

# Qualified Small Business Stock

## A Guide For Founders and Investors

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# Presentation Overview

## 1. Basic Rules

- ❖ QSBS Tax Benefits
- ❖ QSBS Requirements

## 2. QSBS Pitfalls

## 3. Choice of Entity and QSBS

- ❖ Should I be a “C Corp” for QSBS Benefits?
- ❖ Should I Convert to a “C Corp” For QSBS Benefits?

## 4. QSBS Planning

- ❖ Stacking
- ❖ Packing



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# Basic Rules

## QSBS Tax Benefits

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## QSBS Tax Benefits

- **Headline:** Under current rules, taxpayers can exclude 100% of their gain from the sale of “qualified small business stock” (QSBS) held for more than five years up to the greater of \$10 million or 10x their adjusted basis in the disposed of stock.
- **Example:** Kim created Sparks Fly Inc., a dating app in January 2017. She sells the company for \$100M in March 2022. At exit, her zero basis shares are worth \$30M. Assuming her shares meet the QSBS requirements, Kim pays tax on \$20M of gain (not \$30M), thus saving her \$2.38M:
  - Current Long Term Capital Gain Rate = 20%
  - Net Investment Income Tax Rate = 3.8% (applies to ST and LT capital gains)
  - Excluded Gain on Sale = \$10M
  - Tax Savings on Excluded Gain = \$10M x 23.8%



## QSBS Tax Benefits

- **Tax Benefit in Greater Detail:** Under Section 1202(a) of the Internal Revenue Code of 1986, taxpayers are permitted to exclude from their gross income **50% (the Exclusion Percentage)** of their gain on the sale of “qualified small business stock”, which has been held for more than five years.
- **Per-Issuer Limitation:** Under Section 1202(b), the maximum amount of gain to which the Exclusion Percentage can be applied under Section 1202(a) for any taxable year is limited to the greater of \$10M or 10x the taxpayer’s adjusted basis in the disposed of stock.
- **Exclusion Percentages Vary\*:**
  - **100%:** for stock issued after September 27, 2010
  - **75%:** for stock issued after February 17, 2009 through September 27, 2010
  - **50%** for stock issued after August 10, 1993 through February 17, 2009\*

\*AMT Preference: For taxpayers who acquired their stock on or before September 27, 2010, 7% of the excluded gain is an AMT preference item. See §§ 57(a)(7) and 1202(a)(4)(C).

## QSBS Tax Benefits

- **Special Tax Rate for “Section 1202 Gain”:** Gain that must be included in gross income **when the applicable Exclusion Percentage is less than 100%** is taxed at a special 28% rate (Section 1(h)(7)).
  - Little Relevance Today: The Exclusion Percentage has been 100% since September 28, 2010. However, Biden’s tax plan proposes to reduce the Exclusion Percentage to 50% for taxpayers with AGI over \$400,000 (and all trusts and estates regardless of income levels).
- **50% Exclusion Percentage Example:**
  - Assume Kim created Sparks Fly, Inc. in 2001. Thus, her Exclusion Percentage on exit would be **50% (not 100%)**. Of her \$30M of gain, up to \$10M is eligible for exclusion by the applicable Exclusion Percentage. Thus, her tax bill is \$6.35M (instead of \$4.76M).



# QSBS Tax Benefits

## 50% Exclusion Percentage

	Type	Gain	Tax Rate	Tax Due
Gain Eligible for Section 1202 Benefits (greater of 10M or 10X basis)	Excluded from Gross Income (50% of \$10M)	\$5M	0%	\$0
	Included in Gross Income (50% of \$10M)	\$5M	31.8% (28% plus 3.8%)	\$1.59M
Other Gain	Remaining Gain (\$30M - \$10M)	\$20M	23.8% (20% plus 3.8%)	\$4.76M
	<b>Total</b>	<b>\$30M</b>	-	<b>\$6.35M</b>



