

Qualified Small Business Stock (QSBS) §1202

Continuing Education

Pear Tree Partners, LP (dba U.S. Boston Growth Capital)

Presented by Caleb Powers, Vice President Private Placements
781-541-8091 / cpowers@peartreepartnerslp.com



~ 1 hour



Disclosure Statement

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Welcome

1 — Introduction

2 — Entrepreneur Considerations

3 — Investor Considerations

4 — §1045 Rollover

5 — QSBS Miscellaneous

 — **Wrap up**



At the end of this session, you will have a general understanding of QSBS, the tax benefits, and the criteria an investor and business must meet to qualify for §1202.

What's the big deal?

If you invest in a company that meets QSBS criteria...

and you remain invested for 5 years....

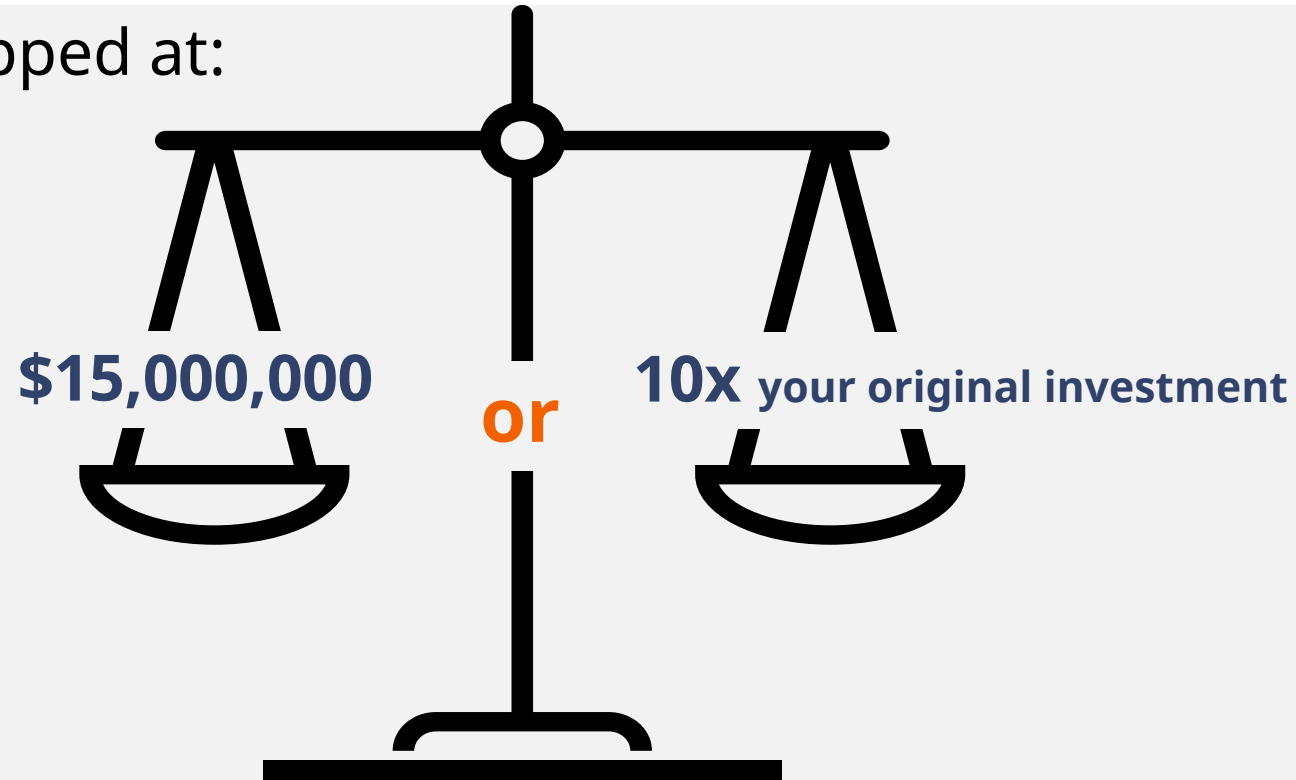
...you may be able to take the proceeds from that investment 100% capital gains tax-free*



* Subject to a number of important requirements and restrictions

How big is big?

Tax-free gains are capped at:



