Recent Developments & Observations

Incorporating a Partnership to Take Advantage of the Qualified Small Business Stock Rules

*By Bahar Schippel**

Among the tax breaks included under the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") is a permanent extension of the favorable treatment for qualified small business stock (QSBS). This provision permits an exclusion for 100 percent of the gain (up to a ceiling amount) arising from the sale of QSBS, including under the alternative minimum tax (AMT) rules. With an effective tax rate of zero percent, this provision benefits both investors and businesses looking to raise equity. And, it comes at a time when the maximum effective tax rate on gains from the sale of capital assets is otherwise 23.8 percent.[1] For businesses operating as a partnership for tax purposes, is converting to a C corporation to take advantage of these benefits an option, and if so, what are the implications?

I. A Brief History of QSBS Through the PATH Act

Special treatment available for taxpayers selling QSBS has existed since 1993.[2] At that time, the maximum long-term capital gain rate for individuals was 28 percent. When first enacted, taxpayers were permitted to exclude 50 percent of their gain from the sale of QSBS. As a result, the tax rate on the sale of qualifying QSBS was effectively 14 percent.[3] In this respect, the legislation strongly favored investing in QSBS.

In the following years, although long-term capital gain rates began to decrease, the 28-percent rate applicable to QSBS remained unchanged, meaning that if 50 percent of the gain was excluded and 50 percent of the gain was taxed at 28 percent, the tax rate on the sale of qualifying QSBS effectively continued to be 14 percent. As a result, the benefit of investing in QSBS was similarly reduced.[4] The benefit of investing in QSBS was effectively eliminated in 2003, when the maximum long-term capital gain rate was reduced to 15 percent, resulting in just a one-percent benefit when comparing (i) the effective rate for gains from the sale of QSBS to (ii) the effective rate from the sale of stock, which did not qualify as QSBS. For many investors, after taking into account the required five-year holding period and other applicable limitations (discussed below), including the

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TABLE 1

For stock acquired in …	… the maximum effective long-term capital gain tax rate was…	… and the effective tax rate on certain QSBS was…
1993	28 percent	14 percent
2003	15 percent	14 percent
2009 – Sept. 27, 2010	15 percent	7 percent
Sept. 28, 2010 – 2011	15 percent	0 percent (and no AMT)
2012	20 percent	0 percent (and no AMT)
2013 – Present	23.8 percent	0 percent (and no AMT)

application of the AMT to gain from the sale of QSBS, investing in QSBS hardly seemed worth the effort.[5]

In reaction to the difficult economic times beginning in early 2008, legislative efforts were taken to stimulate investments in qualified small businesses by excluding more QSBS gain from being subject to the 28-percent tax.[6]

[B]efore converting to a C corporation to take advantage of the benefits provided under Code Sec. 1202, partnerships should carefully weigh all of the pros and cons associated with such incorporation.

In late 2010, a change in law allowed taxpayers to exclude 100 percent of their gain from the sale of QSBS acquired between September 28, 2010, and December 31, 2011.[7] Significantly, this change in law also provided that such gain would not be subject to the AMT. As a result, the benefit of investing in QSBS during that time period could be calculated as the difference between (i) a 15-percent tax rate generally applicable to long-term capital gains at that time, and (ii) a zero-percent effective tax rate applicable to gain from the sale of such QSBS.

In 2012, the maximum long-term capital gain rate for certain "high-income" taxpayers increased to 20 percent. And since 2013, certain high-income taxpayers must pay an additional 3.8-percent Medicare tax on their net investment income, which includes, among others, capital gains.[8] As a result, for certain individuals, the effective long-term capital gains tax rate is currently 23.8 percent.

The 2010 change was extended a number of times and has applied every year since then, but it was set to expire as of the end of 2015. The PATH Act permanently extends both (i) the zero-percent tax rate applicable to gain from the sale of certain QSBS and (ii) the exclusion of such gain from calculating the AMT. Therefore, by investing in QSBS in 2016 and going forward, investors can avoid the 23.8-percent tax that applies to the gain upon the sale of such stock. Table 1 illustrates this history.

II. Incorporating a Partnership

Stock Issued in Exchange for Property

In general, to qualify as QSBS, the stock must be that of a domestic C corporation and must be acquired in an original issuance from the corporation in exchange for money or property. Although there are different ways of converting a partnership into a corporation,[9] in each case, property is deemed contributed to the corporation, either by the existing partnership or by its partners, in exchange for stock of the corporation. For example, in the case of a state law conversion of a partnership (or a limited liability company taxed as a partnership), or a check-the-box incorporation of a partnership, the partnership is deemed to contribute its assets to a corporation in exchange for the stock of the corporation, followed by a distribution of the stock to its partners in liquidation.[10] In that case, since property is being contributed to a corporation in exchange for stock at original issuance, then the stock may qualify as QSBS so long as the other requirements of Code Sec. 1202 are met.

