Tax-Free Rollovers of Qualified Small Business Stock

Federal and California Issues for Venture Capitalists

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Introduction

- This presentation covers several issues relating to tax-free rollovers of qualified small business stock (QSBS)
  - Basic Federal and California tax-free rollover laws
  - Issues for venture capitalists
    - Rollovers involving partnerships
    - Consequences of fund transfers and amendments
    - Rollovers of gain arising from carried interests
  - Mechanics of the rollover election
  - Tracking and compliance burdens
  - Differences between Federal and California law

Tax-Free Rollovers Under Federal Law

- In certain circumstances a *non-corporate taxpayer (Taxpayer)* may defer Federal tax liability by rolling over gains on the sale of QSBS
- Basic Rule
  - If a *Taxpayer* recognizes gain on a sale of QSBS
  - Which QSBS was held for more than *6 months* prior to the date of sale
  - And the Taxpayer purchases *new QSBS* within *60 days* following such sale
    - The Taxpayer will be taxed on gain recognized in the original sale only to the extent that the sale proceeds exceed the purchase price of the new QSBS
    - All non-taxed gain will be *rolled-over* into the new QSBS

Example: 100% Investment

- Individual A purchases 100 shares of Original QSBS for $1,000
- A holds the Original QSBS for more than 6 months
- A sells the Original QSBS for $2,000
- Within 60 days, A purchases Replacement QSBS for $2,000
- Result: No taxable gain ($1,000 gain rollover)
  - A takes a $1,000 basis in the Replacement QSBS
  - Some time later, A sells the Replacement QSBS for $3,000 and recognizes taxable gain of $2,000

Example: Partial Reinvestment

- Individual A purchases 100 shares of Original QSBS for $1,000
- A holds the Original QSBS for more than 6 months
- A sells the Original QSBS for $2,000
- Within 60 days, A purchases Replacement QSBS for $1,500
- Result: Taxable gain of $500 ($500 gain rollover)
  - A takes a $1,000 basis in the Replacement QSBS
  - Some time later, A sells the Replacement QSBS for $3,000 and recognizes taxable gain of $2,000

What is QSBS?

- General requirements for stock to qualify as QSBS
  - Original issue stock of domestic C corporation
  - Meets active business requirement
  - Less than $50 million gross assets
  - No violation of redemption rules
- Definitions
  - Rollover defined by IRC Section 1045
  - QSBS defined by IRC Section 1202

Original Issue Stock

- To qualify as QSBS, stock must be
  - Issued by a domestic C corporation
  - After August 10, 1993
  - To the holder directly or through an underwriter
  - In exchange for money, property (other than stock), or services to the issuer
- There is slight uncertainty regarding “domestic” status of a U.S. corporation with foreign subsidiaries
  - Foreign subsidiaries *should not* preclude domestic status for U.S. parent

Active Business Requirement

- 80% of issuer's assets (by value) must have been used in the active conduct of a qualified trade or business during substantially all of the period during which the Taxpayer held the stock
  - A qualified trade or business generally may include R&D and other start-up activities
  - Working capital (e.g., cash) generally is treated as used in a trade or business
  - Assets held for investment and reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business, or to fund increased working capital needs of a qualified trade or business generally, are treated as used in a qualified trade or business
  - Excess cash on hand may not be treated as used in a trade or business
    - Could be an issue for companies that raise money in very large amounts

Active Business Requirement (cont.)

- Qualified trade or business *does not include*:
  - The performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees
  - A banking, insurance, financing, leasing, investing, hotel, motel, restaurant or similar business
  - A farming or natural resources extraction business

Gross Assets Requirement

- At all times during the period beginning on August 10, 1993 and ending immediately after the issuance of the stock, the gross asset value of the issuer must not have exceeded $50 million (generally determined on a tax basis)
  – Note that the tax basis of an asset may be far less than its fair market value; a company with a FMV > $50 million may still issue QSBS

Non-Redemption Requirement

- Certain stock redemptions by issuer will destroy QSBS status
  - Any redemptions from the holder or a related person
    - Within 4-year period beginning 2 years prior to issuance of stock
  - Significant redemptions from other holders
    - Within 2-year period beginning 1 year prior to issuance of stock
- However, redemptions associated with the termination of an individual's status as an employee or director generally will be disregarded
  - Treatment of redemptions from independent contractors remains uncertain

Replacement Stock Requirements

- Replacement stock must be QSBS on date of purchase
- During the first 6 months following date of purchase,* the replacement stock issuer must meet the Active Business Requirement
- Area of Uncertainty: It is unclear whether subsequent redemptions by the replacement stock issuer could retroactively destroy rollover qualification