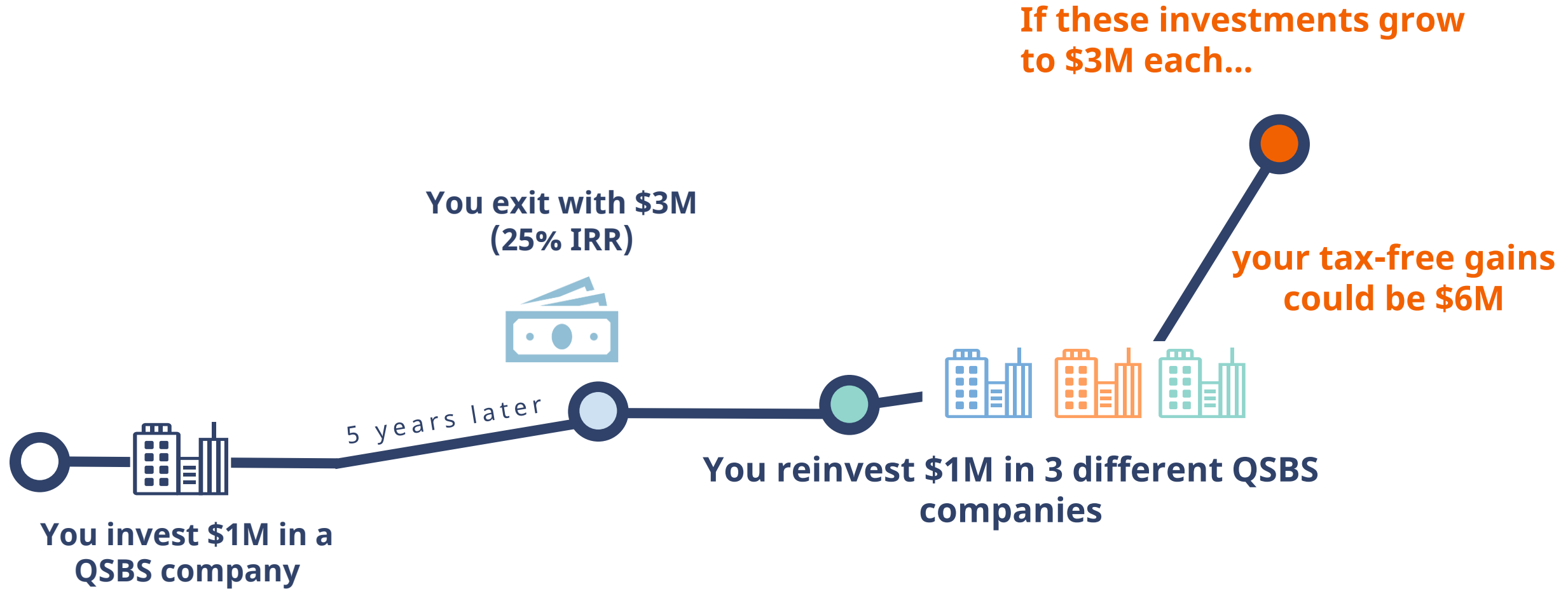
Whichever is greater



Let's do some math

| If your QSBS Company investment is... | you could enjoy up to... |
|---------------------------------------|------------------------------------|
| \$500,000 | \$15,000,000 in tax-free gains |
| \$5,000,000 | \$50,000,000 in tax-free gains |
| \$20,000,000 | \$200,000,000 in tax-free gains |

What's the potential?



§1202's potential is extraordinary!

History of §1202

Purpose of §1202: Incentivize non-corporate taxpayers to invest in or start small businesses, stimulate economic growth, and create innovative technologies.

PL 103-66 §1202 Passed

- 50% QSBS exclusion on the 28% Capital Gains Tax

1993

1998

2003

Congress Lowered the Top Capital Gains Rate...AGAIN

- Non-QSBS rate lowered to 15%, but QSBS exemption kept at 28% thereby reducing the tax savings to 1%!

2009

Congress Temporarily Increases the §1202 Exclusion to 100%

2010

2015

Tax Cuts and Jobs Act (TCJA)

2017

OBDD

2025

Congress Lowered the Top Capital Gains Rate

Congress Increases the §1202 Exclusion

- 50% exclusion raised to 75%

PATH ACT makes the 100% exclusion permanent

Entrepreneur Considerations

- Choice of Entity
- Qualified Trade or Business
- Gross Assets Test
- Active Trade or Business
- Redemptions & Buybacks

● Entrepreneur Considerations: Choice of Entity

Must be a domestic C corporation (other than a DISC or former DISC, a regulated investment company, real estate investment trust, REMIC or a cooperative) on the date of issuance and during substantially all of the shareholder's holding period.



