

QUALIFIED SMALL BUSINESS STOCK & THE EB-5 VISA PROGRAM – AN ATTRACTIVE COMBINATION FOR POTENTIAL INVESTORS

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In today's start-up world, angel investing¹ is a typical part of an entrepreneur's routine. Angel investors generally provide start-ups or entrepreneurs with seed capital, which can be structured in many ways, including pure equity investments with or without voting rights, convertible notes, and stock options. Not often mentioned, however, are investment models that are fashioned to be equity investments in "small business corporations." This article explains how gain realized on the sale of qualified small business stock ("Q.S.B.S.") is completely free of Federal income taxes for U.S. tax residents, including those holding green cards. This preferential but little-known tax break became permanent with the passage of the Protecting Americans from Tax Hikes ("P.A.T.H.") Act on December 18, 2015.²

Q.S.B.S. is an interesting investment tool. Although (i) the regime is limited to stock in U.S. C-corporations and (ii) individuals living outside the U.S. are generally not subject to capital gains realized on the sale of stock in a U.S. corporation, it provides benefits for non-U.S. investors who plan to move to the U.S., particularly those who enter under the EB-5 visa program of the U.S. Citizenship and Immigration Services ("U.S.C.I.S.") of the Department of Homeland Security. It also offers incentives for U.S. investors to invest in U.S. start-ups, as opposed to non-U.S. start-ups. Most importantly, it constitutes an additional incentive start-up founders can use to attract funding.

Under the Q.S.B.S. regime, a U.S. resident investing in Q.S.B.S. could be totally exempt from U.S. capital gains tax upon sale.³ Further, if that individual is a N.Y. resident, the capital gain would also benefit from an exemption at the state and local levels. Finally, the excludable gain does not carry adverse alternative minimum tax consequences and is not subject to net investment income tax.

DEFINITION OF Q.S.B.S.

The Q.S.B.S. regime is limited to stock meeting the following cumulative requirements:⁴

- The stock constitutes stock of a C-corporation issued after August 10, 1993.
- The issuing corporation is a qualified small business as of the date of the issuance (the "Q.S.B. Test").

¹ See Simon Prisk, "[Corporate Matters: Angel Investing, an Introduction](#)," *Insights* 4 (2014).

² Code §1202(a)(4) as amended by 2015 P.A.T.H. Act §126(a)(1), DivQ, P.L. 114-113.

³ Corporate investors are excluded from this provision (Code §1202(a)(1)).

⁴ Code §1202(c)(1).

- The stock is generally acquired by the taxpayer at its original issue in exchange for money or other property, or as compensation for services (the “Original Issuance Test”).
- During substantially all of the shareholder’s holding period of such stock, the issuing corporation meets an active business requirement (the “Active Business Test”).

The Q.S.B. Test

The following cumulative requirements must be met for purposes of the Q.S.B. test:

- The issuing entity is a U.S. C-corporation.⁵
- The aggregate gross assets of the corporation (or a predecessor) do not exceed \$50,000,000 from August 10, 1993, until immediately after the issuance of the stock for which preferential treatment is sought.⁶
- The issuing corporation submits reports to its shareholders and the I.R.S. as the I.R.S. may require.⁷

For the purpose of the gross asset requirement, cash and the adjusted bases of property held by the corporation constitute “aggregate gross assets.”⁸ As a result, the post-issuance growth of a start-up does not disqualify such corporation from meeting the Q.S.B. test.

All corporations that are part of the same parent-subsidary controlled group will be treated as one person.⁹ A parent-subsidary controlled group is constituted by one or more chains of corporations connected through ownership with a common parent.¹⁰ A 50% ownership test (by vote or value) must be met for the corporations to be part of said controlled group.

The Original Issuance Test

As mentioned earlier, this test is generally met if the stock is acquired by the taxpayer at its original issue in exchange for money or other property (other than stock) or as compensation for services.¹¹

In order to ensure that only new investments in start-ups give rise to the beneficial tax regime, the following pre-issuance or post-issuance redemption transactions disqualify the stock from the beneficial regime:

⁵ Code §1202(d)(1).

⁶ Code §§1202(d)(1)(A), (B).

⁷ Code §1202(d)(1)(C). The I.R.S. did not publish any guidance yet as to such reports.

⁸ Code §1202(d)(2). For assets contributed to the corporation, the basis is the fair market value of the contributed assets immediately after the contribution.

⁹ Code §1202(d)(3)(A).

¹⁰ Code §1202(d)(3)(B). Direct ownership and constructive ownership rules under Code §§1563(e)(1), (2), and (3) apply.

¹¹ Code §1202(c)(1)(B). Stock acquired as compensation for services excludes stock acquired for services performed as an underwriter of the stock (Code §1202(c)(1)(B)(i)).



