NEW REGULATIONS CONCERNING TAX-FREE ROLLOVERS OF GAIN FROM QUALIFIED SMALL BUSINESS STOCK

On August 13, 2007, the United States Department of the Treasury issued new regulations under Section 1045 of the Internal Revenue Code.

The new regulations specify the manner in which tax-free rollovers of gain from the sale of qualified small business stock (“QSBS”) can be accomplished via structures involving partnerships. In general, the regulations broadly allow QSBS gain rollovers to be accomplished through partnership structures, but place very strict limits on rollovers of gain attributable to “carried interest.”

This Client Alert briefly describes the new regulations as well as their implications for venture capital and other private equity funds (“Funds”) and the individuals who manage Funds (“Fund Managers”) through “General Partner” entities.1

Background

Under Section 1045, a non-corporate taxpayer who (i) acquires QSBS, (ii) holds it for more than six months, (iii) sells the QSBS, and (iv) within 60 days of such sale reinvests all or a portion of the proceeds into replacement QSBS generally is required to recognize taxable gain on the sale only to the extent that the sale proceeds exceed the purchase price of the replacement QSBS. Any gain not recognized is rolled over into the replacement QSBS, and generally will be recognized only to the extent that the replacement QSBS is sold in a transaction that does not itself qualify for rollover treatment.

In general, QSBS is stock acquired via original issue from a domestic C corporation that uses at least 80 percent of its assets in a qualified business, has less than $50 million of gross assets at the time of the stock issuance, and has not engaged in certain disqualifying stock redemption transactions.2 Most businesses can be qualified businesses. The primary exceptions are professional services (e.g., law, accounting, performing arts, and athletics), financial services (e.g., banking, insurance, leasing, and investing), farming, and natural-resources extraction. Many investments made by venture capital funds, and a smaller percentage of investments made by other types of private equity funds, give rise to QSBS.

In general, Section 1045 provides that (i) QSBS rollover benefits flow through partnerships to their constituent partners, and (ii) QSBS distributed by a partnership retains its QSBS status in the hands of a recipient non-corporate partner.3

The New Regulations

The new regulations provide a detailed set of rules for many complex transactions involving QSBS purchases, sales, and reinvestments made by or through partnerships. Most of the rules relate to technical compliance issues such as making elections and tracking basis. However, several address fundamental issues of qualification for rollover benefits. Those rules are highlighted below.

Reinvestments through a different partnership. Before issuance of the new regulations, it generally was understood that a qualified reinvestment into replacement QSBS could be made under the following circumstances:

(i) Partnership A sells original QSBS and purchases replacement QSBS;

(ii) Partnership A sells original QSBS and a constituent partner purchases replacement QSBS; or

(iii) Partnership A distributes original QSBS to a constituent partner, who sells the original QSBS and purchases replacement QSBS.

The new regulations clarify that a qualified reinvestment into replacement QSBS also could be made under the following circumstances:

(iv) Partnership A sells original QSBS, and allocates gain to a constituent partner who also holds an interest in Partnership B, which then purchases replacement QSBS; or

(v) Partnership A distributes original QSBS to a constituent partner, who sells the original QSBS and holds an interest in Partnership B, which then purchases replacement QSBS.

This clarification can be beneficial in common circumstances involving Funds. For many Fund participants, the only readily available source of QSBS investments is through Funds. Yet many Funds make substantially all of their QSBS purchases early in their term, and make few (if any) later-in-time investments that could serve as qualifying reinvestments with

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1 For a more general discussion of Section 1045 and QSBS rollovers, please see our presentation titled “Tax-Free Rollovers of Qualified Small Business Stock: Federal and California Issues for Venture Capitalists.”

2 Note that the $50 million gross assets limit generally is determined with regard to the tax basis of the issuer’s assets. Thus, an issuer may be deemed to have less than $50 million in gross assets even though its true fair market value is greatly in excess of $50 million.

3 As used in this Client Alert, the term “partnership” includes a limited liability company that elects to be treated as a partnership for federal income tax purposes, and the term “partner” includes a member of such a limited liability company.

