Qualified Small Business Stock:

The Next Big Bang
(Queries, Qualms, and Qualifications)

Paul S. Lee, J.D., LL.M.
Global Fiduciary Strategist
The Northern Trust Company
New York, NY
PSL6@ntrs.com

January 15, 2019
Qualified Small Business Stock: Good, Bad, Ugly?

**QUINTESSENTIALLY COMPELLING**
- ✓ 100% Capital Gain Exclusion
- ✓ Rollover Taxable Gains
- ✓ Multiply (Stack & Pack) Exclusion

**QUASHING REQUIREMENTS**
- ❖ C Corporation
- ❖ 5-Year Holding Period
- ❖ Applies to Stock Sale (Not Assets)

**QUARRELSOME QUAGMIRE**
- o Quixotic Definitions
- o Quirky Qualifications
- o Quibbling IRS Guidance
QSBS: 25 Years to Mature

$1202 (QSBS) Enacted
(50% Exclusion)

Acquired
8/11/93 to 2/17/09

QSBS Rate: 14%
AMT QSBS Rate: 19.9%, then 17.9%

LTCG: 28%

1993

1998

2003

2008

2013

2018

LTCG: 15%

QSBS Rate: 14%
AMT QSBS Rate: 14.98%

QSBS Rate: 15.9%
AMT QSBS Rate: 16.88%

QSBS Rate: 14%
AMT QSBS Rate: 19.9%, then 17.9%

QSBS
75% Exclusion

Acquired:
2/18/09 to 9/27/10

QSBS Rate: 7.95%
AMT Rate: 9.42%

QSBS
100% Exclusion

Acquired:
After 9/27/10

QSBS Rate: 0%
AMT Rate: 0%

LTCG: 23.8%
QSBS: 25 Years to Mature

QSBS Rate: 14%
AMT QSBS Rate: 19.9%, then 17.9%

QSBS Rate: 14%
AMT QSBS Rate: 14.98%

QSBS Rate: 15.9%
AMT QSBS Rate: 16.88%

QSBS Rate: 7.95%
AMT Rate: 9.42%

QSBS Rate: 0%
AMT Rate: 0%

RRA '93
TRA '97
IRRA '98
JGTRRA '03
ARRA '09
HCERA '10
SBJA '10
ATRA '12
PATHA '15
TCJA '17


LTCG: 28%

LTCG: 15%

LTCG: 23.8%

$1202 (QSBS)
Enacted (50% Exclusion)

Acquired: 8/11/93 to 2/17/09

QSBS 75% Exclusion

QSBS 100% Exclusion

“Clueless”
60% = Every Time

Superhero

Acquired: After 9/27/10

Acquired: 2/18/09 to 9/27/10

"Clueless" 60% = Every Time Superhero
QSBS: 25 Years to Mature (TCJA Creates Path to QSBS)

TCJA ‘17

2018

2023

2028

2033

2038

C Corporation Tax Rate of 21%

§ 199A 20% Deduction
QBI of “Pass-Thru” Entities
(37% to 29.6%?)

§ 168(k) 100%
Expensing

80/60/40/20%
(2023-2026)

§ 1400Z
Qualified Opportunity Zone
(Deferral/Reduction/Exclusion)

39.6% [+ 3.8%?]
Owner

“Pass-Thru”

Conversion?

C Corporation
21%

[23.8%?] Owner
"Qualified Trade or Business" Overlap

- Services consisting of: investing, investment management, trading or dealing in securities, partnership interests, or commodities.
- Services in field of: health, law, accounting, performing arts, consulting, athletics, financial services, brokerage services, or principal asset is reputation/skill of 1 person.
- Performing services as an employee.
- § 1202 "qualified trade or business"
- § 199A "qualified trade or business"
- Services in field of: engineering & architecture.
- Real estate development & management.
- Banking, insurance, financing, and leasing.
- Farming and forestry.
- Oil, gas, and mineral extraction.
- Operating hotels, motels, and restaurants.
QSBS & QSB: Corporate and Shareholder Qualifications

