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# Number Crunching and Qualified Small-Business Stock Gains

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If you sell stock at a gain, you hope to pay tax at capital gains rather than ordinary income rates. As long as the stock wasn't tied to particular kinds of options, and as long as you've held the stock for more than a year, you should be happy. After all, the difference between a 15 percent rate and a 35 percent rate is substantial.

But taxpayers are to be forgiven for not rushing to pay even a 15 percent tax when they don't have to. Even better, some might hope to qualify for a surprisingly little known (but generous) benefit to which company founders and some others are entitled. The benefit is known generically as ''qualified small business stock,'' or QSBS for short.

Although some of the rules are simple, most are not. It behooves every investor, lawyer, and accountant to know the basics of this bonanza, particularly since so many taxpayers seem to be ignorant of the provision. Moreover, it turns out that for those taxpayers who do claim tax benefits under this provision, audit rates appear to be high. That means you need to know not only enough to claim the deduction or exclusion, but also enough to later defend it.

Section 1202 allows many taxpayers to exclude 50 percent of the gain on selling QSBS held for more than five years. Three important issues are the holding period requirements, the applicable tax rates, and the impact of the alternative minimum tax. But before we get to those nuances, just what is QSBS?

## QSBS Defined

To qualify as QSBS, stock must be:

- issued by a C corporation with no more than $50 million of gross assets at the time of issuance;
- of a corporation that uses at least 80 percent of the asset value in an active trade or business, other than in the fields of personal services, finance, farming, restaurants or hotels, and so on;
- issued after August 10, 1993;
- held by a noncorporate taxpayer (meaning any taxpayer other than a corporation);
- acquired by the taxpayer on original issuance (although there are exceptions to that rule); and
- held for more than six months (to be eligible for a tax-free rollover under section 1045) and more than five years to qualify for a 50 percent gain exclusion.

It should be evident from this list that there are really two types of QSBS benefits, one involving an exclusion and one just a rollover of the gain. The stock's holding period is the key. The rollover provision was first available for sales after August 5, 1997. Yet, since the corporation must have issued the stock after August 10, 1993, no one could qualify for the exclusion until August 12, 1998.[1]

The exclusion has some wrinkles too. The 50 percent gain exclusion is generally limited to $5 million per taxpayer per issuer. Thus, a taxpayer who sells shares with a gain in excess of $10 million may be able to exclude 50 percent of the gain up to $5 million. If you are a company founder, or if you represent founders, that should get your attention.

The $50 million standard is unforgiving. For a corporation's stock to be QSBS:

- 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.
- Immediately after it issues the stock, the corporation must have aggregate gross assets that do not exceed $50 million. For the purposes of this requirement, amounts received in the stock issuance are taken into account.[2]

A company may pass into and out of those standards, but it has consequences. If a corporation satisfies the gross asset tests on the date the stock was issued but later exceeds the $50 million asset threshold, stock that otherwise constitutes QSBS does not lose that character solely because of that later event. On the other hand, if a corporation (or a predecessor corporation) exceeds the $50 million asset threshold, it can never again issue QSBS.[3]

You don't have to be an individual to benefit from the QSBS rules. Nonrecognition of gain is possible through a

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[1]Section 1202 was enacted on Aug. 10, 1993, and it applies to QSBS issued on or after Aug. 11, 1993. However, the exclusion applies only if the taxpayer sells or exchanges QSBS held more than five years. Thus, the earliest date on which a sale or exchange was able to take advantage of the section 1202 exclusion was Aug. 12, 1998.

[2]*See* section 1202(d)(1)(A) and (B).

[3]H. Rep. No. 103-111 (P.L. 103-66), p. 602.

partnership, S corporation, regulated investment company, or common trust fund if:

- the entity held the qualifying stock for more than five years; and
- a taxpayer sharing in the gain held the interest in the passthrough entity when the taxpayer acquired the qualifying stock, and at all times thereafter.

### Four Holding Period Rules

When a noncorporate investor sells QSBS at a gain, the tax consequences depend on the taxpayer's holding period.

**1. Six months or less.** If the taxpayer has held the QSBS for six months or less, the gain is a short-term capital gain, taxed at individual rates. Obviously, this is not an attractive option unless the gain can be offset with capital losses.

