



## Qualified Small Business Stock Update

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In the Revenue Reconciliation Act of 1993 (P.L. 103-66), Congress enacted a limited exclusion for noncorporate taxpayers for 50 percent of any gain from the sale of "qualified small business stock" held for more than five years. *P.L. 103-66 § 13113(a), enacting I.R.C. § 1202*. Since stock can be classified as qualified small business stock only if it is issued after August 10, 1993, the date of enactment of the Revenue Reconciliation Act of 1993, this provision has only recently begun to apply.

In 1993 the maximum federal income tax rate applicable to capital gains was 28 percent; the 50 percent exclusion thus reduced that maximum rate for five-year qualified small business stock gains to 14 percent. That effective rate could actually have been higher, because one-half of the excluded portion of the gain (one-quarter of the overall gain) was made an item of tax preference for purposes of the alternative minimum tax. *P.L. 103-66 § 13113(b), enacting I.R.C. § 57(a)(7)*. When Congress in the Taxpayer Relief Act of 1996 (P.L. 105-34) reduced the maximum federal income tax rate for certain capital gains of individuals to 20 percent, it provided that the nonexcluded portion of five-year gain from qualified small business stock was still to be taxed at a maximum rate of 28 percent, not 20 percent. *P.L. 105-34 § 311(a), enacting I.R.C. §§ 1(h)(1), 1(h)(4), 1(h)(7)*. While this approach maintains the maximum rate applicable to five-year qualified small business stock gains at 14 percent, that rate is the equivalent of only a 30 percent exclusion for gain otherwise eligible for the 20 percent maximum rate (as would generally be the case).

In the Taxpayer Relief Act of 1996, Congress did amend the alternative minimum tax rules such that only 42 percent (not one-half) of excluded qualified small business stock gain constitutes an item of tax preference. *P.L. 105-34 § 311(b), amending I.R.C. § 57(a)(7)*. More importantly, Congress also provided an elective "rollover" rule for noncorporate taxpayers such that gain is not recognized on the sale of qualified small business stock

held for more than six months to the extent the taxpayer reinvests in other qualified small business stock during the 60-day period following the sale. *P.L. 105-34 § 313, enacting I.R.C. § 1045*.

### Limits on Exclusion

The amount of gain which can be excluded by a taxpayer for a given taxable year on the disposition of qualified small business stock of a particular corporation cannot exceed the greater of (i) \$10 million less any gain of the taxpayer eligible for the exclusion from the sale of stock in the same corporation in prior taxable years and (ii) 10 times the basis of the qualified small business stock of the corporation disposed of by the taxpayer in the taxable year (determined without regard to basis adjustments after original issuance). *I.R.C. § 1202(b)*.

### Qualified Small Business Stock

Qualified small business stock means any stock in a C corporation issued after August 10, 1993, the date of enactment of the Revenue Reconciliation Act of 1993, if:-

- as of the date of issuance of the stock, the corporation is a "qualified small business,"
- the stock is acquired by the taxpayer upon its original issuance (either directly or through an underwriter) in exchange for money or other property (not including stock) or as compensation for services provided to the issuing corporation (other than services as the underwriter of the stock),
- during substantially all the taxpayer's holding period for the stock the issuing corporation is a C corporation and meets the "active business requirement" and
- the issuing corporation does not undertake certain redemptions of its stock. *I.R.C. § 1202(c)*.

Presumably, the "substantially all the taxpayer's holding period" requirement permits shareholders to remain eligible for the 50 percent exclusion by disposing of otherwise qualified small business stock within a reasonable period of time after the issuing corporation ceases to satisfy the active business requirement.

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### Qualified Small Business

A qualified small business is any domestic C corporation if:–

- the aggregate gross assets (cash and the adjusted tax basis of other property) of the corporation at all times on or after August 10, 1993, the date of enactment of the Revenue Reconciliation Act of 1993, and before issuance of the stock in question did not exceed \$50 million,
- such aggregate gross assets immediately after the issuance of the stock in question (taking into account amounts received for that stock) do not exceed \$50 million and
- the corporation agrees to submit such reports to its shareholders and the Internal Revenue Service (“IRS”) as may be prescribed by the IRS (no such reports having yet been required). *I.R.C. § 1202(d)*.