**Exclusion Percentage**

**Per-Issuer Limitation**
- $10 Million Per Taxpayer Limitation
- 10 Times Basis Limitation

**Qualified QSBS Shareholders**

**QSBS: Original Issuance Requirement**
- Permissible Transfers
- Disqualifying Redemptions/Purchases

**Eligible Gain (5-Year Holding Period)**
- Tack
- Disqualifying Hedges

**Section 1045 Rollovers**

**Qualified Small Business (QSB)**
- Aggregate Gross Asset Requirement
- “at all times”

**QSBS: Active Business Requirement**
- 80 Percent Test
- Qualified Trade or Business
## QSBS Basic Elements: Exclusion Percentage

<table>
<thead>
<tr>
<th>Acquisition Date</th>
<th>Exclusion Percentage</th>
<th>Maximum QSBS Rate</th>
<th>Maximum QSBS AMT Rate</th>
<th>Maximum Rate (No QSBS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug. 11, 1993 to Feb. 17, 2009</td>
<td>50%</td>
<td>15.90%</td>
<td>16.88%</td>
<td>23.80%</td>
</tr>
<tr>
<td>Feb. 18, 2009 to Sep. 27, 2010</td>
<td>75%</td>
<td>7.95%</td>
<td>9.42%</td>
<td>23.80%</td>
</tr>
<tr>
<td>After Sep. 27, 2010</td>
<td>100%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>23.80%</td>
</tr>
</tbody>
</table>
### Exclusion Percentage and Calculating Gain

<table>
<thead>
<tr>
<th>Category Of Gain</th>
<th>Maximum Tax Rate</th>
<th>Amount Of Gain</th>
<th>Federal Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excluded Section 1202 Gain</td>
<td>0.00%</td>
<td>$25 Mil.</td>
<td>$0.00</td>
</tr>
<tr>
<td>Section 1202 Gain</td>
<td>31.80%</td>
<td>$25 Mil.</td>
<td>$7.95 Million</td>
</tr>
<tr>
<td>Non-Section 1202 Gain</td>
<td>23.80%</td>
<td>$45 Mil.</td>
<td>$10.71 Million</td>
</tr>
<tr>
<td>TOTALS</td>
<td>N/A</td>
<td>$95 Mil.</td>
<td>$18.66 Million</td>
</tr>
</tbody>
</table>

- **Non-Section 1202 Gain**
- **Excluded Section 1202 Gain**
- **Section 1202 Gain**
- **Per-Issuer Limitation** $50 Mil. (10 x Basis)

*If stock had been acquired for appreciated property in tax free transaction...*
**Per-Issuer Limitation**

- Prescribes the maximum gain that can be excluded (or partially excluded) each taxable year.

- **Each taxable year** shall not exceed the **GREATER of**:
  - $10 million **reduced by aggregate eligible gain taken for prior taxable years** ($10 Million Per Taxpayer Limitation); or
  - 10 times the aggregate adjusted basis of QSBS sold by the taxpayer **in the taxable year** (10 Times Basis Limitation).

---

**Quixotic Definition of “Adjusted Basis”:**

- If taxpayer acquires QSBS through a contribution of property, “adjusted basis” shall **NOT be less than fair market value** at the time of contribution.

- “Adjusted basis” is determined **without** regard to any **addition** to basis after stock was originally issued to the taxpayer.

---

**Quirky of Rules of Construction:**

- Calculated each taxable year;
- $10 Million Per Taxpayer reduced by previous eligible gain from prior years; and
- 10 Times Basis Limitation is NOT reduced by previous year (only the current year counts).

---

**Queechering Quagswag???:**

§ 1202(i)(2) provides basis can be adjusted by reason of a “contribution to capital” after original issuance, providing for an upward adjustment of no less than the fair market value of any contributed property.