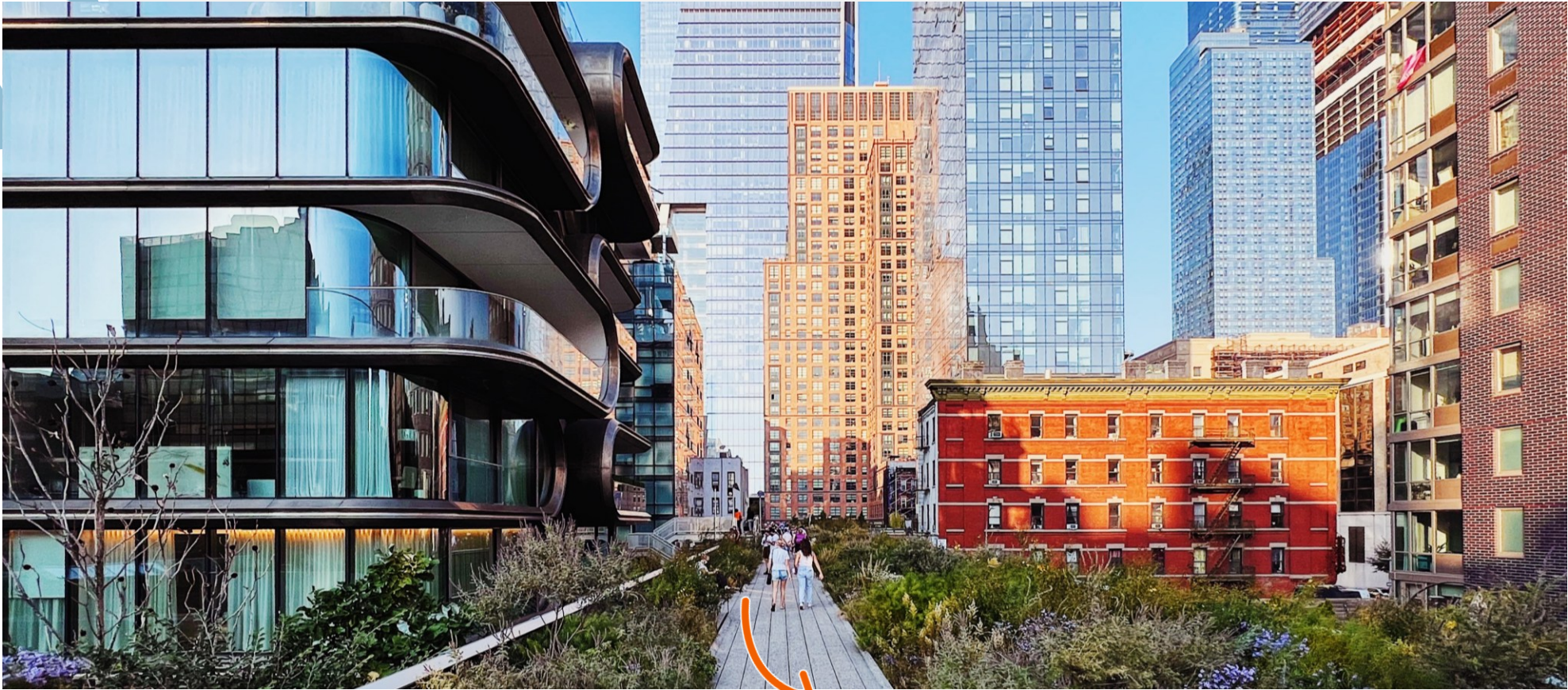
What about an S Corporation?

A brief period as an S corporation – less than 10% of the owner's holding period for the stock – **may** (read the fine print) be acceptable, provided the stock was not issued to the shareholder at that time.



— Entrepreneur Considerations: Qualified Trade or Business

Any trade or business OTHER than:



What does this mean?

Treasury Regulation §1.199A-5(b)

“The principal asset of such trade or business is the reputation or skill of one or more of its employees or owners”:

- Fees for endorsements (products or services)
- Paid appearances (events, radio, TV, etc.)
- N I L

With that said.....

- Not all services can be excluded
- Focus seems to be on professional licenses or designations.
- Having employees with professional licenses doesn't automatically disqualify a business from being qualified.

● Entrepreneur Considerations: Gross Assets Test

Two parts:

Part 1

Immediately after the date of issuance (including what was raised for the issue), the aggregate gross assets of the corporation must not exceed \$75 million



Part 2

Since Aug. 9, 1993, through the date of issuance, aggregate gross assets (or any predecessor) must not have exceeded \$75 million

What are “aggregate gross assets”?

Amount of cash + the aggregate adjusted basis of other property held by the business.

This test looks at the basis of the assets, not value. What about intangibles?

● Entrepreneur Considerations: Gross Assets Test

Testing the limits....

- To reduce any potential “funny business”, the adjusted basis of any property contributed to the corporation is equal to its fair market value (FMV) on the date of contribution.
- In testing the \$75M limit, all corporations that are members of the same parent-subsidary controlled group are treated as one corporation.

● Entrepreneur Considerations: Active Trade or Business

To qualify, the company must be **actively engaged in the trade or business**.

- No more than 20% of gross assets can be:
 - Used in non-qualified trade or business activities
 - Can be held in assets such as: investment securities, non-active business-related real estate or excess cash
 - Renting property is not considered an active business activity
- The value of all the corporation's assets and self-created intangibles such as goodwill, should be taken into consideration in applying this test.



If this could be an issue, consider spinning-off the qualifying trade or business into a separate corporation or consider a section 301 distribution of non-qualifying assets while value is low.

Think
Active vs.
Passive!