# QSBS Tax Benefits

## 100% Exclusion Percentage

	Type	Gain	Tax Rate	Tax Due
Gain Eligible for Section 1202 Benefits (greater of 10M or 10X basis)	Excluded from Gross Income (100% of \$10M)	\$10M	0%	\$0
	Included in Gross Income (0% of \$10M)	\$0	31.8% (28% plus 3.8%)	\$0
Other Gain	Remaining Gain (\$30M - \$10M)	\$20M	23.8% (20% plus 3.8%)	\$4.76M
	<b>Total</b>	<b>\$30M</b>	-	<b>\$4.76M</b>



# QSBS Tax Benefits

## No QSBS Benefits

	Type	Gain	Tax Rate	Tax Due
Gain Eligible for Section 1202 Benefits (greater of 10M or 10X basis)	N/A	\$0	0%	\$0
	N/A	\$0	31.8% (28% plus 3.8%)	\$0
Other Gain	Remaining Gain (\$30M - \$0M)	\$30M	23.8% (20% plus 3.8%)	\$7.14M
	<b>Total</b>	<b>\$30M</b>	-	<b>\$7.14M</b>



# QSBS Tax Benefits

4 **SEC. 138150. LIMITATION ON CERTAIN SPECIAL RULES FOR**  
5 **SECTION 1202 GAINS.**  
6 (a) **IN GENERAL.**—Section 1202(a) is amended by  
7 adding at the end the following new paragraph:  
8 “(5) **LIMITATION ON CERTAIN SPECIAL**  
9 **RULES.**—In the case of the sale or exchange of  
10 qualified small business stock after September 13,  
11 2021, paragraphs (3) and (4) shall not apply to any  
12 taxpayer if—  
13 “(A) the adjusted gross income of such  
14 taxpayer (determined without regard to this  
15 section and sections 911, 931, and 933) equals  
16 or exceeds \$400,000, or  
17 “(B) such taxpayer is a trust or estate.”.  
18 (b) **EFFECTIVE DATE.**—Except as provided in sub-  
19 section (c), the amendment made by this section shall  
20 apply to sales and exchanges on or after September 13,  
21 2021.

## Internal Revenue Code, § 1202. Partial Exclusion For Gain From Certain Small Business Stock

### 1202(a) Exclusion —

1202(a)(1) **In General** — In the case of a taxpayer other than a corporation, gross income shall not include 50 percent of any gain from the sale or exchange of qualified small business stock held for more than 5 years.

### 1202(a)(2) Empowerment Zone Businesses

1202(a)(2)(A) **In General** — In the case of qualified small business stock acquired after the date of the enactment of this paragraph in a corporation which is a qualified business entity (as defined in section 1397C(b)) during substantially all of the taxpayer's holding period for such stock, paragraph (1) shall be applied by substituting “60 percent” for “50 percent”.

1202(a)(2)(B) **Certain Rules To Apply** — Rules similar to the rules of paragraphs (5) and (7) of section 1400B(b) (as in effect before its repeal) shall apply for purposes of this paragraph.

1202(a)(2)(C) **Gain After 2018 Not Qualified** — Subparagraph (A) shall not apply to gain attributable to periods after December 31, 2018.

1202(a)(2)(D) **Treatment Of DC Zone** — The District of Columbia Enterprise Zone shall not be treated as an empowerment zone for purposes of this paragraph.

1202(a)(3) **Special Rules For 2009 And Certain Periods In 2010** — In the case of qualified small business stock acquired after the date of the enactment of this paragraph and on or before the date of the enactment of the Creating Small Business Jobs Act of 2010 [September 27, 2010]—

1202(a)(3)(A) — paragraph (1) shall be applied by substituting “75 percent” for “50 percent”, and

1202(a)(3)(B) — paragraph (2) shall not apply.

In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223.

