Can Founder Legal Settlements Be Tax Free or Tax Deferred?

by Robert W. Wood


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In this article, Wood discusses the potential application of qualified small business stock benefits in settlements arising from disputes between founders and companies over equity interests.

In business, litigation is a fact of life. Some types of litigation dry up in good economic times, while other types of litigation explode. Whether settlement negotiations occur in good or bad economic times can matter too. Examples include disputes between founders and between companies and founders.

Fighting over who was a founder or how big a piece of the company someone was promised can be important at any time. But those matters can be even more important when valuations are soaring, especially when buyouts are being discussed. Tempers may flare when the cupboard is dry, but tempers can *really* flare when the cupboard is full of cash, or about to be.

Some founders are unquestionably founders and unquestionably *real* equity holders. In a fight, they may have employment-based claims, including wrongful termination. But they may also be able to sell their equity, or they may *have* to sell it as part of their exit.

In contrast, some founders occupy that vaunted status in name only, a kind of disputed status. Hence the lawsuit over it. Those putative founders may have a panoply of claims.

However, the right to sell off *whatever* one owns can be pretty powerful. It may be equity or quasi-equity. Of course, all potential resolutions raise tax issues.

A. Capital Gain

An obvious tax question is whether a selling founder has capital gain, ordinary income, or both. Some rules are mechanical. For example, one must know how a founder was issued stock, when, and for what consideration. Some founders who exercised options will be stuck with ordinary wage income when they exercise.

Some founders may have received optioned or restricted stock but will play their tax cards carefully. For example, some will have made section 83(b) elections to lock in capital gain on sale. Some will not have been so lucky or prescient.

Some will sell stock issued under incentive stock options too soon and will end up with mostly ordinary income. By and large, however, many founders will find a way to argue for capital gain treatment on their big payday. Of course, a departing founder with employment-based claims will hope that the wages and ordinary income part of that lump sum is smaller than the long-term capital gain part.

At federal tax rates, ordinary income is taxed at rates up to 39.6 percent. Long-term capital gain is taxed at up to 20 percent, although in most cases, one must add 3.8 percent. The Obamacare net investment income tax thus brings the federal total to 23.8 percent for long-term capital gain.

State taxes can also play a big role. Some states conform to the capital versus ordinary distinction and provide a rate preference. Some states — notably including California — do not. California's top 13.3 percent rate applies to both ordinary income and capital gain. Put differently, you do not get a better deal in California, no matter what.

B. Qualified Small Business Stock Benefits

Some founders (and other employees) who are selling out may qualify for qualified small business stock treatment (QSBS). Before we get too far into the weeds and the numerous technical rules about QSBS, why should founders care? There are several good reasons.

If one holds stock qualifying as QSBS for at least five years before selling, some or all of your gain can be excluded from federal income tax. The percentage varies, but in many cases, the figure is a whopping 100 percent. That means no federal tax on gain generally up to $10 million.

Any remaining gain is taxed as a capital gain, but at a 28 percent rate, not 20 percent. The upper limit on this incredible deal is actually the greater of $10 million or 10 times the taxpayer's adjusted basis in the stock. That generally means the cap is $10 million.

What if you are selling QSBS but have not held it for five years? There is another QSBS benefit. You can defer the gain by rolling it over into a new investment in QSBS. Think of it a little like a section 1031 exchange or an IRA rollover.

Rollover treatment is available if you held the original stock for more than six months and make a special election on your tax return. The rollover works only if you invest in new QSBS within 60 days of your sale. You can reinvest all or part.

If you do a rollover, you can double up on the QSBS tax treatment. That is, you can roll over your first gain into new QSBS. At a later date, you could sell your second QSBS and exclude 100 percent of your gain if you meet the five-year holding period requirement.

Most QSBS cases will obviously involve stock that has unequivocally been issued. However, can a founder suing for his equity ever claim QSBS treatment? An initial question is whether the tax doctrine that applies to litigation settlements (the origin of the claim doctrine) can be taken literally enough to actually create a deemed stock issuance that qualifies as QSBS.