— Entrepreneur Considerations: Active Trade or Business

Start-up Provision



Working Capital Provision



● Entrepreneur Considerations: Redemptions / Buybacks

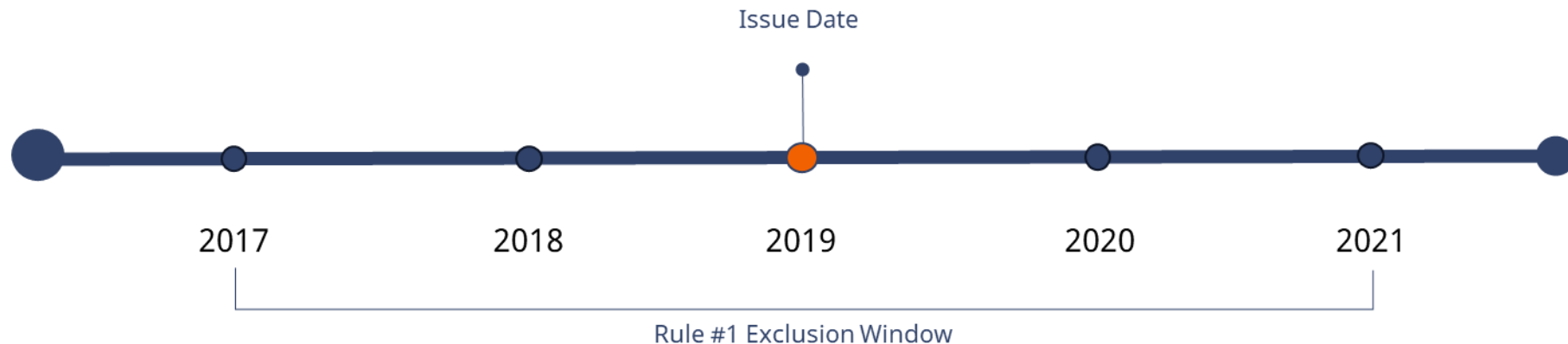
Two rules:

Rule 1

If, during the four-year window straddling a new issue, the corporation purchased (directly or indirectly) more than a **de minimis** amount of stock from the taxpayer or from a related person.

Exceeding the de minimis amount: > \$10,000 in value and more than 2% of the holdings

Then, all redeemed stock during the window is disqualified.



● Entrepreneur Considerations: Redemptions / Buybacks

Two rules:

Rule 2

If, during the two-year period straddling the issue date, the corporation redeemed more than 5% (by value) of all the outstanding stock as of the beginning of the two-year period.

All the stock issued during that two-year period is disqualified.



Entrepreneur Considerations

- Choice of Entity
- Qualified Trade or Business
- Gross Assets Test
- Active Trade or Business
- Redemptions & Buybacks

Wrap up

Investor Considerations



Holding Period



Issuance Date



Original Issue Stock



State Taxes

● Investor Considerations: Holding Period

- Stock held for:
3yrs = 50%
4yrs = 75%
5yrs = 100%
- Clock generally begins to tick on the date of acquisition



- Long only /
No offsetting
positions



What is an “offsetting short position”?

- Shorting / acquiring an option to sell identical property
- A transaction that substantially reduces your risk of loss

Shares and holding period...

Options & Convertible Debt

The individual's five-year holding period begins, **at the time of exercise/ conversion**, not grant, for the shares to qualify for the exclusion.

83(b) Election Shares

The clock starts ticking the date you make the election.

SAFEs

It isn't clear if the holding period begins when the SAFE is issued or when it converts.

Seek the advice of professionals

Holding period rules can be nuanced, especially in situations involving various types of stock transactions. Consulting a tax professional who is familiar with QSBS rules is essential for accurate guidance.

● Investor Considerations: Issuance Date

- Issuance date is important for several reasons
 - It sets the start of the 5-year hold period
 - Determines % exclusion
 - The gross assets test begins on that date
- The portion of a taxpayer's eligible gain on the sale of QSBS that may be excluded depends on when the shares were acquired:

| | |
|--|------------------------------|
| September 28, 2010 or later | ➤ 100% of gain is excludible |
| February 18, 2009 – September 27, 2010 | ➤ 75% of gain is excludible |
| August 10, 1993 – February 17, 2009 | ➤ 50% of gain is excludible |



●— Investor Considerations: Original Issue Stock

Stock must be acquired in exchange for:



