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Tax Insights

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Permanent QSB stock exclusion may offer opportunity

The 100% exclusion for gain on qualified small business (QSB) stock is now a permanent part of the Code and offers a substantial benefit for businesses considering organizing as a C corporation or converting from a partnership to a C corporation.

The 100% exclusion under Section 1202 was made permanent by the Protecting Americans from Tax Hikes (PATH) Act of 2015. It is available for QSB stock acquired after Sept. 27, 2010. The provision builds on an earlier version from the 2009 stimulus bill that had allowed a temporary 75% exclusion.

Before these provisions were enacted, QSB stock offered only a modest tax benefit. Taxpayers were allowed to exclude only 50% of the gain on QSB stock against a 28% rate. The resulting 14% tax on QSB stock gain was only one percentage point lower than the 15% rate generally allowed on long-term capital gain. The ability to fully exclude all gain on QSB stock offers a new tax opportunity that could change the analysis of how to organize a business.

Eligibility for exclusion

The requirements for qualifying for the gain exclusion at both the individual and business level may limit some of the potential benefits.

QSB stock must be original issue stock in a domestic C corporation meeting active business requirements with aggregate assets not exceeding $50 million (immediately after the issuance of the stock). An individual must hold onto the stock for five years to qualify for the exclusion, and the exclusion is limited to the greater of $10 million or 10 times the adjusted basis.

To meet the qualified business requirements, the corporation must use 80% of its assets in the active conduct of one or more "qualified trades or businesses." The statute specifically excludes the following from qualified trades or businesses:

- Services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial and brokerage services,

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and any business where the principal asset is the reputation or skill of one or more of its employees
- Banking, insurance financing, leasing, investing or similar businesses
- Farming (including trees)
- Any mining, drilling or extraction business qualifying for percentage depletion under Section 613 or 613A
- Any business of operating a hotel, motel, restaurant or similar business

In addition, the C corporation's assets CANNOT consist of more than:
- 10% non-subsidiary stock or securities;
- 10% real property not used in the active trade or business; or
- 50% cash (after the first two years of existence).

The corporation must also comply with limits on how much of its own stock can be redeemed from related parties and perform reporting to shareholders and the IRS.

Potential opportunities

The exclusion provides an obvious opportunity for a business already established in the C corporation structure or considering establishment as a C corporation for non-tax reasons. The tax analysis is more complicated when a pass-through structure is available and the taxpayer does not necessarily need to organize as a C corporation for any non-tax reasons. From a net tax perspective, there are actually many circumstances in which organization as a C corporation will not provide a better tax result even with the full gain exclusion.

First, the exclusion only provides a benefit on the disposition of the interest in the business, and the QSB stock must be held at least five years. The ongoing earnings of the business in the meantime will be subject to tax both at the corporate level, and to the extent it is distributed, at the individual level. More importantly, the partnership or pass-through structure will often provide a better tax result upon the sale of the business or disposition of the interest in the business — regardless of the QSB gain exclusion.

For example, most buyers will prefer an asset sale in order to use the stepped-up tax basis to enhance future amortization and depreciation deductions. Consequently, retention of pass-through status as a partnership or S corporation (which facilitates a single tax asset sale) is a valuable attribute that would be lost upon conversion to a C corporation. Specifically, many sellers can maximize after-tax proceeds when divesting assets out of a pass-through entity as compared to the after-tax sale proceeds upon divestiture of assets by a C corporation. This matter must be considered carefully when determining whether the conversion to a C corporation makes economic sense.

Despite these limitations, the full gain exclusion available for QSB stock will offer a tax benefit for a conversion to or organization as a C corporation in many circumstances. Section 1202 specifically allows a conversion from a partnership into a C corporation in which the converted partnership interests are treated as acquisitions that can qualify for the QSB stock gain exclusion. Section 1202 does not allow S corporation stock to be converted QSB stock, but any new stock issued after a revocation of S status or a conversion can be eligible. Situations in which the QSB stock gain exclusion offers a significant tax benefit for a C corporation conversion or organization, include:

- **Low outside basis, high inside basis:** If partners have a low basis in the partnership interest itself but a high basis in the assets inside the partnership, then an asset sale after a conversion to a C corporation may generate little corporate level tax and allow for a tax-free liquidation as a QSB.

- **Section 751 "hot" assets:** A C corporation conversion from a partnership can be considered if a substantial amount of the assets in the partnership are unrealized receivables or inventory items that would generate ordinary income under Section 751 on a sale of the partnership interests. In this case, the corporate tax rate on the asset sale (and ability to then liquidate tax-free as a QSB) could result in better tax treatment than ordinary income treatment at the partnership level, especially if individual tax rates go up. The current top ordinary income rate of 35 percent is scheduled to increase to 39.6 percent in 2013, but could be extended.

- **Significant future appreciation as compared to current appreciation:** If the current built-in gain in the business (e.g., full market value of assets and intangibles as compared to tax basis of such assets and intangibles) is relatively low *as compared to the expected future appreciation in the business over the next five years,* then it may make sense to convert to a C corporation to qualify for the QSB stock gain exclusion.

- **Potential sale to tax-indifferent party:** The C corporation structure and QSB exclusion may be preferable if the business or interests in the business will be sold to a tax-indifferent party, such as a tax-exempt entity or business with unused NOLs. In this case, it may be possible to perform a tax-free QSB stock sale (rather than an asset sale) without any significant discount in price.

- **IPO aspirations:** If the business is considering an eventual public stock offering, it may make sense to convert to a C corporation to qualify for the QSB stock gain exclusion.

- **Planned loss of S corporation status:** If it has been planned that S corporation status will be lost in the next few years (e.g., a nonqualified investor will become a shareholder), it may make sense to convert to a C corporation to qualify for the QSB stock gain exclusion.

- **Already contemplating conversion for other reasons:** If the business is considering the C corporation structure for any other non-tax reasons, whether for access to an IPO or otherwise, the business should consider accelerating the process so stock is issued before year-end and qualifies for the full gain exclusion.

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