INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

QUALIFIED SMALL BUSINESS STOCK CAN PROVIDE A STRATEGIC ADVANTAGE TO PRIVATE EQUITY GROUPS AND VENTURE CAPITALISTS

By Randy Schwartzman

February 2021

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Introduction

Internal Revenue Code Section 1202 may offer a generous tax benefit for private equity groups and venture capitalists. Section 1202 permits a taxpayer, other than a corporation, to exclude up to 100% of the gain from the sale or exchange of qualified small business stock (QSBS) held for more than five years. Originally enacted in 1993 to encourage investment in small companies, Section 1202 initially granted a 50% exclusion of gain, which was later increased to 75% for QSBS stock acquired after February 17, 2009 and then to 100% for QSBS stock acquired after September 27, 2010.

The investment in QSBS can be made either directly by an individual or by an eligible pass-through entity, which can be defined for these purposes as an S corporation, partnership, regulated investment company or common trust fund. Private equity (PE) groups and venture capital (VC) firms will be eligible to invest in QSBS in most cases, as they are typically taxed as partnerships, and should consider the potential tax benefits offered by such an opportunity.

The percentage of excludable gain under Section 1202 depends on the year in which the stock was acquired, and the holding period of QSBS begins on the day after the date the stock was issued, regardless of whether the QSBS is received in a taxable or non-taxable transaction.

The exclusion of the gain can provide PE funds and VC a valuable tax savings opportunity upon their exit from an investment in a qualifying small business.

BACKGROUND

The Protecting Americans from Tax Hikes Act of 2015 made the 100% exclusion under Section 1202 permanent and, despite the current political climate to increase taxes on capital gains, there are no plans to change this taxpayer-favorable provision. Once a portion or all of a gain is excluded from income taxation, it is no longer subject to the alternative minimum tax (AMT) or the net investment income tax of 3.8%.

However, for QSBS acquired after August 10, 1993, and on or before February 17, 2009, the taxable portion of the gain is subject to a capital gains tax rate of 28%, and 7% of the gain excluded from gross income on the sale of QSBS is an AMT preference item, meaning that this amount must be added back to income in determining alternative minimum taxable income, which is subject to marginal AMT rates of up to 28%.

Section 1202 was unutilized for years from its enactment, largely because the non-excludable portion of the Section 1202 gain is taxed at 28%, which is notably higher than the reduced tax rates applicable to capital gains from the sale of non-QSBS (which is based on taxable income but the highest current rate is generally 20%). Using a 50% exclusion, half of the gain would have been taxed at 28%, resulting in an effective tax rate of 14% when the long-term capital gains rate was 15%, thus mitigating much of the benefit that was otherwise intended since the savings were only 1% and could have resulted in additional AMT.

It was not until recent years that Section 1202 attracted the attention of founders and PE groups since the 100% exclusion for original issuance stock after September 27, 2010 started applying around five years ago (after September 27, 2015 since there is a five-year holding period), as the 28% special tax rate becomes moot if 100% of the gain is excluded.

The importance of Section 1202 was amplified by the passage of the Tax Cuts and Jobs Act (TCJA) in 2017. The TCJA reduced the corporate tax rate from 35% to 21% and eliminated the corporate AMT. Although the individual income tax rate was reduced from 39.6% to 37%, under the TCJA individuals may be able to reduce their effective tax rate to 29.6% if their income is eligible for the 20% qualified business income deduction under Section 199A.

Despite the lower corporate income tax rate, most investors were historically advised to operate businesses as flow-through entities (i.e., partnerships and S corporations), largely because C corporations are subject to double taxation. The double taxation results in a combined corporate and shareholder tax approaching 40% (21% corporate rate and 23.8% dividend rates on 79% of the distributable income), which is still much higher than 29.6%. However, if earnings can be retained in the business to support continued growth and expansion, and if a second level of tax could be avoided by using the QSBS provisions, it follows that Section 1202 could fundamentally change the choice of entity dynamic for founders and other investors, including PE groups.

President Biden has recommended raising income taxes on corporations from 21% to 28%, as well as raising taxes on high wealth individuals. He has also suggested raising the ordinary individual income tax rate to 39.6% for taxable income of more than $400,000 a year, and increasing the long-term capital gains tax rate to 39.6% for those with taxable income exceeding $1 million. The capital gains tax rate could go up to 43.4% when considering the net investment income tax of 3.8%.

