

Qualified Small Business Stock: Redemption Issues

By [Susan Schalla](#) & Joe Wallin

If you are not familiar, Section 1202 of the Internal Revenue Code provides startup founders and investors with a very significant potential tax break on the ultimate sale of their stock, if the stock is "qualified small business stock."

What is the Tax Break?

The tax break is a complete exclusion from tax on up to \$10M on gain on the sale of qualified small business stock held for more than 5 years.

This is a per issuer/per company exclusion. Thus, you can exclude up to \$10M in gain on every company you invest in if the stock you buy is qualified small business stock and you hold it for 5 years before you sell it.

What is Qualified Small Business Stock?

Qualified small business stock is:

- stock in a C corporation (S corporation stock or interests in an LLC taxed as a partnership do not count)
- engaged in a qualified small business
- issued in exchange for money or other property or services.

Thus, your founder stock can qualify as qualified small business stock *if* you organize your startup as a C corporation, it has less than \$50M in gross assets before and after you put your money in, and your business is not a services business (like a law firm).

You have to hold your founder stock for 5 years. But if you do, on the sale of the stock you can exclude up to \$10M in gain from U.S. federal income tax entirely. If you don't hold your founder stock for 5 years before sale, Section 1045 of the IRC has a friendly rollover provision.

This is probably the most significant tax break in startup land. But it only works if you form a C corp. If you and your co-founders form an S corp, your founder stock won't qualify for the benefit. If you form an LLC, your LLC interests won't qualify, but you can incorporate an LLC as a C corp and then start the clock.

We received the following question recently, and we wanted to share the answer as this can be a pretty typical scenario.

Question:

I'm considering joining a startup as a late-entry co-founder and want to make sure my shares get 1202 treatment if possible.

One problem is that one of the company's co-founders left recently, and the company 'automatically' repurchased the unvested shares per the employment agreement, on the order of 25% of the total outstanding shares.

I looked up the statute and it seems that if the company buys back more than 5% of its shares from anyone (in the last 2 years), then no QSB shares can be issued for at least 2 years from that repurchase date.

Here is [*what the statute says*](#):

(b) Significant redemptions -

(1) In general. Stock is not qualified small business stock if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period.

Is my assessment correct? Would love to hear what you think. Thanks!

Answer:

The statute does have a prohibition on redemptions. However, the Treasury Regulations contain an important exception for certain events, including when the company redeems shares of an employee or director upon their termination of service.

Here is [*what the regulations say*](#):

(d) Exceptions for termination of services, death, disability or mental incompetency, or divorce. A stock purchase is disregarded if the stock is acquired in the following circumstances:

(1) Termination of services -

(i) Employees and directors. The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.

This should cover many of the circumstances in which founders stock is repurchased on termination of service.

This blog post does not constitute legal or tax advice. Please consult with your legal or tax advisor with respect to your particular circumstance.