The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 31, NO. 3 • MARCH 2024

Sweating the Small Stuff: How Private Equity Funds Can Pass the Benefits of Qualified Small Business Stock to Their US Taxable Investors

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Internal Revenue Code (Code) § 1202[1] permits individuals to exclude 100 percent of the capital gain from the sale of qualified small business stock (QSBS) held for more than five years up to the greater of US$10 million or 10 times the stockholder's basis in QSBS sold during the year (the QSBS Exclusion).[2] Do we have your attention now? Then it may surprise you that small- and mid-cap private equity (PE) funds too often fail to consider the potential benefits of the capital gain exclusion for QSBS found in Code § 1202. This is the case even though the costs to PE funds of obtaining these benefits are usually low and funds can pass them along to investors (and possibly members of the sponsor) who are US individuals. In other words, there is no good reason why Code § 1202 remains so underutilized in the PE space. In this article, we explain the benefits of Code § 1202 to PE fund investors and describe some of the issues a PE fund may encounter during its formation, acquisition, and exit stages in trying to comply with the requirements of Code § 1202 specifically focusing on practical considerations.

Overview and Requirements of the QSBS Exclusion

The three main requirements for stock to qualify as QSBS are: (1) the taxpayer must purchase the QSBS at original issuance (the Original Issuance Requirement); (2) the issuer must be a qualified small business (QSB) on the issuance date meaning that its gross assets must be below a certain threshold (the Asset Test); and (3) the issuer must be a taxable "C" corporation[3] that uses 80 percent of its assets, by value, in a qualifying active trade or business (the Active Business Test), and satisfies certain other requirements for substantially all of the taxpayer's holding period.[4]

Original Issuance Requirement

QSBS must be acquired at its "original issue" by the taxpayer such that the taxpayer receives the stock directly from the corporation in exchange for money, other property (not including stock), or as compensation for services to the corporation.[5] Stock that is secondarily purchased from a prior holder is ineligible for the QSBS Exclusion although the Original Issuance Requirement contains a limited exception for certain secondary transfers of stock such as a gift, a transfer resulting from the death of the transferor, or a distribution from a partnership to a partner.[6] Although these exceptions to the Original Issuance Requirement are not the focus of this article, we note that they can be particularly useful for estate planning purposes.

Certain redemptions by the issuer will jeopardize a taxpayer's satisfaction of the Original Issuance Requirement. These include the redemption of *any* stock from such taxpayer or a related party within the relevant testing period (the four-year period beginning two years before the purported QSBS was issued),[7] or the redemption by the issuer of more than 5 percent of its shares from any shareholders within the relevant testing period (the two-year period beginning one year before the purported QSBS was issued).[8] Certain de minimis rules apply to both categories of redemptions[9] and certain redemptions of stock by a corporation are disregarded in applying these tests, including redemptions incident to retirement and other bona fide termination of services by employees and directors, as well as the death, divorce, or incapacitation of the shareholder.[10]

Qualification as a QSB and the Asset Test

A QSB is a domestic "C" corporation, other than an excluded entity,[11] the aggregate gross assets of which (or any predecessor) at any time through and including immediately after the taxpayer acquires the stock do not exceed US$50 million.[12] For purposes of the Asset Test, a corporation's aggregate gross assets are generally measured by the aggregate adjusted bases of all of the corporation's property,[13] although any property contributed to the corporation would be measured at its fair market value at the time of contribution.[14] The corporation only needs to meet the Asset Test when the QSBS is issued and the QSBS will not be disqualified if the corporation's gross assets later exceed the threshold amount. Because startup companies often have low basis in certain valuable assets (for example, goodwill), they may pass the Asset Test where the gross fair market value of their assets exceeds US$50 million.

Active Business Test

During substantially all[15] of the investor's holding period in the QSBS, the issuer must use at least 80 percent of its assets (measured by value) in the active conduct of one or more eligible business activities.[16] An eligible business activity generally is any business activity other than certain enumerated service activities.[17] The Active Business Test also requires that no more than 10 percent of the corporation's net assets may consist of either the stock or securities of another corporation (other than majority-owned subsidiaries as described below) or real property that is not used in active conduct of a qualified trade or business.[18] For purposes of the Active Business Test, the stock of a 50 percent-or-greater subsidiary corporation is disregarded, and a corporation will be treated as owning the assets and conducting business of subsidiary corporations.[19]

Application of Code § 1202 to PE Funds

The main reason that PE funds can pass along the benefits of Code § 1202 to investors and members of the sponsor is that taxpayers are permitted to own QSBS indirectly through a domestic or foreign pass-through entity (the Pass-Through Rule).[20] Most PE funds are limited partnerships classified as partnerships (that is, pass-through entities) for US federal income tax purposes, so a PE fund offers investors an attractive structure through which to acquire QSBS while also allowing for the issuance of potentially qualifying profits interests.

