Founders Selling Stock or Settling Claims Want Tax Savings

by Robert W. Wood

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Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2021), available at www.TaxInstitute.com.

In this article, Wood explores the tax treatment of a founder's stock sales.

This discussion is not intended as legal advice.

Founders and employees often sell stock. Some founders are employees, and some sell stock they acquired under a company option plan (either incentive stock options or nonqualified options), stock bonus plans, restricted stock plans, and so on. There can be special considerations in some of these situations, such as making timely section 83(b) elections. In the hubbub of start-up culture, some details may be ignored or forgotten or perhaps planned to be properly handled later when the business succeeds or when there is time and money to address them.

Of course, section 83(b)'s election requirements are unforgiving, with service providers having just 30 days to file their elections after acquiring their shares. But this article is not about section 83(b) elections for new shares; it's about the treatment of a founder's stock sales. A key objective in any stock sale is tax minimization, and capital gain treatment is a major goal in almost any circumstance. Of course, even better than that would be the nirvana, or perhaps holy grail, of no tax at all.

Sometimes a stock sale is simple, with stock that clearly qualifies for long-term capital gain. In some cases, however, the stock may qualify as qualified small business stock (QSBS) under section 1202, the best of all worlds. Most founders are unquestionably *real* equity holders. However, the situation can be murkier when a founder is also being paid for additional claims *other than* for their shares.

For example, if they are in a fight with their companies or their fellow founders, they may have employment-based claims, including wrongful termination. They may be able to sell their equity voluntarily or be required to sell it as part of their exit. In this case, a founder would want any exit agreement to clearly identify how much of any separation payment is compensation for their shares and how much is for any unpaid wages, severance, or other less tax-beneficial claims.

Some founders claim to be shareholders but may not be holding certificates, a kind of disputed status. Sometimes, they clearly were shareholders, but they may have been pushed out of the business or perhaps had shares redeemed against their will. Winning the right to sell whatever they own (or claim to own) can be powerful. What they sell may unequivocally be equity, or it may be what we might call quasi-equity. All these potential resolutions raise tax issues.

To address whether a seller has capital gain, ordinary income, or both, one must know when shares were issued and for what consideration. Some founders who exercised options may be stuck with ordinary wage income when they exercise. Some may have received optioned or restricted stock but will have made timely section 83(b) elections, locking in capital gain on a future sale.

Some won't be so lucky or prescient. Some will sell stock issued under incentive stock options too soon and end up with mostly ordinary income. By and large, founders will strive to find a way to argue for capital gain treatment on their big payday. At federal tax rates, ordinary income is taxed up to 37 percent. Long-term capital gain is taxed up to 20 percent, although one must add the 3.8 percent net investment income tax. That brings the federal total to 23.8 percent for long-term capital gain.

State taxes can also play a big part. Some states conform to the capital versus ordinary distinction and afford a rate preference. Some states, such as California, do not. California's top 13.3 percent rate applies to both ordinary income and capital gain.

I. Qualified Small Business Stock

Some shareholders who are selling out qualify for QSBS treatment under section 1202. If you hold stock qualifying as QSBS for at least five years before selling, some or all of your gain can be *excluded* from gross income and hence from federal income tax.[1] The percentage varies, but in many cases, the figure is a whopping 100 percent.[2] That generally means no federal tax on up to $10 million in gain.

Any remaining gain is taxed as a capital gain but at a 28 percent rate, not 20 percent.[3] The upper limit on the exclusion is the *greater* of $10 million or 10 times the taxpayer's adjusted basis in the stock.[4] With founders, that generally means the cap is $10 million. 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.

Rollover treatment is available if you held the original stock for more than six months and if you make an election on your tax return.[5] The rollover works only if you invest in new QSBS within 60 days of your sale, and you can reinvest all or part. But if you do a rollover, you can even double up on the QSBS tax treatment.

That is, you could 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 (up to the cap) if you meet the five-year holding period requirement. Most QSBS cases will obviously involve stock that has actually (and unequivocally) been issued.

II. Founder Lawsuits

Can a founder suing for his lost or undocumented equity ever claim QSBS treatment? An initial question is whether the tax doctrine that applies to litigation settlements (called the origin-of-the-claim doctrine) could be taken literally enough to create a deemed stock issuance that qualifies as QSBS. Some of this may depend on the settlement agreement and how the case was framed in the pleadings.

One would need to get comfortable 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, which require a five-year holding period.

III. QSBS Requirements

Section 1202 provides for the *exclusion* from taxable income of some amounts arising from the sale of QSBS. The amount of the exclusion depends on when the QSBS was originally acquired. QSBS is defined in 1202(c) 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.