Solely for purposes of the \$50 million tests, the adjusted basis of property contributed to the corporation (and of any other property the basis of which is determined in whole or in part by reference to the basis of such contributed property) is determined as if its basis immediately after its contribution were equal to its fair market value at that time. *I.R.C. § 1202(d)(2)(B)*.

### Active Business Requirement

A corporation meets the active business requirement for any period if during such period:–

- at least 80 percent (by value) of the assets of the corporation are used by the corporation in the active conduct of one or more qualified trades or businesses and
- the corporation is a domestic corporation other than (i) a domestic international sales corporation (“DISC”) or former DISC, (ii) a corporation having, or with a direct or indirect subsidiary having a section 936 election (relating to possessions corporations) in effect, (iii) a regulated investment company (“RIC”), real estate investment trust (“REIT”), real estate mortgage investment conduit (“REMIC”) or, for periods beginning on or after September 1, 1997, a financial asset securitization investment trust (“FASIT”) or (iv) a cooperative. *I.R.C. §§ 1202(e)(1), 1202(e)(4)*.

Under a special rule, assets used in certain start-up and research and experimental activities related to any future qualified trade or business are treated as used in the active conduct of a qualified trade or business. *I.R.C. § 1202(e)(2)*.

A qualified trade or business is any trade or business other than:–

- 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 the principal asset of which is the reputation or skill of one or more employees,
- any banking, insurance, financing, leasing, investing or similar business,
- any farming business (including the business of raising or harvesting trees),
- any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Internal Revenue Code sections 613 or 613A (relating to depletion) or
- any business of operating a hotel, motel, restaurant or similar business. *I.R.C. § 1202(e)(3)*.

Assets (i) held as part of the reasonably required working capital needs of a qualified trade or business or (ii) held for investment and reasonably expected to be used within two years to finance research and experimentation or increases in working capital needs of a qualified trade or business (“eligible working capital assets”) are treated as used in the active conduct of a qualifying business; however, after the corporation has been in existence for two years, no more than 50 percent of the corporation’s assets may qualify as eligible working capital assets. *I.R.C. § 1202(e)(6)*. Stock and debt of a subsidiary corporation are disregarded and the parent corporation is treated as owning its ratable share of the subsidiary’s assets and conducting its ratable share of the subsidiary’s activities. *I.R.C. § 1202(e)(5)(A)*. A subsidiary is a corporation in which the parent corporation owns more than 50 percent of the combined voting power of all classes of voting stock and more than 50 percent in value of all outstanding stock. *I.R.C. § 1202(e)(5)(C)*.

A corporation fails to satisfy the active business requirement for any period during which more than ten percent of the value of the corporation’s assets (in excess of liabilities) consists of stock or securities of any other corporation which is not a subsidiary (not including stock or securities constituting eligible working capital assets). *I.R.C. § 1202(e)(5)(B)*. A corporation also fails to satisfy the active business requirement for any period during which more than ten percent of the value of its assets consists of real property not used in the active conduct of a qualified trade or business; for purposes of this rule, the

ownership of, dealing in or renting of real property is not treated as the active conduct of a qualified trade or business. *I.R.C. § 1202(e)(7)*.

#### *Redemptions of Stock*

Stock acquired by a taxpayer is not qualified small business stock if during the four-year period beginning two years before its acquisition, the issuing corporation purchased (directly or indirectly) any of its stock from the taxpayer or a related person. *I.R.C. § 1202(c)(3)(A)*. Stock is similarly disqualified if during the two-year period beginning one year before its issuance the issuing corporation made one or more purchases of its stock with an aggregate value (at the time of purchase) in excess of five percent of the value of all the issuing corporation's outstanding stock at the beginning of the two-year period. *I.R.C. § 1202(c)(3)(B)*. Regulations adopted by the Treasury Department at the end of 1997 add *de minimis* exceptions to both repurchase rules. The regulations also disregard repurchases by a corporation of restricted stock from employees and directors upon termination of service and, if certain conditions are met, repurchases upon death, disability, mental incapacity or divorce of a shareholder. *Income Tax Regs. § 1.1202-2*.