1202(a)(4) **100 Percent Exclusion For Stock Acquired During Certain Periods In 2010 And Thereafter** — In the case of qualified small business stock acquired after the date of the enactment of the Creating Small Business Jobs Act of 2010 [September 27, 2010]—

1202(a)(4)(A) — paragraph (1) shall be applied by substituting “100 percent” for “50 percent”,

1202(a)(4)(B) — paragraph (2) shall not apply, and

**Build Back Better Act (H.R. 5376)**

**Section 1202 of the Code**



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# Basic Rules

## QSBS Requirements

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## QSBS Requirements (4 Main Ones)

<b>1. Stock</b>	Must be a sale of C Corp shares. Sales of S Corp shares and LLC/LP Interests are not QSBS eligible.
<b>2. Original Issuance</b>	Shares must be acquired from the C Corp in an original issuance. Shares purchased from an existing shareholder are not QSBS eligible.
<b>3. Qualified Small Business</b>	At issuance and immediately thereafter, the company did not have aggregate gross assets in excess of \$50M. Aggregate gross assets determined by reference to cash and aggregated adjusted basis of assets (not FMV). Thus, companies with valuations above \$50M can still be a “qualified small business”.
<b>4. Active Business Requirement</b>	At least 80% of the company’s assets must be used in the active conduct of 1 or more “qualified trades or businesses” (generally, not a personal services business).

# Active Business Requirement

- **Qualifying Trade or Business:** Any trade or business other than...
  - Certain Personal Services Businesses. A 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 1 or more of its employees.
  - Finance. Any banking, insurance, financing, leasing, investing or similar business.
  - Hospitality. Any business of operating a hotel, motel, restaurant or similar business.
  - Real Estate. A corporation with more than 10% of its total value in real estate assets (excluding real estate used in the active conduct of a qualified trade or business).
- **Complicated Fact Patterns:** Not always clear if a business provides services in one of these fields. For example, does a company that provides diagnostic support to medical practices using proprietary technology provide services in the field of health?

# Active Business Requirement

- **Limited Guidance:**
  - PLR 201436001 (Sep. 5, 2014): A company that worked with pharmaceutical industry clients to help them commercialize experimental drugs was engaged in a qualified trade or business.
  - PLR 201717010 (Apr. 28, 2017): A company with a patent on a medical test and analyzed test results and prepared lab reports for health care providers using the patented technology was engaged in a qualified trade or business.
  - PLR 20214002 (Apr. 9, 2021): A company that sold insurance products as a representative of insurance companies and was compensated with commissions from the same companies was not engaged in “brokerage services”.
  - PLR 20215004 (Jun. 25, 2021): A company that designed and manufactured unspecified products for health care providers was engaged in a qualified trade or business because its business was more analogous to custom manufacturing than the provision of services.
  - PLR 202204007 (Jan. 28, 2022): A business that facilitated the leasing of property between lessors and lessees using proprietary software was engaged in a “brokerage services” business and was not a qualified trade or business.
- **But See 199A Regs...**

# Active Business Requirement

1202(e)(3) **Qualified Trade Or Business** — For purposes of this subsection, the term “qualified trade or business” means any trade or business other than—

1202(e)(3)(A) — 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 1 or more of its employees,

1202(e)(3)(B) — any banking, insurance, financing, leasing, investing, or similar business,

1202(e)(3)(C) — any farming business (including the business of raising or harvesting trees),

1202(e)(3)(D) — any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

1202(e)(3)(E) — any business of operating a hotel, motel, restaurant, or similar business.

199A(d) **Qualified Trade Or Business** — For purposes of this section—

199A(d)(1) **In General** — The term “qualified trade or business” means any trade or business other than—

199A(d)(1)(A) — a specified service trade or business, or

199A(d)(1)(B) — the trade or business of performing services as an employee.