While the doubling of the long-term capital gains tax rate may seem alarming to many investors, the silver lining is that Section 1202 will offer a remarkable federal tax saving of up to 43.4% for founders and investors before taking into account possible state income tax savings, assuming all of the requirements as discussed below can be met. The Biden administration plans do not currently include a proposal to amend Section 1202, since to do so would arguably discourage start-up business activities, especially now when businesses are trying to recover from the COVID-19 pandemic.

SECTION 1202 GUIDANCE

Given that Section 1202 was largely under-utilized until recent years, Treasury and the IRS have not issued an extensive body of guidance on specific aspects of utilizing the provision, including how it could be used by PE groups in merger and acquisition transactions, but we expect that regulations and other guidance will be forthcoming to address some of the uncertainty. In the meantime, we have laid out some of the history and factors that are needed by PE groups to maximize utilization of this valuable provision.

SECTION 1202 GAIN EXCLUSION LIMITATION

While the tax savings under Section 1202 are not without limits, the limitations that have been provided are generous. In all cases, the amount of gain that can be excluded is limited (per taxpayer and per issuer) to **the greater of**:

- $10 million ($5 million in the case of married individuals filing separately); or
- Ten times the taxpayer's aggregate adjusted basis in the QSBS sold during the taxable year.

The $10 million limitation is reduced by the dollar amount of any gain that was excluded in prior years with respect to the same issuing corporation. The tax basis for a taxpayer who invests money in QSBS is generally equal to the cash purchase price or investment. However, where a taxpayer exchanges QSBS for property other than cash (for example, the assets of an existing business), the tax basis for purposes of Section 1202 is deemed to be the fair market value of the property transferred, which is commonly encountered when converting a partnership or sole proprietorship to a corporation for income tax purposes.

ELIGIBILITY

Only non-corporate shareholders, such as individuals, partnerships, trusts and S corporations, are eligible for the gain exclusion under Section 1202. Individual taxpayers for these purposes include U.S. citizens and non-U.S. citizens that are resident in the United States. Since this provision applies to non-corporate shareholders, C corporation shareholders of other C corporations that are QSBS' will not qualify for the Section 1202 exclusion provisions.

Corporate Ownership of Subsidiary Stock

When one corporation owns another corporation, those activities are generally aggregated and we look to the upper-tier corporation for qualification purposes. As discussed further below, when the stock was originally issued, the issuing corporation must be a C corporation, and during "substantially all" of each shareholder's holding period, the issuing corporation must remain a C corporation.

In the PE context, ownership of QSBS stock by a blocker would not generally qualify since corporate taxpayers are not eligible for the exclusion and the blocker entity is not what is being sold on exit.

Corporate Ownership of Partnerships

As such, ownership in partnerships and S corporations (at the time of original issuance and sale) will not generally qualify for the gain exclusion. However, corporate ownership of a partnership could qualify depending on the amount of the corporation's investment into the lower-tier partnership and/or level of activity. In this case, the upper-tier flow through entity could flow through some or all of the benefits to its investors when it sells the QSBS stock as described below.

Ownership of Corporations Previously Taxed as S Corporations

While an S corporation's shareholders, especially founders, cannot qualify for Section 1202 benefits, a revocation of subchapter S status followed by the issuance of new stock in the C corporation can potentially qualify if the stock is held for more than five years and if all of the other requirements outlined below can be met.

Ownership of QSBS through Partnerships or S Corporations

As stated above, only non-corporate taxpayers are eligible for gain exclusion under Section 1202. Therefore, QSBS that qualifies for gain exclusion may be owned through the investment vehicle if the entity meets the statutory requirements of Section 1202. An individual investor would be eligible for gain exclusion with respect to his/her proportionate share of the gain if the individual held his or her interest in the pass-through entity on the date the stock was acquired, and at all times thereafter until disposition of the QSBS.

Moreover, the excludable gain is limited to the individual's interest in the entity at the time the entity acquired the QSBS. The $10 million and 10-times-basis limitations are applied at the level of the individual owner by considering the owner's allocated share of the gain from sale of the QSBS and the basis in such stock. It should be noted that each investor has a separate cap of $10 million per issuer (qualifying QSBS), such that this floor is not considered a partnership item that must be allocated to the investor in the S corporation or partnership.