Original Issuance Requirement

One of the requirements is that QSBS must be stock acquired at original issuance and must be held by a taxpayer other than a corporation. As such, if the incorporation of the partnership is accomplished through a state law conversion or a check-the-box incorporation, the stock will be deemed to be momentarily held by a partnership and then transferred to its partners. Does that mean that the partner will fail to meet the requirement that the stock must be acquired in an original issuance from the corporation? The answer, fortunately, is no. This is because there is a special rule that allows a partnership to "transfer" QSBS held by it to its partners without running afoul of the acquisition at original issuance rule. This rule generally requires that the amount of QSBS transferred to the partner not exceed the partner's interest in the partnership on the date that the QSBS was issued.[11] And, in the case of a transfer by a partnership upon its incorporation, since the transfer by the partnership would occur immediately after the issuance of the QSBS, this requirement would be met.

Aggregate Gross Asset Test

Another requirement for qualifying as QSBS under Code Sec. 1202 is that the aggregate gross assets of the corporation, or any predecessor, could not have exceeded $50 million at any time between August 10, 1993, and immediately following the issuance (*i.e.,* the calculation takes into account amounts received from the issuance) (referred to as the "aggregate gross asset" test). Under the "aggregate gross asset" test, the "aggregate gross assets" of the corporation (and any predecessor corporation) may not exceed $50 million at any time after August 9, 1993, and before the stock was issued.[12] In addition, the aggregate gross assets of the corporation immediately after the stock issuance, including the consideration received by the corporation for the stock issued, may not exceed $50 million. For this purpose, "aggregate gross assets" include all the money and the adjusted basis of all other property of the corporation. As such, for the corporation to be able to issue QSBS, the adjusted basis of the corporation's assets, *plus* its cash on hand cannot, on any day since August 9, 1993, have exceeded $50 million. In addition, the corporation will be limited in how much QSBS it can issue based on the difference between $50 million and the sum of the total cash on hand and the adjusted basis of the corporation's other assets at the time of the issuance.

There is a special rule if property other than cash is contributed to the corporation. In that case, for the purpose of determining the aggregate gross assets of the corporation, the adjusted basis of the property contributed is deemed to be equal to the fair market value of the property immediately after the contribution. This means that if the value of the partnership is $50 million or more at the time of the incorporation, then the stock issued at the time of the incorporation cannot qualify as QSBS. What if the aggregate gross assets of the partnership are not more than $50 million at the time of the incorporation, but they exceeded such amount at some point before the incorporation? The aggregate gross asset test applies to the corporation and any of its predecessors, but the term predecessor is not defined in this context. Thus, it is not clear whether, under those circumstances, the stock would qualify as QSBS.

Redemptions

As discussed above, stock generally may qualify as QSBS only if it is acquired at original issuance. That means that stock acquired from another shareholder would not qualify as QSBS. But, absent safeguards, this rule could be circumvented if, for example, instead of buying shares from another shareholder, the shares were purchased from a corporation and the corporation used the proceeds of that stock sale to redeem the stock of an existing shareholder. Thus, if a corporation redeems stock from a stockholder within the four-year period commencing two years prior to the issuance of the stock, subject to certain limited exceptions, the QSBS exclusion rules will no longer apply to that stockholder.[13] Similarly, if the corporation redeems a significant portion of its outstanding stock within the two-year period commencing one year prior to the issuance of the stock, the QSBS exclusion rules may no longer apply to *any* stockholder. These rules apply only to direct or indirect purchases by the "issuing corporation," and no mention is made in the statute or the regulations in this context to the corporation's predecessors. Thus, it would appear that redemptions by the partnership before its incorporation would not be taken into account for this purpose, regardless of whether or not the partnership is considered a predecessor for the purposes of Code Sec. 1202.

Incorporating Shortly Before a Sale

If the partners of a pre-existing partnership contemplate a sale of the partnership, could they incorporate the partnership close to the time of the sale and avoid paying taxes on the transaction using the benefits of Code Sec. 1202? The answer is no, because of two rules embedded in Code Sec. 1202. The first rule essentially limits gain that is excludable under Code Sec. 1202 to gain that accrues after the date of incorporation.

As a general rule, the amount of "gain" from the sale of QSBS eligible for exclusion is limited to the greater of (i) $10 million,[14] or (ii) 10 times the taxpayer's adjusted basis of all qualified stock of the issuing corporation disposed of during the year.[15] And gain, in the normal sense, is the excess of the amount realized on the sale of the QSBS over the adjusted basis of the stock. However, there is a special rule that applies in the case of QSBS acquired in exchange for property other than money or stock. In that case, if the taxpayer's basis in the contributed property is less than its fair market value at the time of the contribution, the stock's basis for the purposes of determining the amount of gain that is excludable under Code Sec. 1202 is increased to equal the fair market value of the property contributed.[16] In the case of an incorporation of an existing partnership, this rule prevents pre-conversion gain from being excludable under Code Sec. 1202. Thus, for example, if the fair market value of the partnership at the time of the conversion is $40 million, then only growth in value of the stock above the $40 million value would be excludable under Code Sec. 1202.