199A(d)(2) **Specified Service Trade Or Business** — The term “specified service trade or business” means any trade or business—

199A(d)(2)(A) — which is described in section 1202(e)(3)(A) (applied without regard to the words “engineering, architecture,”) or which would be so described if the term “employees or owners” were substituted for “employees” therein, or

199A(d)(2)(B) — which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

# QSBS Requirements

## Key Takeaways:

- ❖ If you own stock in an emerging company, **whether as a founder, employee, or investor**, it could be QSBS.
- ❖ If you manage a fund that invests in emerging companies, those portfolio company securities could be QSBS to the GP and LPs.
- ❖ Do not assume that a company must have a valuation less than \$50M to be QSBS-eligible.
- ❖ If it is unclear whether a corporation is engaged in a “qualified trade or business” because it is involved in one of the prohibited service fields, consult your tax advisor.
- ❖ Consider requesting a QSBS representation or affidavit from the company in connection with your investment.

# QSBS Rep in Series A Preferred Purchase Agreement

**Section XX. Qualified Small Business Stock.** As of and immediately following the Closing: (i) the Company will be an eligible corporation as defined in Section 1202(e)(4) of the Code, (ii) the Company will not have made purchases of its own stock described in Code Section 1202(c)(3)(B) during the one (1) year period preceding the Initial Closing, except for purchases that are disregarded for such purposes under Treasury Regulation Section 1.1202-2, and (iii) the Company's aggregate gross assets, as defined by Code Section 1202(d)(2), at no time between its incorporation and through the Initial Closing have exceeded \$50 million, taking into account the assets of any corporations required to be aggregated with the Company in accordance with Code Section 1202(d)(3); provided, however, that in no event shall the Company be liable to the Purchasers or any other party for any damages arising from any subsequently proven or identified error in the Company's determination with respect to the applicability or interpretation of Code Section 1202, unless such determination shall have been given by the Company in a manner either grossly negligent or fraudulent.

# Is a SAFE Considered Stock?

POST-MONEY VALUATION CAP Version 1.1

THIS INSTRUMENT AND ANY SECURITIES ISSUABLE PURSUANT HERETO HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR UNDER THE SECURITIES LAWS OF CERTAIN STATES. THESE SECURITIES MAY NOT BE OFFERED, SOLD OR OTHERWISE TRANSFERRED, PLEDGED OR HYPOTHECATED EXCEPT AS PERMITTED IN THIS SAFE AND UNDER THE ACT AND APPLICABLE STATE SECURITIES LAWS PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT OR AN EXEMPTION THEREFROM.

[COMPANY NAME]

**SAFE**  
(Simple Agreement for Future Equity)

THIS CERTIFIES THAT in exchange for the payment by [Investor Name] (the "Investor") of \$[\_\_\_\_\_] (the "Purchase Amount") on or about [Date of Safe], [Company Name], a [State of Incorporation] corporation (the "Company"), issues to the Investor the right to certain shares of the Company's Capital Stock, subject to the terms described below.

This Safe is one of the forms available at <http://ycombinator.com/documents> and the Company and the Investor agree that neither one has modified the form, except to fill in blanks and bracketed terms.

The "Post-Money Valuation Cap" is \$[\_\_\_\_\_]. See Section 2 for certain additional defined terms.

**1. Events**

(a) **Equity Financing.** If there is an Equity Financing before the termination of this Safe, on the initial closing of such Equity Financing, this Safe will automatically convert into the greater of: (1) the number of shares of Standard Preferred Stock equal to the Purchase Amount divided by the lowest price per share of the Standard Preferred Stock; or (2) the number of shares of Safe Preferred Stock equal to the Purchase Amount divided by the Safe Price.

In connection with the automatic conversion of this Safe into shares of Standard Preferred Stock or Safe Preferred Stock, the Investor will execute and deliver to the Company all of the transaction documents related to the Equity Financing; *provided*, that such documents (i) are the same documents to be entered into with the purchasers of Standard Preferred Stock, with appropriate variations for the Safe Preferred Stock if applicable, and (ii) have customary exceptions to any drag-along applicable to the Investor, including (without limitation) limited representations, warranties, liability and indemnification obligations for the Investor.