Some of this may depend on the settlement agreement. One would have to accept the idea that the stock that should have been issued would have been QSBS and that the founder is truly being treated as disposing of shares that should have been issued, even if they might not have been. In many cases, the rollover provisions are easier to satisfy than the exclusion provisions. The latter would require a five-year holding period.

C. Defining QSBS

There are, of course, several technical rules. Even so, QSBS belongs on every founder's checklist. Section 1202 provides for the exclusion from taxable income of some amount arising from the sale of QSBS. The amount depends on when the QSBS was originally acquired.

QSBS is defined as stock of a domestic C corporation that was originally issued after August 10, 1993, if several requirements are met. First, as of the date of issuance of the stock, the corporation must be a qualified small business (we'll come back to that).

Second, the stock must be acquired by the taxpayer at original issue in exchange for money or other property (not including stock), or as compensation. Also, stock will generally not be considered QSBS unless, during substantially all of the taxpayer's holding period, the active trade or business requirement of section 1202(e) is met. Finally, the company must be a C corporation during substantially all of the taxpayer's holding period.

D. Qualified Small Business

To be a qualified small business, the company must be a C corporation. At all times after August 10, 1993, it must have gross assets of less than $50 million. To be QSBS, the taxpayer must have acquired the stock directly (or through an underwriter) from the issuing corporation at original issuance.[1]

The stock can be acquired by the taxpayer in exchange for property (other than stock). It can also be awarded as compensation provided for the issuing corporation.[2] However, stock purchased from *other* shareholders (that is, not acquired at original issuance) generally cannot be QSBS.

E. Active Trade or Business

At least 80 percent by value of the assets must be engaged in the conduct of a qualified business. Moreover, the corporation must be an eligible corporation.[3] An eligible corporation includes all corporations that are not (1) a domestic international sales corporation or former DISC; (2) a corporation that has made an election under section 936; (3) a regulated investment company, real estate investment trust, or real estate mortgage investment conduit; or (4) a cooperative.[4]

A qualified trade or business is any business that is not specifically enumerated in section 1202(e)(3). The businesses that are specifically listed and therefore are not considered qualified businesses include (1) 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 in which the principal asset is the reputation or skill of one or more of its employees; (2) any banking, insurance, financing, leasing, investing, or similar business; (3) any farming business; (4) any business involving the production or extraction of products if a character for which a deduction is allowable under section 613 or 613A; and (5) any business involving the operation of a hotel, motel, restaurant, or similar business.

[1] Section 1202(c)(1)(B).
[2] *Id*.
[3] Section 1202(e)(1).
[4] Section 1202(e)(4).

Importantly, having an active trade or business does not require that the corporation generates gross income. Under section 1202(e)(2), if in connection with a future qualified trade or business, a company engages in start-up expenditures as defined in section 195(c)(1)(A), research or experimental procedures as defined in section 174, or incurs in-house research expenses as defined in section 41(b)(4), assets used in those activities will be considered used in a qualified trade or business.

Finally, section 1202(e)(6) provides that working capital reasonably required to run the business — including investment assets that are expected to be used within two years by the company in its trade or business — qualify as assets that are used in the active conduct of a trade or business for purposes of the 80 percent test.

F. Exclusion vs. Rollover

The exclusion provisions of section 1202 and the rollover provisions of section 1045 have a lot in common. At the same time, the requirements of each section can pose different challenges for founders who look to qualify their sale proceeds or settlement proceeds for QSBS treatment.

1. C corporation requirement. Both section 1202 and section 1045 require that the stock at issue be QSBS when acquired. Fundamentally, that means that a C corporation must issue the stock.[5] That can cause problems for some founders because businesses are often started as flow-through entities, such as limited liability companies or S corporations.

Converting from a flow-through entity to a C corporation probably will not help equity acquired before the conversion. However, stock issued after the conversion could qualify as QSBS if the other requirements are met.