---

**Quibbling Question of Application?**

- ✓ Is Per-Issuer Limitation applied against eligible gain first, followed by application of the Exclusion Percentage?
- ✗ Is Exclusion Percentage applied against eligible gain first, followed by the Per-Issuer Limitation?
Section 1202 exclusion is available to "a taxpayer other than a corporation" (Qualified QSBS Shareholder), including:

- Individual
- Trust
- Estate

Qualified QSBS Shareholders may benefit from the section 1202 exclusion if QSBS is held by a "Pass-Thru Entity," including:

- Partnership
- S Corporation
- Regulated Investment Company
- Common Trust Fund

**Pass-Thru Entity Requirements:**

Partner, shareholder, or owner (who is a Qualified QSBS Shareholder) of a Pass-Thru Entity is entitled to section 1202 exclusion on gain that allocated to the taxpayer, if the eligible gain is:

- Attributable to a sale or exchange by the Pass-Thru Entity of stock which is QSBS in the hands of such entity (treating such entity as an individual) and which was held by such entity for more than 5 years; and

- Includible in the gross income of the owner "by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock."

**Pass-Thru Entity Benefit Limitations:**

Allocated gain subject to a partial or complete exclusion “shall not apply to any amount to the extent such amount exceeds the amount … which … would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired.”
In order for stock to be considered Qualified Small Business Stock (QSBS), it must be:

- Stock in a C corporation;
- Issued after August 10, 1993;
- On the date of issuance, issued by a Qualified Small Business (QSB);
- Acquired by the taxpayer at its “original issue” (Original Issuance):
  - In exchange for money or other property (other than stock), or
  - As compensation for services provided to such corporation.

“Original issue” refers to an issuance of stock directly from the corporation to a Qualified QSBS Shareholder, as opposed to an acquisition of such stock on the secondary market or from another person who acquired it at original issuance.

This requirement is meant to promote new investment in small business.
**Permissible Transfers:**

The Original Issuance requirement is not violated if taxpayer receives:

- “By gift”,
- “At death,” or
- In a transfer from a partnership to a partner.

**Disqualifying Corporate Redemptions/Purchases:**

- Any purchase from taxpayer (or related person)
  - Disqualifies all stock held by the taxpayer.

- Significant purchase (>5% aggregate stock of corporation)
  - Disqualifies all stock of the corporation.

**Exceptions:**

- “By gift” and “at death” are NOT defined.
- Transfer from an S corporation to a shareholder is NOT a permissible transfer.
- Contribution from a partner to a partnership is NOT a permissible transfer.

- De Minimis Amounts:
  - $10,000, and
  - >2% of taxpayer/corporation.

- Certain purchases involving:
  - Service providers, and
  - Death of acquiring taxpayers.
Eligible Gain: 5-Year Holding and Tacking

Eligible Gain:

The section 1202 exclusion and the Per-Issuer Limitation is applied against “eligible gain” which is:

- Any gain from the sale or exchange of QSBS
- Which has been held by the taxpayer for more than 5 years.

Tacking:

“Tacking” of transferor’s holding period to the transferee allowed with Permissible Transfers:

- “By gift”,
- “At death,” or
- In a transfer from a partnership to a partner.

“Tacking” also available with:

- Corporate conversions,
- Tax-Free Exchanges (E.g., Sections 351 and 368), and
- Section 1045 Rollover.

Disqualifying Hedging Transactions:

If taxpayer (or related party) has “offsetting short position” (short sale, option to sell at a fixed price, or any other transaction that substantially reduces the risk of loss) on any QSBS, gain will not qualify for exclusion unless:

- Taxpayer held for more than 5 years on first day of the short position, and
- Taxpayer elects to recognize gain as if the stock was sold at fair market value on that day.
Section 1045 Rollover

Taxpayer may defer recognition of gain on the sale of QSBS if:

- Original QSBS has been held by the taxpayer for more than 6 months;
- Taxpayer makes an election to apply section 1045 to the sale; and
- Replacement QSBS is acquired within 60 days of the original sale.

