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Focus on Private Equity

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For Private Equity Investors, Section 1202 May Be Worth Another Look

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Included in the American Taxpayer Relief Act of 2012 (ATRA) are provisions that extended some of the more significant benefits of Internal Revenue Code Section 1202, the Code provision that permits eligible noncorporate taxpayers to exclude from taxable income (within limits) a specified percentage of any gain from the sale or exchange of "qualified small business stock" (QSBS) held for more than five years. That percentage, which, when Section 1202 was first enacted in 1993, was 50 percent of the recognized gain from the sale of the QSBS, was increased to 100 percent of such gain for QSBS acquired after September 27, 2010, and before December 31, 2010. The 100 percent exclusion was extended through December 31, 2011, pursuant to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. ATRA retroactively extended the 100 percent exclusion for QSBS acquired in 2012 and 2013. More importantly (to some), ATRA also extended the rule that excluded that gain not only for regular income tax purposes but for alternative minimum tax (AMT) purposes as well.

Historically, trying to qualify for the benefits of Section 1202 was of little interest to private equity investors. This was the case for a number of reasons, including the following:

- *Section 1202 is, by its terms, limited to newly issued stock of a C corporation.* Section 1202 has a number of requirements that must be satisfied in order for stock to qualify as QSBS relating to the method by which the noncorporate taxpayer acquires the stock, the type of business in which the corporation can be engaged and, as discussed below, the size of the corporation (measured by gross assets). Indeed, with regard to the first requirement, it is arguably the case that the benefits of Section 1202, which were aimed at encouraging investments in new enterprises, were not intended to apply to a typical private equity investment (which often results in no new capital being invested in the business but rather a cashing out of the current owners' invested capital). That said, where, as in the situation with many private equity investments, the structure of the transaction calls for a new corporation to be created, it may be that this particular requirement can be satisfied.
- *The corporation issuing the QSBS could not, at the time the QSBS was issued (and at all times since August 10, 1993, through that date), have more than $50 million of gross assets.* Many corporations in which private equity is invested have gross assets that exceed this threshold.
- *The five-year holding period for the stock was not realistic.* Many private equity firms plan to, or in fact do, exit their investment in less than five years. Whatever tax benefits might be derived from Section 1202 are frequently (and appropriately) trumped by business and investment considerations.
- *The treatment of a portion of the excluded gain as a "tax preference" item for AMT purposes would often negate the regular income tax benefit from Section 1202.* The allocation of gain on a disposition of a private equity investment and the eligibility of such gain for exclusion under Section 1202 is all determined at the investor level. For an investor who is otherwise an AMT taxpayer or whose allocable share of Section 1202 gain made the investor an AMT taxpayer, the treatment of a portion of that excluded gain as a tax preference would often make the effective federal income tax rate on the gain only two to 12 basis points below what was the effective rate had the gain not been eligible for Section 1202. Indeed, in this situation, an investor probably would only claim the benefits of Section 1202 if, as was sometimes the case, it resulted in an effective reduction in the state income tax rate payable with respect to the gain.

So why should private equity investors now take another look at Section 1202?

First, while the requirements for what constitutes QSBS remain unchanged, the character of certain private equity investments has changed—in particular, it may no longer be considered unrealistic for holding periods to be longer than five years or for investments to be in companies with gross assets of less than $50 million.

Second, federal long-term capital gains tax rates have gone up, from 15 percent to what is, for most individual private equity investors, 23.8 percent. In the meantime, the tax rate applied to the non-excluded Section 1202 gain has not changed. As such, a 2013 sale at a gain of otherwise eligible QSBS stock (*i.e.*, stock that, among other things, has been held since 2008) would be subject to an effective federal income tax rate of 15.9 percent or, to the extent the investor is an AMT taxpayer, an effective federal income tax rate of 16.88 percent—in either case, a savings over the regular capital gains tax rate of almost nine percentage points. (These effective rates assume that the investor's income will be at a level at which the new 3.8 percent "net investment income tax," enacted as part of the Obama health care legislation, will be applicable and that the 50 percent of the gain not excluded under Section 1202 will be subject to this tax.) This savings, of course, is on top of any effective reduction in the investor's state income tax rate on the gain.

Third, depending on when the QSBS was acquired, the reduction in the effective federal income tax rate on the gain from a sale in future years could be even more significant. For QSBS acquired between February 18, 2009, and September 27, 2010—not eligible for the benefits of Section 1202 until February 19, 2014, at the earliest—the portion of the gain eligible for the exclusion under Section 1202 is 75 percent, making the effective federal income tax rate on the gain 7.95 percent (for investors who are not subject to AMT) and 13.83 percent (for investors who are). For QSBS acquired between September 28, 2010, and December 31, 2013, the effective federal income tax on such gains is zero percent for both regular income tax and AMT purposes. Of course, the first sales of QSBS eligible for the zero percent rate cannot occur until September 29, 2015, and, for any QSBS investments made in 2013, not until sometime in 2018 (by which time the federal capital gains tax rates generally may have changed one or more times).