(b) **Liquidity Event.** If there is a Liquidity Event before the termination of this Safe, this Safe will automatically be entitled (subject to the liquidation priority set forth in Section 1(d) below) to receive a portion of Proceeds, due and payable to the Investor immediately prior to, or concurrent with, the consummation of such Liquidity Event, equal to the greater of (i) the Purchase Amount (the "Cash-Out Amount") or (ii) the amount payable on the number of shares of Common Stock equal to the Purchase Amount divided by the Liquidity Price (the "Conversion Amount"). If any of the Company's securityholders are given a choice as to the form and amount of Proceeds to be received in a Liquidity Event, the Investor will be given the same choice, *provided* that the Investor may not choose to receive a form of consideration that the Investor would be ineligible to receive as a result of the Investor's failure to satisfy any requirement or limitation generally applicable to the Company's securityholders, or under any applicable laws.

Notwithstanding the foregoing, in connection with a Change of Control intended to qualify as a tax-free reorganization, the Company may reduce the cash portion of Proceeds payable to the Investor by the amount determined by its board of directors in good faith for such Change of Control to qualify as a tax-free reorganization for U.S. federal income tax purposes, *provided* that such reduction (A) does not reduce the total Proceeds payable to such Investor and (B) is applied in the same manner and on a pro rata basis to all securityholders who have equal priority to the Investor under Section 1(d).

(c) **Dissolution Event.** If there is a Dissolution Event before the termination of this Safe, the Investor will automatically be entitled (subject to the liquidation priority set forth in Section 1(d) below) to receive a portion of Proceeds

POST-MONEY VALUATION CAP Version 1.1

(f) All rights and obligations hereunder will be governed by the laws of the State of [Governing Law Jurisdiction], without regard to the conflicts of law provisions of such jurisdiction.

(g) The parties acknowledge and agree that for United States federal and state income tax purposes this Safe is, and at all times has been, intended to be characterized as stock, and more particularly as common stock for purposes of Sections 304, 305, 306, 354, 368, 1036 and 1202 of the Internal Revenue Code of 1986, as amended. Accordingly, the parties agree to treat this Safe consistent with the foregoing intent for all United States federal and state income tax purposes (including, without limitation, on their respective tax returns or other informational statements).

*(Signature page follows)*



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# QSBS Pitfalls

Easy To Accidentally Lose QSBS Status

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# Common QSBS Pitfalls

1. Five-Year Holding Period
2. Non-Qualifying Transfers
3. Redemptions
4. Commingled Business Activity



# 1. Five-Year Holding Period

- **Know The Rule.** Know if you own QSBS stock and, if you do, be mindful of your holding period. The five-year holding period requirement is a bright line test.
- **Forward Contracts.** If you have a concentrated QSBS position which you've held for less than five years and want to reduce your exposure while continuing to hold the stock, consult your tax advisor. Strategies like variable prepaid forward contracts (see Rev. Rul. 2003-7) may allow you to cap and collar your existing position without be treated as having disposed of your stock for QSBS purposes.
- **No Offsetting Short:** Stock is disqualified as QSBS if the taxpayer acquires an “offsetting short position” before meeting the five-year holding period. An “offsetting short position” is defined as:
  - A short sale of substantially identical property.
  - Acquiring an option to sell substantially identical property at a fixed price.
  - To the extent provided in regulations, the taxpayer enters into a transaction that substantially reduces the risk of loss from holding such QSBS stock