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 generally won't 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.

[1] Section 1202(a)(1).

[2] Section 1202(a)(4).

[3] Section 1(h)(4)(A)(ii).

[4] Section 1202(b)(1).

[5] Section 1045(a).

A. Qualifying Small Businesses

To be a qualified small business, the company (and its predecessors, if any) must have gross assets of less than $50 million at all times after August 10, 1993.[6] To be QSBS, stock must also have been acquired directly (or through an underwriter) from the issuing corporation at original issuance.[7] Stock purchased from *other* shareholders (that is, not acquired at original issuance) generally cannot be QSBS.

B. Active Trade or Business

At least 80 percent by value of the company's assets must be used in the conduct of a qualified trade or business during substantially all of the taxpayer's holding period.[8] Moreover, the corporation must be an *eligible* corporation.[9] An eligible corporation includes any corporation that is 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.[10]

A qualified trade or business is any business that is not enumerated in section 1202(e)(3). The businesses that are listed and therefore not considered qualified businesses include: (1) any trade or business involving the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services, or any trade or business in which the principal asset of such trade or business 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 of a character for which a deduction is allowable under section 613 or 613A; and (5) any business of operating a hotel, motel, restaurant, or similar business.

Importantly, having an active trade or business does not require that the corporation generate 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, qualifies as assets that are used in the active conduct of a trade or business for purposes of the 80 percent test.

IV. Exclusion or Rollover?

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

A. C Corporation Requirement

Both section 1202 and section 1045 require that the stock at issue be QSBS when acquired. Fundamentally, this means that a C corporation must issue the stock.[11] That can cause problems for some founders because a business is often started as a flow-through entity, such as a limited liability company or an S corporation.

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

B. Holding Period

To take advantage of section 1202, a shareholder must hold the QSBS for at least five

[6] This includes amounts received for the issuance of the shares that are to be classified as QSBS.

[7] Section 1202(c)(1)(B).

[8] Section 1202(c)(2)(A).

[9] Section 1202(e)(1).

[10] Section 1202(e)(4).

[11] Section 1202(c)(1), (d)(1).

years.[12] That precludes many founders from claiming the exclusion, especially when proceeds are received via a lawsuit. It can often take less than five years for disputes about founder status and unissued equity to develop and be resolved.

When the five-year requirement for the section 1202 exclusion is not satisfied, a founder might turn to a section 1045 rollover. To qualify for a section 1045 rollover, a shareholder must hold the stock for only six months before acquiring new QSBS.[13]

C. How the QSBS Is Acquired

Sections 1202 and 1045 both 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).[14] That rule seemingly prevents the acquisition of replacement QSBS in a section 351 transfer.

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

D. Timing Considerations

Under section 1045, the taxpayer has 60 days to use the proceeds from the sale of QSBS to purchase replacement QSBS, which gives the taxpayer a relatively small amount of time in which to identify replacement QSBS and execute the acquisition.[15] Taxpayers looking to take advantage of the rollover provisions must plan ahead, researching and negotiating the acquisition of replacement QSBS in advance.

Also, section 1045 provides that the taxpayer must establish that the issuer of the replacement QSBS is operating an active business during the first six months of the taxpayer's holding period.[16] The rule presumably prevents a shareholder from storing cash in a newly formed corporation to take advantage of the rollover provisions. To use rollover treatment, a taxpayer should plan to invest in a business that will actively conduct a qualified trade or business (as defined by section 1202) upon the taxpayer's acquisition of the stock.

V. 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 of 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.[17] For stock acquired after September 27, 2010, the gain exclusion is 100 percent.[18] It is worth dwelling on this astonishing 100 percent figure.

Ultimately, though, the benefits of section 1202 are not unlimited. Section 1202(b) limits the total amount of 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.[19] However, any reduction to the $10 million limitation is applied on a corporation-by-corporation basis and only to the extent the taxpayer has disposed of QSBS in 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 his QSBS in

[12] Section 1202(a)(1).

[13] Section 1045(a).

[14] Section 1202(c)(1).

[15] Section 1045(a)(1).

[16] Section 1045(b)(4)(B).

[17] Section 1202(a)(3).

[18] Section 1202(a)(4).

[19] Section 1202(b)(1).

Corporation 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 his QSBS in corporations B and C, recognizing $14 million of eligible gain. The taxpayer's eligible gain is limited to $10 million, and he 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 his remaining QSBS in Corporation A, recognizing an additional $7 million of gain. The taxpayer's eligible gain is $4 million, and he is allowed to exclude $2 million of the total $7 million gain.