2. Holding period requirement. To take advantage of the section 1202 exclusion, a shareholder must hold the QSBS for at least five years.[6] That requirement can preclude many founders from being able to use the benefit, especially when proceeds are received as the result of a lawsuit. Disputes about founder status and unissued equity often take less than five years to develop.

When the five-year requirement in section 1202 is not satisfied, a founder might turn to section 1045. To qualify for section 1045 rollover, a shareholder must have held the stock for only six months before acquiring new QSBS.[7]

[5]Section 1202(c)(1), (d)(1).
[6]Section 1202(a)(1).
[7]Section 1045(a).

3. How the QSBS is acquired. Both sections 1202 and 1045 require that QSBS be acquired at original issuance in exchange for property or services. However, section 1045 requires that the replacement QSBS be purchased in a transaction in which basis is determined by the cost of the stock as determined under section 1012 (other than basis adjustments to take into account gain from the sale of the original QSBS).[8] That rule seemingly prevents the acquisition of replacement QSBS in a section 351 transfer.

Obviously, section 351 transfers are common when new businesses are formed. Therefore, this anti-section 351 rule likely makes it more difficult for founders to roll over their QSBS gain into newly formed qualified small businesses. However, it may be possible to break the nonrecognition treatment in section 351 with careful planning.

4. Timing considerations. Under section 1045, the taxpayer has 60 days to use the proceeds from the sale of QSBS to purchase replacement QSBS.[9] That rule gives the taxpayer a relatively small amount of time to identify replacement QSBS and execute the acquisition. Taxpayers looking to take advantage of the rollover provisions need to plan ahead. It is appropriate to research and negotiate the acquisition of replacement QSBS in advance.

Further, section 1045 requires the taxpayer to establish that the replacement QSBS is operating an active trade or business during the first six months of the taxpayer's holding period.[10] That rule presumably prevents shareholders from taking advantage of the rollover provisions by storing cash in newly formed corporations. To use rollover treatment, taxpayers should plan to invest in a business that will operate an active trade or business (as defined by section 1202) upon their acquisition of the stock.

G. Mixing and Matching

Tax exemptions are always preferable to tax deferrals. Thus, the exclusion offered by section 1202(a) is vastly superior to the deferral in section 1045. Generally, taxpayers can exclude 50 percent of their gain from the sale of QSBS.

However, in some cases, the benefit is even larger. For stock acquired after February 9, 2009, and before September 28, 2010, the gain exclusion is 75 percent.[11] For stock acquired after September 27, 2010, the gain exclusion is 100 percent.[12] It is worth dwelling on that astonishing 100 percent figure.

[8]Section 1202(c)(1).
[9]Section 1045(a)(1).
[10]Section 1045(b)(4)(B).
[11]Section 1202(a)(3).
[12]Section 1202(a)(4).

Ultimately, however, the benefits of section 1202 are not unlimited. Section 1202(b) limits the total gain that can be excluded under section 1202. A taxpayer cannot exclude more than the greater of (1) $10 million (reduced by the aggregate amount of eligible gain taken into account regarding that corporation); or (2) 10 times the aggregate adjusted basis of QSBS issued by the corporation and disposed of during the tax year.

For purposes of determining the total amount of eligible gain, all dispositions of QSBS by the taxpayer from all corporations are aggregated.[13] However, any reduction to the $10 million limitation is applied on a corporation-by-corporation basis only to the extent the taxpayer has disposed of QSBS of the corporation in a prior tax year.

As an example, assume that a taxpayer has QSBS in three corporations: A, B, and C. In year 1, the taxpayer disposes of half her QSBS in Corp. A, recognizing $6 million of gain. All that gain should be considered eligible gain and assuming the 50 percent exclusion applies, the taxpayer should recognize $3 million of gain.

In year 2, the taxpayer disposes of all her QSBS in corporations B and C, recognizing $14 million of eligible gain. The taxpayer's eligible gain is limited to $10 million, and she is allowed to exclude $5 million of the total $14 million of gain (again assuming a 50 percent gain exclusion). Finally, in year 3, the taxpayer disposes of her remaining QSBS in Corp. A, recognizing an additional $7 million of gain. The taxpayer's eligible gain is $4 million, and she is allowed to exclude $2 million of the total $7 million gain.