Although the recent changes in capital gains tax rates have made the benefits of Section 1202 more compelling, these benefits are still speculative for many reasons. Therefore, an otherwise unsuitable investment should not be made, nor fundamental business terms compromised, solely to fit within the parameters of Section 1202. That said, if the size of the investment, the structure of the transaction and the anticipated holding period for the stock all indicate that private equity investors could take advantage of reduced federal (and state) capital gains tax rates, making sure that the investment otherwise constitutes valid QSBS should not be overlooked.

Items of Interest in Recently Finalized Regulations on Noncompensatory Partnership Options

By Kevin J. Feeley, Partner, and Thomas P. Ward, Partner, U.S. & International Tax Practice Group

This article highlights items that may be of interest to private equity funds regarding recently finalized regulations on the tax treatment of noncompensatory options issued by an entity taxed as a partnership, particularly for a private equity fund with tax-exempt and foreign investors that uses partnership options to minimize the risk of unrelated business taxable income or effectively connected income, respectively, that could otherwise arise if the fund held a partnership interest in the operating partnership. The final regulations are effective, and proposed regulations issued at the same time are proposed to be effective, for options issued on or after February 5, 2013.

In general, the final regulations (1) do not apply to compensatory options or options issued by a tax disregarded entity; (2) define "option" to include a call option, warrant or similar arrangement, as well as the conversion feature of convertible debt and convertible equity; (3) provide that the issuance and exercise of an option do not trigger immediate tax to the holder of the option and issuing partnership; (4) provide that the lapse of an option results in taxable income for the partnership and a loss by the option holder; and (5) retain the capital account mechanics for options, including a corrective rule that can allocate taxable income in the year of exercise to the holder following exercise.

The final regulations retain the proposed regulations' characterization rule whereby an option holder will be treated as a partner if (1) the option holder's rights are "substantially similar" to the rights afforded to a partner, and (2) as of the date the option is issued, transferred or modified (each a measurement event), there is a "strong likelihood" that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate federal tax liabilities (substantial reduction test).

Rights are substantially similar to the rights afforded to a partner if either the option is reasonably certain to be exercised or the option holder possesses partner attributes. Two new safe harbors provide that an option is not considered reasonably certain to be exercised under the following circumstances (unless a principal purpose of the option is to substantially reduce tax):

- *Safe harbor #1*: The option may be exercised no more than 24 months after the date of the measurement event, and the strike price is equal to or greater than 110 percent of the fair market value of the underlying partnership interest on the date of the measurement event.
- *Safe harbor #2*: The option terms provide that the strike price is equal to or greater than the fair market value of the underlying partnership interest on the exercise date.

For both safe harbors, a *bona fide* formula-based strike price may be considered equal to or greater than the fair market value of the underlying partnership interest on the exercise date. Partner attributes are based on facts and circumstances, but negative covenants imposing reasonable restrictions on partnership distributions or dilutive issuances are not treated as partner attributes.

For exempt and foreign investors, it might be difficult for the fund to avoid violating the substantial reduction test, thus making it critical for the fund to structure the option so that it does not confer rights substantially similar to the rights of a partner. Unfortunately, the new safe harbors may not be helpful in practice because of the limitations on duration and strike price of the option.

The characterization test applies upon (1) an option issuance, (2) an option transfer (other than transfers at death, between spouses or in a tax disregarded transaction) if the option term exceeds 12 months or is pursuant to a plan in place at the option issuance or modification with a principal purpose to substantially reduce taxes, and (3) a modification of the option or the underlying partnership interest (other than one that neither materially increases the likelihood of exercise nor provides the option holder with partner attributes, or one that changes the option strike price or the interests in the issuing partnership pursuant to *bona fide* reasonable adjustment formula intended to prevent dilution of the option holder).

Proposed regulations issued at the same time as the final regulations would expand the measurement events to include certain issuances, transfers or modifications of an interest in the issuing partnership or an interest in a look-through entity that owns the partnership option or owns an interest in the issuing partnership.

The final regulations state that any option recharacterization on a transfer takes effect immediately prior to the transfer. If the transferor is treated as exercising the option and selling a partnership interest, then, for example, any realized gain on the sale would be treated as short-term capital gain, and such capital gain could be recharacterized as ordinary income to the extent attributable to "hot assets" inside the partnership. A deemed exercise could also trigger deemed distributions to the other partners to the extent the issuance of the new interest reduces their share of partnership debt.

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