The second rule requires that the stock is held for five years after the incorporation. In other words, although the holding period of the stock acquired in connection with the contribution of property in a Code Sec. 351 transaction generally includes the holding period of the property contributed in exchange for the stock, the stock's holding period for the purposes of starting the five-year clock under Code Sec. 1202 starts when the stock is issued.[17]

III. Is It Worth It?

With respect to issuing or acquiring QSBS on a going-forward basis, the ability of an investor to exclude from tax, including the AMT, 100 percent of the gain from the sale of a five-year investment is enticing, to say the least. But the analysis is far more complicated than a comparison of the applicable tax rates. Both investors and businesses seeking to attract equity need to consider whether it makes sense for the investment vehicle to be (i) taxed as a C corporation, in which case it may be able to issue QSBS, or (ii) taxed like a partnership (*e.g.*, a multi-member LLC) in which case, other benefits may be available. For example, buyers generally prefer to acquire assets with a stepped-up basis so they can depreciate or amortize over time the purchase price they pay for a business. Since purchasing QSBS will not allow the purchaser to depreciate or amortize the purchase price paid, all other things being equal, purchasers will often pay less for a stock acquisition than they would for an asset acquisition. And since there is a five-year holding period for QSBS, it is possible that a sale may occur before the shareholders can benefit from the gain exclusion benefits under Code Sec. 1202. Thus, before converting to a C corporation to take advantage of the benefits provided under Code Sec. 1202, partnerships should carefully weigh all of the pros and cons associated with such incorporation.

ENDNOTES

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1 This rate includes the 3.8-percent Net Investment Income Tax under Code Sec. 1411.

2 *See*, the Revenue Reconciliation Act of 1993 (P.L. 103-66).

3 For example, on $100 of gain from the sale of QSBS, only 50 percent would be subject to tax at a rate of 28 percent (*i.e.*, $50 of gain, *multiplied by* a 28-percent tax rate, equals $14 of tax).

4 *See*, the Taxpayer Relief Act of 1997 (P.L. 105-34) and Code Sec. 1(h)(1) (reducing the long-term capital gain rate from 28 percent to 20 percent, but retaining the 28-percent rate applicable to gain from the sale of QSBS stock). As a result, the benefit of investing in QSBS could be calculated as the difference between (i) a 20-percent rate generally applicable to long-term capital gains and (ii) a 14-percent effective tax rate applicable to gain from the sale of QSBS.

5 Compare (i) a 15-percent rate generally applicable to long-term capital gains at the time and (ii) a 14-percent effective tax rate (or higher if the AMT applied) applicable to gain from the sale of QSBS. In certain circumstances, if the issuing corporation were a qualified business under the Empowerment Zone Rules, then the amount of gain excludible was increased from 50 percent to 60 percent. As a result, the effective tax rate applicable to gain from the sale of certain QSBS was 11.2 percent (*i.e.,* 40 percent of gain, *multiplied by* a 28-percent tax rate).

6 *See*, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) (providing an exclusion of 75 percent of gain from the sale of QSBS acquired after February 17, 2009, and before September 28, 2010). The result was an effective tax rate from the sale of such QSBS of seven percent (*i.e.,* 25 percent of such gain was subject to a 28-percent tax), which investors compared to the 15-percent rate generally applicable to long-term capital gains.

7 *See*, the Small Business Jobs Act of 2010 (P.L. 111-240), and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312).

8 This 3.8-percent tax was enacted pursuant to the Patient Protection and Affordable Care Act of 2010 (P.L. 111-148). For these purposes, "high income" means, for example, married taxpayers filing jointly with certain amounts of income that exceed $250,000, which dollar amount is not indexed for inflation.

9 *See* Rev. Rul. 84-111, 1984-2 CB 88, for a discussion of the different methods of incorporating a partnership.

10 *See* Rev. Rul. 2004-59, 2004-24 IRB 1050.

11 Code Sec. 1202(g) and (h).

12 A controlled group of corporations, consisting of a parent and any "more than 50-percent-owned subsidiaries," are treated as one corporation for the purposes of the aggregate gross assets test.

13 Code Sec. 1202(c)(3); Reg. §1.1202-2.

14 The $10 million limitation is reduced to $5 million for a married individual filing separately. Code Sec. 1202(b)(3).

15 Code Sec. 1202(b)(1).

16 Code Sec. 1202(i)(1).

17 *See* Code Sec. 1202(i)(1)(A).