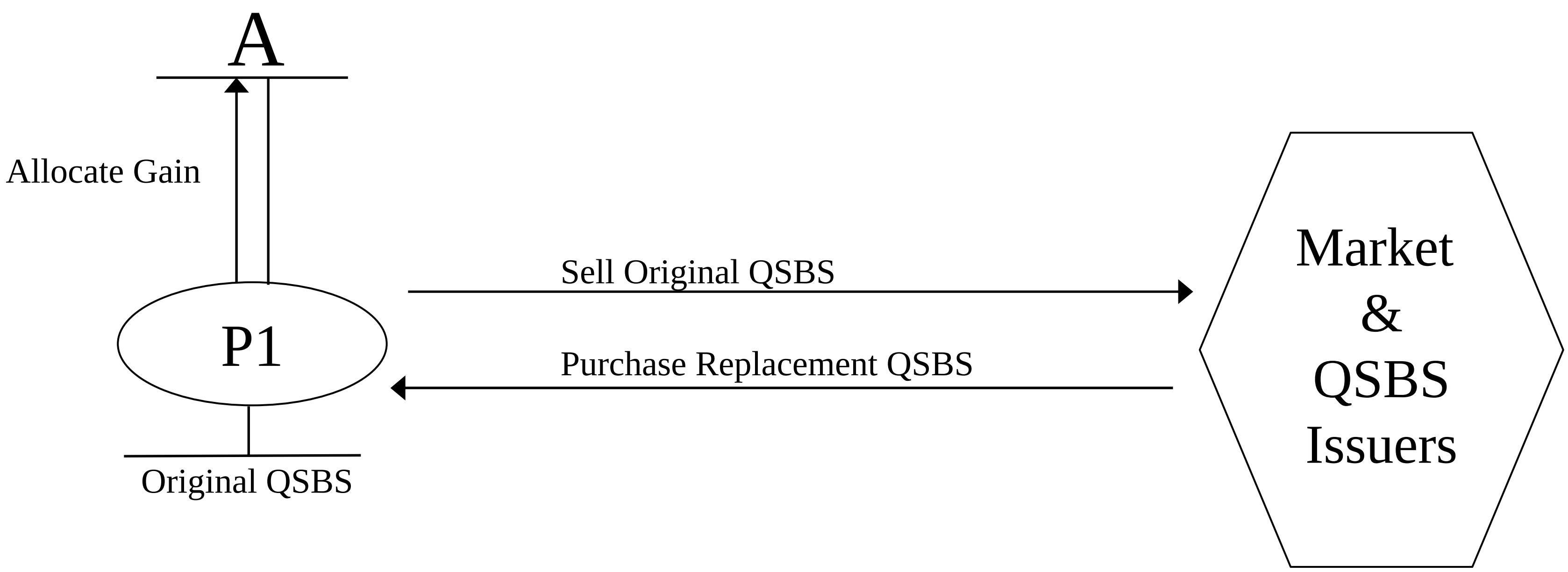
* Or, if shorter, Taxpayer's holding period for the replacement stock

Rollovers Involving Partnerships

- Basic type of rollover occurs when a single person (*i.e.* individual or partnership) engages in the following transactions
  - Purchase of Original QSBS
  - Sale of Original QSBS
  - Purchase of Replacement QSBS
- Rollover benefits may flow through a partnership to its partners when the partnership engages in all above transactions
- Rollover benefits may also be available when a partnership engages in at least one of the above transactions
  - See Proposed Regulation Sec. 1.1045-1, which would (if finalized) deny rollover benefits in certain partnership transactions