#### *Conversion of Stock*

If any stock of a corporation is acquired solely through the conversion of other stock of the corporation which is qualified small business stock then the acquired stock is treated as qualified small business stock held during the period the converted stock was held. *I.R.C. § 1202(f)*.

#### *Stock Held by Partnerships*

Gain allocated to a partner from the disposition of stock which is qualified small business stock in the hands of a partnership (determined as if the partnership were an individual) and which is held by the partnership for more than five years is also eligible for the exclusion if the partner held an interest in the partnership at all times during which the partnership held the qualified small business stock. *I.R.C. §§ 1202(g)(1)(A), 1202(g)(2)*. However, gain eligible for the exclusion can be no greater than the gain which would have been allocated to the partner based upon the partner's interest in the partnership at the time the partnership acquired the qualified small business stock. *I.R.C. § 1202(g)(3)*. The \$10 million per issuing corporation limitation applies at the partnership level, but the partner's proportionate share of the partnership's basis is used for the "10 times basis" limit. *I.R.C. § 1202(g)(1)(B)*. Similar rules apply to S corporations, regulated investment companies and common trust funds. *I.R.C. § 1202(g)(4)*.

#### *Tax-Free Transfers*

In the case of a transfer by gift or at death the transferee is treated as having acquired stock in the same manner as the transferor and as having held stock during the period it was held by the transferor. *I.R.C. §§ 1202(h)(1), 1202(h)(2)*. This rule also applies where a partnership transfers stock to a partner as long as the partner could have excluded gain allocated to the partner were the partnership to have sold rather than distributed the stock (determined without regard to the five-year holding period requirement). *I.R.C. § 1202(h)(2)(C)*.

Where qualified small business stock is exchanged for other stock in a section 351 exchange (as long as immediately after the exchange the corporation to which the stock is transferred is in "control," generally an 80 percent stock ownership test, of the corporation the stock of which was transferred) or in a tax-free reorganization, the stock received is treated as qualified small business stock acquired on the date the exchanged stock was acquired. However, upon disposition of that newly acquired stock, the gain which is eligible for the 50 percent exclusion is limited to the amount of gain which would have been recognized at the time of the exchange of the original qualified small business stock had that exchange been taxable. This limitation does not apply if the newly acquired stock is issued by a corporation which at the time of issue is a qualified small business. *I.R.C. § 1202(h)(4)*. Thus, where the acquiror in a tax-free reorganization is not a qualified small business, gain attributable to postreorganization appreciation from disposition of acquiror stock by holders receiving that stock in exchange for qualified small business stock in the reorganization is not eligible for the 50 percent exclusion.

#### **Rollover of Gain**

A taxpayer other than a corporation may elect not to recognize capital gain from a sale of qualified small business stock held for more than six months to the extent of the cost of other qualified small business stock which the taxpayer purchases during the 60 days following the sale. *I.R.C. § 1045(a)*. This provision applies to sales occurring after August 5, 1997, the date of enactment of the Taxpayer Relief Act of 1997. *P.L. 105-34 § 313(c)*.

Qualified small business stock has the same meaning for purposes of the rollover provision as it does under the 50 percent exclusion rules. *I.R.C. § 1045(b)(1)*. A purchase of stock occurs when its basis is determined by reference to its cost to the taxpayer. *I.R.C. § 1045(b)(2)*. For example, an acquisition by gift would not be a purchase. The gain which is not recognized by virtue of the rollover provision is applied to reduce the basis of the purchased qualified

small business stock (in the order in which acquired). *I.R.C. § 1045(b)(3)*. The issuing corporation of the purchased qualified small business stock must meet the active business requirement for the six months following the purchase. *I.R.C. § 1045(b)(4)*. The holding period of the purchased stock will include the holding period of the stock sold, except for purposes of determining whether the six-month holding period requirement is satisfied upon sale of that purchased stock. *I.R.C. §§ 1223(15), 1045(b)(4)(A)*.