Finally, and very importantly, a sale of an interest in a partnership or S corporation is not considered a sale of the underlying interest in the QSBS and any future benefit would thus be lost by the investor. If one investor wishes to terminate his/her interest in the upper-tier partnership, it may be possible to liquidate the partnership and distribute the QSBS stock (potentially tax-free) so that each investor would then hold their own shares. As such, each investor could separately plan for and time the disposition of their QSBS shares.

The same strategy would not work in the context of an S corporation holding QSBS stock as most distributions of appreciated property out of an S corporation are taxable with the sole exception relating to tax-free spin-offs, split-offs or split-ups where would be difficult to qualify if there is a pre-planned divestiture of a majority of the QSBS stock or the divested division.

REQUIREMENTS FOR GAIN EXCLUSION

Four main requirements must be met for the capital gain on the sale of stock to be eligible for exclusion under Section 1202:

1. Stock Issued by a C Corporation with Assets Not Exceeding $50 Million: The stock must be originally issued by a domestic C corporation with aggregate gross assets, cash and other property held by the corporation, taken into account at its adjusted tax basis at the time of the stock issuance, totaling $50 million or less at all times prior to and leading up to the point that includes immediately after the stock is issued.

Cash and property received in the issuance are taken into account for purposes of the aggregate gross assets test. However, if QSBS is acquired in exchange for property, then for purposes of computing the excludable gain and the limitation, the basis of the stock will be deemed to be at least the fair market value of the contributed property.

In effect, this limits the exclusion to gain accruing after the stock issuance. While the fair market value of contributed property limits the gain to post-contribution appreciation and is used for purposes of applying the $50 million aggregate gross assets test, the upside to the contribution is that the fair market value of the property is also used for the 10 times basis computation when determining the limitation on gain exclusion.

2. Acquired by Eligible Taxpayer at Original Issuance: The taxpayer must acquire the stock at its original issuance in exchange for money or property, or as compensation for services. As noted below, exceptions apply for certain tax-free transactions, and special rules apply to ownership through partnerships and S corporations.

3. Qualified Trade or Business of Eligible Corporation: On the date of the stock issuance, the issuing corporation must be an eligible corporation, defined in Section 1202 as any domestic corporation other than a current or former domestic international sales corporation, regulated investment company, real estate investment trust, real estate mortgage investment conduit or a cooperative.

At least 80% of the value of the eligible corporation's assets must be used in a qualified trade or business during "substantially all" of the taxpayer's holding period. While "substantially all" is not defined by statute, we typically recommend using a 90% threshold based on judicial precedent and IRS guidance in other areas.

The IRS has taken the position that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of certain types of services requiring individual/owner expertise. Therefore, stock issued by corporations that manufacture or sell products, as opposed to selling services/expertise, can more easily meet the requirements for QSBS. Under a look-through rule, the qualified trade or business requirement can be met through a subsidiary corporation if more than 50% of the subsidiary is owned by its parent.

Excluded from the definition of a qualified trade or business is 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 where the principal asset of such trade or business is the reputation or skill of one or more of its employees, any banking, insurance, financing, leasing, investing or similar business, any farming business (including the business of raising or harvesting trees), certain businesses involving the production or extraction of products, and any business of operating a hotel, motel, restaurant or similar business.

4. Special Rules and Requirements: The taxpayer must hold the QSBS for more than five years. In general, the holding period for all taxable exchanges begins on the day after the exchange. The holding period of QSBS begins on the day after the date of issuance for these purposes.

Certain restrictions can apply to redemptions followed by new issuances specifically designed to qualify the new issuances for QSBS benefits by first extracting value from the corporate contraction as a result of the distribution.

Moreover, certain exceptions and special rules exist for contributions into and distributions out of a partnership, stock option transactions, gift transfers, and transfers at death.

OPPORTUNITY FOR PE/VC INVESTMENT AND EXIT

As stated above, Section 1202 gain exclusion benefits are available both to a limited partner investor in a PE or VC fund, and to an eligible investor that is allocated capital gains as a partner in the fund's general partner entity.

