Sustainability Reporting to Develop a Competitive Advantage

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Code Section 1202 Exclusion of Capital Gain from Taxation

By J. Leigh Griffith, CPA, JD, LLM

The Taxpayer Relief Act of 2012 extended Code Section 1202’s 100 percent gain exclusion (up to a maximum of $10 million or 10x investment) from sales of Qualified Small Business Stock (“QSBS”) for individuals, trusts, and estates. For 100 percent exclusion, the QSBS must be acquired from the issuer on or after September 29, 2010 and before January 1, 2014. If applicable, the gain from a sale of QSBS is not (i) subject to income tax, (ii) an AMT preference and (iii) subject to the 3.8 percent tax on investment income for the higher income.

Whether a business should (i) form as an LLC or other pass-through entity or as a C corporation or, (ii) if formed as a pass-through, convert in 2013 to a C corporation attempting to be eligible for Section 1202 treatment is a complex decision. If a partnership converts, the holding period appears to start on conversion, and the subsequent appreciation could be protected by Section 1202 if the other requirements are met. A shareholder holding of an S corporation that converts to a C corporation must be mindful of the requirement that the corporation must be a C corporation for substantially all of the time the shareholder holds the stock. This makes an S corporation conversion more problematic. The potential advantage of a Section 1202 exclusion must be weighed against the competing advantages of a pass-through entity in light of the anticipated future course of the company and the degree of certainty that the corporation can continue to meet the tests. Once an entity becomes a C corporation, it is generally tax expensive to liquidate to a pass-through.

Requirements for Application of Section 1202

- The issuer must be a C corporation and the stock obtained from the issuer (or underwriter for the company). The stock can be acquired for property or services. Certain corporations with special tax attributes such as REITS, RICs, DISCs and cooperatives will not qualify.

- Qualified Trade or Business. The corporation (counting the activities of 50 percent or greater owned subsidiaries) must be engaged in one or more qualified trades or businesses for substantially all of the time the investor holds the stock. A qualified trade or business is any other than (i) the performance of services in the fields of health, law, engineering, architectural, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of the principles; (ii) banking, insurance, financing, investing or similar business; (iii) farming; (iv) business for which parentage depletion is allowable; or (v) operation of hotel, motel, restaurant or similar business. In short, most qualified trade or businesses will be manufacturing, distribution and/or sales.

- Principal Additional Requirements.
  - (i) Maximum Gross Assets. Gross assets, including proceeds of a stock offering, cannot exceed $50 million at any time since August 10, 1993. For this purpose gross assets are measured by adjusted basis, except property acquired by contribution will start off not less than fair market value at such time. All assets of an affiliated group (as defined in Code Section 1563(a)(1) [which is by vote or value except substituting over 50 percent for over 80 percent are counted in determining the $50 million; (ii) Limitation on Certain Assets. No more than 10 percent of gross assets can consist of real property not used in the active conduct of the trade or business and not more than 10 percent of the net assets can consist of portfolio stock or securities other than reasonably required working capital; (iii) Assets Used in Active Trade or Business. At least 80 percent by value of the assets must be used in an active trade or business (Reasonable working capital, including amounts reasonably anticipated to be expended within two years, is deemed to be used in the active trade or business. However, after the first two years of existence only, working capital of up to 50 percent of the assets of the business will be considered used in the active trade or business). Assets held by 50 percent or greater subsidiaries are included in the testing; (iv) Redemption Limitations. The corporation cannot have redeemed more than 5 percent of its stock within one year of the issuance date or any stock from the taxpayer or related person within two years of the issuance date (other than disminim amounts or retirement, death, divorce or separation from service); and (v) Agreement to Report. The corporation must agree to any reports to the IRS or shareholders required by the Commissioner. At this time there are no reporting requirements.

- Pass-Through Entities May Own QSBS. A partnership, LLC or S corporation may own QSBS. Only those owners at the time of purchase and no more than the percentage of the stock they indirectly owned at the time of purchase and all times thereafter will qualify for exemption. If intervening capital contributions to the pass-through entity are to be made after the acquisition of the shares, special allocations at the time of the subsequent contribution may be able to be placed in a partnership or operating agreement to preserve the exempt nature of the gain for those owners eligible for the exemption and not allocate such to those not eligible. Reverse 704(c) allocations may partially achieve this result. QSBS distributed by an entity taxable as a partnership to its owners will have the tacked holding period of the partnership. While this is helpful for QSBS acquired by a partnership after September 27, 2010, it will hurt if the QSBS was acquired by the pass-through prior to such date when a smaller exclusion applies.

