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Structuring Search Fund Investments as "Qualified Small Business Stock"

Introduction

Common search fund investment targets range in enterprise value from $5 to 15 million, are founder-owned, and are organized as "S" corporations for tax purposes or as LLCs classified as partnerships. With this target profile, it is often possible to structure search fund investments as investments in "qualified small business stock" ("QSBS"). This memorandum describes techniques for structuring search fund investments as QSBS.

General Benefits of Qualified Small Business Stock

Gain recognized by an individual, trust or estate from the sale of QSBS held for more than five years can be eligible for exclusion from gross income, resulting in no federal income tax on sale.[1] The amount of gain eligible for exclusion by an individual, estate or trust with respect to the stock of any single corporation is limited to the greater of $10 million of QSBS-eligible gain in the aggregate or ten times the holder's basis in the QSBS sold during the tax year. Additionally, a holder may be able to exclude gain from the sale of QSBS by the holder's partnership or S corporation in circumstances described in more detail below.

Although QSBS is limited to stock of domestic C corporations[2], under some circumstances it may be possible to hold an investment in a pass-through entity such as a limited liability company ("LLC") indirectly through a corporation whose stock qualifies as QSBS. This too is discussed in more detail below.

Qualified Small Business Stock

Following are the highlights of the tests for QSBS:

- QSBS includes only stock of a domestic C corporation obtained at original issue in exchange for cash, services, or property other than stock.
- The aggregate gross assets of the corporation at all times before and immediately after the issuance must not exceed $50 million. Property of the corporation is valued at its adjusted tax basis, except that property contributed to a corporation is valued at its fair market value at the time of contribution.

Comment: While this size limit will often not be an issue for a search fund target, the size limit may exclude investments in S corporation or LLC targets with an enterprise value in excess of $50m and larger growth equity investments in C corporation targets.

- The corporation must not have redeemed more than a de minimis amount of stock from the purchaser during the two years before or after the issuance to the purchaser. Additionally, the corporation must not have redeemed stock in an amount exceeding five percent (5%) of the aggregate value of its stock as of one year prior to the issuance of stock from any shareholder during the year before or the year after the issuance.

Comment: A search fund investment in a C corporation target with a primary equity investment (in addition to liquidity to existing shareholders) may need to be structured as part cross-purchase and part original issuance to avoid redemptions from existing stockholders.[3] See the discussion of this subject below.

During substantially all of the taxpayer's holding period for the stock, the corporation must have used at least 80% by value of its assets in the active conduct of a trade or business. Special rules determine how much working capital is permitted.

Comment: This requirement could be failed immediately after a significant cash investment. Appropriate due diligence and cash flow management should be considered for search fund investments with growth capital.

- No more than ten percent (10%) of the assets of the corporation may consist of real estate or stock or securities of other corporations that are not more-than-50%- owned subsidiaries.
- The corporation must not be engaged in the following businesses:
  - health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more employees;
  - banking, insurance, financing, leasing, investing or similar businesses;
  - farming;
  - the production or extraction of minerals; and/or
  - operating a hotel, motel, restaurant or similar business.

Holding QSBS Through an LLC

While only stock of a C corporation can qualify as QSBS, it is possible for an individual, trust or estate to hold stock that qualifies as QSBS through an LLC or other pass-through entity. Such a structure could be useful if, for example, it were desirable to grant "profits interests" in the LLC to members of management of the corporation, since profits interests in an LLC can be quite tax-efficient for management. This approach is subject to the following:

- The stock must be QSBS in the hands of the LLC determined as if the LLC were an individual;
- The LLC must have held the stock for more than five years at the time of sale;
- The taxpayer must have held an interest in the LLC on the date on which the LLC acquired the stock and at all times thereafter until sale; and
- QSBS treatment is limited to the interest the taxpayer held in the LLC on the date the LLC acquired the stock.

Structuring QSBS Investments in LLC Operating Companies

If the target operating company is a pass-through entity, one approach is to convert the target entity itself to a C corporation immediately after the acquisition.[4]

As an alternative to converting the target LLC into a C corporation, it may be possible to hold an interest in the LLC through a corporation whose stock qualifies as QSBS.[5] The corporation would need to meet all of the eligibility tests for QSBS described above. In order to do so, it would be necessary for the corporation to be able to "look through" to the assets and business of the LLC. If the LLC is wholly owned by the corporation, it is clear that the corporation can look through to the assets and business of the LLC, which would be treated as disregarded as separate from the corporation. For search fund investments, the LLC would be expected to be wholly owned and thus the corporation would look through to the assets and business of the LLC for purposes of the QSBS eligibility tests.[6]

If the target pass-through entity is converted to a corporation (or held by a C corporation) and the five-year holding period test and the other requirements for QSBS treatment are met, the approach will have been a success. By contrast, if the QSBS requirements are not met, the operating company, by converting to a C corporation (or held by a C corporation), will have been subject to corporate income taxes on operating profits and will have given up the opportunity to sell assets to an acquirer in a way that results in a "step-up" in the tax basis in the assets of the business. Some acquirers will pay a premium if they are able to acquire depreciable assets in a purchase transaction that steps up the tax basis in the assets. In addition, while converting a pass-through entity to a C corporation (or using a C corporation to acquire a pass-through entity) can be done in a tax-efficient way, such an approach cannot be undone tax-efficiently. Consequently, there is an important trade-off that must be weighed before taking this approach.

