EY Private equity: portfolio company insights

How portfolio companies can avoid qualified small business stock pitfalls

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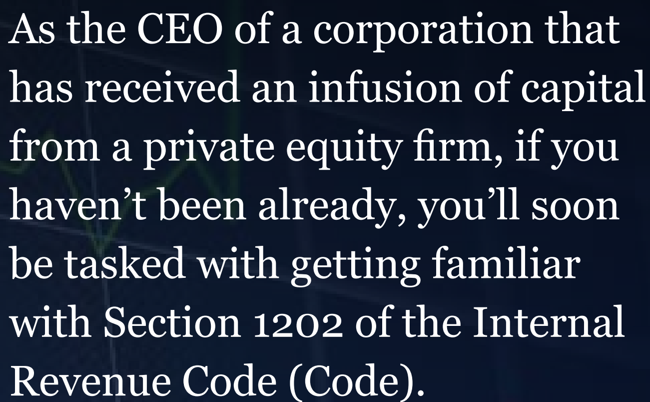

As the CEO of a corporation that has received an infusion of capital from a private equity firm, if you haven't been already, you'll soon be tasked with getting familiar with Section 1202 of the Internal Revenue Code (Code).

And for good reason: while the day-to-day success of the company will always be the priority, neither the founders nor private equity investors will take their eyes off an exit, and there's no more tax-efficient exit than one that allows a shareholder to exclude the gain arising from the sale of the company's stock from taxable income.

That's exactly what can happen if the stock of a portfolio company meets the definition of "qualified small business stock (QSBS)" under the meaning of Section 1202. For shareholders other than a corporation who own QSBS acquired after September 27, 2010 and held for five years, upon a sale of that stock, the shareholder can exclude from gain up to the greater of $10 million or 10 times the shareholder's basis in the stock.

Does my portfolio company qualify for QSBS deduction?

For a private equity firm structured as a pass-through partnership, the exclusion is available at the partner level rather than the partnership level. Thus, rather than the partnership being subject to one $10 million exclusion, each partner may avail themselves of their own $10 million exclusion. In order to benefit from Section 1202, however, in addition to the other requirements discussed below, each partner must have been a partner in the partnership on the date the QSBS was acquired and at all times through the date of sale, and the percentage that may be excluded cannot exceed the partner's ownership percentage in the partnership at the time the stock was acquired.

Reduced exclusions existed for prior periods. Stock acquired after August 9, 1993 and before February 18, 2009 is eligible for a 50% exclusion, while stock acquired between February 18, 2009 and September 27, 2010 will enjoy a 75% exclusion.

The crux, however, is meeting the definition of QSBS, a task that requires a portfolio company to make sense of numerous terms of art and to undergo several quantitative tests. And this is no one-time effort; rather, these tests must often be performed for the duration of the corporation's life. One small misstep, and a $10 million exclusion that is unlike any other incentive available in the current Code will disappear in an instant.

If a round of financing pushes the corporation over the $50 million threshold, stock issued in that round — and at any point in the future — will not be QSBS.

Below is a discussion of the considerations that must be addressed at the corporate level to confirm that investors — assuming they satisfy additional requirements at the shareholder level — will be able to benefit from the exclusion upon exit.

It is best to segregate the statutory requirements of Section 1202 between those that must be met at a moment in time — the issuance of stock to any shareholder — and those that must be met on an ongoing basis during substantially all of a shareholder's holding period of the stock.

Requirements that must be met on the date of issuance

C corporation requirement

On the date of any stock issuance, the issuing corporation must be a domestic C corporation. Thus, stock issued while a corporation was an S corporation will never be QSBS, even if the election subsequently terminates.

Qualified small business requirement

At all times from August 9, 1993 through the date of issuance, the aggregate gross assets of the corporation (or any predecessor) must not have exceeded $50 million. Thus, if at any point after August 9, 1993, the gross assets of a corporation exceed $50 million, the corporation can never again issue QSBS, even if, on the date of a subsequent issuance, the gross assets are again below $50 million. Stock issued prior to exceeding the threshold will not be tainted, however.

In addition, immediately after the date of issuance (and after taking into account amounts the corporation received in the issuance), the aggregate gross assets of the corporation must not exceed $50 million. As a result, if a round of financing pushes the corporation over the $50 million threshold, stock issued in that round — and at any point in the future — will not be QSBS.

In general, aggregate gross assets means the amount of cash plus the adjusted tax basis of other property the corporation holds. Because this test looks at the tax basis of the corporation's assets, rather than the value of those assets, a corporation could have substantial self-created intangible value (such as goodwill) without running afoul of the $50 million limit.

