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Qualified Small Business Stock: Beware State Conformity (Part I)

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A merger (or other transaction that involves the sale of stock) carries an opportunity for tax savings. Internal Revenue Code ("Code") Section 1202 can apply to the stock sale, resulting in the exclusion of gain from income for federal or state tax purposes. Code Sec. 1202 allows a taxpayer to exclude 50 percent of any realized gain from the sale or exchange of qualified small business stock (QSBS) the taxpayer has held more than five years.

Under Code Sec. 1202, the tax treatment of gain on QSBS realized by noncorporate taxpayers differs from gain on other securities transactions. Consistent with other stock transactions, the capital gain may be short term or long term. However, under Code Sec. 1202(a), a 50-percent exclusion may apply, and a tax-deferral opportunity may exist. Two key issues are the holding period requirements and the impact of the alternative minimum tax (AMT).

Federal Statutory Requirements

To qualify as QSBS, the stock must be:

1. issued by a C corporation with no more than $50 million of gross assets at the time of issue;
2. of a corporation that uses at least 80 percent of the asset value for active trade or business purposes, other than in the fields of personal services, finance, farming, restaurants or hotels, etc; and
3. issued after August 11, 1993;
4. held by a noncorporate taxpayer (meaning any taxpayer other than a corporation);
5. acquired by the taxpayer on original issue (though there are exceptions to this rule); and

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6. held for a period for more than six months to be eligible for a tax-free rollover under Code Sec. 1045, and more than five years for a 50-percent gain exclusion.

The rollover provision has been available for sales after August 5, 1997. Since the corporation must have issued the stock after August 11, 1993, no one could qualify for the exclusion until August 11, 1998. Thus, 1998 state income tax returns filed in 1999 were the first returns to reflect the QSBS exclusion. Such income tax returns are only now working their way through the audit and protest stages with the FTB.

The 50-percent gain exclusion is generally limited to $5 million per taxpayer per issuer. Thus, a taxpayer normally sells shares with a gain in excess of $10 million and can exclude 50 percent of the gain up to $5 million.

In order for a corporation's stock to be QSBS, Code Sec. 1202 provides the following:

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1. At all times after August 10, 1993, and before it issues the stock, the corporation must have aggregate gross assets (as defined below) that do not exceed $50 million.
2. Immediately after it issues the stock, the corporation must have aggregate gross assets that do not exceed $50 million. For this purpose, amounts received in the issuance are taken into account.

[Code Secs. 1202(d)(1)(A) and 1202(d)(1)(B).] California mirrors these subsections of the Code in California Revenue and Taxation Code (CR&TC) Sections 18152.5(d)(1)(A) and 18152.5(d)(1)(B), although I'll get to California and its peccadillos in this area shortly.

If a corporation satisfies these gross assets tests as of the date of issuance, but later exceeds the $50 million asset threshold, stock that otherwise constitutes QSBS does not lose that character solely because of that later event. But, if a corporation or a predecessor corporation exceeds the $50 million asset threshold, it can never again issue QSBS. [H.R. REP. NO. 103-111 (P.L. 103-66), at 602.]

Nonrecognition of gain may be achieved through a partnership, S corporation, regulated investment company or common trust fund if the entity held the qualifying stock for more than five years, and if a taxpayer sharing in the gain held the interest in the passthrough entity at the time the taxpayer acquired the qualifying stock and at all times thereafter.

Holding Period Rules

The tax consequence of QSBS sold at a gain by a noncorporate investor depends on which of four different holding periods apply.

1. Holding period of six months or less. The gain is a short-term capital gain, taxed at individual tax rates. This is not an attractive option unless the gain can be offset with capital losses.
2. Holding period of more than six months but not more than one year. The gain is a short-term capital gain, taxed at individual tax rates. However, as an alternative to recognizing short-term gain, the investor may defer the gain by rolling over the investment to other QSBS under Code Sec. 1045 within 60 days of the sale. As with other nonrecognition sections, the seller recognizes and realizes gain to the extent he retains part of the sales proceeds ("boot").

The basis of the stock sold becomes the basis of the stock purchased, subject to adjustment (less boot and plus gain recognized), and a taxpayer may tack the holding period of the old stock onto that of the new stock.

3. Holding period of more than one year but not more than five years. Any gain recognized is long-term taxed at the maximum rate of 15 percent (five percent if the investor is in the 10-percent or 15-percent bracket), unless offset by capital losses.
4. Holding period of more than five years. Under Code Sec. 1202, a taxpayer would not recognize long-term capital gain. Instead, a taxpayer is permitted to exclude one-half of the gain recognized (reduced by any gain deferred through a rollover) under Code Sec. 1202. Of this amount, seven percent is a preference item for AMT purposes. [*See* Code Sec. 57(a)(7).] The statute places the remaining one-half in the 28-percent tax basket, together with net long-term gains from collectibles and long-term capital loss carryovers.