Basis of property equals
FMV for QSBS purposes

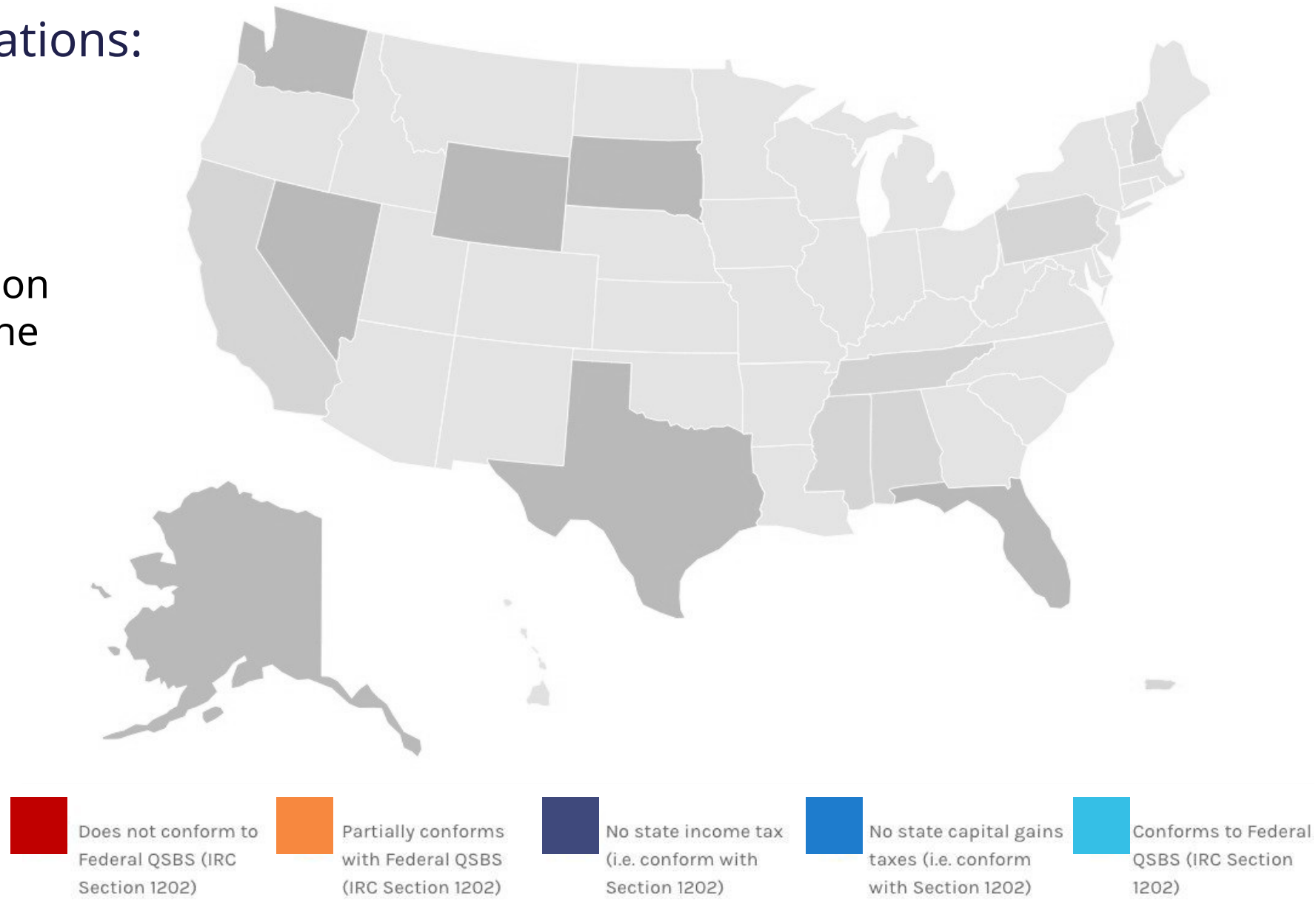
- Shares must be acquired in an original issuance to be QSBS-eligible
- The seller is usually the original owner
- Three transfer exceptions:
 1. Shares acquired by gift
 2. Shares acquired at death
 3. Shares distributed from a partnership to a partner
- **Cannot transfer to Family Limited Partnership**

●— Investor Considerations: Original Issue Stock

- Purchases from a third party do not qualify for §1202 treatment.
 - No secondaries
- QSBS transfers/gifts from a partnership to a partner is OK if the partner held its partnership interest on the date the partnership acquired the QSBS.
 - QSB status terminates upon a taxpayer's transfer of QSBS to a partnership.
- Most kinds of stock can qualify for QSBS treatment
 - Common voting and non-voting stock
 - Convertible Preferred voting and non-voting stock

Investor Considerations: State Taxes

- RC §1202 provides an exclusion from federal income tax of the gain from the sale of QSBS.
- The state and local tax treatment may be **different**.



Several states have raised questions of whether they should continue to conform.

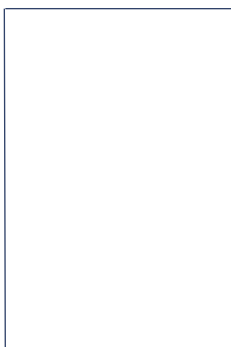
Investor Considerations

- Holding Period
- Issuance Date
- Original Issue Stock
- State Taxes

Wrap up

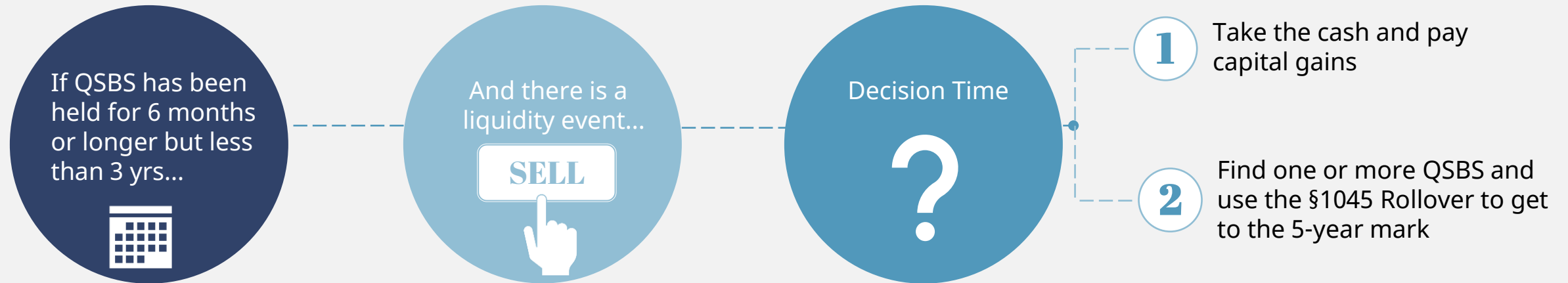
The §1045 Rollover

QSBS Secret Weapon

- 
- Overview
 - Entrepreneur Considerations
 - Partial §1045 Rollover

● The §1045 Rollover: Overview


- Similar to the §1031 exchange in real estate



You have 60 days to rollover

— The §1045 Rollover: Overview (cont'd)

- Any new QSBS must meet the active business test for the first 6 months, and be QSBS for 6 months prior
- Unlimited rollovers to get to the “promised land” and beyond
- Each replacement company gets its own exclusion amount

 Make sure tax returns are coded correctly (Form 8949), “Q” for QSBS and “R” for rollover



If you can't find a suitable QSBS in 60 days, you may create a new C corporation that actively seeks to acquire another company meeting QSBS criteria.