**To date, no such regulations have been issued.**

## 2. Non-Qualifying Transfers.

- **Think Before You Transfer Your Shares:** Shares must be acquired in an original issuance to be QSBS-eligible. Three exceptions where the **transferee** will be treated as acquiring the shares in the same manner as the **transferor**:
  1. Shares acquired by gift.
  2. Shares acquired at death.
  3. Shares distributed from a partnership to a partner (not contributions in!).
- **Estate Planning:** Common estate planning involves the creation of family limited partnerships and transferring existing investments into those limited partnerships. If one of those investments is QSBS stock, QSBS status is lost.
  - Limited ways to cure such a default.
- **Investment Partnerships/Clubs:** Partners in investment partnerships -- **including funds organized as LPs** -- that own QSBS stock are eligible for QSBS benefits. Partners must have been a partner when the partnership made the QSBS investment and at all times thereafter before the partnership disposes of the QSBS stock. Unclear whether someone who receives an LP interest by gift is eligible for QSBS benefits because they did not own the interest at the time of the original investment.

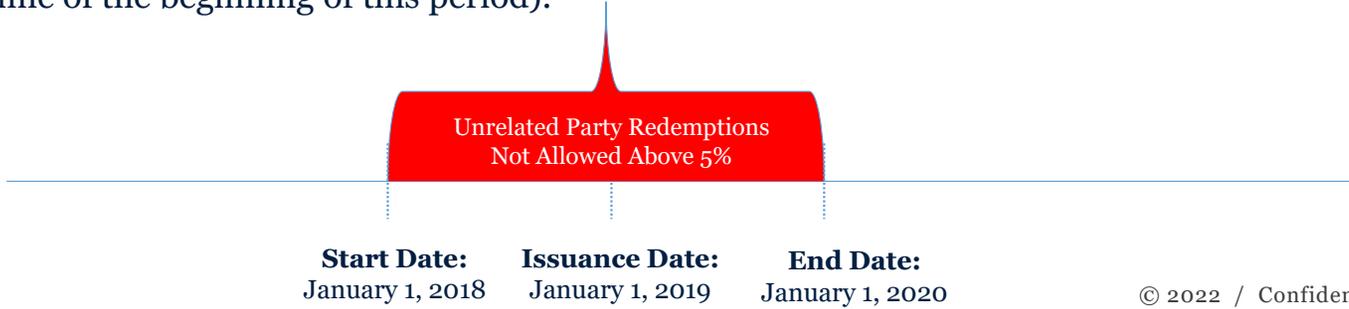
# 3. Redemptions

- **Two Redemption Rules:**

1. Related-Party Redemptions: Your shares are not treated as QSBS if at any time during the four-year period beginning two-years before the issuance date of the shares the corporation redeemed any of its stock from you or someone related to you.



2. Unrelated Party Redemption: Your shares are not treated as QSBS if at any time during the two-year period beginning one-year before the issuance date the corporation redeemed stock with an aggregate value exceeding 5% of the aggregate value of all stock (valued at the time of the beginning of this period).



## 3. Redemptions

- **Exceptions:**
  - ❖ De Minimis:
    - ❖ Redemption is considered de minimis if **2% or less** of the stock held by the taxpayer or related persons is redeemed, or price paid for the redeemed stock is **\$10,000 or less** (for related party redemptions).
    - ❖ Redemption is considered de minimis if **2% or less** of all outstanding stock is redeemed, or price paid for the redeemed stock is **\$10,000 or less** (for unrelated party redemptions).
  - ❖ Termination of Service, Death, Disability or Mental Incompetency or Divorce.

### 3. Redemptions

**Example:** In December 2017, Zach creates a video game start-up, Star Power Inc., issuing himself 100,000 founder shares representing 100% ownership. In January 2018, two brothers (Mario and Luigi) each invest \$50,000 into the start-up for a 5% interests. 18 months later, Mario agrees to be redeemed of his interest for \$200,000. In February 2023, Star Power is sold for \$100M and Luigi receives \$2M for his ownership stake. Is Luigi's gain excluded under Section 1202?