Each partner's allocable share of the exclusion is limited to the amount that the partner could have excluded at the time the QSBS was first acquired by the fund. The limitation of 10 times the investor's basis in the stock is applied by considering the investor's proportionate share of the adjusted basis of the fund in the stock.

In effect, each partner can only exclude gain equal to his respective ownership interest at the time the QSBS was acquired by the fund, and only if he has been a fund partner for the entire period during which the fund owned the securities. The partner will assume the fund's holding period in the QSBS as long as the individual held his interest in the entity when it acquired the QSBS and continuously thereafter.

Moreover, Section 1202 applies to both common and preferred stock. When QSBS is acquired by converting preferred stock, the aggregate gross assets test is applied at the time the convertible preferred stock is issued, and the holding period begins when the convertible stock is first acquired.

PE Target Acquisition Transactions

Without proactive planning, it could be difficult for PE firms to qualify since many of the corporations in which PE or VC firms typically choose to invest have gross assets that exceed the $50 million aggregate gross assets threshold, and thus do not meet the requirements for a qualified small business. Further, PE/VC firms typically exit their investment in less than the five-year holding period required under Section 1202. The planning could entail incorporating the acquiring entity in advance of the acquisition and holding the investment for more than five years.

When the asset threshold is exceeded, while the benefits for the PE/VC firms could be lost, Section 1202 could continue to apply for the rollover equity to target shareholders. For example, where QSBS is exchanged for corporate stock that is not QSBS eligible, in the corporate formation or acquisition transaction, the non-QSBS received nevertheless qualifies as QSBS, and the holding period tacks onto the holding period of the surrendered QSBS. However, the amount of gain eligible for Section 1202 in the corporate transaction is limited to the appreciation in the old QSBS as of the transaction date. The portion of the gain that does not qualify for deferral under either Section 351 (capital contribution transactions) or Section 368 (tax-free reorganization transactions) would be considered taxable and eligible for QSBS benefits on the date of the exchange, subject to the limitations discussed above.

However, if the benefits from the taxable portion of an acquisition transaction are not exhausted at that time, the rollover could qualify for future benefits up to the appreciation at the time of the exchange not to exceed the overall limitation. The rule is even more favorable if the exchanged stock does qualify as QSBS, since the limit does not apply if the "new" stock received in the exchange is also QSBS.

For example, on January 1, 2015, a sole shareholder was issued stock in Corporation A, which is QSBS. On January 1, 2017, when the shareholder held the A stock for two years, he exchanged the A stock for stock in Corporation B in a transaction that qualifies as an exchange under Section 351 or a reorganization under Section 368. At the time of the exchange, the shareholder had built-in gain of $1 million in the A stock. On January 1, 2021, the shareholder sold the B stock realizing a total capital gain of $5 million.

If the B stock is also QSBS, the entire $5 million gain realized by the shareholder is eligible for Section 1202 gain exclusion. However, if B stock is not QSBS, the B stock would nonetheless be treated as QSBS, but only $1 million of the gain realized by the shareholder is eligible for Section 1202 gain exclusion. Even if the B stock does not qualify as QSBS stock, the exchanging shareholder is allowed to combine the holding periods of A and B stock for purposes of the five-year holding period requirement.

Formation and Capitalization in Advance of Target Acquisition

Typical investment opportunities through a new corporation include:

- Using cash to purchase assets or a membership interest in a limited liability company taxed as a partnership that is engaged in a qualifying trade or business. If 100% of the target LLC is acquired, it is generally treated as a taxable asset purchase/sale for income tax purposes;
- Using cash to purchase an S corporation with either a Section 338(h)(10) election or a Section 336(e) election in place, which is treated as an asset sale followed by a liquidation of the target for federal tax purposes; or
- Using cash to purchase a C corporation or an S corporation without a Section 338(h)(10) election.

It should be noted that the $50 million asset test is conducted **immediately after** the capital infusion by the PE/VC group in the stock of the newly formed acquisition corporation. Assume that the capital contributed on formation is $40 million, and that those funds are used to acquire 100% of an entity with gross assets of $100 million, while using leverage of $60 million. Also assume that the acquisition is via the actual or deemed purchase of assets as described in the first two scenarios outlined above.

