

Banking Sector Events May Affect Qualified Small Business Stock Treatment

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Startups and emerging companies that are reevaluating their cash management policies following recent events in the banking sector should be aware of the implications of such policies on qualified small business stock (QSBS) treatment for their stock. Investments in mutual funds – including money market funds – can potentially jeopardize QSBS treatment.

Background

Stock issued by a corporation is not treated as QSBS unless, among other requirements, at least 80% of its assets (by value) are used by such corporation in the active conduct of one or more “qualified trades or businesses” – known as the “**active business requirement**” – during substantially all of the applicable investor’s holding period for such stock.

A corporation cannot qualify for the active business requirement for any given period if more than 10% of the value of its assets (in excess of liabilities) consist of portfolio stock – known as the “**portfolio stock limitation**” – other than assets that qualify under the working capital exception, which we’ve described below. Portfolio stock generally means stock of other corporations that are less than 50% owned by the putative QSBS-issuing corporation. This limits the amount that a QSBS-eligible corporation can invest in other companies.

Under a “**working capital exception**,” assets are treated as used in the active conduct of a corporation’s trade or business if they “are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or” if they “are held for investment and are reasonably expected to be used within [two] years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.”

For periods after the corporation has been in existence for at least two years, no more than 50% of its total assets can qualify for the working capital exception.

For purposes of the portfolio stock limitation, investments in mutual funds are likely to be treated as portfolio stock. There may be arguments that interests in money market funds should not be treated as portfolio stock given their cash equivalency, but the statute itself does not exempt interests in mutual funds based on the composition of their assets.

Guidance for companies reassessing cash management

A corporation that intends to qualify as a QSBS issuer should exercise caution with its cash management policies following recent events in the banking sector. An investment in a mutual fund (including money market funds), if in excess of 10% of the value of a corporation’s net assets (combined with any other portfolio stock), could run afoul of the portfolio stock limitation, which could increase risk that the corporation does not satisfy the active business requirement during substantially all of the investors’ holding periods.

By contrast, investments of cash in more traditional working capital accounts – for example, savings or checking accounts, money market accounts (to the extent they are not used to invest in securities, money market funds or other funds), Treasury bills or other government securities, or certificates of deposit – generally do not raise issues under the portfolio stock limitation. Companies are cautioned, however, that certificates of deposit, other bank time deposits and short-term corporate obligations (such as commercial paper) are considered investment securities under the Investment Company Act of 1940, as amended, and if held in sufficient amount may cause a company to be considered an “investment company” under that act, which could affect the company adversely.

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