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VENTURE CAPITAL CORNER

## Tax exclusions and gains from sale of emerging company stock

By David Strong

The Protecting Americans from Tax Hikes Act of 2015, aka the PATH Act, amended Section 1202 of the Internal Revenue Code to permanently extend the 100 percent exclusion for eligible gain on sales of qualified small business stock. Under Section 1202, an individual shareholder who has held qualified small business stock for more than five years generally qualifies for a full or partial exclusion of eligible gain realized with respect to a sale of qualified small business stock.

The portion of a taxpayer's gain that is excluded under Section 1202 generally depends on when the qualified small business stock at issue was issued to the taxpayer. As originally enacted in 1993, Section 1202 allowed for a 50 percent exclusion of the amount of eligible gain from the sale of qualified small business stock held more than five years. A subsequent amendment to Section 1202 raised the percentage to 75 percent for qualified small business stock acquired between Feb. 18, 2009, and Sept. 27, 2010.

In 2010, the exclusion percentage was increased to 100 percent for qualified small business stock acquired after Sept. 27, 2010, and before Jan. 1, 2012 (this period was later extended to qualified small business stock issued in 2012, 2013 and 2014). Then the PATH Act later made the 100 percent exclusion applicable for 2015 and all years thereafter, including for purposes of the alternative minimum tax.

### “Qualified Small Business Stock” Defined

An individual shareholder who has held qualified small business stock for more than five years is generally eligible for a full or partial exclusion of gain realized from the sale of qualified small business stock

under Section 1202. To qualify as qualified small business stock, stock must be: (1) issued by a “qualified small business” after Aug. 10, 1993; and (2) acquired by the taxpayer at original issuance in exchange for money, property (other than stock), or services; or acquired in a non-recognition transaction from a transferor meeting these requirements.

### “Qualified Small Business” Defined

A corporation is engaged in a qualified small business if it is a domestic corporation that has been a C corporation for substantially all of the taxpayer's holding period. Additionally, the aggregate gross assets of the corporation at all times from Aug. 10, 1993, until immediately after the issuance of the taxpayer's stock do not exceed \$50 million. For this purpose, a corporation's “aggregate gross assets” are equivalent to its cash (including any cash contributed in connection with the current issuance) plus the aggregate adjusted bases of any other property held by the corporation. Finally, during substantially all of the taxpayer's holding period for the stock, at least 80 percent of the corporation's assets have been used in the active conduct of one or more qualified small businesses. For this purpose, the term “qualified small business” means 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 where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
- any banking, insurance, financing, leasing, investing, or similar business;
- any farming business (including

the business of raising or harvesting trees);

- any business involving mining or natural resource production or extraction; and
- any business of operating a hotel, motel, restaurant, or similar business.

For purposes of the 80 percent test, it should also be noted that there are special rules relating to stock held in majority-owned subsidiary corporations, portfolio stock or securities, allowable levels of working capital (including cash obtained from capital raising transactions), maximum real estate holdings, and revenue generated from computer software royalties.

### Annual Limitation on Amount of Excludable Gain

The annual amount of gain that may be excluded by a taxpayer with respect to the qualified small business stock of any particular issuer under Section 1202 is limited to the greater of: \$10 million, reduced by the aggregate amount of eligible gain attributable to the qualified small business stock of the issuer and previously excluded by the taxpayer under Section 1202 in prior years; or 10 times the aggregate adjusted bases of qualified small business stock of the issuer disposed of by the taxpayer during the taxable year.

For purposes of the 10 times adjusted basis rule, it should be noted that a taxpayer's basis in any qualified small business stock received in exchange for property (other than money or stock) is deemed to equal the fair market value of the property at the time of contribution. As a result, in a case where a taxpayer contributes property to a corporation, the amount of eligible gain that may be potentially excluded under Section 1202 may be far in excess of \$10 million. For example, if a taxpayer contributed property with a

fair market value of \$50 million to a newly formed corporation in exchange for qualified small business stock, and assuming all the requirements of Section 1202 were otherwise satisfied, the taxpayer could potentially exclude up to \$500 million of eligible gain following a sale of the qualified small business stock after five years.

### Treatment of Non-excluded Gain

Any portion of a taxpayer's realized gain that is attributable to qualified small business stock and that is not eligible for the exclusion under Section 1202 is generally taxed at applicable capital gains rates. In addition, for shares of stock acquired before Sept. 28, 2010, a portion of any excluded gain is generally treated as an item of tax preference under the alternative minimum tax.

### Conclusion

The potential exclusion of eligible gain realized in connection with sales of qualified small business stock under Internal Revenue Code Section 1202 can be incredibly valuable to taxpayers that own stock in emerging companies.

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