● — The §1045 Rollover: Founder Considerations at Exit

Cash Sale

If you're short of the 5 years, and you are considering a potential exit, try not to

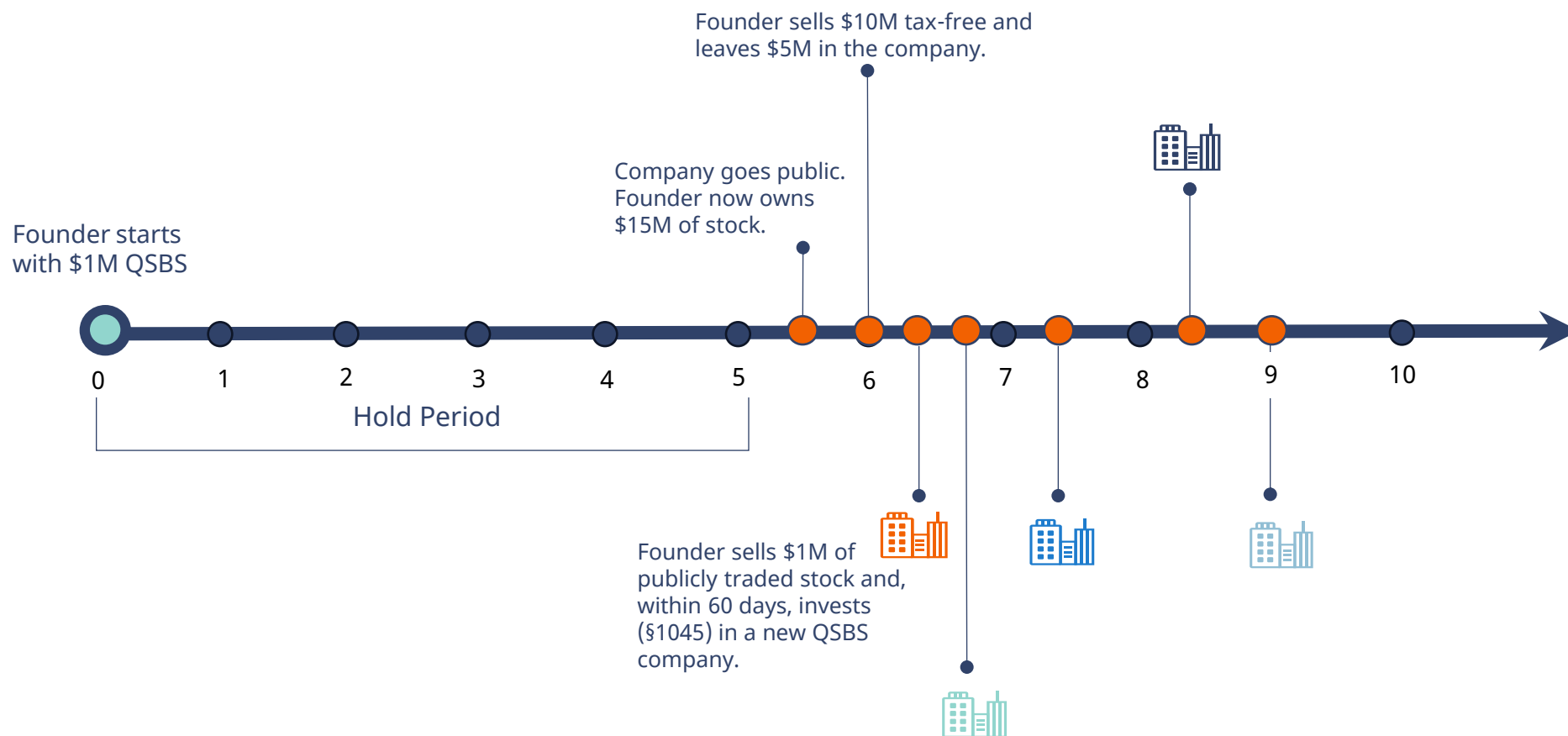
- Given the tax benefits, a lower offer once you have met the hold period might make sense (Risk: no offers)
- Negotiate a sale with a deferred closing date

Stock Swap

- QSBS > QSBS: Hold period tacks to the new stock; no impact on your exclusion
- QSBS > non-QSBS: Gain is limited; holding period tacks
- RISK: Stock doesn't hold its value

● The §1045 Rollover: Entrepreneur Considerations

QSBS IPO Example:



Hypothetical outcome:

Investment 1 becomes worth \$5M

Investment 2 becomes worth \$3M

Investment 3 becomes worth \$10M

Investment 4 becomes worth \$8M

Investment 5 becomes worthless

Holding period does not apply!