In order to take advantage of the Pass-Through Rule, a taxpayer must hold an interest in the pass-through entity from the date the pass-through entity acquires the QSBS until the date of its disposition.[21] In other words, an investor must be a partner in the PE fund during that period.[22] This means that if a partner's interest in the partnership holding QSBS fluctuates, the partner can only benefit from Code § 1202 to the extent of its lowest interest in the partnership. A partner who buys into the partnership *after* it acquires QSBS will not benefit from the exclusion with respect to that QSBS at all.

Pass-Through Rule and Carried Interests

An important economic consideration for PE fund sponsors is whether the Pass-Through Rule

permits carried interest recipients (including members of a carry vehicle) to benefit from Code § 1202 with respect to allocations of capital gain attributable to the fund's sale of stock. Code § 1202 requires holding an interest in a partnership during the entire period that the partnership holds the QSBS; and a profits interest is on its face an "interest" in a partnership, although it initially has a zero share of the partnership's capital. While there is currently no guidance applying the Pass-Through Rule to carried interest, some practitioners believe that allocations of gain from a carried interest are eligible for Code § 1202.[23] An individual fund sponsor member's ability to qualify for the QSBS exclusion generally should not be negatively impacted by Code § 1061.[24]

In order to avoid any uncertainty surrounding the treatment of carried interest, individual members of the sponsor could directly acquire interests in a QSB either for cash or as compensation for services. However, "profits interest" treatment would be unavailable to a taxpayer due to the QSB's "C" corporation classification, meaning that the taxpayer would need either to pay fair value for the stock or treat the stock as compensation and pay tax on its fair market value. If the PE fund issues a nonrecourse loan to finance the sponsor member's purchase of the QSBS, for tax purposes the sponsor member might not be treated as purchasing the QSBS (and therefore the holding period for the QSBS would not begin) until the nonrecourse loan is paid off.[25] Given these pitfalls, most PE sponsors likely will prefer to stick to the traditional carried interest structure.

PE Fund Compliance with Code § 1202

In order to secure Code § 1202 benefits, a PE fund must be mindful of the basic requirements of the QSBS exemption and how those requirements apply at various stages of the fund's life cycle. While these requirements are by no means excessively onerous, they may dictate certain aspects of the fund's operation.

Issues Arising at the Fundraising Stage

The largest potential pitfall for PE funds at the fundraising stage is complying with the Pass-Through Rule, which requires that an investor be a partner at the time the QSBS was acquired by the partnership. This becomes an issue for PE funds that would otherwise admit investors and "rebalance" after the target is acquired. These later admitted investors will be ineligible to benefit from the QSBS Exclusion.

PE funds may consider several approaches to deal with this issue. The simplest solution would be for the fund to complete fundraising for QSBS-eligible investors (for example, individuals) in the period before the fund acquires any QSBS-eligible targets. Admitting non-QSBS-eligible investors (such as US tax-exempt and foreign investors) after acquisition of the target would not taint the investment for the earlier admitted investors, allowing a PE fund to adopt a staggered approach to admit qualifying investors first. Alternatively, a PE fund may be able to structure the acquisition so that the QSBS is deemed acquired after the fund's final closing.[26]

PE funds at the fundraising stage should also be aware that QSBS-eligible investors may request side letter provisions related to the investor's eligibility for Code § 1202 benefits. Such side provisions would typically include representations that the PE fund will provide certifications, and possibly back-up documentation, demonstrating that its investments qualify for QSBS benefits. No guidance has been issued on what documentation is sufficient in this regard, so the PE fund and the investor should have significant leeway in negotiating these provisions.

Issues Arising upon Target Acquisition

Thoughtfully structuring investment acquisitions to comply with the Original Issuance Requirement is crucial for a PE fund to maintain its investors' eligibility for the QSBS Exclusion. This is because the most common way for a PE fund to purchase a portfolio company, by purchasing the stock

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of the portfolio company, will not qualify for Code § 1202 purposes—the purchased stock will not have been acquired at original issuance. Furthermore, efforts to effect a back-door secondary purchase through a series of contributions and redemptions involving the portfolio company are likely futile due to the redemption limitations on QSB status that backstop the Original Issuance Requirement.[27] Therefore, the typical PE acquisition structure normally will not work. However, a PE fund can structure around this problem by forming a new domestic corporate entity (NewCo) (thereby satisfying the Original Issuance Requirement) to acquire QSBS-eligible portfolio companies. The benefit of this structure is that NewCo can qualify as a QSB and issue QSBS, so NewCo's (and the PE fund's indirect) acquisition of the underlying portfolio company does not need to comply with QSBS requirements (including the Original Issuance Requirement).

