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Qualified Small Business Stock Ruling

By Robert W. Wood • Wood & Porter • San Francisco

Company founders love it, and why not? Internal Revenue Code Section ("Code Sec.") 1202 is a darling of a provision, allowing certain taxpayers to exclude a whopping chunk of their gain. Noncorporate taxpayers can exclude 50 percent of the gain on qualified small business stock (QSBS) acquired before February 18, 2009 (or after 2010) and held for more than five years. Noncorporate taxpayers can exclude a whopping 75 percent of the gain on QSBS acquired after February 17, 2009, and before 2011. As you can see, line-drawing is critical.

Drawing Critical Lines

One of the first line-drawing exercises is just what qualifies as QSBS. Essentially, the stock must be issued by a corporation that, as of the date of issuance, is a qualified small business. That means a domestic C corporation with total gross assets *at all times* after August 10, 1993, not in excess of $50 million. [Code Sec. 1202(d).] This $50 million cap takes into account the value of the gross assets both before the issuance, and immediately after the issuance of QSBS.

There's lots of line-drawing here. Although it does not appear that the IRS has targeted Code Sec. 1202 for frequent audits, at least one state (California) reportedly audits every single taxpayer who claims QSBS benefits. That may be hyperbole, but I've seen lots and lots of QSBS audits. And California's tax authorities play hardball.

There are numerous nuances about these rules, both trips and traps. For example, under Code Sec. 1202(f), if stock is acquired solely through the conversion of QSBS of the same corporation, the acquired stock retains that QSBS character. The holding period of that stock even includes the holding period of the convertible stock.

ALSO IN THIS ISSUE

Feeling Sick About *Wellpoint*, Part II 3
Deducting with Occam's Razor 5
Recovering from *Recovery Group* 7

Nate's Case

Recently, the Tax Court considered a QSBS fact pattern in *S. Natkunanathan*, 99 TCM 1071, Dec. 58,118(M), TC Memo 2010-15 (Feb. 1, 2010). Natkunanathan (we'll call him "Nate") was an employee of Cognet Microsystems, a domestic C corporation. Nate received options to purchase Cognet stock. When Cognet merged into Intel, Nate's options became options to purchase Intel stock. Nate exercised the Intel options, sold the resulting stock on the same day, and had a gain of nearly $300,000.

Nate didn't originally claim the QSBS treatment, but did so in an amended return. The Tax Court acknowledged that Code Sec. 1202(f) allows for carryover treatment and for tacking of holding periods on a conversion of QSBS into other stock. Yet Nate could hardly take advantage of that provision.

Options for Special Treatment?

After all, he never even *held* Cognet stock. He only held an option to purchase the stock. The Tax Court specifically rejected the argument that the term "stock" as it is used in Code Sec. 1202 should be read to include options to acquire stock.

The Tax Court acknowledged that there is no authority interpreting the term "stock" under the Code Sec. 1202 rules. However, the court denied Nate relief based on statutory construction, concluding that it would not extend the term "stock" beyond its plain meaning to include options, citing *D.E. Gantner*, 91 TC 713, Dec. 45,108 (1988).

The Tax Court then resorted to the legislative history. Reading the committee report to the Omnibus Budget Reconciliation Act of 1993 (which added Code Sec. 1202), the court focused on the description of the gross assets test providing that the $50 million calculation is determined "at the time of exercise … and the holding period of such stock is treated as beginning at that time." [H. Conf. Rept. 103-213, at 526 (1993), 1993-3 CB 393, 404.] According to the Tax Court, this meant the original issuance contemplated by Code Sec. 1202 would be the issuance of Nate's *Intel stock* upon exercise of his options.

Five Long Years

Nate sold the Intel stock received upon exercise of his options on the same day he exercised the options. Therefore, the Tax Court concluded, Nate clearly did not fulfill the holding period for QSBS, since he held the Intel stock for, at most, one day. Nate only held the Intel *options* from the time of Intel merger with Cogent in 2001 until he exercised these options sometime in 2003. Furthermore, Nate could not show when he had acquired the Cognet options or how long he had held these options before Cognet merged with Intel. So even if the QSBS rules had included options, Nate could not demonstrate he held these options for the requisite five years.

QSBS Qualification

Finally, said the Tax Court, Nate had failed to show that Cognet was a qualified small business on the days he received his options. Nate—who was a *pro se* litigant—submitted,

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as part of his reply brief, a statement of the Cognet CEO. The CEO's statement said that to the best of his knowledge, Cognet's assets did not exceed $50 million before the Intel merger.

Nate tried to submit a notarized version of this statement to the court. The Tax Court refused to admit either of these statements into evidence, citing procedural shortcomings. That meant Nate couldn't show that he came within the tacking rules of Code Sec. 1202(f).

Conclusion

The Code Sec. 1202 rules are a boon to taxpayers who come within the stringent requirements. Taxpayers, who wish to take advantage of this provision, should make sure they qualify.