AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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SECTION 1202 – ELIMINATING THE DOUBLE TAX BIAS FOR SMALL C CORPORATIONS

Section 1202 can eliminate the double tax burden on C corporations entirely with proper tax planning. But buyer beware – there are hurdles, limitations, and traps galore to navigate for our clients. Section 1202 allows certain noncorporate taxpayers to exclude 50 to 100 percent of gain from the sale of "qualified small business stock" (QSBS) held for at least five years. This provision was designed to provide "relief for investors who risk their funds in . . . small businesses, many of which have difficulty attracting equity financing." H.R. Rep. No. 103-111 (1993). QSBS includes certain stock issued after August 10, 1993, in a domestic C corporation conducting a qualified active business. Generally, the gain exclusion is 50, 75, and 100 percent for QSBS acquired after August 10, 1993, February 17, 2009, and September 27, 2010, respectively. In addition, to the extent such gain is excluded from gross income, it is now also exempt from both the individual AMT and the net investment income tax.

DETAILS

To the extent that bias against C corporation status remains following the reduction in the corporate income tax rate and capital gain/dividend rate, section 1202 may reverse that bias in favor of C corporations by eliminating a second level of tax for some taxpayers, while subjecting the first level of tax to an historically low 21 percent tax rate. Section 1244 allows ordinary loss treatment with respect to the stock of small business corporations. Section 1045 allows for the rollover of QSBS (sale of existing QSBS and purchase of QSBS in a different issuing corporation within 60 days). Both section 1244 and section 1045 contain their own complex set of rules that are outside the scope of this alert. Collectively, sections 1202, 1244, and 1045 are provisions that level the playing field for C corporations which have traditionally been subject to two levels of tax, thereby reducing the federal income tax law's bias against C corporations, if certain stringent requirements can be met.

The amount of gain a shareholder may exclude from gross income upon the sale of QSBS originally issued after September 27, 2010, is limited to the greater of $10 million or 10 times the shareholder's adjusted tax basis in the stock. The $10 million shareholder gain limitation takes into account all gain recognized from the sale of QSBS in each issuing corporation. The 10 times exclusion amount is a yearly limitation based on the shareholder's gain from the disposition of QSBS in each issuing corporation each year.

QSBS is generally stock issued in a domestic C corporation, as opposed to a foreign corporation, an S corporation, a partnership, or an interest in a wholly-owned limited liability company treated as a disregarded entity. QSBS usually must be acquired at original issuance in exchange for money, property (other than stock), or services provided to the issuing corporation. If stock is issued in connection with the performance of services, the stock will be treated as originally issued at the time of the taxpayer's income inclusion, including upon a section 83(b) election for restricted stock. A taxpayer must hold QSBS for more than five years before disposition to benefit from the section 1202 exclusion.

The shareholder's holding period generally begins on the day after the date of issuance, regardless of whether the property contributed would otherwise take a tacked holding period for capital gain purposes. There are some exceptions to this limitation on tacked holding periods (e.g., certain section 351 tax-free contributions to capital and section 368 tax-free reorganizations).

If QSBS is exchanged under section 351 or section 368 for non-QSBS, the amount of excludable gain is generally limited to the gain that would have been recognized at the time of that exchange (i.e., further appreciation post-transaction may not qualify).

At the time a corporation originally issues QSBS, its aggregate gross assets must not have exceeded $50 million (after giving effect to the issuance). Testing upon issuance makes for good policy, because the goal is to encourage investing when the business is still considered small enough under this definitional threshold. Still, investors will rightly hope that the value of the business appreciates beyond the $50 million threshold soon after their investment is made. It is not clear whether the step-transaction doctrine applies where multiple pre-planned investments make the value equal or exceed the $50 million threshold. Because early organizational costs may reduce aggregate gross assets and thus allow for subsequent issuances of potential QSBS, balancing taxpayer intent and economic expectations for future capital needs with the mechanical section 1202 regime creates the need to address substance over form principles and the underlying Congressional goals. Aggregate gross assets are equal to cash plus the aggregate adjusted basis of property.

The adjusted basis of property contributed to a corporation in a transaction in which tax basis otherwise carries over is equal to the fair market value of that property at the time of the contribution. All corporations that are treated as part of the same parent- subsidiary controlled group under section 1563(a)(1), determined by substituting more than 50 percent for at least 80 percent, are treated as one corporation in calculating aggregate gross assets.

The issuing corporation must conduct an active qualified trade or business (active business) for substantially all of the taxpayer's holding period in the QSBS. At least 80 percent of the corporation's assets, by value, must be used in the active business during this period. For this purpose, the issuing corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of a more than 50 percent, by voting power and value, owned subsidiary's activities. Greater than 10 percent ownership of stock or securities, other than those of a more than 50 percent-owned subsidiary, will cause a corporation to fail the active business requirement. Assets used in start-up activities (e.g., R&D) are considered active business assets for these purposes.

While investment assets are generally non- qualifying, those reasonably expected to be used within two years of formation in an active business or held to meet reasonable working capital needs are considered qualified assets.

An active business must be a qualified trade or business, a term defined by exclusion. A qualified trade or business is one other than: 1) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business in which the principal asset of that trade or business is the reputation or skill of at least one of its employees; 2) any banking, insurance, financing, leasing, investing, or similar business; 3) any farming business (including the business of raising or harvesting trees); 4) any business involving the production or extraction of products of a character for which a deduction is allowable under section 613 or 613A; and 5) any business of operating a hotel, motel, restaurant, or similar business. IRS guidance (e.g., PLR 201717010 and PLR 201436001) highlights the importance of analyzing the businesses' facts and circumstances because what constitutes a qualifying business is not always clear (e.g., determining the reputation or skill of an employee is not a principal asset of the business).

For the majority of the time since 1993, the section 1202 benefits have been far less than under current law. Half of the gain was still taxed at 28 percent, which resulted in an overall effective tax rate of 14 percent. The regular capital gains tax rate was only 15 percent so the overall benefit of one percent (15 -14 percent) was minimal. Now with the 100 percent exclusion, the tax benefit is substantial. Section 1202 will now impact choice of entity determinations for some and provide traps for the unwary for others.

For example, the benefit of a stock sale under section 1202 may largely be negated by the benefits of an asset sale to a buyer, particularly with increased expensing and bonus depreciation following the 2017 tax reform legislation. But as with most acquisitions of businesses, such tax factors and attributes are merely a point for purchase price negotiations. Acquirers who want basis step-ups will have to weigh the costs of doing so (e.g., those resulting from section 331 taxable liquidations) against the purchase price reductions they'll obtain from giving sellers of QSBS the now large tax benefits of section 1202.

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