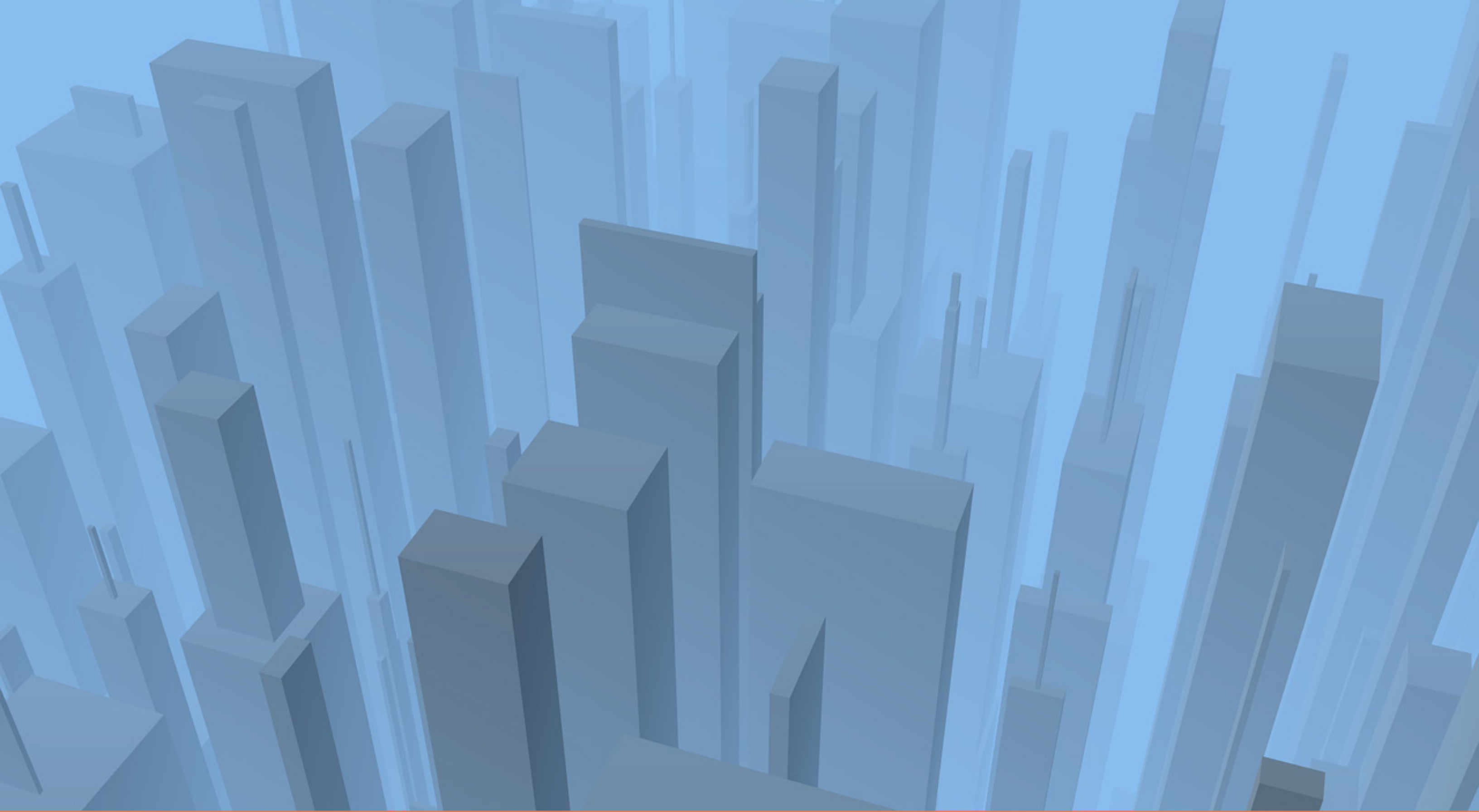

The 21% Corporate Tax Rate Breathes New Life Into IRC § 1202

Prepared by:
Scott W. Dolson, Frost Brown Todd LLC

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PROFESSIONALS

Scott W. Dolson
sdolson@fbtlaw.com
502.568.0203

PRACTICES

Corporate/Business
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Legal update

In the aftermath of the 1986 tax act and the introduction of LLCs, pass-through entities (LLC and S corporations) replaced C corporations as the default choice for closely-held businesses. Several changes made by the 2017 Tax Cuts and Jobs Act (the "2017 Tax Act") have put this settled planning issue back into play. The 2017 Tax Act reduced the top corporate tax rate from 35% to 21%, eliminated the corporate alternative minimum tax, and left untouched the C corporation's right to deduct state and local taxes. In prior years, the potential benefits of IRC § 1202 tax treatment for C corporation stock were usually dismissed as being too speculative to move the dial in favor of choosing the C corporation. But in combination with the recent tax law changes, the additional benefits of IRC § 1202 make a strong case for at least taking a close look at organizing a new business through a C corporation.