- Redemptions from the shareholder, or a person related to the shareholder, during the period starting two years prior to the issuance of the stock and ending two years after the issuance of the stock¹²
- One or more significant redemptions made during the period starting one year prior to the issuance of the stock and ending one year after the issuance of the stock¹³

For this purpose, a “significant redemption” is one or more purchases by a corporation of its stock, wherein the aggregate value exceeds 5% of the aggregate value of all of the stock of the corporation as of the beginning of the aforementioned two-year period. In addition, the purchased stock must be in excess of \$10,000 and constitute more than 2% of all outstanding stock.¹⁴

Certain tax-free transfers, such as (but not limited to) gifts or inheritances,¹⁵ certain transfers from partnerships to partners,¹⁶ certain stock conversions,¹⁷ and certain reorganizations and incorporations¹⁸ do not disqualify the stock from meeting the Original Issuance Test.

The Active Business Test

This test must be met during substantially all of the taxpayer’s holding period for such stock.¹⁹ Further, the following cumulative requirements must be met:²⁰

- The corporation must actively conduct one or more qualified trades or businesses.²¹
- At least 80%, by value, of the assets of the corporation are used by such corporation in the active conduct of such qualified trades or businesses.²²

¹² Code §1202(c)(3)(A). A *de minimis* exception exists for redemptions not meeting the following requirements: (i) The aggregate amount paid for the stock exceeds \$10,000, and (ii) more than 2% of the stock held by the taxpayer and related persons is acquired (Treas. Reg. §1.1202-2(a)). For this purpose, any stock purchase by a corporation related to the issuer that is treated as a redemption pursuant to Code §304 is treated as a purchase by the issuing corporation in an amount equal to the amount treated as a redemption distribution (Code §1202(c)(3)(C)).

¹³ Code §1202.

¹⁴ Treas. Reg. §1.1202-2(b). Any stock purchase by corporations related to the issuer and treated as a redemption pursuant to Code §304 is treated as a purchase by the issuing corporation in an amount equal to the amount treated as a redemption distribution (Code §1202(c)(3)(C)).

¹⁵ Code §§1202(h)(2)(A), (B).

¹⁶ Code §1202(h)(2)(C).

¹⁷ Code §1202(f).

¹⁸ Code §1202(h)(4).

¹⁹ Code §1202(c)(2)(A).

²⁰ Code §1202(e). A waiver exists for specialized small investment companies (Code §1202(c)(2)(B)(i)).

²¹ Code §1202(e)(1)(A).

²² *Id.*

“While the [Active Business] test is comprehensive . . . most early-stage investments in C-corporation technology companies should, for example, meet these requirements.”

For this purpose, stock and debt in subsidiaries²³ are disregarded and the parent is considered to own its ratable share of the subsidiary’s assets and to conduct its ratable share of the subsidiary’s activities.²⁴ Certain assets that are (i) used for research or start-up activities²⁵ and (ii) are held as working capital²⁶ or constitute rights to computer software²⁷ may automatically be treated as used in the active conduct of a qualified trade or business. Other assets held excessively, such as real estate or portfolio securities, automatically disqualify the corporation from meeting the Active Business Test.²⁸

- The corporation is an eligible corporation.

A qualified trade or business is any business with the exception of the following:²⁹

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees
- Any banking, insurance, financing, leasing, investing, or similar business
- Any farming business (including the business of raising or harvesting trees)
- Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Code §§613 or 613(a)
- Any business of operating a hotel, motel, restaurant, or similar business

The corporation is an eligible corporation if it is any U.S. C-corporation other than the following:³⁰

- A domestic international sales corporation (“D.I.S.C.”) or former D.I.S.C.
- A corporation with respect to which an election under Code §936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect
- A regulated investment company, real estate investment trust, or real estate mortgage investment conduit (“R.E.M.I.C.”)
- A cooperative

While the test is comprehensive, requiring a detailed review that is beyond the scope

²³ For this purpose, a corporation is considered a subsidiary if the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock of such corporation.

²⁴ Code §1202(e)(5)(A).

²⁵ Code §1202(e)(2).

²⁶ Code §1202(e)(6).

²⁷ Code §1202(e)(8).

²⁸ Code §§1202(e)(5)(B), (7).

²⁹ Code §1202(e)(3).

³⁰ Code §1202(e)(4).

of this article, most early-stage investments in C-corporation technology companies should, for example, meet these requirements.

EXCLUSION OF GAIN FROM INCOME

If the stock qualifies as Q.S.B.S., an individual shareholder may claim an exemption on part or all of the gain realized upon a sale of the stock³¹ – subject to a holding period requirement,³² an acquisition date-based limitation,³³ and a per-issuer cap.³⁴

First, in order to be able to claim the exclusion, the taxpayer must hold the Q.S.B.S. for more than five years.³⁵ A deferral of capital gains tax may be available when the taxpayer does not respect the five-year holding period, has held the stock for six months, and uses the sales proceeds to purchase Q.S.B.S. within 60 days of the sale.³⁶

Second, the extent of the available exclusion varies depending on the acquisition date of the Q.S.B.S. stock. The following acquisition dates give rise to income exclusions:

- Capital gain realized on the sale of Q.S.B.S. acquired on or before February 17, 2009, can benefit from a 50% exclusion.³⁷
- Capital gain realized on the sale of Q.S.B.S. acquired after February 17, 2009, and before September 28, 2010, can benefit from a 75% exclusion.³⁸
- Capital gain realized on the sale of Q.S.B.S. acquired after September 27, 2010, can benefit from a total exclusion.³⁹

Lastly, the above exclusions are capped on a per-issuer basis.⁴⁰ The eligible excluded gain cannot exceed the greater of

- \$10,000,000, reduced by the aggregate amount of eligible gain for prior taxable years and attributable to dispositions of stock issued by the same corporation,⁴¹ or
- 10 times the aggregate adjusted bases of the Q.S.B.S. issued by the corporation and disposed of by the taxpayer during the taxable year.⁴²

³¹ Code §1202(a).

