalized regulations that provide exceptions to such rules. In particular, these regulations, which apply to all stock issued after August 10, 1993, allow a " *de minimis* " amount of stock to be redeemed by an issuer without disqualifying the issuer's stock as QSB Stock.

With regard to the 4-year rule, the regulations provide that stock acquired from an investor or a related person exceeds a *de minimis* amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2% of the stock held by the investor and related persons is acquired. With regard to the 2-year rule, the regulations provide that stock exceeds a *de* *minimis* amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2% of all of the outstanding stock of the issuer is purchased.

In addition, the regulations provide exceptions to the 4-year and 2-year rules for redemptions in connection with certain events. For purposes of such rules, deemed redemptions resulting from transfers of stock by a shareholder to an employee or to an independent contractor in connection with the performance of services (or to a beneficiary of such employee or independent contractor) will not be taken into account. Moreover, redemptions will be disregarded if:

- the stock was acquired in connection with the performance of services as an employee or director and is redeemed incident to the seller's retirement or other bona fide termination;
- under certain circumstances, the stock is redeemed from a decedent's estate, beneficiary, heir, surviving joint tenant, surviving spouse, or trust within 3 years and 9 months of the decedent's death;
- the stock is redeemed incident to the disability or mental incompetency of the seller; or
- the stock is redeemed incident to the divorce of the seller.

**Proposed Legislation**

Currently, Congress is considering proposed legislation that not only would significantly enhance the benefits of investing in QSB Stock (by, among other things, repealing the alternative minimum tax preference described above), but also would permit larger corporations to issue QSB Stock. While there is no certainty that this legislation will be enacted or that it will be enacted in its present form, investors and issuers should continue to monitor its progress, as it may significantly alter the mechanics and overall effects of Sections 1202 and 1045.

**Conclusion**

Particularly in light of the regulations recently promulgated by the Treasury, investors should consider the significant benefits that may become available to them by properly structuring their investments as investments in QSB Stock. Similarly, issuers should consider the fact that if they properly ensure that their stock is QSB Stock, they may be able to enhance its value, perhaps with little or no additional cost.

Nevertheless, Sections 1202 and 1045 are quite complex, spanning several pages of statutory text, and only some of their provisions, benefits, and implications are summarized in this Tax Advisory. Moreover, the various states afford differing treatment to, or may even have their own versions of, Sections 1202 and 1045. Accordingly, investors and issuers should consult with their tax advisors regarding their specific circumstances prior to relying on Sections 1202 and 1045.

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