IRC § 1202 provides favorable tax treatment for gains on the sale of qualifying C corporation stock, subject to the various requirements and limitations described below. These benefits are not available to S corporation shareholders or the holders of disregarded entities or partnership (LLC) interests.

Whether the tax law changes and IRC § 1202 now tip the scales in favor of selecting the C corporation will depend on a thoughtful analysis of the unique facts associated with a business and its owners. In recent years, attorneys at Frost Brown Todd have worked extensively with their start-up clients addressing choice of entity planning issues, including the potential benefits of IRC § 1202. Contact Scott Dolson or other members of our tax practice if you need assistance.

If you qualify under IRC § 1202, you may be eligible to exclude 100% of the gain on the sale of your qualifying stock!

A taxpayer, other than a corporation, may exclude 100% of the gain on the sale "qualified small business stock" (QSBS) acquired after September 27, 2010, subject to certain limitations discussed below. A sale transaction can include a third-party sale or a redemption of stock by the corporation, if the redemption qualifies for sale treatment under IRC § 302. If a corporation sells substantially all of its assets, its shareholders can liquidate the corporation in order to take advantage of IRC § 1202's benefits.

The potential benefits of IRC § 1202 are compelling when they apply. What shareholder wouldn't welcome excluding 100% of his or her gain from income? The catch is that there are numerous limitations on the availability of IRC § 1202's benefits. These qualification requirements and other limitations must be carefully considered in the planning process.

QSBS must be acquired directly from the issuing corporation by an individual or pass-through entity for cash or property (other than stock) or services

An individual investor (an individual can also own QSBS through a partnership or S corporation) must acquire QSBS directly from the issuing C corporation, not from another stockholder. An exception to this original issuance requirement is where a stockholder gifts QSBS or QSBS is transferred in connection with the original stockholder's death. Unless one of the few exceptions discussed below applies, QSBS will lose its eligibility if it is transferred by the original owner.

An investor can purchase QSBS with cash, or property other than stock. An exception to the "no stock" rule is where the stockholder exchanges QSBS for other stock in a transaction that qualifies for tax-free treatment under IRC §§ 351 or 368. If the acquiring corporation meets the various IRC § 1202 requirements, then the acquiring corporation's stock issued in the transaction is fully treated as QSBS. If the acquiring corporation does not meet the various QSBS requirements, then the exclusion will apply only to the stockholder's built-in gain in the surrendered QSBS at the time of the tax-free exchange. The holding period of exchanged QSBS will be tacked onto the holding period for the replacement stock for purposes of satisfying the five-year holding period requirement.

For IRC § 1202 purposes, "property" is generally broadly defined to include most tangible and intangible assets, so long as, in the case of intangible assets, the transferor transfers "all substantial rights" to the property. "Founder stock" issued for nominal consideration should qualify as QSBS, but care should be taken to document the payment of some amount of cash or contribution of tangible or intangible assets, or clearly bring the stock within the scope of IRC § 83 as compensation for services. QSBS can be issued in connection with a partnership's incorporation. QSBS can also be issued upon the exercise of options and warrants, or in exchange for convertible debt, with the five-year holding period commencing when the stock is issued.

Stock issued as compensation for services (i.e., subject to IRC § 83) can also qualify as QSBS. If the stock is subject to restrictions, it will be treated as being issued for purposes of the five-year holding period requirement when the restrictions lapse, or when an IRC § 83(b) election is made.

Start-up businesses anticipating substantial funding should consider the potential impact of cash investments on the corporation's eligibility to issue QSBS under the $50 million "gross assets" test. In some cases, it will make sense to organize a business as an LLC taxed as a partnership, allowing for the pass-through of losses. But the LLC should be converted into a C corporation before the fair market value of the business exceeds $50 million.

If a start-up business is operated as an S corporation, the founders cannot convert the business to a C corporation and take advantage of QSBS treatment for their previously issued stock. A corporation must be a C corporation when QSBS is issued. But stock acquired after the conversion of an S corporation may qualify as QSBS.

The issuing corporation must be engaged in an active business

IRC § 1202 provides that at least 80% by value of a C corporation's assets must be used in the conduct of one or more "active businesses" for the stock to qualify as QSBS. No more than 10% of the total value of the corporation's assets may be held in the form of real estate not used in the conduct of the "active businesses." Additionally, no more than 10% of the total value of the corporation's assets may be held in portfolio stock or securities in other corporations which are not subsidiaries of the corporation. The active business requirement is waived in determining QSBS qualification for stock of any Specialized Small Business Investment Company (Small Business Administration licensed, privately run investment funds that provide debt and equity financing to small businesses).