Unlike section 1202, section 1045 does not impose a cap on the amount of gain that can be deferred. 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. Such a strategy could increase the amount of gain that may ultimately be excludable on the eventual sale of the new stock under section 1202.

VI. Investing in QSBS: Flow-Throughs

A corporation cannot claim the benefits of section 1202 or section 1045.[20] QSBS must be held by an individual or a passthrough entity.[21] If stock qualifying as QSBS is held by a passthrough entity, the disposition occurs at the entity level. Gain includable in the individual's taxable income (by virtue of the passthrough entity's disposition of the stock) is then eligible for the section 1202 exclusion.[22]

VII. Other Considerations

As noted, the sale of stock is generally subject to the NII tax in addition to capital gain tax. Some taxpayers may also face state tax on the sale. However, claiming federal QSBS benefits can indirectly reduce the effect of the NII tax.[23] Also, some states have rules that largely mirror the federal QSBS benefits.[24]

A. Net Investment Income Tax

The net investment tax imposes a 3.8 percent tax on some passive income defined as "net investment income" (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 regarding 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).[25]

The application of the net investment 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.[26] Because section 1202 excludes all or a portion of the gain realized from the taxpayer's gross income, that amount should not be subject to the net investment tax.

As an example, assume that a taxpayer realizes a $300,000 gain on the sale of QSBS stock. Of that amount, $150,000 is excluded by section 1202, resulting in a 28 percent capital gains tax on the remaining $150,000. The net investment 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 net

[20] Section 1202(a).

[21] For this purpose, a passthrough entity is specifically defined in section 1202(g)(4) as: (1) any partnership; (2) any S corporation; (3) any RIC; or (4) any common trust fund.

[22] Section 1202(g)(1).

[23] As discussed in more detail below, the NII tax applies to amounts included in the taxpayer's gross income. Because section 1202 effectively excludes amounts from gross income, the NII tax should not apply to the amount excluded.

[24] Most states adopt federal gross income as a starting point for the calculation of state tax. Therefore, most states implicitly adopt the federal QSBS rules. However, some states do not allow for a QSBS exclusion. For example, California explicitly eliminated QSBS benefits for tax years after 2012.

[25] Section 1411(c).

[26] Section 1411 includes net gains from the disposition of property that are included in the taxpayer's taxable income. Because section 1202 operates to exclude amounts from gross income, those amounts should not be subject to the NII tax.

investment tax should not apply to the $150,000 of gain that is excluded from gross income by section 1202.

B. 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, California long had its own brand of QSBS that worked only if the business was California-centric in sales, payroll, and other areas. The California brand of QSBS rules was so exacting that it became known as an almost guaranteed audit.

That meant there were many California QSBS contests in the wake of the audits that almost invariably ended with the California Franchise Tax Board's telling the taxpayers that they did not qualify. Eventually, California did away with its version of QSBS entirely, and it now has no QSBS counterpart. Many sellers in California with their feet firmly planted pay the California tax and stay put. But not everyone.

Indeed, regardless of whether stock is QSBS, a looming sale often prompts California residents (and those of other high-tax states) to move before they sell. This isn't unique to stock sales or any location. But moves like New York to Florida (or closer by, New York to New Hampshire) or California to Nevada before a sale (or, for that matter, before settling a big lawsuit) are among the most common.

The no-tax states of Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, and Wyoming seem most popular with tax émigrés, but most states are materially better than California and New York. Washington state used to be more popular than today because (even though it does not have a general state income tax) it now levies a state capital gains tax on some high earners.[27] Of course, most moves are not solely about taxes, but taxes may play a role — especially before a major income event.

VIII. Conclusions

A sale of a founder's stock may represent the biggest single lump sum payment of a taxpayer's lifetime. A large tax bill may go along with a large amount of income. The QSBS provisions in sections 1202 and 1045 can provide a break (either temporary or permanent) on these taxes. However, taking advantage of the QSBS provisions can require care and planning.

If the proceeds are coming from a lawsuit, the same is true. It is important to ensure that the equity at stake is QSBS, and that the settlement agreement properly documents the founder's claim for equity. Careful planning is also needed if the taxpayer hopes to take advantage of the section 1045 rollover. Given the short 60-day time frame available to purchase replacement QSBS, you want to be ready before the proceeds are received and the 60-day clock starts to run. ■

[27] The Washington Supreme Court upheld on March 24 the constitutionality of the capital gains tax, which had been passed by the Legislature in 2021.