Important Planning Considerations:

- Taxpayer has the option to elect rollover for each sale, if there is more than one sale of QSBS in a year.
- Applies based on the amount of sale proceeds used to acquire replacement stock.
- Separate lot accounting is critical to maximize deferral (otherwise first-in, first-out).
- Basis in the replacement QSBS is applied “in the order acquired.”

Replacement period for QOZ Fund deferral is 180 days.

Query whether QOZ Fund investments can be combined with QSBS to eliminate deferred capital gain.

Can rollover be used to multiply the Per-Issuer Limitation?

Partnership Treasury Regulations:

In 2007, very detailed guidance was issued on the availability of section 1045 rollover to partnerships and their eligible partners.

- Allows three different methods of rollover, with elections that can be made by the partnership or by the partners. Replacement QSBS can be purchased by the partnership or the partners.

- Deferral of gain is limited by the Nonrecognition Limitation, defined as:
  - Partnership realized gain from the sale of QSBS, multiplied by
  - Eligible partner’s “smallest percentage in partnership capital” determined “at the time of acquisition” of the original QSBS.
Qualified Small Business (QSB) Defined

“Qualified Small Business” (QSB) is:

- Domestic C corporation
- That meets the “Aggregate Gross Asset Requirement”
- That also “agrees to submit such reports to the Secretary and to shareholders as the Secretary may require.”

Aggregate Gross Asset Requirement:

- “At all times” on or after August 10, 1993,
- Before the issuance of stock,
- Immediately after issuance,
- “Aggregate Gross Assets” do NOT exceed $50 million.

Quixotic Definition of “Aggregate Gross Assets”:

- Liabilities are ignored.
- Amount of cash and the aggregate adjusted bases of property held by the corporation.
- Adjusted basis of contributed property is deemed to be the fair market value at the time of contribution.

Does “at all times” mean every day? Does it suffice that on average or at the end of each fiscal year the $50 million threshold is met?

What types of records are to required to prove that the Aggregate Gross Asset Requirement is met?

Treasury has not published any reporting requirements to be considered a QSB. Can IRS require unreasonable reports during an examination and conclude QSB requirements are not met?
QSBS: Active Business Requirement

Stock will not be considered QSBS unless
- “During substantially all of the taxpayer’s holding period,” the corporation meets
- the “Active Business Requirement”

Active Business Requirement:
- At least 80 percent (by value) of all of the assets are “in the active conduct of 1 or more qualified trades or businesses” (80 Percent Test); and
- Corporation is an “eligible corporation” (domestic corporation, with certain exceptions).

“Substantially all” is NOT defined.
Applies only to taxpayer’s holding period.
No guidance on how “substantially all” applies in conjunction with the 80 Percent Test.
QOZ Treasury guidance helpful?

80 Percent Test:
- No guidance as to whether this must be met at all times, on average, or at the end of each year.
- Parent-Subsidiary (50% or more) look-through rule.
- Deemed to fail if >10 percent of assets consist of real property not used in the active conduct of the trade or business.
- Deemed to fail if 10 percent or more of assets in stocks or securities of non-subsidiary corporations.
- Exceptions and special rules for:
  - Working capital operating needs and for research/experimentation of the trade or business.
  - Assets needed for start-up activities and certain deductible research and experiment expenses.

Qualified Trade or Business:
Defined by negation (see venn diagram above). See section 199A regulations regarding specified service trades or businesses.
Formation of C corporation under section 351
- No gain or loss on transfer of property in exchange for stock in the corporation if
  - Immediately after, transferors are in “control” (at least 80 percent of stock).

Methods of converting partnership (incl. LLC, taxed as) to C corporation:
- “Assets-Over”
- “Assets-Up”
- “Interests-Up”
- Check-the-box election (treated as “Assets-Over” for tax purposes)

Each method of conversion results in different basis in corporate shares and different “inside basis” for corporation.

No separate lot accounting of basis.