**2. More than six months but not more than one year.** If the taxpayer has held the QSBS for more than six months but not more than a year, the gain is a short-term capital gain, taxed at individual rates. However, as an alternative to recognizing short-term gain, the investor may defer the gain by rolling over the investment into other QSBS under section 1045 within 60 days of the sale. As with other nonrecognition sections, the seller recognizes gain to the extent he retains part of the sales proceeds (boot). The basis of the stock sold becomes the basis of the QSBS purchased, subject to adjustment (less boot and plus gain recognized). Plus, the taxpayer may tack the holding period of the old stock onto that of the new stock.[4]

**3. More than one year but not more than five years.** If the taxpayer has held the stock for more than one year but not more than five years, any gain is taxed at the maximum rate of 15 percent (5 percent if the investor is in the 10 percent or 15 percent bracket), unless it is offset by capital losses.

**4. More than five years.** If the taxpayer has held the stock for more than five years, the tax benefits of QSBS are paradoxically cut back. Under section 1202, a taxpayer does not recognize regular old long-term capital gain. Instead, the taxpayer is permitted to exclude one-half of the gain recognized (reduced by any gain deferred through a rollover) under section 1202. However, the AMT creeps into the mix, which may cause the taxpayer to pay nearly as much tax — despite the long holding period — as he would under the regular long-term capital gain rate.

### Effective Tax Rates

Although the QSBS rules are a good deal, and the details are worth fretting over, tax rate issues can sometimes be confusing. Even before we get to AMT (more about that below), there's a tax rate foible one must recognize. The whopping 50 percent gain exclusion for QSBS was enacted in 1993, when the capital gain rates for noncorporate taxpayers were still 28 percent. Many readers will recall that the capital gain rate was reduced to 20 percent in 1997 and then again to 15 percent in 2003. There is much talk today of increasing the capital gain rate, but it remains at 15 percent for at least the foreseeable future.

The bad news here is that the 50 percent gain exclusion provided by section 1202 requires reference to the historical 28 percent capital gain rate. A 50 percent exclusion from the historic rate means a taxpayer will generally pay 14 percent on his gains. For a current sale, paying a 15 percent capital gain tax on the entire gain versus paying 28 percent on 50 percent of the gain (for an effective rate of 14 percent) seems like a trivial difference. It certainly accounts for the relative lack of interest in QSBS stock rules today compared with the period before 1997, and even up through 2003.

### AMT in the Mix

AMT seems omnipresent lately. And of course, it changes the landscape of the exclusion. The gain from the sale of a QSBS can be divided into two parts, excludable gain and includable gain. Let's start with the gain included in income. That gain is taxed in the 28 percent tax bracket, together with net long-term gains from collectibles and long-term capital loss carryovers.[5] That's straightforward.

The excludable gain involves AMT and is more complicated. To illustrate, let's say Joe purchases QSBS in a qualified entity on January 1, 1995. He holds the stock continuously until he sells the stock on January 1, 2005. The gain on the sale of the stock is $1 million. Joe is eligible for a 50 percent exclusion, which is $500,000. If the AMT does not apply, Joe is taxed on only $500,000 at 28 percent and pays $140,000 in taxes. The effective tax rate is 14 percent.

However, if AMT applies, 7 percent of the $500,000 exclusion is treated as a preference item.[6] That means Joe can exclude only $465,000 (7 percent x $500,000) of gain, rather than $500,000. Joe must include $35,000 in his taxable income, in addition to the remaining $500,000. Joe's effective tax rate increases to 14.91 percent (paying tax of $149,100) if he is in the 26 percent AMT bracket, or 14.98 percent if he is in the 28 percent AMT bracket (paying tax of $149,800).

The AMT creates a disincentive to hold stock for five years, because Joe, from the example above, could hold the stock for merely one year and be taxed at the long-term capital gain rate of 15 percent (or pay a tax of $150,000). The obvious question is whether it's worth it to hold on to stock for an extra four years if the taxpayer saves just $200 in taxes.

### New Mindset

Because of the obvious benefit of having gain on stock taxed as long-term capital gain, taxpayers have long been accustomed to thinking of "more than one year" as the requisite holding period to obtain tax savings. The QSBS rules require a considerably longer view (five-plus years), or a considerably shorter view (six months and a day). Indeed, taxpayers who invest in QSBS should not be misled. If they merely intend to reinvest their proceeds

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[4] *See* section 1045(b)(5), which incorporates by reference some provisions of section 1202.