While it would appear that the gross asset test can be met for these purposes, since definitive guidance has not been issued with respect to the application of the step-transaction doctrine in these instances, the more time has elapsed since the funding of the acquisition company and its acquisition of target assets, the more likely it would be that the stock issuance would qualify.

However, in planning the timing of the funding and the acquisition of the target assets, it is important to balance how much time elapses as there is an “active trade or business” requirement that must be met for “substantially all” of the taxpayer’s holding period, and a corporation holding cash may not be considered active for these purposes (although some challenge that a permissible period of time can be allowable for an acquisition company).

Applying the same facts to an acquisition of the stock of the target without a deemed asset sale election, we would need to consider the same timing rules since an acquisition of 100% of the target stock would require a look through to the subsidiary for purposes of measuring the amount of gross assets at the time of the issuance.

ENTITY CONVERSION TRANSACTION

PE groups sometimes set up partnerships, rather than corporations, to acquire targets. Businesses operating in partnership form can be converted into C corporations on a tax-free basis (subject to some possible traps when liabilities exceed the tax basis of assets and when a partner has a negative tax capital account). A conversion could take many forms, including what is known as an “assets up,” “assets over” or “interest over” incorporation. However, a conversion could be as simple as filing a check-the-box election on Form 8832 to treat an LLC taxed as a partnership as a corporation as of a specified date.

This is a common strategy when a VC or PE firm intends to operate a business through a pass-through entity during the start-up period so that investors can take advantage of losses from depreciation, interest and other acquisition-related items, but the owners should be prepared to convert to a C corporation before Section 1202's $50 million fair market value threshold presents a problem.

As discussed above, the gain eligible for exclusion is limited to the appreciation in the target post-incorporation but the 10 times limitation is increased to the fair market value of the property transferred even though the tax basis for overall gain or loss purposes is equal to the carryover tax basis of the asset. For example, if an investment is converted when the adjusted tax basis of the assets is $10 million but the fair market value of the assets is $40 million, the PE fund investor's exclusion for these purposes would be $10 million or its shares of the exclusion cap, which could be as high as $400 million in total ($40 million x 10).

There is no election or filing required at the time of issuance for stock to qualify as QSBS. The Section 1202 gain exclusion is claimed on the tax return for the year the QSBS is sold. Therefore, PE funds should look at past investments that are being sold before informing their investors of their individual reporting requirements as significant gain exclusion opportunities may already be available

Application of QSBS Provisions to Carried Interests and Profit Interests

While the rules with respect to qualification clearly apply to capital interests in a partnership, there is less certainty surrounding the issuance of profits interests and thus the treatment of carried interests. The gray area is based on language contained in Section 1202(g)(3), which is relevant in determining the applicability to pass-through entities. This section provides that the exclusion only applies to the amount of gain that would have been excluded if determined "by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired." The question that remains open is whether this was meant for the typical 1% capital interest and the typical 20% carried interest, or just the capital interest.

The most favorable interpretation would be to argue that Section 1202(g)(3) allows the gain to be allocated with reference to the carry allocation percentage. However, Section 1202(k) then directs Treasury to prescribe regulations as necessary to carry out the purpose of Section 1202. Unfortunately, this is another area where there is no direct guidance in the form of regulations or other authoritative sources. As such, it is necessary to consider the legislative history of Section 1202 in the context of applicability to partnerships. The legislative history starts with the 1993 Revenue Reconciliation Act where the House Explanation notes:

> Gain from the disposition of qualified small business stock by a partnership, S corporation, regulated investment company or common trust fund that is taken into account by a partner, shareholder or participant (other than a C corporation) is eligible for the exclusion, provided that (1) all eligibility requirements with respect to qualified small business stock are met, (2) the stock was held by the entity for more than five years, and (3) the partner, shareholder or participant held its interest in the entity on the date the entity acquired the stock and at all times thereafter and before the disposition of the stock. In addition, a partner, shareholder, or participant cannot exclude gain received from an entity to the extent that the partner's, shareholder's, or participant's share in the entity's gain exceeded the partner's, shareholder's or participant's interest in the entity at the time the entity acquired the stock.