Table 1

Requirement	Federal Requirements	California Requirements
Entity	C corporation	C corporation
Stock Issued	By the corporation as original issue	By the corporation as original issue
Date Issued	After August 11, 1993	After August 11, 1993
Asset Limitation	No more than $50 million	No more than $50 million
Asset Test	Use at least 80 percent of its assets in an active trade or business	Use at least 80 percent of its assets in an active trade or business in California
"Asset" Defined	Defined by statute to include gross assets including current assets and intangible assets	Defined by statute to include gross assets including current assets and intangible assets (the FTB tries to use the Schedule 100R property definition instead of the definition provided by the statute)
Payroll Test	No requirement	Employ at least 80 percent of its total payroll expense in an active trade or business in California (the FTB tries to use "payroll" as defined in the California Schedule 100R instead of the term used in the statute)
Qualification Period	During substantially all of the 60-month holding period	During substantially all of the 60-month holding period (State Board of Equalization precedent defines substantially all to mean 80 percent or more; however, the FTB argues for a higher percentage)
Holder	Noncorporate taxpayer	Noncorporate taxpayer
Holding Period—No rollover	60 months	60 months (although on audit, FTB auditors frequently try to apply the asset test and the payroll test over the entire period the taxpayer owns the stock)
Holding Period—If rolled over	6 months	6 months

Thus, the effective overall rate is 14 percent on the entire gain. If, however, the seller is in the top AMT bracket, which is also 28 percent, the effective tax rate is 14.9 percent ([7% x 14%] + 14%). This removes any incentive to qualify for the Code Sec. 1202 exclusion.

Holding, Winning and Losing

Due to the well-publicized benefit of having stock profits taxed as long-term capital gain, taxpayers are accustomed to thinking of more than one year as the requisite holding period to obtain tax savings. Taxpayers who invest in QSBS should not be misled. If they intend to reinvest their proceeds from the sale of QSBS in other QSBS stock, the relevant holding period is more than six months; passing the one-year mark does not offer an additional benefit.

Also, taxpayers may have been encouraged to purchase QSBS because of the potential for a 50-percent exclusion of gain if they held the stock for more than five years. Taxpayers who are subject to AMT often find (much to their chagrin) that the benefit of reaching this holding period (rather than the shorter one for long-term capital gain) turns out to be minimal.

Under Code Sec. 1244, an individual (a more restrictive classification than the noncorporate taxpayer eligibility rule in Code Sec. 1202) may deduct (as ordinary losses) up to $50,000 per year ($100,000 on a joint return) of losses on "small business stock," even if the stock is also QSBS. Only the first $1 million of stock qualifies for ordinary loss treatment. Only the original shareholders are eligible, and an active trade or business must generate more than half the gross receipts. The loss may be a result of a sale, worthlessness or a liquidation.

California QSBS Rules

The state tax consequences of QSBS should not be overlooked. In California, QSBS disputes have become a cottage industry, and with good reason. Indeed, many California tax practitioners (myself included) have seen a stream of QSBS cases under audit, the likes of which suggest a veritable targeting of QSBS benefits. Interestingly, one FTB official told me that *every* California return with QSBS on it gets audited. Even if that is hyperbole, it's not a happy thought.

Instead of conforming to the federal QSBS provisions of Code Sec. 1202, California has enacted its own similar (but not identical) provisions in CR&TC Sections 18152 and 18152.5. Table 1 compares the federal QSBS requirements with the California requirements. Under the California rules, a taxpayer must have held the stock for five years. There is a lifetime limit on the amount that a taxpayer may exclude as gain with respect to qualifying stock issued by the same issuer, $10 million ($5 million for married individuals filing separately), or 10 times a taxpayer's original basis in the stock of the issuing corporation. To determine the limit for any one individual in later years, gain previously excluded on a joint return will be allocated equally between the spouses for purposes of measuring the limitation.

Section 18152.5 requires the corporation to meet an active business requirement during substantially all of a taxpayer's holding period for the stock. The active business requirement is satisfied if 80 percent of the corporation's assets are used, and 80 percent of its payroll is employed, in California during substantially all of a taxpayer's holding period for the stock.

California did not adopt the federal rollover provision of Code Sec. 1045. [CR&TC Section 18038.4]. With the conviction of Moses, California enacted its own provision. CR&TC Section 18038.5. The California rollover provisions are similar, but the gain must be used to purchase QSBS as defined under California law. For sales after August 5, 1997, noncorporate taxpayers may elect to roll over the gain from the sale of QSBS held for more than six months if the gain is used to purchase other QSBS within 60 days.

Fine Determinations Needed

If the rollover is elected, a taxpayer recognizes capital gain from the sale only to the extent that the amount realized from the sale exceeds the cost of the stock purchased, reduced by any portion of the cost previously taken into account under this rollover rule. California applies unrecognized gain to reduce (in the order acquired) the basis for determining gain or loss of any QSBS that a taxpayer purchases during the 60-day period. Except for purposes of determining whether the replacement stock meets certain active business requirements during the six-month period following its purchase, the holding period of the replacement stock includes the holding period of the stock sold.

Some nonbelievers might say that the benefit of holding QSBS has declined with falling capital gain rates. In fact, the complexity of the statute, together with modifications in state rules, may offset the benefit that originally existed. Taxpayers need to be creative here. In some cases, a better strategy may be to fail the QSBS test under Code Sec. 1202. This analysis might be dependant on whether a taxpayer is paying AMT.

However, the rollover opportunity might still be significant. If a taxpayer plans to reinvest any proceeds from sale, or if a taxpayer is making another investment that might meet the timing of Code Sec. 1045 discussed above, it may be worthwhile to consider a rollover.

California's Audit Frenzy

Many investors acquired their stock from the issuing company as early as 1993 or 1994. Beginning in 1998 and 1999, investors began to divest themselves of their stock, sometimes as a block, but more often in a series of sales. It is important for investors to allow more than 60 months to pass before this first sale of small business stock. Of course, that is because a taxpayer can exclude 50 percent of any realized gain from the sale or exchange of QSBS held more than five years (60 months) by the taxpayer. [*See* Code Sec. 1202 and CR&TC Sections 18152 and 18152.5.]

The second part of this article (in the November issue of the M&A TAX REPORT) will discuss specific audit issues encountered in connection with a QSBS audit in California.