



MOSSADAMS

# Understanding QSBS Exclusion and Limitations

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*Tax Implications for Angel Investors of  
IRC 1202*



# Agenda

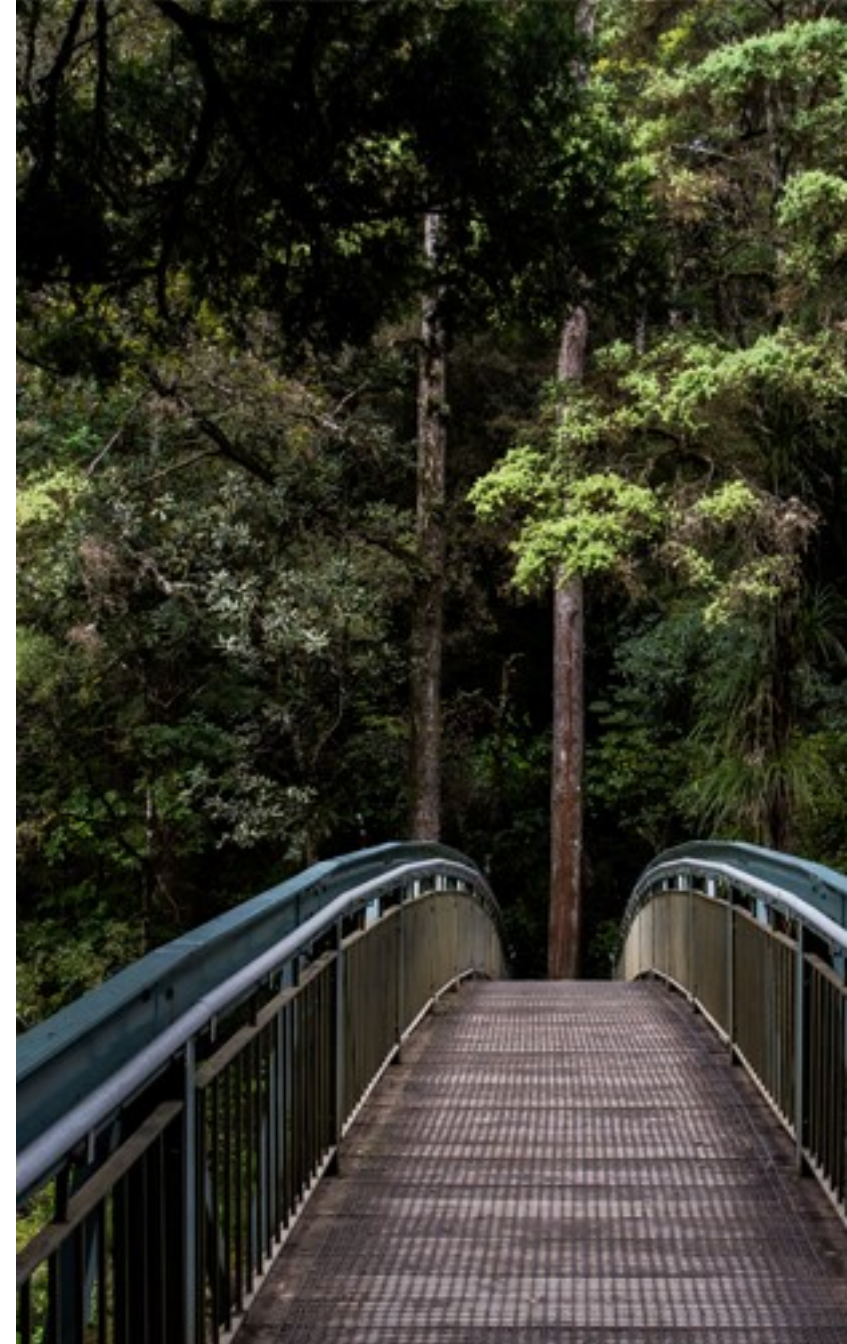
- General Requirements of Qualified Small Business Stock (“QSBS”)
  - Corporate and shareholder level
- Planning Opportunities
  - Including 1045 rollover
- Examples and Discussion



# Section 1202

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## Qualified Small Business Stock (“QSBS”)



# QSBS General Requirements

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- Domestic C-Corporation Stock Acquired at Original Issuance
- Qualified Small Business
- Active Business Requirement
- Five-Year Holding Period



# QSBS General Requirements (cont.)

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- C-corporation Stock Acquired at Original Issuance after August 10, 1993
  - In exchange for money or other property (generally property determinations in accordance with Section 351 and case law)
  - Restrictions on Redemptions
  - Stock received for services treated as issued/received when included in recipient's gross income in accordance with Section 83.
  - Exercise of options or warrants or conversion of convertible debt
    - Gross asset test at time of exercise/conversion
    - Holding period begins at time of exercise/conversion