**Answer: No.** Because Star Power redeemed a related party, Mario, for more than a de minimis amount (greater than 2% and more than \$10,000) within the 4-year window, Luigi's shares are not considered QSBS.



## 4. Commingling Business Activity

- **Qualified and Non-Qualified Activity in the Same Corporation:** A corporation may be engaged in multiple lines of business in the same corporation. If the corporation's assets are not substantially all used in the qualifying trade or business (i.e., 80% or more by value) then stock in the corporation is not QSBS.
- **Practice Tip:** Consider spinning-off the qualifying trade or business into a separate corporation.





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# Choice of Entity

Should I Be a C Corp For QSBS Benefits?

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## Choice of Entity

C Corporation	LLC
QSBS Eligible	Flow-Through Taxation
Preferred by VCs:	Basis Step-Up to Buyer on Exit
<ul style="list-style-type: none"><li>• No UBIT Concerns</li></ul>	Ability to Issue Profits Interests
<ul style="list-style-type: none"><li>• No K-1s</li></ul>	
<ul style="list-style-type: none"><li>• Standard Forms/Governance</li></ul>	

**Comment:** If your start-up is clearly a “qualified trade or business” under Section 1202 and not likely to exit before 5-years, eligibility for QSBS benefits may tip the scales in favor of being a C-Corporation. However, PE buyers are more likely to discount for lack of a basis step-up if forced to buy stock.

## Choice of Entity

**Example:** Peter plans to start a company that makes a special type of drone to be used by police to monitor speeding. Peters plans to put a significant amount of his own money into the venture. He does not anticipate having many sales in the first few years and any sales revenues are likely to be reinvested in the business. Potential buyers for his company would be large corporate manufacturer of drones. He may also exit by IPO/SPAC. On these facts:



**C Corp or LLC?**





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# Choice of Entity

Should I Convert My LLC to a C Corp For QSBS Benefits?

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## C Corporation Conversion

- **Question:** My start-up is a qualified trade or business. However, I formed it as an LLC before I knew about QSBS. Is it too late to become a C-Corporation so that my equity is eligible for the exclusion under Section 1202 on exit?
- **Answer:** It depends. Stock received on conversion of an LLC to a C-Corporation can qualify as QSBS provided the newly-formed corporation meets the QSBS requirements at the time of conversion. Note, however:
  1. Pre-Conversion Gain Not Eligible for Exclusion under 1202. Only post-conversion appreciation is eligible to be excluded under 1202. (QSBS received upon contribution of property to the newly-formed corporation is no less than the FMV of such contributed property for 1202 purposes. See Section 1202(i)(1)(B)).
  2. Harder to Satisfy The Gross Asset Test. For purposes of the \$50M gross asset test, assets contributed to a corporation are valued at FMV (not adjusted basis, as is the case for created assets). Thus, stock received upon conversion of an LLC valued at \$50M+ will not be QSBS.
  3. Holding Period. Holding period for purposes of meeting the five-year requirement under Section 1202 begins on the date of conversion.
  4. 10X Basis Limitation Benefit. Gain eligible for exclusion under 1202(a) is greater of \$10M or 10X basis of disposed of stock (in this case, FMV at the time of conversion).

## C Corporation Conversion

- **Example:** On March 1, 2015, Dana and James formed Wise Wallet LLC, a start-up that allows users to safely store their cryptocurrencies from hackers (50% each). By May 2018, the company is worth \$30M. After hearing about QSBS, Dana and James decide to convert their LLC to a C Corporation. The conversion occurs by Dana and James contributing their LLC interests to a newly-formed corporation (Wise Wallet Inc.) and then liquidating the LLC. In May 2022, Dana and James sell Wise Wallet Inc. for \$40M, each receiving \$20M in the sale. Assuming Dana had zero basis in her shares, how much of the \$20M gain is she eligible to exclude under Section 1202?