A manufacturing or technology business would generally qualify as an "active business." Licensing computer software for royalties is considered engaging in an "active business." The list of businesses that don't qualify as "active businesses" is a long one: most services businesses, real estate businesses, banking, insurance, financing, leasing, investing businesses, farming, mining or mineral production businesses, and hospitality businesses. In connection with the choice of entity decision, founders should consider whether their business will satisfy the "active business" requirement.

The "aggregate gross assets" of the issuing corporation must not exceed $50 million at any time prior to QSBS issuance

The term "aggregate gross assets" means the sum of cash and the aggregate adjusted bases of all other property. If property other than cash is contributed to the corporation, the adjusted basis of the property contributed is deemed to be equal to the fair market value of the property (including goodwill) at the time of contribution (beware of this rule in connection with the incorporation of a partnership).

The $50 million aggregate gross assets test applies at the time of the issuance of QSBS, including at the time of the exercise or conversion of options, warrants or convertible debt. The rule addressing contributed property should be considered in connection with timing of a partnership's incorporation. The fact that a corporation's "aggregate gross assets" exceeds $50 million after the issuance of QSBS doesn't affect the favorable tax treatment afforded the already-issued stock.

QSBS must be held at least five years after issuance

The five-year holding period requirement will always add an element of uncertainty to a choice of entity analysis. If shares are issued in connection with the incorporation of a partnership, the clock doesn't start running until the date of incorporation, regardless of how long the business has operated in partnership form.

This is true even though the holding period for other purposes includes the holding period of property contributed in a tax-free IRC § 351 transaction. The holding period for QSBS issued upon the exercise of warrants or options or the conversion of debt begins when the stock is issued. The holding period for restricted stock issued to service providers begins when the restrictions lapse or when an IRC § 83(b) election is made. The holding period rule has exceptions for gifted stock or stock transferred in connection with a stockholder's death.

Limitations on eligible gain

A stockholder's gain from QSBS is limited to the **greater of** (i) $10 million reduced by the aggregate amount of eligible gain taken into account by the taxpayer under IRC § 1202 in prior taxable years with respect to stock of the same issuer, or (ii) 10 times the aggregate tax bases of the QSBS of that issuer disposed of by the stockholder during the taxable year. Basically, for each issuer of QSBS, a taxpayer is generally limited to applying the IRC § 1202 limitation to $10 million of eligible gain. With respect to the sale of a corporation's stock, a stockholder is not entitled to both the QSBS gain exclusion and reduced capital gains rates. If a stockholder is lucky enough to own QSBS that blows through the $10 million ceiling, the 20% long-term capital gain rate will apply to any gain which is not excluded under IRC § 1202.

Stock redemptions in close proximity to the issuance of stock may adversely affect eligibility for QSBS treatment

Stock redemptions that occur around the time of issuance of stock will adversely affect its qualification as QSBS. First, stock cannot qualify as QSBS if the issuing corporation has redeemed any stock from the taxpayer or a related party within a four-year period beginning two years before the issuance date. Second, stock cannot qualify as QSBS if the issuing corporation has redeemed more than 5% in value of any of its stock within a two-year period beginning one year before the issuance of QSBS. Redemptions of compensatory QSBS upon termination of employment are excluded from these redemption rules, as are redemptions triggered by the death, disability or divorce of the redeemed stockholder. If there is no disqualifying redemption in years surrounding the issuance of QSBS, these rules don't prevent a qualifying redemption of QSBS five or more years after issuance.

Rollovers of QSBS under IRC §1045

If a stockholder holding stock that would otherwise qualify as QSBS is forced or decides to sell the stock prior to meeting the five-year holding period requirement, the stockholder may be able to take advantage of IRC § 1045, which permits a stockholder with a holding period of at least six months to roll over the gain within 60 days into other QSBS. The corporation issuing the replacement stock must satisfy the active business requirement for at least six months after the exchange. The stockholder must file an election with the IRS in order to take advantage of this rollover opportunity. Stockholders considering a rollover transaction should review and comply with IRC § 1045's requirements.

State tax implications

IRC § 1202 provides an exclusion from federal income tax of the gain from the sale of QSBS. But the state and local tax treatment of this gain may not follow the federal treatment, and this possible difference should be considered during the choice of entity planning process.

For additional information and assistance, please contact Scott Dolson or any other member of Frost Brown Todd's Tax Law Practice Group.