Capital Gains Exclusion for PE Investors Under IRC §1202: How it Works and Where it Makes Sense

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As transactional advisers and taxpayers, we are all aware of the most prominent capital gains deferral and exclusion provisions offered by the Internal Revenue Code of 1986, as amended ("**Code**" or "**IRC**"), which include like kind exchanges of real estate (IRC §1031), programs that invest capital into blighted business areas known as Qualified Opportunity Zones (IRC §1400), and others.

Despite these well-known tax provisions, however; there is a provision of the Code that many have not heard of, which is IRC §1202. **This provision offers a significant income tax break to investors who invest in qualified stock of certain venture capital ("VC") and early-stage businesses.** This article will discuss certain income tax consequences associated with IRC §1202(c), which provides income tax forgiveness on long-term capital gains realized from investments in qualified small business stock ("**QSBS**").

Historical Background

IRC §1202 was introduced as part of the Small Business Job Protection Act of 1996. The primary objective of this provision was to encourage investment in small businesses. The provision offers tax incentives to investors who hold QSBS for a specific period. The initial version of IRC §1202 allowed investors to exclude 50% of the gain from the sale of QSBS held for more than five years. However, the provision has undergone several changes over the years.

In 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act modified IRC §1202 to allow investors to exclude 100% of the gain from the sale of QSBS held for more than five years. This change was made to encourage investments in small businesses during the Great Recession. The 100% exclusion was further extended in 2015 under the Protecting Americans from Tax Hikes (PATH) Act, which made the provision permanent.

How IRC 1202 Works

IRC §1202 provides a tax incentive for investors who invest in QSBS. QSBS is stock issued by a domestic C corporation that meets certain requirements. The issuing company must have gross assets of less than $50 million at the time of issuance, and at least 80% of its assets must be used in an active trade or business. Investors who hold QSBS for more than five years can exclude a portion of their gains from the sale of the stock. The amount of the exclusion depends on the date the stock was acquired. For stock acquired after September 27, 2010, investors can exclude 100% of their gains from the sale of QSBS held for more than five years. For stock acquired before that date, the exclusion is 50%.

There is also a cap on the amount of gain that can be excluded. The cap is the greater of $10 million or 10 times the taxpayer's basis in the QSBS. This means that if an investor holds QSBS with a basis of $1 million for more than five years and sells the stock for $20 million, the maximum amount of gain that can be excluded is $10 million.

Despite the compelling tax incentive for QSBS issuing companies, please note that there are several rules that must be strictly followed to qualify for the capital gains forgiveness. These requirements are set forth within the following paragraphs.[1]

1. **Stock is not QSBS unless acquired from a C corporation through an <u>original issuance</u> and <u>sold</u> while the issuer is a C corporation**. Although this requirement seems straightforward, it can present exit complications in cases where a buyer requires an exit transaction to be structured as an asset sale. As such, and while we are aware of VC oriented private equity programs out there seeking to differentiate themselves through QSBS focused investments,[2] please note that it is possible that some or many of the portfolio companies' exits from such programs will fall outside of this requirement.

2. **Any stockholder, other than a C corporation, can qualify for claiming IRC §1202's benefits, including individuals, trusts, partnerships, and S corporations so long as they are the recipient of the QSBS during its initial issuance**.

3. **QSBS must be acquired directly from the subject corporation for cash, property, or services.** Property contributed for QSBS may include intellectual property contributed by the founders. Property (non-cash consideration) is also deemed to be contributed by equity owners upon the conversion of a limited liability company to a corporation, or upon an exchange of membership interests for QSBS. Stock issued by a corporation as a grant to an employee or director also qualifies as QSBS, so long as the stock is vested when issued or the recipient makes an IRC §83(b) election. On a related note, QSBS transferred upon the death of the stockholder, or transferred as a gift during the stockholder's life, retains its status as QSBS in the hands of the recipient.

4. **QSBS can be voting or nonvoting common or preferred stock**. Nonvested stock (subject to substantial risk of forfeiture under IRC §83) is not treated as "*stock*" until it vests unless the recipient makes an IRC §83(b) election. Also, stock options and warrants do not qualify as stock for federal income tax purposes.

5. **If QSBS is sold before a stockholder achieves a five-year-holding period, it is possible to reinvest the proceeds in replacement QSBS under IRC §1045**. QSBS can also be exchanged for QSBS or non-QSBS as part of an IRC §351 nonrecognition exchange or in an IRC §368 reorganization. *The holding period for QSBS starts on the date of issuance*.