10 Times Basis Limitation & Aggregate Gross Assets are calculated, in part, by basis.
Federal Reporting

- Section 1202 is NOT elective
- QSB corporations currently have no reporting requirements.
- QSBS shareholders report sales on Schedule D and Form 8949.
  - Exclusion is reported as a negative number.
  - 28% Rate Gain Worksheet
  - Special instructions for installment sales.
- IRS has held that gain excluded under section 1202 may not be used to extend the assessment period to 6 years.

State Income Tax Treatment:

- Large proportion of states follow federal treatment of QSBS (or do not have an income tax).
- Some states (e.g., CA and PA) completely disallow the QSBS exclusion.
- Some states (e.g., MA, NJ, and HI) make modifications to the QSBS exclusion.
Quest for Quantum Exclusions

- Defining transfers “by gift,” “at death,” and other transfers (or non-transfers)

- “Stacking” & “packing” (multiplying & leveraging) the Per-Issuer Limitation

- QSBS with pre-existing businesses (sole proprietorships, S corporations, and partnerships, etc.)

- Common ways to inadvertently lose QSBS status

- QSBS and carried interest

- Reporting QSBS installment sales

- Charitable planning with QSBS and the basis adjustment at death
LEGAL, INVESTMENT AND TAX NOTICE: This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own counsel. These materials do not constitute and should not be treated as, legal, tax or other advice regarding the use of any particular tax, estate planning or other technique, device, or suggestion, or any of the tax or other consequences associated with them. Although reasonable efforts have been made to ensure the accuracy of these materials and the seminar presentation, neither Paul Lee, nor The Northern Trust Corporation, assumes any responsibility for any individual’s reliance on the written or oral information presented during the seminar. Each seminar attendee should verify independently all statements made in the materials and during the seminar presentation before applying them to a particular fact pattern, and should determine independently the tax and other consequences of using any particular device, technique, or suggestion before recommending it to a client or implementing it for a client.

OTHER IMPORTANT INFORMATION: This presentation is for your private information and is intended for one-on-one use only. The information is intended for illustrative purposes only and should not be relied upon as investment advice or a recommendation to buy or sell any security. Northern Trust and its affiliates may have positions in, and may effect transactions in, the markets, contracts and related investments described herein, which positions and transactions may be in addition to, or different from, those taken in connection with the investments described herein. Opinions expressed are current only as of the date appearing in this material and are subject to change without notice.

No information provided herein shall constitute, or be construed as, a recommendation or an offer to sell or a solicitation of an offer to acquire any security, investment product or service and should not be treated as legal advice, investment advice or tax advice. This material is provided for educational and informational purposes only. Opinions expressed are those of the presenter and are subject to change without notice.

Past performance is no guarantee of future results. Periods greater than one year are annualized. Performance assumes the reinvestment of dividends and earnings and is shown gross of fees, unless otherwise noted. Returns of the indexes and asset class projections do not reflect the deduction of fees, trading costs or expenses. It is not possible to invest directly in an index. Indexes and trademarks are the property of their respective owners, all rights reserved. A client's actual returns would be reduced by investment management fees and other expenses relating to the management of his or her account. To illustrate the effect of compounding of fees, a $10,000,000 account which earned a 8% annual return and paid an annual fee of 0.75% would grow in value over five years to $14,693,281 before fees, and $14,150,486 million after deduction of fees. For additional information on fees, please read the accompanying disclosure documents or consult your Northern Trust Representative.

There are risks involved in investing including possible loss of principal. There is no guarantee that the investment objectives or any fund or strategy will be met. Risk controls and asset allocation models do not promise any level of performance or guarantee against loss of principal. All material has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation cannot be guaranteed.

Securities products and brokerage services are sold by registered representatives of Northern Trust Securities, Inc. (member FINRA, SIPC), a registered investment adviser and wholly owned subsidiary of Northern Trust Corporation. Investments, securities products and brokerage services are:

Not FDIC Insured | No Bank Guarantee | May Lose Value