³² Code §1202(b)(2).

³³ Code §1202(a).

³⁴ Code §1202(b).

³⁵ Code §1202(b)(2).

³⁶ Code §1045.

³⁷ Code §1202(a)(1).

³⁸ Code §1202(a)(3).

³⁹ Code §1202(a)(4).

⁴⁰ Code §1202(b).

⁴¹ Code §1202(b)(1)(A).

⁴² Code §1202(b)(1)(B). As a result, if the taxpayer does not qualify for the 100% exclusion, but only for the 75% exclusion for instance, only 75% of the above

Finally, for Q.S.B.S. acquired after September 27, 2010, the excluded gain no longer carries an alternative minimum tax exposure.⁴³ Notably, the 3.8% net investment income tax does not apply to the amount of the exclusion.⁴⁴ While some states, such as New York, follow the Federal exclusion regime,⁴⁵ others may not. Hence, state and local law should be checked prior to making an investment decision for purposes of benefitting from the Q.S.B.S. rules.

From a compliance perspective, an individual investor should be aware of the obligation to file Form 8949, *Sales and Other Dispositions of Capital Assets*, for the year in which the gain is realized.

THE EB-5 VISA PROGRAM

The U.S.C.I.S. administers the EB-5 program, which was created to stimulate the U.S. economy through job creation and capital investment by foreign investors. In broad terms, all EB-5 investors must invest in a new commercial enterprise,⁴⁶ which means any for-profit activity formed for the ongoing conduct of lawful business by any one of several types of entities, including a corporation.⁴⁷ This definition includes a holding company and its wholly owned subsidiaries, provided that each such subsidiary is engaged in a for-profit activity and is formed for the ongoing conduct of a lawful business.⁴⁸

An EB-5 investor must generally invest the required amount of capital in a new commercial enterprise that will create full-time positions for at least 10 qualifying employees.⁴⁹ For a new commercial enterprise not located within a regional center, the full-time positions must be created directly by the new commercial enterprise. This means that the new commercial enterprise (or its wholly owned subsidiaries) must itself be the employer of the qualifying employees. For a new commercial enterprise located within a regional center, the full-time positions can be created either directly or indirectly by the new commercial enterprise.

Direct jobs are those jobs that establish an employer-employee relationship between the new commercial enterprise and the persons it employs.⁵⁰ Indirect jobs are those jobs held outside of the new commercial enterprise but that are created as a result of the new commercial enterprise.⁵¹

Capital means cash, equipment, inventory, other tangible property, cash equivalents, and indebtedness secured by assets owned by the alien entrepreneur, provided that

limits (*i.e.*, \$7,500,000 and 7.5 time the aggregate adjusted bases) apply.

⁴³ Code §1202(4)(C).

⁴⁴ Code §1411(c)(1)(A)(iii).

⁴⁵ N.Y. Tax Law §612.

⁴⁶ 8 C.F.R. 204.6(e): a new commercial enterprise is any commercial enterprise established after November 29, 1990.

⁴⁷ *Id.*

⁴⁸ *Id.* at *Commercial Enterprise*.

⁴⁹ 8 C.F.R. 204.6(j).

⁵⁰ 8 C.F.R. 204.6(e), *Employee*.

⁵¹ *Id.*

“For Q.S.B.S. acquired after September 27, 2010, the excluded gain no longer carries an alternative minimum tax exposure.”

the alien entrepreneur is personally and primarily liable and that the assets of the new commercial enterprise upon which the petition is based are not used to secure any of the indebtedness. All capital is valued at fair-market value denominated in U.S. dollars.⁵²

If the terms of the EB-5 program are met, the investor is granted a temporary green card, which may become permanent after two years if all requirements regarding job creation and investment levels are met. This means that from the time the visa is issued, the holder is subject to U.S. Federal income tax on worldwide income. If the investment is made in Q.S.B.S., tax on gains derived from the sale of shares that meet the requirements of the Q.S.B.S. provisions can be eliminated within the limitations of U.S. tax law.

CONCLUSION

The combination of the Q.S.B.S. tax regime and the EB-5 program for foreign investors provides foreign persons interested in obtaining green cards with a trifecta of benefits:

- They provide foreign investors with the opportunity to obtain permanent residence in the U.S. if all EB-5 requirements are met.
- They grant green card holders the opportunity of obtaining tax-free gain if their investment meets the Q.S.B.S. requirements.
- They avoid the costs and problems that are frequently encountered when investments are made through packagers of EB-5 programs.

⁵² 8 C.F.R. 204.6(e), *Capital*.