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[1] *See*, Scott W. Wilson, *A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion* (Sept. 2022) (providing a comprehensive overview of IRC 1202 and the requirements pertaining to QSBS gain deferrals).

[2] Among certain VC and early-stage program sponsors that specialize in sourcing and acquiring QSBS are Seedbrite Ventures, LLC of Buffalo, New York, Areca Holdings Management, LLC of Miami, Florida, Impellent Ventures II, LLC of Rochester, New York, and Motivate Venture Capital LLC of Chicago, Illinois.

6. **Subject to certain limited exceptions, QSBS must be acquired through an <u>original issuance</u> and sold by the original stockholder.** The exceptions to this rule include (i) gifts made during the original stockholder's life, (ii) a transfer upon such stockholder's death, or (iii) a distribution by a partnership to a partner.

   As a result of the original issue requirement, note that S-Corporation stock will not automatically convert to QSBS if its election is terminated and it becomes a C-Corporation as a result. Thus, to get the advantage of the QSBS capital gain exclusion, the converted S-Corporation would need to issue new stock to its shareholders for cash, services, or other property (or the S-Corporation would contribute assets to a newly formed C-Corporation in an IRC §351 transaction in exchange for QSBS and hold such shares for its shareholders until a sale is effectuated).

7. **For an issuance of stock to qualify as QSBS, the $50 million gross assets test must be passed immediately after issuance**. For purposes of satisfying this rule, "**gross assets**" include cash plus the adjusted income tax basis of other assets on the subject corporation's balance sheet.

8. **The "active trade or business requirement" has several components**. First, the issuer of the QSBS must be a C-Corporation both when the stock is issued and when it is sold. Second, at least 80% (by value) of the corporation's assets must be used in trades or businesses. Third, not more than 10% (by value) of the corporation's assets can consist of stock or securities in corporations which are not subsidiaries. Finally, not more than 10% (by value) of the corporation's assets can consist of real estate not used in the active conduct of a trade or business. The corporation must have also satisfied these requirements for "substantially all" of the QSBS' holding period (i.e., which has been suggested as 80-90% of such holding period).

9. **The 80% Test requires the issuer's "trades or businesses" to be focused within certain sectors not precluded by the statute**. On this point, the 80% Test has two components. First, the corporation must be primarily engaged in one or more business activities that are not excluded businesses under IRC §1202(e)(3). Second, at least 80% of the corporation's assets (considering the assets of any majority-owned corporate subsidiaries) must be used in business activities that are qualified trade or business activities. IRC §1202(e)(3) defines "**qualified trade or business**" to be any trade or business **<u>other than:</u>**

   - 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);
   - 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 (e.g., oil/gas exploration), and

- any business of operating a hotel, motel, restaurant, or similar business.

In view of the many restrictions in place with respect to the disqualified business activities, it begs the question as to what types of businesses can qualify for the IRC §1202 capital gains exclusion. Despite the restrictions that apply to finance, oil/gas, banking, insurance, farming, real estate, and personal professional services, there are many sectors of the U.S. economy whose activities fall within the scope of permitted commerce. Among the permitted activities are manufacturing, technology, research and development, and software design and development.

Addressing whether a corporation is engaging in an excluded activity is often the most significant issue associated with QSBS planning or with vetting the eligibility of a stockholder to claim the gain exclusion. Even if the corporation's principal activities qualify, it is still necessary to make sure that the corporation continuously satisfies the 80% Test. This requires monitoring whether at least 80% of the corporation's assets (by value) are used in qualified business activities, which exclude assets used in non-qualifying activities, investment assets, non-qualifying real estate, and cash not required for working capital needs. The activities of a majority-owned subsidiary are considered in administering the 80% Test.

How Wide is the Reach of IRC 1202?

Although IRC §1202 offers a significant tax break to QSBS investors, most retail investors don't have access to it. There are several reasons for this. First, IRC §1202 applies only to QSBS. Not all small businesses issue QSBS, and not all QSBS meet the requirements of IRC §1202. To be eligible for IRC §1202, a company must have gross assets of less than $50 million at the time of issuance, and at least 80% of its assets must be used in an active trade or business. Most broker-dealer or RIA retail investors are unlikely to directly come across QSBS opportunities that meet these requirements. Additionally, QSBS is not widely traded, as most QSBS is held by the founders and early investors of a company.