[5] *See* section 1(h)(4)

[6] *See* section 57(a)(7).

from the sale of QSBS in *other* QSBS stock, the relevant holding period is more than six months.

Continuing to hold the stock and passing the one-year mark may not offer an additional tax benefit. On the other hand, five years is a long time. For taxpayers who may have been encouraged to purchase QSBS because of the potential for a 50 percent exclusion of gain if they hold the stock for more than five years, that five years and a day may seem a long time coming.

Moreover, taxpayers who are subject to AMT may find the benefit of reaching the more-than-five-year holding period (rather than the shorter one for long-term capital gain) to be minimal.

### If You Have Losses on QSBS?

Although the tax bonanza of the QSBS rules are plainly geared toward gains, losers are not left out entirely. In fact, there is limited ordinary loss treatment. Under section 1244, an individual 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. That's a broader class of stock than QSBS. Yet, only the first $1 million of stock qualifies for that ordinary loss treatment.[7]

Note that that rule applies only to individual taxpayers, which is a much more restrictive classification than the noncorporate taxpayer eligibility rule in section 1202.[8] Furthermore, 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.

### State QSBS Rules

As if it weren't enough to consider the federal taxation of QSBS, parallel (and nonparallel) state rules need to be observed as well. Unfortunately, some taxpayers will find themselves caught between state and federal compliance. Many states simply conform to the federal rule. Some, however, have their own version.

There are seven states — Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming — that do not impose individual state income taxes, so we can easily dispense with those no-tax states. The remaining states appear to either mimic section 1202 for state tax purposes or follow section 1202 with additional requirements.

### California QSBS Rules

In my home state of California, there are similar (but not identical) provisions to the federal law. That can cause real confusion. The California spin on the QSBS rules appears in California Revenue and Taxation Code (CR&TC) sections 18152 and 18152.5. Under the California rules, to receive any benefit a taxpayer must have held the stock for five years. That means the California holding period is simplified, but it is dramatically tougher than the federal rule.

Plus, there is a lifetime limit on the amount a taxpayer can exclude as gain from qualifying stock issued by the same issuer. The lifetime limit must not exceed the greater of either $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 must be allocated equally between the spouses for purposes of measuring the limitation.

California also imposes an antiportfolio sentiment. Section 18152.5 of the California law 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. Those state-specific rules, it turns out, are the real guts of the QSBS rules in California.

### California Roll

Sushi lore suggests that the ''California roll'' — consisting of avocado and crabmeat — was invented by a Los Angeles chef in the 1970s. Considerably less famous (and less tasty) is California's take on tax deferral by rolling over gain from one stock issuance into another. California did not adopt the federal rollover provision of section 1045.[9]

Instead, California enacted its own rollover provisions.[10] 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. Notably, the gain must be used to purchase QSBS as defined under California (not federal) law. For example, the company must be headquartered in California, clearly designed to keep the money in the Golden State.

If the taxpayer elects rollover treatment, the taxpayer will recognize capital gain from the sale only to the extent the amount realized from the sale exceeds the cost of the stock purchased. That amount is then further 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 a taxpayer purchases during the 60-day period.

California generally allows tacking of holding periods so they aggregate. Thus, 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.

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[7]*See* section 1244(c)(3).

[8]*See* section 1244(a), which states, ''In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as an ordinary loss.''

[9]CR&TC section 18038.4.

[10]CR&TC section 18038.5.

### To Pay or Not to Pay?

One hallmark of any tax rollover is that you are delaying the incidence of taxation. Tax deferral is traditionally the province of tax planners. Axiomatically, a tax paid later is always better than one paid today.

Yet, with federal capital gains rates at a historic low, and with nearly every projection contemplating an eventual increase in capital gains rates, paying tax now can make sense. Our primordial urge to defer gain should be tempered with the knowledge that every rule should occasionally be broken. Even axioms can have exceptions.

The benefit of holding QSBS has arguably declined with falling capital gain rates. The complexity of the federal statute, together with state QSBS rules that can be dizzying, may offset some of the anticipated tax benefits. In some cases, it may pay to intentionally fail the QSBS tests. One variable in this analysis should be whether the taxpayer is paying AMT.

Of course, for many of us a rollover opportunity is still significant. If a taxpayer plans to reinvest any proceeds from sale in any event, or if a taxpayer is making another investment that might meet the timing of section 1045 discussed above, the rollover should be considered. Just as with section 1031 like-kind exchange analysis for real estate investments, consider the benefits and burdens of each approach.