### Revenue Procedure 98-48

The IRS recently published [Revenue Procedure 98-48](#) setting forth the manner by which taxpayers can make the election to roll over gain from the sale of qualified small business stock. Any election must be made before the later of December 31, 1998 or the due date (including extensions) for filing the income tax return for the taxable year of the sale. *Rev.Proc. 98-48 § 3.01*. The election is made by reporting the full amount of gain on Schedule D with the notation "section 1045 rollover" on the line immediately following the line on which the gain is reported and by entering the amount of gain not being recognized as a loss on that immediately following line. *Rev.Proc. 98-48 § 3.02(1)*. Returns filed prior to October 21, 1998 may instead disclose the gain and include an affirmative statement to the effect that section 1045 applies to the gain; otherwise an amended return is required if the appropriate section 1045 entries were not made on Schedule D of an originally filed return. *Rev.Proc. 98-48 § 3.02(2)*.

Revenue Procedure 98-48 also clarifies application of the section 1045 rollover rules in the case of partnerships. It states that partnerships selling qualified small business stock may make an election to roll over gain from that sale to the extent of other qualified small business stock purchased by the partnership during the 60 days following the sale. The benefit of that election would flow through to taxpayers (other than C corporations) who were partners during the partnership's entire holding period for the sold qualified small business stock. In addition, any such partner could directly purchase other qualified small business stock to roll over the partner's share of partnership gain which the partnership does not roll over.

### Stock Purchase Representations and Covenants

Investors have become more focused on the benefits available to holders of qualified small business stock and of the numerous technical requirements which must be satisfied in order to be eligible for those benefits. It is now not uncommon for investors to request not only that an issuing corporation represent that it meets all those

requirements at the time of issuance of stock, but that the corporation agree that it will continue to do so, or make all reasonable efforts to do so, as long as the investor holds its stock. In lieu of such a broad agreement, and sometimes in addition to it, issuers can agree to notify investors of any action or failure to act which could reasonably be expected to cause the issuer's stock held by investors to cease to be qualified small business stock. Alternatively, the corporation could agree to issue reports on a regular basis to investors as to the continuing status of its stock as qualified small business stock. All of these notification approaches have become more workable following enactment of the rollover rules since an investor may be able to take corrective action (*i.e.*, selling the stock and reinvesting in other qualified small business stock) even though the five-year holding period has not yet then been satisfied.

### California Conformity

Although California generally conformed its personal income tax law to the federal 50 percent exclusion, the California exclusion applies only to stock issued after August 10, 1993 and before January 1, 1999 and is subject to the following California-focused requirements:—

- At the time stock is issued at least 80 percent of the issuing corporation's payroll, as measured by total dollar value, must be attributable to employment located within California;
- A corporation meets the active business requirement only during periods when 80 percent of the corporation's assets is used in the active conduct of one or more qualified trades or businesses within California;
- A corporation fails to meet the active business requirement for any period during which more than 20 percent of the corporation's total payroll expense is attributable to employment outside of California;
- The corporation must satisfy reporting requirements prescribed by the Franchise Tax Board ("FTB"), currently by filing FTB Form 3565 with its California corporate franchise or income tax return and providing copies to shareholders. *Cal.Rev.& Tax.Code § 18152.5*.

In March 1998 but effective for sales after August 5, 1997, California conformed its personal income tax law to the Internal Revenue Code section 1045 rollover rules. However, both the stock sold and the stock purchased and their respective issuers must satisfy the additional California-focused requirements noted above. *Cal.Rev.& Tax.Code § 18038.5*.