Unlike in section 1202, there is no cap on the amount of gain deferred under section 1045. Moreover, there is no limitation on mixing and matching the benefits of both sections. Conceivably, a taxpayer could exclude some eligible gain under section 1202 and roll over some gain into new QSBS under section 1045.

Alternatively, perhaps a taxpayer will want to invest in multiple small businesses, the stock of which would be QSBS. That strategy could increase the amount of gain that could ultimately be excludable on the eventual sale of the new stock under section 1202.

H. Investing Through a Flow-Through Entity

A corporation cannot claim the benefits of section 1202 or 1045.[14] QSBS must be held by an individual or a passthrough entity. If stock qualifying as QSBS is held by a passthrough entity, the disposition occurs at the entity level.

Then, gain includable in the individual's taxable income (by virtue of the passthrough entity's disposition of the stock) is eligible for the section 1202 gain exclusion.[15] For this purpose, a passthrough entity is specifically defined in section 1202(g)(4) as any (1) partnership, (2) S corporation, (3) RIC, or (4) common trust fund.

I. Other Considerations

As noted above, the sale of stock is generally subject to the NII tax in addition to capital gain tax. Some taxpayers may also face state tax. However, claiming federal QSBS benefits can indirectly reduce the impact of the NII tax. Further, many states have rules that largely mirror the federal QSBS benefits.

1. NII tax. The NII tax imposes a 3.8 percent tax on specific passive income defined as NII (in addition to the tax already imposed on the income by section 1). NII includes (1) gross income from dividends, interest, rents, royalties, annuities, and other income derived in the active conduct of a trade or business; (2) gross income derived from a business that is passive activity within the meaning of section 469 for the taxpayer; and (3) net income (to the extent taken into account in computing taxable income) on the disposition of property (not including property held in an active trade or business).[16]

The application of the NII tax to net gain on dispositions of property generally applies to gains realized on the disposition of stock. However, the tax should apparently not apply to gain excluded from the taxpayer's *gross* income by section 1202.[17]

Because section 1202 excludes a portion of the gain realized from the taxpayer's gross income, that amount should not be subject to the NII tax. As an example, assume that a taxpayer realizes a $300,000 gain on the sale of QSBS stock. Under section 1202, $150,000 of the gain is excluded, resulting in a 28 percent capital gains tax on the remaining $150,000. The NII tax should apply to the $150,000 that is included in the taxpayer's taxable income (resulting in a total tax of 31.8 percent on that income). But the NII tax should not apply to the $150,000 of gain that is excluded from gross income under section 1202.

2. State income tax. The federal tax benefits of QSBS are huge, but one should think about state taxes too. Some states have parallel laws, some do not, and some put their own spin on the issues. For example,

[13]Section 1202(b)(1).
[14]Section 1202(a).
[15]Section 1202(g)(1).
[16]Section 1411(c).
[17]Section 1411 includes net gains from the disposition of property that are included in the taxpayer's taxable income.

California long had its own brand of QSBS that worked only if the business was California-centric in sales, payroll, etc.

That meant there were many California QSBS audits and disputes. Eventually, however, California did away with it and now has no QSBS counterpart. So wherever you are located, consider state taxes.

J. Conclusion

Sales of founders' stock can sometimes represent the biggest single lump sum payment of a taxpayer's lifetime. But a large tax bill usually goes hand in hand with a windfall of income. The QSBS provisions in sections 1202 and 1045 can provide a break (either temporary or permanent) on those taxes.

However, taking advantage of the QSBS provisions can require advance planning. If the proceeds are coming from a lawsuit, it is important to ensure that the equity at stake is QSBS and that the settlement agreement (or trial transcript) properly documents the founder's claim for equity.

Careful planning is also needed if the taxpayer hopes to use a section 1045 rollover. Given the short 60-day time frame available to purchase replacement QSBS, it is important to research and identify targets before the proceeds are received and the 60-day clock starts to run. ■