While this guidance is not sufficient to answer the question, Section 1045 is a related provision addressing the rollover of gain from Section 1202 QSBS to other QSBS. Treas. Reg. §1.1045-1(d) provides that the amount of gain that is not recognized under Section 1045 cannot exceed the "nonrecognition limitation." The nonrecognition limitation is defined as the product of (1) the partnership's realized gain from the sale of QSBS and (2) the partner's smallest percentage interest in partnership capital. The smallest percentage interest in partnership capital is determined based on capital ownership, i.e., exclusive of profits interests.

In trying to connect the sources, we look at the preamble to Treas. Reg. §1.1045-1 published in 2007. Based on language in the preamble, Treasury and the IRS appear to believe that the same limitation described in Section 1.1045-1(d) applies for purposes of Section 1202(g)(3). The relevant part of the preamble provides:

> The proposed regulations provided that the amount of gain that an eligible partner may defer under section 1045 may not exceed: (A) The partner's smallest percentage interest in the partnership's income, gain, or loss with respect to the QSB stock that was sold, multiplied by (B) the partnership's realized gain from the sale of such stock. This nonrecognition rule follows section 1202(g)(2) and (3) by ensuring that the partner can defer recognition of only the gain that relates to the partner's continuous economic interest in the QSB stock that was sold.

Commentators agreed with the underlying "continuous ownership" requirement in the proposed regulations but raised concerns that the nonrecognition limitation rule may be difficult to administer when a partnership does not have a simple "pro rata" partnership arrangement. One commentator suggested that the nonrecognition limitation rule only apply in certain situations.

The IRS and the Treasury Department continue to believe that a nonrecognition limitation rule is consistent with Section 1045 and the underlying continuous economic interest requirement in Sections 1202(g)(2) and (3). The continuous economic interest requirement as applied under Section 1202(c)(1)(B) requires that QSBS must be acquired by the taxpayer at its original issuance in exchange for money or other property or as compensation for services provided to such corporation. Taxpayers that invest through a partnership acquire the requisite interest for purposes of the continuous economic interest requirement by an investment of capital in the partnership. Accordingly, to address the commentator's concerns, the nonrecognition rule has been modified to provide that the amount of gain that an eligible partner may defer under Section 1045 may not exceed:

> (A) The partner's smallest percentage interest in partnership capital from the time the QSB stock is acquired until the time the QSB stock is sold, multiplied by (B) the partnership's realized gain from the sale of such stock.

The IRS and the Treasury Department believe that this nonrecognition rule in the final regulations will be easier to administer, is consistent with each partner's economic interest in the partnership and will not inappropriately limit the amount of gain that can be deferred.