Things get more complicated when shareholders transfer appreciated property to a corporation in exchange for shares; for example, when an existing partnership converts to a C corporation. In these scenarios, the adjusted basis of any property contributed to the corporation is not less than its fair market value on the date of contribution. This rule creates complexity in continuing to track compliance with the $50 million test because no statutory guidelines exist for computing a corporation's gross assets on an ongoing basis after property has been contributed to the corporation. And, of course, it also requires that a valuation be performed on any contributed assets.

Original issuance requirement

QSBS must be acquired by the current holder at "original issuance." While this test generally applies only at the shareholder level, a few key points are covered here for corporate consideration:

- Stock must be acquired directly from the issuing corporation in exchange for money or other property (not including stock) or as compensation for services provided to the corporation. Thus, a shareholder who acquires stock from an existing shareholder in a cross-purchase will not be treated as having received the stock at original issuance.
- Stock acquired through the exercise of options or warrants or through the conversion of convertible debt is treated as acquired at original issuance. Note, however, that the holding period for the stock does not begin until the conversion date.

Analysis must be done on an annual or more frequent basis

The most significant challenge to obtaining a Section 1202 exclusion for investors is understanding that certain requirements must be met for substantially all of each shareholder's holding period. This requires analysis to be performed on an annual or, ideally, more frequent basis.

The first hurdle is found in the fact that Section 1202 does not define the term "substantially all," but based on existing tax law, it is reasonable to believe that the below tests must be met for at least 86% of a shareholder's holding period. Because each shareholder's holding period may be different, while this test is performed at the corporate level, each shareholder will have to satisfy the test independently for their respective holding period of the QSBS.

C corporation requirement

The corporation must be a domestic C corporation, but may not be a DISC or former DISC, regulated investment company, real estate investment trust, REMIC or cooperative.

Active business requirement

In addition, at least 80% (by value) of the assets of the corporation must be used by the corporation in the active conduct of one or more "qualified trades or businesses."

A qualified trade or business is defined by exclusion. Many service businesses are on the list of disqualified businesses, including businesses in the field of health, law, consulting, performing arts, farming, and operation of a hotel, motel or restaurant. It's advisable to gain comfort with this issue first, a task made more difficult by the unwillingness of the IRS to provide definitional guidance for any of these critical terms.

The 80% rule and how to manage challenges

The most troublesome test a portfolio company must continuously comply with, however, is the "80% of gross assets test." During substantially all of a shareholder's holding period of the corporation's stock, it must be established that more than 80% of the corporation's gross assets were used in the active conduct of that trade or business. The value of the corporation's assets is measured for these purposes; thus, the value of all assets, including self-created intangibles such as goodwill, should be taken into consideration.

There are several traps lurking in the application of this active trade or business test. First, after a corporation has been in existence for at least two years, no more than 50% of the corporation's assets may be comprised of working capital. Thus, corporations that raise significant capital may face a challenge in satisfying the 80% test immediately after such a raise; though, in practice, because the 80% test is determined in reference to the value of both tangible and intangibles assets, a significant enterprise value will typically mitigate the presence of large cash balances.

Less easy to accommodate, however, are two additional challenges to the 80% test. The corporation will fail the test for a period if more than 10% of the value of its net assets consists of stock or securities in corporations that are not at least 50% owned by the parent corporation. For corporate subsidiaries owned more than 50% by the parent, however, look-through treatment is provided, meaning the assets of the subsidiary will be treated as assets of the parent.

A corporation will also fail the 80% test if more than 10% of the total value of its assets consists of real property that is not used in the active conduct of a qualified trade or business. For these purposes, the ownership of, dealing in or renting of real property is not treated as the active conduct of a trade or business.

Rollovers of QSBS

What if stock in a portfolio company meets all the requirements to qualify as QSBS, only the shareholder has not held the stock for five years prior to exit? All is not lost. A companion provision to Section 1202 — Section 1045 — allows a shareholder who has held QSBS for at least six months to roll the proceeds from a sale into replacement QSBS. To the extent the proceeds are reinvested within 60 days of sale of the relinquished QSBS, the gain on the sale will be deferred. And if the shareholder can get to a combined five-year period between the relinquished and replacement QSBS, a Section 1202 exclusion will be available upon sale of the replacement stock. When QSBS is held by a partnership, Section 1045 affords a great deal of flexibility by permitting the reinvestment to be made — and gain to be deferred — at either the partnership or partner level.

Opportunities for the portfolio at private equity exit

As the controller of a private-equity-backed business, Section 1202 presents significant tax savings for private equity investors as they evaluate an exit strategy. In order to confirm that the deduction is not lost in the process, the portfolio company must continuously monitor the requirements to meet the deduction requirements. In addition, tax legislation needs to be carefully monitored because the version of the Build Back Better Agenda passed by the House would limit the benefit of Section 1202 to a 50% exclusion for sales after September 13, 2021. That legislation, however, remains stuck in the Senate as of the date of this publication.

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