- Stock Must be Held for at Least Five Years to Qualify for the Exemption, and There is a Cap on the Exemption Amount. The taxpayer must have held (or be deemed to have held) the shares for five years or more. If stock is acquired by gift, bequest or distribution from a pass-through, the holding period of the donor/decedent/pass-through counts. If QSBS is exchanged in a tax-free reorganization pursuant to Code Sections 368 or 351, the holding period of the original shares and new shares are tacked together for purposes of the five year test. Will the deemed termination of a partnership under Code Section 708(b)(1)(B) cause the partners to lose the benefit of the exclusion for the QSBS then held by the partnership? The stock is deemed to be contributed to a new
partnership in a transaction in which neither Section 351 nor 368 applies.

- Factors to Consider Whether to Become a C Corporation if the Requirements of Section 1202 are Likely to be Met. In considering whether to form an eligible business as a C corporation or whether an eligible pass-through should convert to a C corporation one should consider: (i) the likelihood that the requirements can be met for a five-year or longer period in which the owners hold the stock; (ii) the loss of flexibility of special allocations; (iii) whether subsequent capital infusions are likely to meet the Section 351 requirements; (iv) whether because of hidden liability risk or other factors it is likely that a buyer will purchase the stock as opposed to the assets; (v) the magnitude of the probable difference in the price for stock versus assets including "liability haircut" as well as the buyer's inability to obtain a stepped-up basis; (vi) whether it is anticipated that significant distributions will be made by the business to its owners over time (particularly those who are not working in the business); (vii) whether the corporate rates on current undistributed income are favorable; and (viii) whether it is likely the taxpayer will sell before five years pass. From a Tennessee tax perspective, unless the pass-through is taxed as a partnership and subject to an exemption from the franchise and excise tax, the Tennessee tax on the entity will be the same. For Tennessee residents, dividends from the QSBS are subject to the Hall Tax whereas distributions from an entity taxable as a partnership are not.

Endnotes
1 An appraisal to establish the value on conversion should be considered.
2 At this time there is no authority as to what constitutes "substantially all" in this context.
3 Per Treas. Reg. §1.1202-2(b)(2) de minimis means no more than the greater of (i) $10,000 or (ii) 2 percent of the stock held by the taxpayer and related persons.

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**BUSINESS VALUATION | columns**

**Involve Yourself in Business Valuation Industry Leadership**

By Carol Carden, CPA/ABV, ASA, CFE

Volunteering at the state or national level is a fantastic way to build your professional network, stay abreast of current developments in the industry and participate in thought leadership. I volunteer at both the state and national level and have found both experiences to be tremendously rewarding. There is no time like the present to get involved!

If you want to become involved at the national level, now is the time to submit your application through the AICPA. Simply go to www.aicpa.org and click on Volunteer and then Volunteer Central. You can apply for several committees and prioritize where your interests primarily lie. You can get other AICPA members to recommend you for selection. Even if you do not get selected for a committee, this volunteer list is also used for ad hoc task force selection throughout the year. Participation on a task force gives you the opportunity to participate while balancing your other professional responsibilities.

TSCPA’s Forensic & Valuation Services Conference Task Force is responsible for planning this annual conference in the fall. The volunteer window will open after the conference in October, so please keep this on your radar if you’re interested in helping plan this three-day event that attracts attendees from across the Southeast.

**About the Author**
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**Life Associate Program**

It is through generous member donations that TSCPA's Educational & Memorial Foundation is able not only to continue, but also expand the scholarship program for worthy accounting students in Tennessee. For information about how to contribute, visit www.tscpa.com. To those of you participating in the associate program, we express our deepest appreciation for your generosity and support and thank you to our newest donors:

**Ben Alexander - Life Associate**

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<th>Platinum Associate</th>
<th>Benefactor</th>
<th>Volunteer</th>
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