The §1045 Rollover

QSBS Secret Weapon

- Overview
- Entrepreneur Considerations
- Partial §1045 Rollover

Wrap up

QSBS Miscellaneous

- Strategies to Maximize Exclusion Amount (“Stacking & Packing”)
- The Binder
- Converting to a C Corp

●— QSBS Miscellaneous: Strategies to Maximize Exclusion Amount

●— Gift your shares to:

- Incomplete non-grantor trusts
 - Children
 - Parents
 - Siblings
 - Spouse
 - Others

●— Gift well before the sale



●— How much is too much?

●— Document valuations

Get several

● — QSBS Miscellaneous: "Stacking"

Gifting QSBS to one or more irrevocable trusts

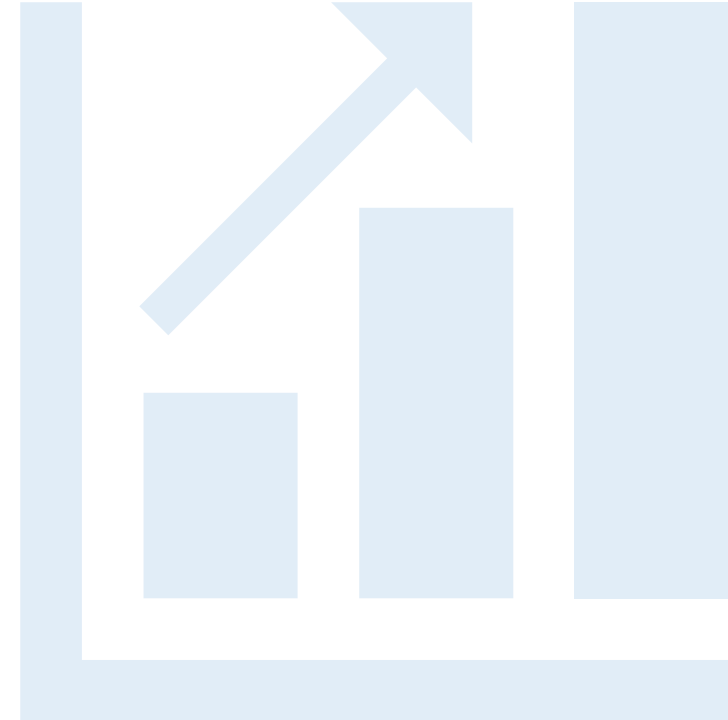


- Gift when the share price is low
- Each gift gets its own exclusion
- Gift long before an exit

● — QSBS Miscellaneous: “Packing”

“Pack” as much eligible gain into your QSBS

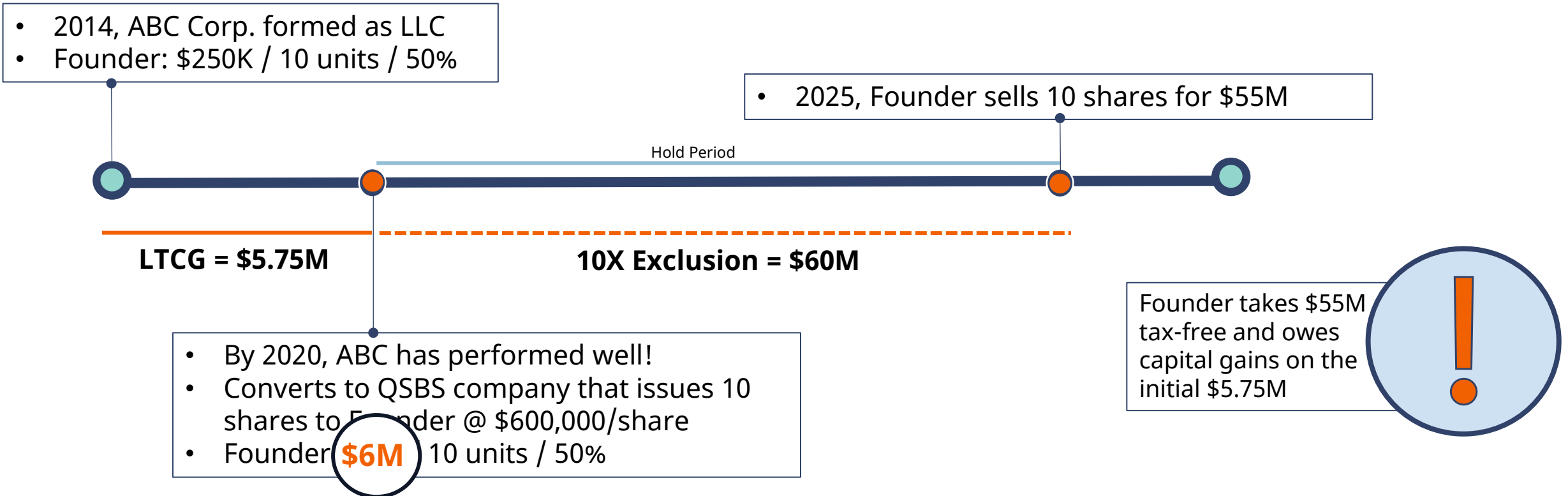
- Pack a QSBS with money, intellectual property and other assets (>\$1M) in exchange for QSBS



● — QSBS Miscellaneous: Converting to a C Corporation

It may make sense to wait...

