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by Raj Tanden, Louis Lehot, and Jacob I. Davis

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Raj Tanden

Louis Lehot

Jacob I. Davis

Raj Tanden and Louis Lehot are partners, and Jacob I. Davis is a tax associate, all with Foley & Lardner LLP. They thank Timothy L. Voigtman and Jordan J. Bergmann for their assistance in writing this article.

In this article, the authors discuss redemption issues with qualified small business stock and how to avoid the founders' stock problem.

To encourage new business creation, formation, and growth in the United States, Congress enacted section 1202, which allows a taxpayer to exclude certain capital gains attributable to qualified small business stock (QSBS), as long as multiple requirements are met. Obtaining QSBS status is part of the investment strategy of most seed and early-stage venture capital firms, and it should be part of every entrepreneur and founder's tax planning and wealth management strategy.

To qualify for QSBS treatment, among other things, the taxpayer must purchase stock directly from the company. However, all of the taxpayer's stock will be disqualified from QSBS treatment if there is a "significant redemption": In general, during a two-year period beginning one year before the purchase, the company makes purchases of its stock in excess of 5 percent of its outstanding stock (determined as of the beginning of this two-year period).[1]

Why do significant redemptions disqualify otherwise "good" QSBS? The purpose behind section 1202 is to encourage taxpayers to seed start-ups with capital. If capital from a start-up is used to redeem shareholders rather than grow the business, the purpose of granting QSBS status would be thwarted.

In the life of a start-up, however, there are many twists and turns — such as founder departures, changes in founder roles and responsibilities, founder divorce, and rebalancing of equity to maintain fairness among the sponsors of the business. Here we focus on significant redemptions in connection with founder stock transactions.

I. Forfeitures of Unvested Stock

When a business start-up is formed with future fundraising in mind, counsel will typically recommend and provide forms of stock purchase agreements that require that the purchaser of the stock at formation remain with the company to "vest" into the stock. Put another way, the stock that the purchaser acquires is forfeited if the purchaser does not complete vesting conditions. Vesting is typically made subject to four-year monthly vesting with a one-year cliff. If the

[1] Section 1202(c)(3). There is a separate disqualification test for the taxpayer's own or a related party's repurchases.

purchaser separates from service with the company before vesting is completed, the unvested stock is forfeited.

In our experience advising hundreds of start-ups and investors in early-stage businesses, we look to ensure that the forfeiture of the stock upon separation from service does not cause disqualification of QSBS status.

In general, any stock redeemed can cause the disqualification problem. Thus, unless an exception applies, if a holder's stock is "forfeited" (which is legally a redemption) and the forfeiture causes the 5 percent disqualification threshold to be met, any stock issued within the applicable two-year window will be disqualified from QSBS treatment.

However, regulations provide a "services exception": Forfeited stock will be disregarded as long as 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 those services.[2]

In general, if the stock was granted with vesting conditions, that stock should be treated as issued in connection with services.[3] Any future forfeiture of stock in connection with a separation therefore should fit within the services exception.

II. The Founders' Stock Problem

Often, when founders form a company without counsel, they do not impose vesting on themselves. If a founder agreed to vesting restrictions on stock received on the date of issuance and the stock is later forfeited in connection with a separation, the forfeited stock should qualify for the services exception.[4]

However, often when a VC investor invests in the company, it will insist that the founder forfeit some stock to rebalance ownership or add vesting at that time.[5] In that situation, it could be difficult to establish that a forfeiture will qualify for the services exception. The founder likely initially maintained that the stock was issued for property or cash and not for services because stock received for services could be taxable.[6] Moreover, even if it is clear that the stock was received for services, the founder may not be leaving the company upon the rebalance; therefore, the services exception would not apply.

To avoid this unfortunate circumstance, we offer the following approaches.

A. Meet the De Minimis Test

Under the regulations, a company can ignore some redemptions under a de minimis exception to the significant redemptions limitation: Stock counts against the 5 percent threshold only when (1) the aggregate amount paid for the stock exceeds $10,000 and (2) more than 2 percent of all outstanding stock is purchased. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.[7]

Under the de minimis exception, redemptions of stock within the two-year window prescribed by the significant redemptions limitation would not result in disqualification as long as (1) the aggregate amount paid for all such redemptions doesn't exceed $10,000 or (2) all of the redeemed stock represents 2 percent or less of the company's stock valued at the time of any such redemption. Thus, all redemptions can be disregarded until the aggregate amount paid for the redeemed stock exceeds $10,000. Applying the 2 percent exception is less clear. It would seem that the 2 percent exception is helpful when the company

[2] Reg. section 1.1202-2(d)(1). The regulations reserve a subsection for independent contractors.