The fact that NewCo subsequently purchases portfolio company stock in a secondary transaction should not matter because it is NewCo's stock (not the portfolio company's stock) that will qualify under the QSBS rules. As long as NewCo owns at least 50 percent of the portfolio company, it generally will be treated as conducting the portfolio company's business thus potentially allowing NewCo to satisfy the Active Business Test, provided that the portfolio company itself would satisfy the test.

The application of the Asset Test to the NewCo structure is, unfortunately, not entirely clear. For example, some commentators have suggested that it may be possible to apply the Asset Test by disregarding NewCo's basis in the portfolio company stock and instead focusing on the portfolio company's basis in its assets.[28] This approach would be highly taxpayer favorable because NewCo could be funded with more than US$50 million and purchase the portfolio company for more than US$50 million and yet satisfy the Asset Test if the portfolio company's aggregate assets (usually measured by basis) are less than US$50 million.

In the event that the Asset Test is applied at the NewCo level, a possible solution involves contributing equity to NewCo in multiple tranches, allowing the first (less than US$50 million) tranche to qualify NewCo as a QSB. Because the Asset Test looks at the corporation's assets prior to and *immediately afte*r the QSBS issuance, future tranches of equity could be disregarded provided that they are not certain to be contributed.

The most taxpayer-unfavorable approach would be to apply the Asset Test at *both* the NewCo *and* portfolio company level. If NewCo's and the portfolio company's assets were aggregated (which may be permitted by Code § 1202(d)(3) because NewCo and a corporate portfolio company would be members of the same parent-subsidiary controlled group), the PE fund would need to consider both NewCo's basis in the portfolio company's stock and the portfolio company's assets. Ultimately, application of the Asset Test in these cases is likely dependent on the specific facts and PE funds should consult their tax advisors.

Issues Arising upon Exit

In order to satisfy the QSBS Exclusion, a disposition must be structured as a sale or exchange of the QSB's stock by the PE fund for tax purposes. If the PE fund is using the holding company structure described above, it can accomplish this by selling NewCo's stock to a third party. However, this approach will not always be available, as a third party may refuse to purchase NewCo absent a significant reduction in purchase price. If the deal is instead structured (legally or for income tax purposes) as a sale of the assets of NewCo and/or the portfolio company followed by a liquidation of NewCo, such a liquidation must be treated for tax purposes as a sale of NewCo's stock by the PE fund for the QSBS Exclusion to apply to the gain from such liquidation. Fortunately, the complete liquidation of a corporation owned by a PE fund typically will receive this treatment.[29]

Note that a sale of an interest in a pass-through entity holding QSBS by an investor is not a qualifying disposition; instead, an investor must be allocated gain from the pass-through entity's sale of the QSB (or from a liquidation that is treated as a sale).[30]

Conclusion

A PE fund can provide significant benefits to investors and members of its sponsor by structuring investments in a manner that qualifies for the QSBS Exclusion. However, a PE fund that seeks to do this needs to be aware of the requirements of Code § 1202 that are relevant at each lifecycle stage of a PE fund—from fundraising to exit. As in much of tax law, a little bit of careful tax planning can go a long way.

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NOTES

1 References in this article to the Code mean the Internal Revenue Code of 1986, as amended (Code).

2 I.R.C. § 1202(b)(1); I.R.C. § 1202(b)(3)(A) (limiting the gain exclusion to US$5 million in the case of a separate return filed by a married individual).

3 I.R.C. § 1202(e)(4). We will refer throughout this article to a QSB as a "corporation," even though it may include an LLC or a limited partnership that elects to be classified as a corporation for US federal income tax purposes.

4 I.R.C. §§ 1202(c)(1)(A), (c)(2)(A).

5 I.R.C. § 1202(c)(1).

6 I.R.C. §1202(h)(1)(B).

7 I.R.C. § 1202(c)(3)(A).

8 I.R.C. § 1202(c)(3)(B).

9 Stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds US$10,000 and more than 2 percent of the stock held by the taxpayer and related persons. And for the second type of redemption, stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds US$10,000 and more than 2 percent of all outstanding stock is purchased. Treas. Reg. §§ 1.1202-2(a)(2), (b)(2).

10 Treas. Reg. § 1.1202-2(d).

11 I.R.C. §§ 1202(e)(2), (e)(4). These excluded entities include (1) a current or former domestic international sales corporation, (2) a corporation with a Section 936 election in effect or has a subsidiary with such an election in effect or (3) a regulated investment company, real estate investment trust, real estate mortgage investment conduit, or cooperative.