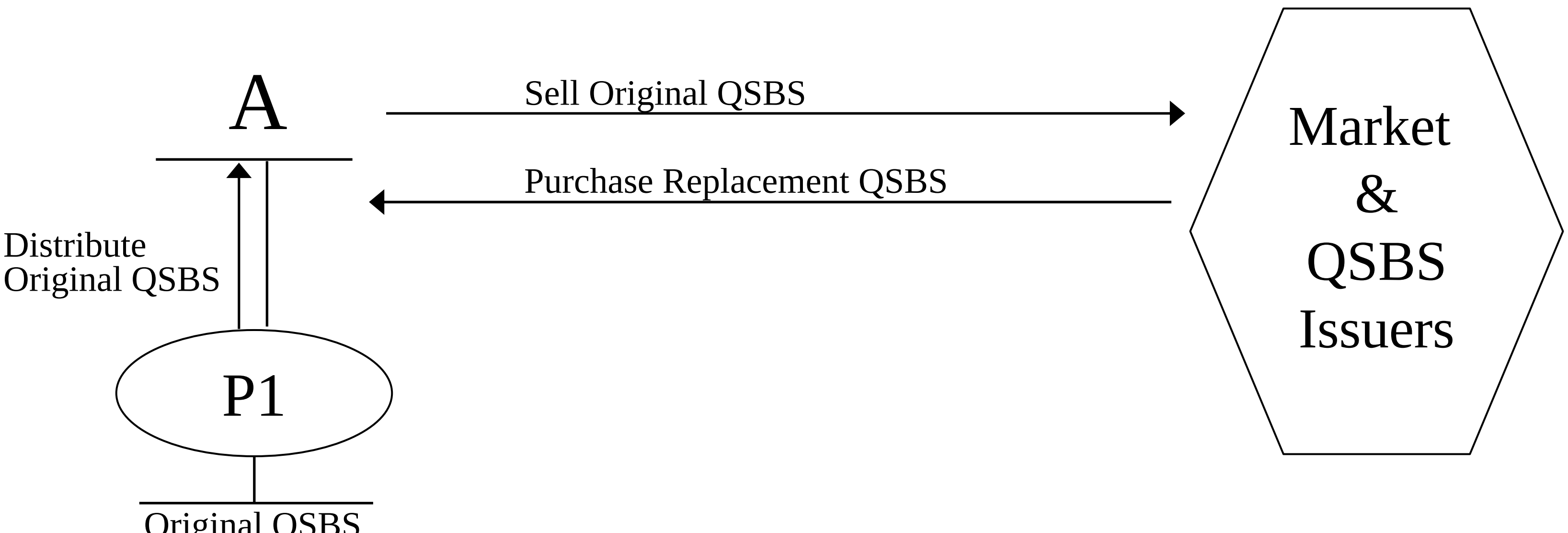
Example 1

- Rollover should be available where
  - Partnership P1 sells Original QSBS and allocates gain to A
  - Within 60 days of sale, P1 purchases Replacement QSBS
  - A rolls over gain