# QSBS General Requirements (cont.)

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- C-corporation Stock Acquired at Original Issuance after August 10, 1993
  - Corporate transactions (§ 368/§ 351)
    - QSB exchanged for stock of another corporation
  - Does other corporation qualify as QSB?
  - Other corporation does not qualify as QSB, then newly exchanged stock only QSBS to extent of gain that would have been recognized at the time of the § 368/§ 351 transaction



# QSBS General Requirements (cont.)

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- **Aggregate Gross Assets**
  - At all times on/after date of enactment and before the issuances of stock being tested do not exceed \$50 million
  - Immediately after issuance aggregate gross assets do not exceed \$50 million
  - Corporation to submit to IRS and shareholder any reports required by IRS (to date IRS has not required any reporting)
  - **Aggregate Gross Assets = Cash + Adjusted bases of all other property of corporation**
    - If property contributed to the corporation, then basis is fair market value at the time of contribution
  - Aggregation rules for parent-subidiaries



# QSBS General Requirements (cont.)

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- Active Business and Eligible Corporation
  - At least 80% of assets (value) used in active conduct of qualified trade or business
  - No service businesses (ex. engineering, architecture, accounting, banking, insurance, farming, financing, leasing, production/extraction for which a deduction under Section 613, operating hotel/restaurant or similar business)





# QSBS General Requirements (cont.)

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- Five-Year Holding Period
  - Begins on original issuance date/exercise/conversion
- Tacking of holding period
  - Example QSBS exchanged for stock that is also QSBS



# Gain Exclusion

- Greater of \$10 million (less any amounts previously excluded) or 10 times adjusted basis
- If acquired before September 27, 2010, be mindful of treatment as an AMT preference item
  - 50% Exclusion - Stocks acquired at original issuance from the domestic C corporation after Aug. 10, 1993 and before Feb. 18, 2009 qualify for 50% gain exclusion; however, there is a federal Alternative Minimum Tax preference addback of 7% of the excluded gain.
  - 75% Exclusion - Stocks acquired at original issuance from the domestic C corporation after Feb. 17, 2009 and before Sept. 28, 2010 qualify for 75% gain exclusion; however, there is a federal Alternative Minimum Tax preference addback of 7% of the excluded gain.
  - 100% Exclusion – Stocks acquired at original issuance from the domestic C corporation after Sept 27, 2010 or later qualify for 100% exclusion for both regular tax and AMT.
- Generally no gain exclusion if taxpayer takes any offsetting short positions with respect to the if stock held for less than 5 years
  - Generally must hold stock for 5 years before attempting to monetize.



# Section 1045 Deferral

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- Available for a taxpayer other than a corporation
- Ability to sell QSBS held for more than 6 month and uses *all* proceeds to purchase other QSBS within 60 days beginning on the date of sale
  - Proceeds not used to purchase QSBS, gain recognized
  - Basis in QSBS purchase price less unrecognized gain
  - Original QSBS holding period counted
  - Gain cannot be ordinary income
  - Possible for partnership to rollover, specific requirements



# Section 1045 Deferral Continued

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- Election must be made timely
  - Made on or before the due date, including extensions, for the tax return for the year the QSBS is sold.
  - Can be made on an amended return if done within 6 months of the original due date of the return (does not include extensions)
  - Revocable only with IRS consent (PLR)



# Questions for consideration:

- Carried Interest Issues:
- Example: Is the partner already in carry (has a capital account because profits were allocated)? No capital account?



# Questions for Consideration:

- Client's Business Questions:
- Example: A minor portion of the corporation's business is providing accounting services with a majority as a software business.
- Example: Is the corporation a US or non-US business? Some components overseas?



# Questions for Consideration:

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- Start up company, founder shares issued, Section 83(b) elections made, 5 years a day later, founders are redeeming a small percentage of shares at the latest preferred round price which is significant in excess of the most recent 409A valuation.
- Alternatively, founders sell the shares to investors instead at the preferred round price.
- QSBS vs compensation?

Thoughts?



# Questions for Consideration:

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- C Corporation has issued many rounds of KISS/SAFE instruments and Client wants QSBS treatment on the KISS/SAFE instruments purchased?

Thoughts?





# Questions for Consideration:

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- S corporation in existence for 17 years and converts to C corporation in 2019 and wants to sell in 2024, isn't this QSBS (substantially all) to exclude gain?

Thoughts?



# Questions?



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