- A) \$10M
- B) \$5M
- C) \$0

## C Corporation Conversion

- **Example:** On March 1, 2015, Dana and James formed Wise Wallet LLC, a start-up that allows users to safely store their cryptocurrencies from hackers (50% each). By May 2018, the company is worth \$30M. After hearing about QSBS, Dana and James decide to convert their LLC to a C Corporation. The conversion occurs by Dana and James contributing their LLC interests to a newly-formed corporation (Wise Wallet Inc.) and then liquidating the LLC. In May 2022, Dana and James sell Wise Wallet Inc. for \$40M, each receiving \$20M in the sale. Assuming Dana had zero basis in her shares, how much of the \$20M gain is she eligible to exclude under Section 1202?

- A) \$10M
- B) \$5M
- C) \$0\*

**\*The conversion occurred in May 2018 and the sale occurred in May 2022, which does not meet the five-year holding period.**



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# QSBS Planning

Stacking; Packing

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# Stacking/Multiplying the Per Issuer Limitation

- Each taxpayer is entitled to his/her own QSBS exemption equal to the greater of \$10M or 10x adjusted basis.
- **Trust Planning:**
  - If a taxpayer owns QSBS that is worth -- **or could become worth** – more than \$10M, he/she may want to consider gifting some shares to non-grantor trusts for the benefit of family members.
  - Generally, gifted shares are taxable gifts for gift tax purposes that count against one’s lifetime gift tax exemption (currently \$12.06M per individual; but reverting to pre-2018 levels beginning Jan 1, 2026). **Gift early at lower valuations; before the stock is worth \$10M.**
  - Taxpayers who do not wish to make a taxable gift for gift tax purposes could consider making transfers to “**incomplete gift, non-grantor trusts**”.
  - For taxpayers in high state tax jurisdictions – can also be a **state tax benefit** to transferring shares to a trust resident in a low-tax jurisdiction. Be mindful of throw-back rules.



## ING-Planning Basics

- Technique used by taxpayers in high tax states to relocate appreciated intangible property to no tax states to eliminate state income tax on gains from the sale of such property.
  - **I:** Incomplete Gift
  - **NG:** Non-Grantor Trust
- **Typical Structure:** Grantor transfers appreciated intangible property to an irrevocable trust with an independent trustee located in a state with no income tax. A committee, selected by the grantor, directs the trustee with respect to trust investments and a committee, selected by the grantor, directs the trustee with respect to distributions as follows:
  - Grantor Consent Power: With majority of the committee and grantor's consent.
  - Unanimous Member Power: With unanimous approval of the committee
  - Grantor Sole Power (Principal Only): At direction of grantor subject to ascertainable standard (e.g., health, maintenance, support and/or education).
- **Rationale:** ING is a non-grantor trust because grantor has not retained any of the powers set forth under Sections 671-679 but has retained sufficient power to direct the trust property such that the transfer to the trust is not considered a completed gift for gift tax purposes.



# Packing

- **Per Issuer Limitation:** The amount of gain from dispositions of QSBS that may be taken into account under Section 1202(a) “shall not exceed...
  - (A) \$10,000,000... or
  - (B) 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year” (emphasis added).
- **No Five-Year Requirement:** QSBS disposed of by the taxpayer during the year does not mean QSBS held for five years. Thus, a taxpayer may be able to “pack” his 1202(b) limitation by making a preferred investment for additional shares prior to sale so long as the corporation is still a QSB at the time of the preferred investment.
- **Example:** Tim owns 20% of a start-up valued at \$100M. His zero-basis founder shares, worth \$20M, are QSBS. One year before sale, Tim makes a \$2M preferred investment for additional shares in the company (at which time the company is still a QSB). At exit, Tim sells both his founder shares and preferred shares for \$22M. Tim’s Section 1202(b) limitation is \$20M as a result of the preferred investment, allowing him to exclude all \$20M of gain on the sale of his founder shares.