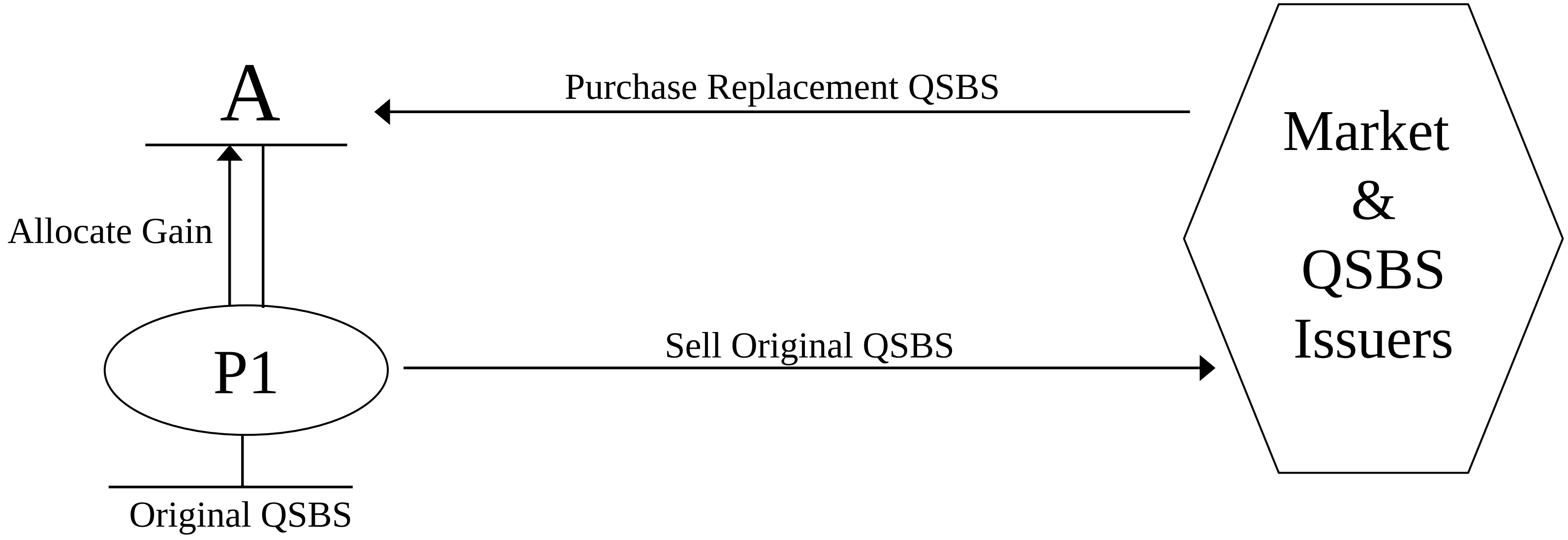
Example 2

- Rollover should be available where
  - Partnership P1 distributes Original QSBS to A
  - A sells Original QSBS and realizes gain
  - Within 60 days of sale, A purchases Replacement QSBS
  - A rolls over gain



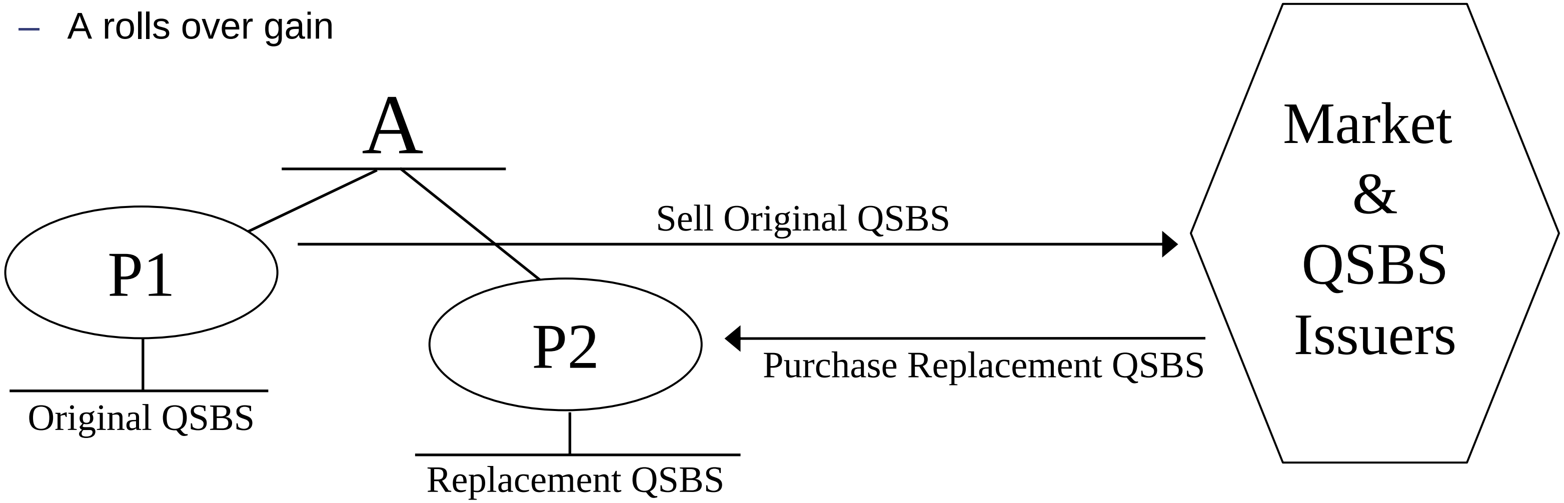
Example 3

- Rollover should be available where
  - Partnership P1 sells Original QSBS
  - Partnership P1 allocates gain from sale to A
  - Within 60 days of sale, A purchases Replacement QSBS
  - A rolls over gain