[3] *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984).

[4] It is important for anyone agreeing to vesting to make a timely election under section 83(b) within 30 days of the grant. It is difficult to impossible to remedy a failure to make a timely election.

[5] Rev. Rul. 2007-49, 2007-2 C.B. 237 (no section 83(b) election is necessary when vesting is added after the grant; stock is not treated as issued for services).

[6] Section 351(a) (stock issued for property can be received tax-free as long as specific requirements are met); and section 83(a) (stock received for services generally taxable for value of stock exceeding amount "paid").

[7] Reg. section 1.1202-2(b)(2).

has appreciated since the value here is applied as of the time of any redemption. By contrast, under the general 5 percent limitation, it is based on the value as of the beginning of the two-year window.[8]

B. Add Vesting When the Stock Is Issued

The founders could agree to simple, founder-favorable vesting when their stock is initially issued. For example, the stock could vest after it has been held for one year. Adding vesting at the outset should be sufficient to qualify for the services exception if the stock is later forfeited upon a separation. Moreover, if a VC investor seeks vesting when it invests, the founders can point to the existing vesting terms and potentially avoid the imposition of harsher vesting conditions. However, this alternative would not be helpful if the founder was not departing the company in connection with the forfeiture.

C. Treat the Stock as Issued for Services

As discussed above, the services exception applies when stock is issued in connection with the performance of services. Usually, founders maintain that their stock was not issued for services but rather was issued for property or cash. If the stock was issued for services, the founder would be taxed on the value of the stock less the value of property or cash transferred for the stock.[9]

However, in the stock-issuing documents, the founders could agree that the stock was issued for services, but the stock is not worth more than the property or cash exchanged for it.[10] If any of that stock was forfeited in connection with a separation, the company could point to this term to establish that the forfeiture qualifies for the services exception. If the founders and company take this approach and face an IRS challenge they should be prepared to defend that the stock was not worth more than the property or cash.[11]

D. Transfer Stock to Others

A QSBS problem arises only when stock is forfeited back to the company. Thus, the forfeiting holder could instead be required to transfer the shares to another person. If that person is a service provider to the company, they will have compensatory income equal to the value of the stock received, and the company will avoid QSBS disqualification.[12] This solution may be especially useful when the founder is not departing the company.

E. Recapitalize the Founder Stock

In Rev. Rul. 2007-49, the IRS made clear that if vested stock is exchanged for unvested stock in a "reorganization," the holder is deemed to receive new stock for services and therefore must make a new, timely section 83(b) election to avoid adverse federal income tax consequences.

In general, a "recapitalization" of stock qualifies as a "reorganization."[13] Under this approach, a company could recapitalize a founder's stock into a new class of stock in connection with a new VC investment, the new stock could be subject to vesting, and the company could treat the new stock as issued for services.[14]

The new stock must be respected as a new class for federal income tax purposes. We think adding a weak liquidation preference should suffice for this purpose. This solution could protect QSBS issuances for future forfeitures of the founders' stock upon a separation, but it would not protect against a forfeiture at the time of the VC's investment. ■

[8] Section 1202(c)(3)(B) causes disqualification when the company has "purchased" stock exceeding the 5 percent threshold. *See also* reg. section 1.1202-2(b). A "purchase" implies that something is paid for the stock. Thus, if stock was forfeited for nothing, arguably, that stock should not be considered purchased and therefore should not count against the 5 percent threshold.

[9] Moreover, only "property" that qualifies under section 351(a) will count. Although the definition of property is broad for this purpose, it is not likely to encompass mere business plans.

[10] *See Alves*, 734 F.2d 478 (services provided for property under section 83(a) are broadly defined).

[11] With a start-up, it is unlikely that any stock received has much value, regardless of whether it has been issued for "property." Cash investors acquiring stock around the same time, though, could be proof of a "pre-money valuation" for the stock.

[12] Reg. section 1.1202-2(c). Any such purchasers' stock cannot be QSBS because QSBS must be purchased directly from the company.

[13] Section 368(a)(1)(E).

[14] The holder must make a timely section 83(b) election for the new stock. *See* Rev. Rul. 2007-49.