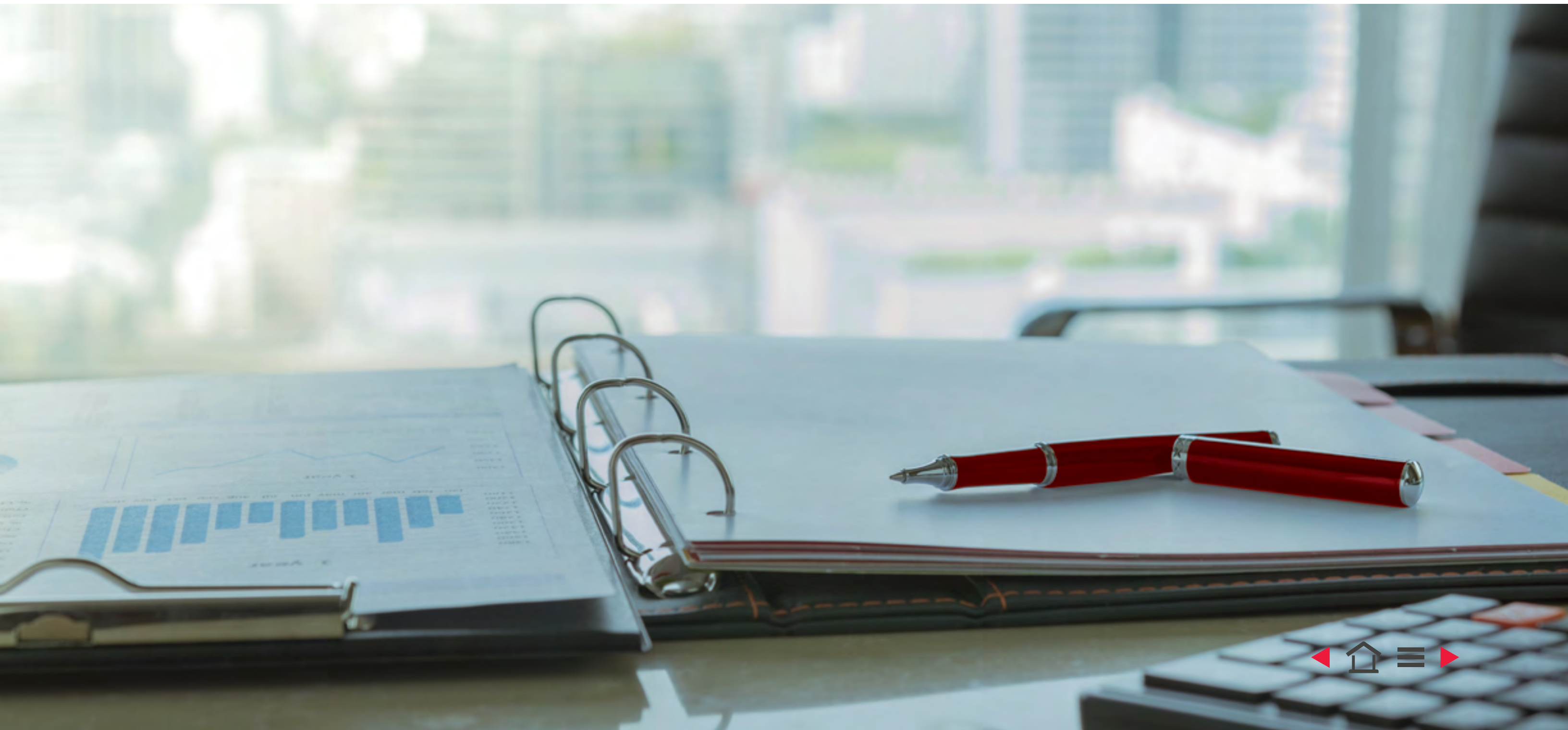
Ultimately, then, there is arguably an unanswered question regarding whether Treasury and the IRS's interpretation of Section 1202(g)(3) is consistent with legislative intent. While there may be a position to exclude the entire gain, that doesn't appear consistent with Treasury's and the IRS's view. Consequently, this risk would need to be considered by PE groups and VCs when taking a position that the QSBS status applies to a carried interest.

Example of Fund Gain Allocation Taxation

During 2021, Fund acquires QSBS for $15 million and sells the QSBS in 2027 for $300 million resulting in total gain of $285 million. Fund then allocates 80% of the total gain to its LPs and 20% of the gain to the GP Entity. Original capital investments were 99% by the LPs and 1% by the GP Entity. LP Investor A contributed 5% of total capital to Fund and is entitled to 5% of recognized gain. GP Partner X contributed 50% of GP Entity's total capital commitment and is entitled to 50% of the GP Entity's allocable share of gain.

The potential Sec.1202 gain exclusion with respect to LP Investor A and GP Partner X is illustrated as follows:

- LP Investor A is allocated total gain of $11.4 million (M) ($285M * 80% * 5%). LP investor A may exclude $10M of allocable gain determined as the greater of: (1) $10M of gain recognized on the sale of QSBS or (2) 10X of LP Investor A's stock basis (10 * $15M * 5% = $7.5M). LP Investor A's remaining gain allocation of $1.4M will be subject to regular taxation.



- GP Partner X is allocated total gain of $28.5M ($285M * 20% * 50%). GP Partner X may exclude $10M of allocable gain determined as the greater of (1) $10M of gain recognized on the sale of QSBS or (2) 10X of GP Partner X's stock basis (10 * $15M * 1% * 50% = $750K). GP Partner X's remaining gain allocation of $18.5M will be subject to regular taxation.

EXIT STRATEGIES

Sec. 1202 can apply to various exit strategies typically employed by PE/VC firms, such as:

- The sale of stock in an initial public offering;
- The taxable exchange of QSBS for publicly traded stock;
- The sale of a company for cash or a combination of cash, stock and debt instruments; or
- The sale of the PE/VC firm's securities back to the company in a redemption transaction that may take the form of a put option.