- Founders will often form start-ups as LLCs (early-stage tax losses)
- **Once/If** the business has achieved significant growth/value, it may make sense to convert to a QSBS eligible C-Corp
- Taxpayer's basis is based the FMV of the business at the time of the conversion – not the carryover basis!



● — QSBS Miscellaneous: “The Binder”

Paper trail....paper trail....paper trail

The §1202 benefit is so valuable and complex, that you should **actively** maintain a repository of §1202 related assets and memoranda throughout the business life-cycle.

If the IRS comes knocking, having the §1202 story laid out in a cohesive, defensible fashion goes a long way.



● — QSBS Miscellaneous: “The Binder”

Items you may include in the repository:

- Certificate of incorporation
- At issuance: Opinion Letter from a Tax or Legal Professional and Tax Returns (if possible)
- After issuance: Opinion Letter from a Tax or Legal Professional and Tax Returns (if possible)
- Stock purchase agreement
- Merger or sale agreement
- Form 8949 for rollovers
- For a start-up you want a tax opinion/memo stating your §1202 status
- Annual §1202 certifications from a third party
- Valuations for anything (other than cash) that was used to acquire QSBS
- S Corp / LLC > C corp conversions need a detailed paper trail from a tax attorney or accountant



QSBS Miscellaneous: “The Binder” / Form 8949

| IF ... | THEN enter this code in column (f) ... | AND ... |
|--|--|--|
| You received a Form 1099-B (or substitute statement) showing accrued market discount in box 1f | D | Use the Worksheet for Accrued Market Discount Adjustment in Column (g) , later, to figure the amount to enter in column (g). However: <ul style="list-style-type: none"> • If you received a partial payment of principal on a bond, don't use the worksheet. Instead, enter the smaller of the accrued market discount or your proceeds in column (g). Also, report it as interest on your tax return. • If you chose to include market discount in income currently, enter -0- in column (g). Before figuring your gain (or loss), increase your basis in the bond by the market discount you have included in income for all years. See the instructions for code B above. If the disposition of a market discount bond results in a loss subject to the wash sale rules, enter "W" in column (f) and follow the instructions for code W below. |
| You sold or exchanged QSB stock and can exclude part of the gain | Q | Report the sale or exchange on Form 8949 as you would if you weren't taking the exclusion and enter the amount of the exclusion as a negative number (in parentheses) in column (g). However, if the transaction is reported as an installment sale, see <i>Gain from an installment sale of QSB stock</i> in the Instructions for Schedule D (Form 1040). |
| You can exclude all or part of your gain under the rules explained in the Schedule D instructions for DC Zone assets or qualified community assets | X | Report the sale or exchange on Form 8949 as you would if you weren't taking the exclusion. Then enter the amount of the exclusion as a negative number (in parentheses) in column (g). |
| You are electing to postpone all or part of your gain under the rules explained in the Schedule D instructions for any rollover of gain (for example, rollover of gain from QSB stock) | R | Report the sale or exchange on Form 8949 as you would if you weren't making the election. Then enter the amount of postponed gain as a negative number (in parentheses) in column (g). |
| You have a nondeductible loss from a wash sale | W | Report the sale or exchange on Form 8949 and enter the amount of the nondeductible loss as a positive number in column (g). See the Schedule D instructions for more information about wash sales generally and Pub. 550 for more information on wash sales involving substantially similar stock or securities. If you received a Form 1099-B (or substitute statement) and the amount of nondeductible wash sale loss shown in box 1g is incorrect, enter the correct amount of the nondeductible loss as a positive number in column (g). If the amount of the nondeductible loss is less than the amount shown on Form 1099-B (or substitute statement), attach a statement explaining the difference. If no part of the loss is a nondeductible loss from a wash sale transaction, enter -0- in column (g). |
| You have a nondeductible loss other than a loss indicated by code W | L | Report the sale or exchange on Form 8949 and enter the amount of the nondeductible loss as a positive number in column (g). See <i>Nondeductible Losses</i> in the Instructions for Schedule D (Form 1040). |

● — QSBS Miscellaneous: “The Binder” / Form 8949

| | | |
|--|---|--|
| | | follow the instructions for code W below. |
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| You have a nondeductible loss from a wash | | Report the sale or exchange on Form 8949 and enter the |



Wrap up

In Summary....



Is now a good time to take advantage of QSBS?



No AMT add back



100% gain exclusion (up to maximum amount)



Business professionals can add significant value to their client relationships and enjoy a competitive advantage in the marketplace by getting QSBS smart!



QSBS isn't for everyone, but for those that it is, it's fantastic.

“Remember, §1202 can make a good deal GREAT....but it WON'T make a bad deal good.”

- Bill Beckett (my colleague)



Thank you!

**Feel free to get in touch on any and all things \$1202.
We're here to be the best resource we can be!**

**Pear Tree Partners, LP
(dba U.S. Boston Growth Capital)**

Caleb Powers

Vice President Private Placements

cpowers@peartreepartnerslp.com

781-541-8091