### California Percentage Tests

In California, QSBS is defined to include any domestic corporation that is a C corporation if (in addition to other statutory requirements discussed previously) 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 in California, and at least 80 percent of the corporation's payroll (as measured by its total dollar value) is attributable to employment in California.[11]

A QSBS must employ at least 80 percent of the corporation's assets and payroll in one or more trades or businesses in California during substantially all of the taxpayer's holding period for the stock. California tax law requires the corporation to meet an active business requirement during ''substantially all'' of the taxpayer's five-year holding period for the stock. That active business requirement is satisfied if the corporation has 80 percent of its assets *and* 80 percent of its payroll in California during substantially all of the taxpayer's five-year holding period for the stock.[12]

As you might surmise, those rules are unforgiving. There are two hurdles one must surmount to satisfy the Golden State's version of the active business requirement.

- Were 80 percent of the company's assets in California during substantially all of the taxpayer's five-year holding period for the stock?
- If so, did the company have 80 percent of its payroll in California during substantially all of the taxpayer's five-year holding period for the stock?

Since 80 percent and the enigmatic phrase ''substantially all'' are both useful in those tests, one might think that evaluating compliance with those hurdles would be numerical and easy. Not! Unfortunately, there are significant questions about the definition of the term ''substantially all,'' under federal law (section 1202) and California law (CR&TC section 18152.5).

The term ''period'' is undefined, other than ''the taxpayer's holding period for the stock,'' which is the five-year holding period for qualifying as a qualified small business.[13] Section 18152.5(c)(2)(A) of the California law specifically provides that:

> Stock in a corporation shall not be treated as qualified small business stock unless, *during substantially all of the taxpayer's holding period for the stock*, the corporation meets the active business requirement of subdivision (e) and the corporation is a C corporation. [Emphasis added].

### Defining 'Assets'

For franchise tax apportionment purposes, California law defines the term ''property'' to mean the real property and tangible personal property of the corporation.[14] The property factor is used as part of the state franchise tax apportionment formula for apportioning a corporation's income to California when the corporation does business both inside and outside California. Significantly, that narrow view of what constitutes property would omit *all* current assets, as well as all intangible assets owned by the corporation.

Under federal law, ''aggregate gross assets'' means the sum of cash and the adjusted basis of other property held by the corporation.[15] For purposes of that calculation, the adjusted basis of any property contributed to the corporation is its fair market value at that time.[16] That definition is broad and encompasses all assets, including cash and cash equivalents. Significantly, California includes these definitions in its version of the QSBS law.[17]

Moreover, California defines the term ''assets'' for purposes of the 80 percent asset test of section 18152.5(e)(1)(A) to include expenditures for start-up activities.[18] Plus, assets held for the working capital needs of the business are included as assets used in the active conduct of a trade or business for QSBS purposes.[19] That includes assets that are reasonably expected to be used within two years to finance research or for increased working capital.[20]

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[11] CR&TC section 18152.5(d)(1).
[12] CR&TC section 18152.5.
[13] CR&TC section 18152.5(c)(2)(A).
[14] CR&TC section 25129.
[15] Section 1202(d)(2)(A).
[16] Section 1202(d)(2)(B).
[17] CR&TC section 18152.5(d)(2)(A).
[18] Section 1202(e) and CR&TC section 18152.5(e)(2).
[19] Section 1202(e)(6)(A) and CR&TC section 18152.5(e)(6)(A).
[20] Section 1202(e)(6)(B) and CR&TC section 18152.5(e)(6)(B).

Assets are defined as the sum of cash (and cash equivalents) and the adjusted basis of other property held by the corporation, working capital, and expenditures for start-up activities and research.[21] Significantly, the California legislature did not alter the definition of assets under CR&TC section 18152.5. Because the legislature defined ''assets'' broadly, the use of the term property by the Franchise Tax Board seems inconsistent with the statute.

California requires that all QSBS corporations must be headquartered in California. Consequently, most current assets and intangible assets would be deemed to be located at the California headquarters of the company. That means the current and intangible assets would be considered used in the business activity in California.