Example 4

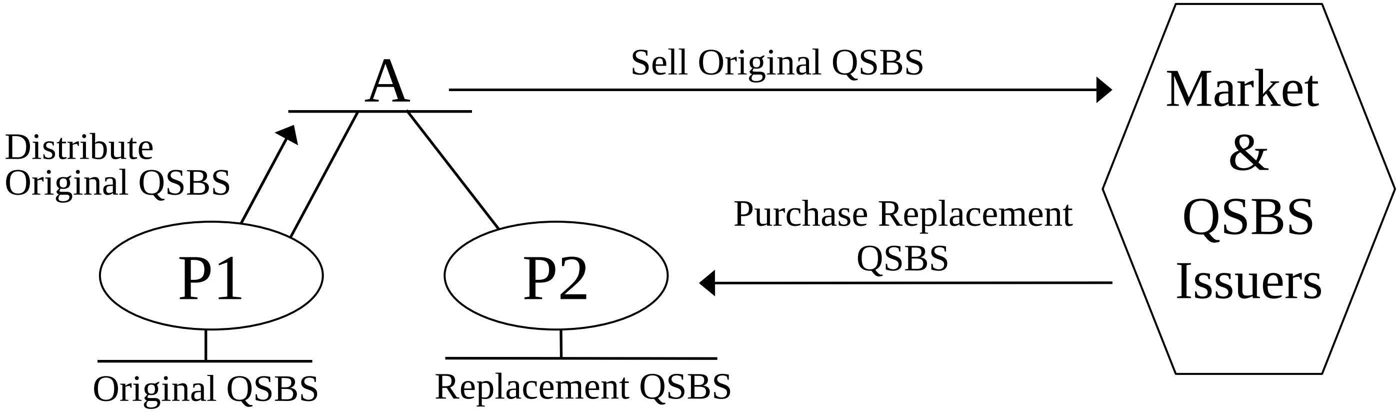
- In many cases, there will be ***substantial authority*** for the position that rollover benefits are available where
  - A is a member of Partnerships P1 and P2
  - P1 sells Original QSBS
  - P1 allocates gain from QSBS sale to A
  - Within 60 days of sale, P2 purchases Replacement QSBS
  - A rolls over gain



- But see Proposed Regulation Sec. 1.1045-1, which might (if finalized) deny rollover benefits in this context. Consult tax advisor.

Example 5

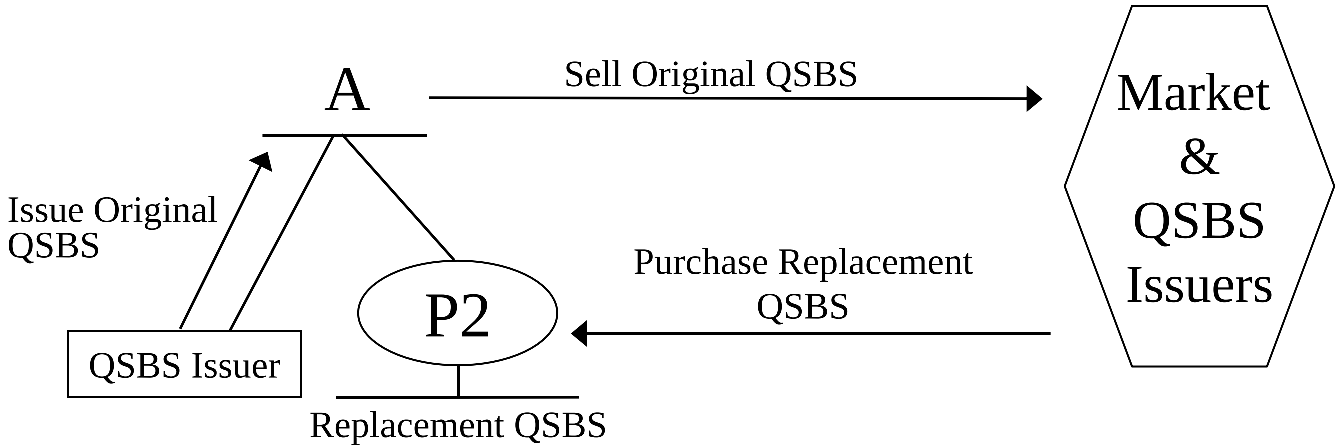
- In many cases, there will be ***substantial authority*** for the position that rollover benefits are available where
  - A is a member of Partnerships P1 and P2
  - P1 distributes Original QSBS to A
  - A sells Original QSBS and realizes gain
  - Within 60 days of sale, P2 purchases Replacement QSBS
  - A rolls over gain



- But see Proposed Regulation Sec. 1.1045-1, which might (if finalized) deny rollover benefits in this context. Consult tax advisor.

Example 6

- In many cases, there will be ***substantial authority*** for the position that rollover benefits are available where
  - A purchases Original QSBS from issuer
  - A sells Original QSBS
  - Within 60 days of sale, Partnership P2 purchases Replacement QSBS



- But see Proposed Regulation Sec. 1.1045-1, which might (if finalized) deny rollover benefits in this context. Consult tax advisor.

Rollovers Involving Partnerships (cont.)

- In Examples 4, 5, and 6, above, P2's purchase of Replacement QSBS provides A with rollover benefits only to the extent that such Replacement QSBS is attributable to A by virtue of A's ownership of P2
  - Example
    - A holds a 10% interest in each of Partnerships P1 and P2
    - P1 purchases 1000 shares of Original QSBS @ $10 per share
    - P1 sells all of the Original QSBS @ $30 per share
      - A's share of proceeds is $3,000
      - A's share of gain is $2,000
    - Within 60 days, P2 purchases QSBS for $20,000
      - A's share of purchase price is $2,000
    - A recognizes $1,000 of gain
      - The amount by which A's sale proceeds exceed A's reinvestment amount

Rollovers Involving Partnerships (cont.)