Depending on the structure of the transaction, gain exclusion under Section 1202 may be worth considering in the PE/VC firm's investment and exit strategy. While these strategies can be successfully executed, other strategies could be planned to increase the number of $10 million floors and there are also traps for the unwary when it comes to exchange interests.

While Section 1202 offers limited exceptions under which a transfer of stock would not imperil the original issuance requirement. Section 1202(h)(2) provides that a transfer by gift, at death or from a partnership to a partner would generally retain the original issuance status of the transferred stock, and the following transfers likely will jeopardize the original issuance status of the QSBS:

- A distribution of QSBS from an S corporation to an S corporation shareholder;
- A contribution of QSBS by a partner to a partnership;
- A contribution of QSBS from a shareholder to a corporation that does not qualify as an exchange under Section 351 or a reorganization under Section 368; and
- A gift of equity interests in a partnership or an S corporation that owns QSBS.

STACKING LIMITATIONS

Where the basis in the shares are relatively low such that the $10 million cap will be used to maximize the gain exclusion for each taxpayer, there are opportunities to increase the $10 million floor by utilizing certain gifting and estate tax planning techniques, including the transfer of interests of QSBS stock held directly by a taxpayer into certain non-grantor trusts. However, tax planning for transfers in advance of a larger transaction should not be done in a vacuum as it could use up or diminish a taxpayer's lifetime exemptions for gifts, the generation skipping tax and for estate tax purposes.

A transfer by gift would likely include a gratuitous transfer of QSBS stock to another individual, a gratuitous transfer of QSBS to a non-grantor trust (including a non-grantor charitable lead trust), regardless of whether the transfer is considered a taxable gift for gift tax purposes, a gratuitous transfer to a charitable remainder trust, a transfer from either a grantor or a non-grantor trust to a non-grantor beneficiary, and most transfers to taxpayers, including trusts that are separately recognized for income tax purposes.

In these cases, QSBS status is retained in the hands of the taxpayer and each taxpayer is eligible for its own $10 million exclusion floor per issuer (qualified corporation).

UTILIZING SECTION 1045 TO ROLL OVER GAIN ON QSBS

Section 1045 allows taxpayers, including PE groups, to roll over gain on the sale of QSBS where the taxpayer has less than a five-year holding period into replacement QSBS. Where the QSBS is held by a fund, an election to roll over gain can be made at either the owner or fund level.

While the Section 1045 regulations contain detailed rules governing the sharing of gain for purposes of Sections 1045 and 1202 when a fund sells QSBS, the application of these rules is once again a gray area when it comes to the tax treatment of profits interest holders for the reasons discussed above.

STATE TAX CONSIDERATIONS

While many states conform to the gain exclusion rules of Section 1202, some states do not. Therefore, the state tax consequences of QSBS should not be overlooked. In a conforming state, such as New York, the reduced amount of gain carries over to the state level, thus reducing the effective state tax rate. However, in a non-conforming state that has enacted differing rules, such as California, state taxes are based on the full amount of capital gain.

Conclusion

With the 100% exclusion now permanent, Section 1202 can present a valuable tax savings opportunity for PE funds and their investors upon their exit from investment in a qualified small business. While the eligibility criteria for such benefits can be complex, PE groups interested in acquiring new targets should carefully evaluate their structuring options with a qualified tax professional before structuring their next acquisition. This will be true under the current tax landscape and can become even more powerful if tax rates increase in the future.

PE groups not only find themselves in a position to benefit from future acquisitions, and they should consider choice of entity when it comes to possibly converting some of their investments that are operating in partnership form assuming QSBS qualifications can be met. Moreover, PE firms may already be in a position to benefit from past acquisitions of portfolio companies since no special election was needed. Therefore, each past acquisition should be reviewed for qualification to possibly pass along favorable QSBS gain exclusion information to investors when exiting a portfolio company investment.

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CONTACT

RANDY SCHWARTZMAN
Corporate Tax and Mergers and Acquisitions (M&A) National Technical Practice Leader
631-927-1159 / rschwartzman@bdo.com

SCOTT HENDON
National Leader, Private Equity
214-665-0750 / shendon@bdo.com

VERENDA GRAHAM
Private Equity Tax National Leader
629-224-4946 / vgraham@bdo.com

JEFF BILSKY
Partner, National Technical Practice Leader, Partnership Taxation
404-979-7193 / jbilsky@bdo.com