Qualified Small Business Stock – Rollover

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Take-Away: The tax benefits from owning qualified small business stock (QSBS) can be enhanced if the sales proceeds are rolled into a new QSBS investment.

Background: The incredible tax benefits of qualified small business stock (QSBS), which can avoid capital gains recognition up to $10 million on its sale, have been covered in the past. Less well known is another Tax Code section that authorizes a *rollover* of the QSBS sales proceeds into replacement QSBS. [IRC 1045.] I'll skip the technical requirements for QSBS which have been covered in the past on several occasions. [IRC 1202.]

IRC 1045: For the shareholder to qualify to *roll* the proceeds that result from the sale of his/her QSBS to replacement QSBS, the shareholder must satisfy the following conditions:

> The original QSBS must have been owned by the shareholder for at least 6 months prior to its sale;
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> The entire proceeds of the sale of the original QSBS must be reinvested by the shareholder in the replacement QSBS within 60 days of the sale of the original QSBS; and
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> The shareholder must elect *rollover* treatment for the sale of the original QSBS on his/her tax return for the calendar year in which the original QSBS is sold.

The result is that the shareholder's gain on the sale on the original QSBS is deferred. The shareholder's income tax basis and his/her holding period in the original QSBS that was sold is carried over to the replacement QSBS.

> Example: Bud owns QSBS, a C corporation that he formed a couple of years ago. Bud's original QSBS was held for three years. The QSBS is sold

by Bud. The QSBS sales proceeds are reinvested by Bud in a new QSBS that was formed. The sales proceeds are reinvested by Bud within the following 60 days of the closing of the sale of the original QSBS. As a result, the gain on Bud's sale of the original QSBS will not be realized by him, i.e., no capital gains will be due, even though he did not own the QSBS for at least 5 years. Bud's new, replacement, QSBS will only have to be held by him for another 2 more years for him to satisfy the IRC 1202 five-year holding period and qualify for the exclusion of capital gains on his sale of the replacement QSBS.

Entrepreneurs: Serial entrepreneurs and 'angel' investors who start or invest in new companies can also use *rollover* proceeds from their sale of original QSBS to capitalize the new C corporation and enjoy the same tax benefits. The sale proceeds that result from the sale of the original QSBS could be used to acquire common C stock in a new corporation that meets the definition of a QSBS.

Example: The founder of a publicly traded QSBS that he intends to sell. Initially the founder already took advantage of IRC 1202 when he sold $10.0 million of his QSBS, tax-free. The founder still holds $5.0 million of his initial QSBS that he acquired more than 5 years earlier. The founder is an active 'angel investor.' Every time the founder intends to make an angel investment, he sells $50,000 of his publicly traded QSBS and he then uses the sales proceeds, within 60 days, to acquire the new QSBS investment. Thus, the founder (i) does not recognize gain on the sale of the publicly traded QSBS, and (ii) he immediately satisfies the 5-year holding period required by IRC 1202 with respect to the newly acquired QSBS. If that newly acquired QSBS is later sold, the founder can take advantage of IRC 1202 to receive up to $10 million in sales proceeds tax-free. Thus, as an active angel investor, the founder easily timed his sale of QSBS the to coincide and occur within 60 days of his acquisition of the replacement QSBS.

QSBS Stacking Opportunity: As was noted in prior missives about QSBS, QSBS can be 'stacked' to exploit the $10 million exemption of capital gain. The

founding shareholder could make gifts of his/her QSBS stock to several trusts created for the benefit of each of the shareholder's family members. Each trust, if structured correctly, then sell its QSBS stock and avoids up to $10 million in gain recognition per trust. In addition, those selling trusts could then reinvest their QSBS sales proceeds in replacement QSBS enjoying the same tax benefits later.

Timing Challenges: The challenge with meeting the conditions of IRC 1045 are the practical problem that is normally encountered when dealing with a small C corporation, which is timing. The timing of the sale of stock in a private, small, C corporation that meets the definition of QSBS can be, at best, unpredictable. The opportunity to then invest in a new 'start-up' C corporation is also unpredictable. Add to that the reality that the QSBS shareholder must (i) time both the sale of the original QSBS and (ii) capitalize the replacement QSBS all within 60 days of the earlier sale, all of which makes qualifying for the IRC 1045 *rollover* of the QSBS sales proceeds a challenge.

Conclusion: The owners of QSBS are normally entrepreneurs. As such, they also tend to be risk-takers and thus are more likely to be 'angel investors.' The tax benefits resulting from IRC 1202 can be stretched even further when IRC 1045 is exploited to *roll* QSBS sales proceeds into new 'angel investments.'