- The foregoing techniques generally can be applied to ***tiered entities***. Thus, in-kind distributions and allocations of gain can pass through a general partner entity without loss of rollover.
  - Example
    - Fund distributes Original QSBS to General Partner LLC
    - General Partner LLC distributes to A
    - A sells Original QSBS and purchases Replacement QSBS
    - A rolls over gain

Rollovers Involving Partnerships (cont.)

- However, a technique that involves the ***contribution*** of QSBS to a fund (or other entity) generally ***will not work***
  - Example
    - Partnership 1 distributes Original QSBS to A
    - A contributes Original QSBS to Partnership 2
    - The contribution causes the contributed stock to lose its status as QSBS
    - Any subsequent sale and purchase by Partnership 2 will not result in a tax-free rollover

Changes in Fund Interests

- A partner is entitled to rollover benefits only in respect of an interest in the partnership held at the time QSBS was acquired by the partnership
  - Subsequent increases in a partner's partnership interest generally do not increase availability of rollover benefits
    - Increases due to purchase of additional partnership interests
    - Increases due to amendment of the partnership agreement
- For purposes of calculating rollover benefits, the same rule applies for allocations of gain realized upon a partnership sale of QSBS
  - Rollover treatment is available only for that portion of the gain attributable to the interest in the partnership held by a partner at the time the QSBS was originally purchased by the partnership

Example: Purchase of Additional Partnership Interest

- Individual A holds a 10% interest in Partnership P
- P purchases 1000 shares of QSBS
- A subsequently purchases an additional 10% interest in P (for a total 20% interest)
  - If P distributes 200 shares of QSBS to A, only 100 of those shares are QSBS in A’s hands
  - If P sells all of the QSBS, allocates $2000 of gain to A, and reinvests all of the sale proceeds in Replacement QSBS, only $1000 of A’s gain may be rolled-over

Changes in Fund Interests (cont.)

- Changes that should not run afoul of this rule
  - Shifts in allocation that occur pursuant to a formula included in the partnership agreement at the time the Original QSBS was acquired (e.g., a carried interest)
  - Shifts in allocation percentages based upon a partnership agreement which requires that allocation percentages be set periodically by vote of the partners
    - Example: Partnership agreement states that each partner’s allocative share of carried interest profits will be determined on an annual basis by vote of the partnership’s compensation committee
  - Temporary allocations to “suspense accounts” pending definitive allocations by vote of some or all partners
  - Shifts in allocation due to vesting
- No authority directly on point, consult tax advisor

Rollovers of Gain Arising from a Carried Interest

- In-kind distributions of Original QSBS
  - In many cases, there is ***substantial authority*** for treating all QSBS distributed to a General Partner by a fund in respect of a carried interest as QSBS in the hands of the General Partner
  - Such QSBS may then be sold as the first step in a rollover transaction
- Allocations of gain from sale of Original QSBS
  - In many cases, there is ***substantial authority*** for treating all taxable gain from the sale of QSBS which is allocated by a fund to a General Partner in respect of a carried interest as gain that may be rolled-over if a qualified investment in Replacement QSBS is made by the General Partner or the fund
- Key Question: If a General Partner holds a carried interest in a fund that makes an investment in Replacement QSBS, what portion of the Replacement QSBS is attributed to the General Partner?

Rollovers of Gain Arising from a Carried Interest (cont.)

- Example
  - GP has a 20% carried interest in Fund 1
  - GP's capital commitment to Fund 1 is 1% of total capital commitments
  - Fund 1 sells Original QSBS
    - Tax basis $0
    - Sale price $10 million
  - Fund 1 allocates $2 million to GP in respect of the carried interest
  - Fund 1 allocates $80k to GP in respect of GP's capital commitment
  - Within 60 days of sale, Fund 1 reinvests all proceeds in Replacement QSBS
  - Is GP's share of the reinvestment amount:
    - $80k?
    - $2.08 million?
    - Something else?
- *This probably is the most difficult question arising under the rollover rules*

Rollovers of Gain Arising from a Carried Interest (cont.)