As a result of the above, it has been difficult for retail investors to acquire QSBS on an intelligent basis. Notwithstanding, we note that Seedbrite Ventures, LLC ("Seedbrite," Buffalo, New York) recently launched a $20 million private equity fund designed to take advantage of the income tax benefits associated with IRC §1202. The Seedbrite fund was designed to provide retail investors with diversified exposure to early stage opportunities, while also enabling them to achieve significant tax savings from the capital gains exclusion previously mentioned. Subject to cautious underwriting and due diligence, we believe that the economic climate is ripe for other private equity sponsors to follow suite in the future with similar structured offerings (i.e., due to the tax savings and the overall need for early-stage companies to access private capital in these times).

PE/VC Capital Raising Climate

Following a year of incredibly high deal count and volumes, Q3 2022 is when Momentum ended for the private equity ("**PE**") sector.[3] That state of declining interest rates and expanding valuations was shattered by the fastest Federal Reserve tightening cycle in 40-plus years. PE borrowing rates are now at twice the levels that they stood at the start of 2022 and are well into the double digits.

PE Activity – All Classes

Year	Deal Count	Deal Values
2019	6,019	$759 billion
2020	6,009	$683 billion
2021	9,120	$1.259 trillion
2022	8,897	$1.014 trillion

It took most of the year, but by August 2022, PE deal activity succumbed to higher interest rates and lower multiples driven by policy makers and public investors, respectively, months earlier.[4] Despite the downturn in PE transactional growth, *growth-oriented* private equity was able to parlay the competitive returns and fundraising from 2021 into strong deal activity in 2022. The strategy bucked the overall downtrend in PE deal activity by delivering a higher number of deals in 2022. The growth sector's share of the total PE deal flow stood at 19.7% at the end of 2022, up from 17.5% in 2021. *This better trend within the growth-oriented sector of PE could present significant opportunities for certain VC oriented programs seeking to leverage the tax benefits of QSBS in an effort to capture market share*.

Growth PE Activity

Year	Deal Count	Deal Values
2019	1,067	$59 billion
2020	1,138	$78 billion
2021	1,599	$130 billion
2022	1,479	$103 billion

IRC 1202/1045 Interplay

IRC §1045 complements IRC §1202, allowing taxpayers who haven't achieved a five-year holding period for their QSBS to roll otherwise taxable gain on the sale of their QSBS on a tax-deferred basis into replacement QSBS.[5] In doing so, IRC §1045 permits a taxpayer to defer otherwise taxable gain on the sale of QSBS held for at least six months by rolling the sales proceeds over into replacement QSBS. If the taxpayer successfully rolls over the sales proceeds under IRC §1045, the gain on the sale of the original QSBS will be deferred until the replacement QSBS is sold. This result applies whether the taxpayer qualifies for IRC §1202's gain exclusion on the sale of the replacement QSBS. The amount of gain deferred under IRC §1045 will be reduced if less

[3] PitchBook, *U.S. PE Breakdown 2022 Annual* (Jan 12, 2023).

[4] *Private Equity 2022 Year in Review: Facing Macroeconomic Uncertainty, Private Equity Lands on Steady Ground,* Cherry Bekaert LLP (2022) (providing commentary regarding headwinds facing PE capital raising at the year-end 2022).

[5] Frost Brown Todd, *Advanced Section 1045 Planning* (Jan. 17, 2020).

than 100% of the proceeds from the sale of the original QSBS are rolled over into replacement QSBS.

IRC §1045 acts as a companion to IRC §1202, allowing taxpayers who have rolled their sales proceeds over into replacement QSBS the opportunity to take advantage of IRC §1202's gain exclusion if all of IRC §1202's requirements are met when the replacement QSBS is sold. Additionally, IRC §1045 acts on a stand-alone basis to defer gain on the initial sale of the original QSBS. This gain deferral applies regardless of whether the ultimate sale of the replacement QSBS qualifies for the IRC §1202 gain exclusion. **For your reference, please note that a stand-alone article regarding IRC 1045 will be published by our firm (and AI Quarterly) later this year**.

Conclusion

Acknowledging that IRC §1031 compatible products and QOF/QOZ oriented funds have dominated the tax product alts space in recent years, we believe that the economic headwinds facing private real estate will no doubt motivate tax minded advisors to seek outsized tax efficient returns in sectors outside of commercial real estate (e.g., such as private equity, infrastructure, energy, and structured finance). Accordingly, this backdrop could present opportunities for certain PE sponsors to leverage IRC 1202 to capture market share for their early-stage PE/VC portfolio companies.