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respect to sales of their previously acquired QSBS. Thus, for many Fund participants, a qualifying reinvestment through Partnership B is the only practical way to obtain a tax-free rollover with respect to QSBS originally acquired by Partnership A.

Limitation based on capital interest in a partnership. Under Section 1045, a partner can be entitled to rollover benefits with respect to QSBS acquired by a partnership only to the extent that the partner held an interest in the partnership at the time of the initial QSBS acquisition and throughout the period during which the QSBS was held by the partnership. However, partnership interests often are complex in nature. Prior to issuance of the new regulations, it was unclear how to measure the “interest” of a partner in a partnership, such as a Fund, where allocations of profit and loss reflect a carried interest held by the General Partner.

The new regulations define “interest in the partnership” in a manner that sharply restricts rollover availability for QSBS gain attributable to a General Partner’s carried interest in a Fund. Specifically, the new regulations provide that the amount of gain a partner may roll over with respect to QSBS held by a partnership shall not exceed the product of:

(i) the partner’s smallest percentage interest in partnership capital from the time the QSBS is acquired until the time the QSBS is sold multiplied by

(ii) the partnership’s realized gain from the sale of such QSBS.

The new regulations provide a corresponding rule to limit the rollover amount with respect to QSBS that has been distributed by a partnership and sold by the recipient partner.

The net effect of this limitation generally is to prevent a Fund Manager from rolling over gain realized by the Fund Manager with respect to a carried, rather than capital, interest in a Fund. This result may cause some Fund Managers to consider moving away from a traditional carried interest and toward alternative Fund structures (such as structures in which the General Partner contributes promissory notes or other assets in order to increase its percentage interest in the Fund’s capital).

Based upon an example in the new regulations, it appears that the determination of a partner’s interest in partnership capital can take into account changes in the value of the partnership’s assets (and the allocation of realized or unrealized gain or loss in respect thereof) through the date on which the applicable QSBS is acquired by the partnership. This may provide at least some degree of potential carried interest rollover benefit with respect to QSBS that is acquired after a Fund’s portfolio has appreciated and the General Partner has been allocated realized or unrealized carried interest profit with respect to such appreciation.

For example, Fund A has total capital of $100 million, of which $1 million has been contributed by General Partner A. General Partner A is owned in equal shares by Fund Managers X and Y, and has an industry-standard 20 percent carried interest in Fund A. At a time when there has been no change in the value of Fund A’s assets, Fund A purchases QSBS1. Under the new regulations, Fund Managers X and Y generally would not be able to roll over more than 1 percent of the gain attributable to QSBS1, because they indirectly held a 1 percent capital interest in Fund A at the time QSBS1 was acquired.

Subsequently, Fund A’s assets appreciate in value to $200 million, reflecting $100 million in gain, of which $20 million is allocated to General Partner A as carried interest profit, and $0.8 million is allocated to General Partner A as a return on capital. Immediately thereafter, Fund A purchases QSBS2. Under the new regulations, Fund Managers X and Y may be able to roll over a maximum of 10.9 percent of the gain attributable to QSBS2, because they indirectly held a 10.9 percent capital interest in Fund A at the time QSBS2 was acquired.¹

¹ Note that X and Y may not ultimately be entitled to this maximum rollover percentage if subsequent carried interest distributions reduce their percentage interest in partnership capital while Fund A continues to hold QSBS2.

Gain recognition on distribution of replacement QSBS. Under the new regulations, if (i) a partner (“Partner P”) has rolled gain into replacement QSBS held by a partnership, (ii) the partnership makes a distribution of QSBS to a different partner, and (iii) the distribution reduces Partner P’s share of the replacement QSBS held by the partnership, then Partner P generally is required to recognize gain (up to the full amount of the rolled gain) in the same manner as if the distributed QSBS had been sold by the partnership for fair market value.

Effective Date

The new regulations apply to sales of QSBS on or after August 14, 2007.

Conclusion

The new regulations generally are favorable to non-corporate investors who contribute capital to Funds that invest in QSBS, but sharply limit the availability of QSBS benefits for Fund Managers and may justify alterations to traditional carried interest structures.

For more information on the new regulations, please contact Jonathan Axelrad or another member of the firm’s Fund Services practice.