- One possible answer is that GP's reinvestment amount is based upon its amount ***at risk*** with regard to the Replacement QSBS
- At-risk amount is determined by prior allocations of carried interest profits and presence/absence of a clawback
- In the preceding example, at the time of the investment in Replacement QSBS, GP has a capital account balance of at least $2.08 million, all of which would be lost if the Replacement QSBS declined in value to zero
  - Thus, there is at least a reporting position that ***all*** of the taxable gain allocated to GP on the sale of Original QSBS may be rolled-over into the Replacement QSBS
- This approach requires careful review of all facts and circumstances
- Consult tax advisor

Determining QSBS Status

- How do you determine if stock is QSBS?
  - Get certificate/representation from issuer at time of purchase
    - Update certificate/representation at time of sale
  - Business issue: Should issuer have liability if stock is subsequently determined not to be QSBS?

Protecting QSBS Status

- As noted above, issuer activities *after* purchase of QSBS, such as the redemption of stock, can destroy QSBS status
- Contractual requirements that issuer protect QSBS status are unpopular
  - General view is that issuer should not alter business plans/practices just to protect a stockholder tax benefit
- However, issuer management typically cares about QSBS status
  - Management can benefit from rollovers just like investors
- The best course is to make management aware of the issues so that QSBS status is not lost through simple inattention

Holding Period

- The holding period of Replacement QSBS is deemed to include the holding period of Original QSBS
- Example
  - A purchases Original QSBS and holds for 6 months
  - A sells Original QSBS and, within 60 days, purchases Replacement QSBS
  - A holds Replacement QSBS for 7 months, then sells for cash
  - A is deemed to have held the Replacement QSBS for >12 months and is entitled to Federal 20% capital gains rate

Mechanics: Making a Rollover Election

- Under Revenue Procedure 98-48, a rollover election can be made by either the partnership or a partner
  - In most cases, it will be preferable for partners (rather than the partnership) to make the election
- Election must be made on tax return Schedule D (Capital Gains and Losses)
- An election may be made separately for one or more qualifying QSBS transactions
- An election can only be made with respect to sales of QSBS after August 5, 1997

Tracking and Compliance Burdens

- To date, the IRS has not issued any guidance on how to track or account for rollover transactions
- In general, fund agreements do not require that the fund provide all information needed for partners to maximize rollover benefits
- When a matched QSBS sale and purchase occur within a fund, partners must receive information with their Federal K-1s in order to make election
- Partners that wish to engage in rollovers which cross fund boundaries generally will need current information on fund investment and disposition activities to comply with the 60-day window for completing rollovers

Tracking and Compliance Burdens (cont.)

- A partner that wishes to treat an investment made by a fund as a reinvestment of proceeds from an independent sale of QSBS may impose upon the fund an obligation to track the reduced basis of the Replacement QSBS in the fund's hands (if the IRS issues guidance on this point)
- Many people exaggerate the difficulties of tracking and compliance
  - In general, book entries need be made only when QSBS is acquired or disposed of
  - Periodic reports to partners can be extremely brief and contain only information that is readily available
- Nevertheless, tracking and compliance may require an allocation of additional resources to the fund CFO

Tracking and Compliance Burdens (cont.)

- Ultimately, each VC firm will need to find a balance between maximizing rollover benefits for all partners and minimizing tracking and compliance costs
  - This may mean refusing to track rollovers that fail to satisfy a dollar value threshold
- This issue will be particularly significant for “affiliates” funds, which typically have many individual investors with small capital commitments

Tax-Free Rollovers Under California Law

- Except for several key differences described below, California law regarding tax-free rollovers is the same as Federal law

Basic Rule: California

- If a non-corporate Taxpayer
  - Recognizes gain on a sale of *California QSBS*
  - Which *California QSBS* was held for more than *6 months* prior to the date of sale
  - And the Taxpayer purchases *new California QSBS* within *60 days* following such sale
- The Taxpayer will be taxed on gain recognized in the original sale only to the extent that the sale proceeds exceed the purchase price of the new California QSBS
- All non-taxed gain will be *rolled-over* into the new California QSBS
- <u>Note</u>: California QSBS must be replaced with California QSBS to obtain rollover benefit

What is California QSBS?