An Acquisition with Rollover by the Selling Equity Holders Raises Additional Issues

As described above, in order for stock to qualify as QSBS, the corporation must not have redeemed any stock from the purchaser during the two years before or after the issuance to the purchaser. Additionally, the corporation must not have redeemed stock for an aggregate purchase price exceeding five percent (5%) of the aggregate value of its stock as of one-year prior to the redemption from any one or more shareholders during the year before or the year after the issuance.

The purpose of this rule is to prevent evasion of the requirement that QSBS be newly issued stock acquired by the taxpayer at the original issuance. Neither the legislative history nor any other authority explains the policy reasons behind the original issuance requirement, but one possible explanation is that QSBS treatment should be limited to circumstances where the selling price for the stock is retained by the corporation and used for growth rather than being used to provide liquidity to selling stockholders.

If the target operating company is a C corporation and the equity investment by the search fund will be used to provide liquidity to selling shareholders and "growth" equity for the business, the liquidity portion should be structured as a secondary purchase, i.e., a purchase by the purchaser directly from the selling shareholders, rather than as a direct purchase from the corporation followed by a redemption by the corporation. The growth equity should be used for a direct purchase of stock from the corporation. While only the growth equity used to purchase stock directly from the corporation could qualify as QSBS, this structure avoids a redemption of stock by the corporation, which could disqualify all of the purchased stock from QSBS treatment.

Similarly, growth equity funded to a C corporation target after the acquisition may also qualify as QSBS. Where growth equity is funded after the initial acquisition, such investment often should be structured as a purchase of newly issued stock by the corporation in order to satisfy the original issuance requirement.

If the target operating company is an LLC and the acquisition will be structured as a purchase of a majority interest in the LLC (but not all of the LLC interests) by a new corporation, there will, at least in form, be no redemption of stock by a corporation and therefore it would appear that the stock of the new corporation could qualify as QSBS in its entirety. However, a question could be raised as to whether such a transaction violates the apparent purpose of the "anti-redemption" requirement that the purchase price for QSBS be retained by the operating entity for growth. A counter argument would be that it should be unobjectionable for a new corporation to acquire all of the interests in an operating LLC, so a partial acquisition should not be treated less favorably. We are not aware of any authority that addresses this issue.

Conclusion

The benefits of QSBS treatment are unusually attractive. From time to time, however, legislation has been proposed to eliminate the benefits of QSBS. Consequently, the possibility of legislative changes during the five-year holding period cannot be dismissed.

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[1] The state income tax treatment of gains from the sale of QSBS varies from state to state. Certain states, such as New York, follow the federal exemption for gains from the sale of QSBS while others, notably California, tax gains from the sale of QSBS in full as gains from the sale of any other sale of stock in a corporation. State tax consequences should be considered in determining whether to structure an investment as QSBS.
[2] A domestic "C corporation" is a corporation incorporated under the laws of any state in the United States, or any other entity organized under the laws of any state in the United States that has elected to be treated as a "C corporation" for federal income tax purposes. For this purpose, any corporation that has elected to be treated as an "S corporation" is not a "C corporation".
[3] It is common in minority venture and growth equity investments to obtain a covenant on the part of the corporation to avoid redemptions for a year after the investment.
[4] Upon conversion, the adjusted tax basis of the targets assets for purposes of the $50m asset limitation test will be deemed to be equal to the fair market value of the assets at the time of conversion.
[5] This structure may be particularly beneficial if there is significant rollover and/or a desire to maintain pass-through treatment

for certain equity-holders (e.g., potentially rollover sellers and/or management).
[6] If the LLC is majority-owned but not wholly owned, the QSBS provisions in the Internal Revenue Code do not explicitly provide the ability to look through to the assets or business of the LLC. However, the Internal Revenue Code does explicitly permit a corporation to look through to the assets and business of a majority-owned corporate subsidiary. Arguably a similar rule should apply with respect to a majority-owned LLC but no authority directly addresses this issue. Additional challenges are posed when the corporation holds only a minority interest in the operating LLC.

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John Marshall Chambers
Partner

Mark A. DeFeo
Co-Chair, Private Equity and M&A

Henry Dormitzer
Managing Director

Lanny Thorndike
Co-Chair, Choate Wealth & President, ChoateIA