12 I.R.C. § 1202(c)(1). All corporations within the same parent-subsidiary control group (as defined in I.R.C. § 1202(d)(3)(B)) are treated as a single corporation for purposes of the Asset Test. I.R.C. § 1202(d)(3).

13 I.R.C. § 1202(d)(2).

14 The incorporation of an LLC taxed as a partnership (or a check-the-box election by an LLC electing corporate tax treatment) would be considered a "contribution" event for this purpose, and the stock received in the incorporation would not qualify as QSBS if the gross fair market value of the LLC's assets exceeded US$50 million immediately before the incorporation.

15 There is no express tax guidance defining what the term "substantially all" means for purposes of I.R.C. § 1202(c)(2)(A). In other contexts the term "substantially all" has generally been interpreted to mean a percentage somewhere between 80 percent and 95 percent. *See* I.R.C. §§ 368(a)(1)(C), 448; Treas. Reg. § 1.41-4(a)(6); Treas. Reg. §§ 1.1400Z2(a)-1(b)(5) and 1.1400Z2(d)-1(c)(3)(i)(C); Comm'r v. First Nat'l Bank of Altoona, 104 F.2d 865, 870 (3d Cir. 1939); Arctic Ice Mach. Co. v. Comm'r, 23 BTA 1223, 1227 (1931).

16 The issue must also be a "C" corporation during substantially all of the investor's holding period.

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[17] These excluded service activities are: (1) a servicing business in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset of the business is the reputation or skill of its employee(s); (2) a banking, insurance, financing, leasing, investing, or similar business; (3) a farming business (including the business of raising or harvesting trees); (4) a business involving the production or extraction of products of a character that permits a deduction under § 613 or § 613A of the Code; and (5) business of operating a hotel, motel, restaurant, or similar business. I.R.C. § 1202(e)(3).

[18] I.R.C. § 1202(e)(1).

[19] I.R.C. § 1202(e)(5). There is no comparable rule that addresses businesses conducted through subsidiary partnerships (or LLCs classified as partnerships for US federal income tax purposes).

[20] I.R.C. § 1202(g). A pass-through entity includes any partnership, S corporation, regulated investment company, or common trust fund. I.R.C. § 1202(g)(4).

[21] I.R.C. § 1202(g)(2).

[22] I.R.C. § 1202(g)(3).

[23] *See*, *e.g.*, Martin D. Ginsburg, Jack S. Levin and Donald E. Rocap, Mergers, Acquisitions, and Buyouts ¶ 215.1.1, Code § 1202 LTCG Rate Reduction to 0 percent (or 7 percent or 14 percent) on "Qualified Small Business Stock," ex. 1 (Dec. 2023 ed.) ("Because individual GP and individual limited partner A have each continued to hold the same 'interest' in the fund throughout the [five]-year [one]-month period from the fund's purchase of the T stock until the fund's sale of the stock as required by [I.R.C.] § 1202(g)(3) (that is, A's 'interest in such entity' has not increased subsequent to its acquisition of the stock), all of the fund's profit on T stock allocated to them should qualify for [I.R.C.] § 1202 treatment."). In contrast, eligibility under I.R.C. § 1045, a companion provision to I.R.C. § 1202, is expressly limited to a taxpayer's interest in "partnership capital." Treas. Reg. § 1.1045-1(d)(1)(ii).

[24] Because the Pass-Through Rule requires the partnership to have a holding period in the QSBS of more than five years, the recharacterization rule in I.R.C. § 1061(a) typically will not apply to gain from the sale of such QSBS.

[25] For example, Treas. Reg. § 1.1202-2(d) provides that for purposes of I.R.C. § 83, acquiring property with a nonrecourse loan may in certain cases be treated as acquiring an option to acquire the property. In order to avoid this result, the loan generally would need to be at least partially recourse.

[26] For example, if the PE fund will hold the target using a corporate Newco that is intended to be a QSB, as discussed below, in some circumstances it may be possible for the PE fund to acquire the target with debt prior to the final closing, then form Newco and have Newco acquire the target from the PE fund after the final closing.

[27] *See* I.R.C. § 1202(c)(3)(A)-(B).

[28] *See* Stefan Gottschalk and Joseph Wiener, "Travels Through 1202," *Tax Notes*, (September 27, 2021), *https://rsmus.com/content/dam/rsm/insights/services/business-tax/federal-tax/pdf/Tax-Notes-Federal-Travels-through-1202.pdf*.

[29] Such a liquidation would trigger corporate-level taxes at the NewCo level. However, a sale of NewCo's underlying assets may give rise to a basis step up for the business's depreciable assets.

[30] Although the distribution of QSBS by a partnership to its partners, followed by a sale of the QSBS the partners, is permitted under the QSBS rules, this type of exit structure is typically not feasible for PE funds.

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