## Payroll Oddities

California's version of the QSBS rules requires that the corporation use 80 percent of its assets, and employ those accounting for 80 percent of its payroll, in California during substantially all of the taxpayer's five-year holding period for the stock. Obviously, those requirements are not included in the federal QSBS statute.[22] As with California's interpretation of assets, California has its own spin on what constitutes California payroll.

California taxing authorities are inclined to use the franchise tax apportionment payroll factor to show the percentage of total payroll expense in California for QSBS purposes. The payroll factor includes the total compensation an employer pays in California during the year as its numerator. The denominator is the total compensation paid everywhere for the same tax year.[23] Total payroll is determined based on the company's accounting method.

Compensation means wages, salaries, commissions, and any other form of remuneration paid directly to employees for personal services connected with a company's business income.[24] However, section 18152.5 does not use the concept of compensation paid in determining total payroll expense. The statute also does not refer to the Schedule 100R or the payroll apportionment factor in defining total payroll expense. That has created ambiguity on such important issues as whether options are considered in the mix, and if so, when.

Given that ''total payroll expense'' seems to be a much, much broader term than ''compensation paid,'' payroll expense presumably includes employer taxes, perquisites, and administrative costs. Unfortunately, California's FTB has refused to consider the broader definitions.

## Key Case

California law requires that to qualify as QSBS, the corporation must meet an active business requirement during ''substantially all'' of the taxpayer's holding period of the stock.[25] 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 the taxpayer's holding period for the stock. One would think ''substantially all'' would have a well-settled meaning.

The California State Board of Equalization (SBE), which operates like a kind of tax court in California, was faced with a similar issue in *In the Matter of Helen Cantor, Betty M. Asman, and Yakov Kras*[26] (hereafter *Cantor*). In *Cantor*, the SBE reviewed the definition of ''substantially equivalent'' in the context of a section of the California tax code relating to payments in lieu of property taxes.[27] After an exhaustive review of various tests, the SBE in *Cantor* found that ''substantially equivalent'' could reasonably be defined as at least 80 percent.

## Rollover Oddities

The federal rollover provision, section 1045, provides for the deferral of gain from the sale of QSBS when replacement QSBS is acquired. A taxpayer may elect to defer the gain on acquiring QSBS within 60 days from the sale. The IRS has been liberal in its allowance of elections. In fact, Rev. Proc. 98-48, 1998-2 C.B. 367, *Doc 98-27480, 98 TNT 173-5*, allows the taxpayer to make the rollover election on either an original return or an amended return.

In California, the FTB has adopted the IRS rules and procedures relating to QSBS and qualified rollovers. Yet, if replacement stock is purchased within 60 days of the sale of the QSBS, but the taxpayer fails to label the replacement stock on the taxpayer's income tax return, California auditors will generally disallow rollover treatment and refuse to permit the taxpayer to file an amended return correcting the election. However, when the taxpayer reinvests and elects, and the only issue is whether the election does not reference the correct date of sale, an amended return is allowed under IRS procedures (adopted by the FTB) to remedy the situation.

## Conclusion

No one will accuse the QSBS rules of being particularly user-friendly or capable of quick summary. Still, there are tax benefits here that more people probably need to know about than currently do. That is the case despite the currently modest tax rates, which to some observers might suggest that taxpayers should simply pay a 15 percent capital gain tax on their gains and not worry about sophisticated tax planning.

After all, while the need for tax-free rollover provisions may be particularly great during times of high tax rates, there has been no suggestion from other sectors of the economy (for example, tax-free real estate exchanges under section 1031) that taxpayers are happy to pay their tax in times of low rates. That leads me to think that the QSBS rules should be examined more closely by more taxpayers.

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[21]Section 1202 and CR&TC section 18152.5.

[22]Section 1202.

[23]*See* California Schedule 100R; *see also* CR&TC section 25132; Cal. Code Regs. 18 sections 25132(b) and 25132(c).

[24]CR&TC section 25120(c); Cal. Code Regs. 18 section 25132(a)(3).

[25]CR&TC section 18152.5.

[26]2002 SBE 008 (Nov. 12, 2002).

[27]*See* CR&TC section 20509.

From a practitioner's point of view, one might well regard the QSBS rules as a malpractice suit waiting to happen. Rather than proving to be a reason practitioners should steer clear of any knowledge of the QSBS rules, perhaps that should serve as a wake-up call that at least its rudiments should be mastered. All in all, it's worth revisiting the QSBS rules, and focusing not merely on federal law, but on applicable state law too.