- Must first qualify as Federal QSBS
- Then must satisfy additional California requirements
  - Active Business Requirement
  - Non-redemption Requirement
  - Payroll Requirement
- California Definitions
  - Rollover defined by Cal. Rev. & Tax. Code Section 18038.5
  - California QSBS defined by Cal. Rev. & Tax. Code Section 18152.5

Active Business Requirement: California

- For substantially all of the period during which Taxpayer held the stock, at least 80% of the issuer's assets (by value) must have been used in the active conduct of a qualified trade or business *in California*
  - Otherwise the definition of "qualified trade or business" is the same as under Federal law

Non-Redemption Requirement: California

- Generally, same as Federal rule
- Certain stock redemptions by issuer will destroy California QSBS status
  - Any redemptions from the holder or a related person
    - Within 4-year period beginning 2 years prior to issuance of stock
  - Significant redemptions from other holders
    - Within 2-year period beginning 1 year prior to issuance of stock
- However, it is unclear whether California will follow Federal rule and disregard redemptions associated with the termination of an individual's status as employee or director

Payroll Requirement: California

- In order for stock to be California QSBS:
  - At least 80% of issuer's payroll (measured by dollar value) must have been attributable to California employment as of the date of issuance of the stock
  - At least 80% of issuer's payroll (measured by dollar value) must have been attributable to California employment for substantially all of the period during which the Taxpayer held the stock
- "Payroll attributable to California employment" probably means wages reported to California for unemployment compensation purposes, less non-business amounts paid to employees
  - Analogy to the payroll portion of the income apportionment rules under Cal. Rev. & Tax. Regulations Section 25132

Rollovers Involving Partnerships: California

- California law governing the availability of California rollover benefits in partnership transactions was recently conformed to Federal law
  - May 8, 2002
  - See slides 13-28, above, for discussion of Federal rules
- The California Franchise Tax Board has not yet released any guidance concerning situations that are unclear or ambiguous under Federal law
- Tax advisor should be consulted

Holding Period: California

- California short-term and long-term capital gains tax rates are identical
- Thus, holding period is largely irrelevant for California QSBS rules

Compliance Issues: California

- Generally, the same analysis as described above with respect to:
  - Determining California QSBS Status
  - Protecting California QSBS Status
  - Tracking and Compliance Burdens
    - To date, the California Franchise Tax Board has not issued any guidance on how to track or account for rollover transactions
    - When a matched QSBS sale and purchase occur within a fund, partners must receive information with their California K-1s in order to make election

Mechanics: Making a California Rollover Election

- California taxpayer elects to roll over gain on California QSBS by adjusting Federal income tax entries on California income tax return
  - No written guidance from California Franchise Tax Board on this point
- Issuer must file Franchise Tax Board Form 3565 on or before the due date of the issuer’s Franchise Tax Board “Form 100 - Corporation Franchise or Income Tax Return” (including extensions) and distribute Form 3565 to its shareholders
  - Per instructions to Form 3565, failure to file the form will not disqualify a shareholder from making rollover election, but will place burden on shareholder of proving that the stock is California QSBS, and issuer may face modest “failure to file” penalties

California Franchise Tax Board - Recent Focus

- The California Franchise Tax Board has begun to aggressively audit taxpayers who claim substantial California QSBS benefits
- Do not automatically copy rollover claims from Federal tax return
  - Use care to ensure that rollovers claimed on California tax return satisfy California QSBS requirements

Summary of Differences Between California & Federal Law

- Sale proceeds of Original California QSBS must be reinvested in Replacement California QSBS to obtain California rollover benefit

Summary of Differences Between California & Federal Law (cont.)

- In order for stock to be California QSBS:
  - During substantially all of the Taxpayer's holding period of the original stock and the first 6 months following date of purchase* of the replacement stock:
    - 80% of stock issuer's assets (by value) must be used in an active trade or business *in California*
    - 80% or more of the stock issuer's payroll expense (measured by dollar value) must be *attributable to California employment*
  - At the date of issuance of the stock, 80% or more of the issuer's payroll expense (measured by dollar value) must be *attributable to California employment*

* Or, if shorter, Taxpayer's holding period for the Replacement Stock

Summary of Differences Between California & Federal Law (cont.)

- California may apply stricter rules disallowing rollover benefit upon issuer redemption of its stock
- Capital gains holding period largely irrelevant for California QSBS

Key Points for Venture Capitalists

- Federal and California tax-free QSBS rollovers can be extremely valuable in the right circumstances
- QSBS qualification or ability to elect rollover benefits may be lost through simple inattention
- Tax advisor should always be consulted in certain situations
  - Rollover benefits through partnerships
  - Development of reporting position on legal issues that have not been completely resolved

Key Points for Venture Capitalists (cont.)

- Be ***extremely careful*** in marketing rollover benefits to limited partners
- A fund should develop internal systems and policies for tracking rollover transactions and providing information to partners
- Fund and general partner entity documents should be reviewed for ways to enhance QSBS benefits (particularly with regard to shifts in interests)

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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