Cooley

QSBS Considerations for Cash Management Policies

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Stock issued by a corporation is treated as qualified small business stock (QSBS) only if, among other requirements, at least 80% of its assets (by value) are used by the issuing corporation in the active conduct of one or more "qualified trades or businesses" (the active business requirement) during substantially all of the applicable investor's holding period for such stock. This requirement has become particularly relevant to many startup and emerging companies that have been reevaluating their cash management policies following recent events in the banking sector, as described in **this April 2023 Cooley alert**.

This alert further explains two aspects of the active business requirement – the **working capital exception** and the **portfolio stock limitation** – with some illustrative examples below.

The working capital exception

Under the working capital exception set forth in the Internal Revenue Code, Section 1202(e)(6), certain passive assets may be treated as used in the active conduct of an issuing corporation's qualified trade or business if they are "held as part of the reasonably required working capital needs of a qualified trade or business of the corporation," or "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." After an issuing corporation has existed for at least two years, no more than 50% of its assets can qualify as used in an active trade or business by reason of the working capital exception (the **50% restriction**).

The portfolio stock limitation

Under the portfolio stock limitation, a corporation that otherwise satisfies the active business requirement will be treated as failing to do so for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of "portfolio stock or securities," other than assets qualifying under the working capital exception. "Portfolio stock or securities" generally means stock or securities of other corporations where the issuing corporation does not own more than 50% of such other corporation's stock (by vote or value).

Accordingly, if the issuing corporation's portfolio stock and securities constitute working capital, such holdings are potentially problematic for purposes of the active business requirement, only if the 10% portfolio stock limitation is exceeded after the issuing corporation has been in existence for more than two years **and** to the extent the issuing corporation's working capital (including eligible portfolio stock and securities) exceeds 50% of its assets.[1]

As discussed in the April 2023 Cooley alert on QSBS, interests in money market funds are likely to be treated as portfolio stock for this purpose

Calculating asset value

The QSBS provisions do not provide guidance on how to calculate the value of an issuing corporation's assets for purposes of the active business requirement, the working capital exception or the portfolio stock limitation – unlike specific valuation rules applicable to certain other QSBS tests (e.g., use of "tax basis" for purposes of the $50 million "aggregate gross asset" value test). Some commentators suggest that, for these purposes, the aggregate value of the issuing corporation's assets (including intangibles) during any particular period could be determined by starting with the then-fair market value of the issuing corporation's capital stock, determined from time to time, and adding to such value the amount of any liabilities (including contingent liabilities) of the issuing corporation and its subsidiaries. The valuations should, in any event, take into account the fair market value of all of the issuing corporation's assets, including those that may not be reflected on the balance sheet (e.g., goodwill). Corporations that intend to issue QSBS should discuss valuation methodologies with their tax advisers.

Illustrative examples

The application of the working capital exception and the portfolio stock limitation are illustrated by the following series of examples.

Assumptions

In each of the examples below, corporation ("C") has been in existence for at least two years, the fair market value of C's total assets is $100, C has no liabilities and all of C's assets would qualify as either assets held as part of the reasonably required working capital needs of a qualified trade or business, or assets held for investment and reasonably expected to be used within two years to finance research and experimentation in, or increases in working capital needs of, a qualified trade or business. In each case, we also assume that investments in money market funds are treated as portfolio stock.

For purposes of these examples, we will refer to assets that are used in the active conduct of a qualified trade or business, other than those qualifying under the working capital exception, as "business assets." Business assets may include fixed assets, intangible assets, etc.

Example 1

C's cash exceeds the 50% restriction under the working capital exception, and C does not have other active business assets sufficient to meet the active business requirement.

Facts: C's assets consist of $71 in cash and $29 of business assets.

Analysis:

- Under the 50% restriction, no more than 50% of C's total assets ($50) can qualify as active assets under the working capital exception.
- Accordingly, $50 of C's cash and all $29 of C's business assets, or $79 of C's total assets (79%), constitute active assets.
- C does not meet the 80% test of the active business requirement during the period when its total active assets are below such threshold.

Example 2

C's money market fund investments exceed both the 50% restriction and the 10% portfolio stock limitation.

Facts: C's assets consist of $61 in money market fund investments and $39 of business assets.

Analysis:

- Under the 50% restriction, no more than 50% of C's total assets ($50) can qualify as active assets under the working capital exception.
- Accordingly, $11 ($61 minus $50) of C's money market fund investments are not treated as active assets under the working capital exception.
- Therefore, 11% of C's total assets are portfolio stock, and the 10% portfolio stock limitation is exceeded.
- This is the case even though $50 of C's money market investments and all $39 of C's business assets, or $89 of C's total assets (89%), constitute active assets.
- C does not satisfy the active business requirement during the period when C has exceeded the 10% portfolio stock limitation.

Example 3

C's cash and money market fund investments collectively exceed the 50% restriction, and C's money market fund investments may exceed the 10% portfolio stock limitation depending on application of the working capital exception.

Facts: C's assets consist of $50 in cash, $11 in money market fund investments and $39 of business assets.

Analysis:

- Under the 50% restriction, no more than 50% of C's total assets ($50) can qualify as active assets under the working capital exception.
- Accordingly, as in Example 2, $89 of C's assets (89%) constitute active assets; however, C may fail the active business requirement as a result of the portfolio stock limitation:
- C's active assets include $39 of business assets, together with $50 of investment assets, which could consist of either $50 of C's cash, or $11 of C's money market fund investments and $39 of C's cash (or a different mix of cash and money market fund investments).
    1. If all $50 of C's cash is treated as active, because C's money market fund investments that are not treated as active assets under the working capital exception (all $11 of C's money market fund investments) constitute 11% of C's total assets, the 10% portfolio stock limitation is exceeded, and C does not meet the active business requirement during the period when C has exceeded the 10% portfolio stock limitation as a result of such treatment of C's money market fund investments.
    2. If all $11 of C's money market fund investments is treated as active, along with $39 of C's cash, C meets the active business requirement during the period when the above facts and such treatment of C's money market fund investments are applicable. The 10% portfolio stock limitation does not apply to C's remaining assets that are not treated as active assets under the working capital exception ($11 of C's cash).[2]

Example 4

C's cash and money market fund investments collectively exceed the 50% restriction, but C's money market fund investments do not exceed the 10% portfolio stock limitation.

Facts: C's assets consist of $30 in cash, $30 in money market fund investments and $40 of business assets.

Analysis:

- Under the 50% restriction, no more than 50% of C's total assets ($50) can qualify as active assets under the working capital exception.

- Accordingly, $90 of C's assets (90%) constitute active assets:
  - $40 of C's business assets, together with a total amount of $50, which could consist of either:
    1. $30 of C's cash and $20 of C's money market fund investments.
    2. $30 of C's money market fund investments and $20 of C's cash.
- C meets the active business requirement in both alternatives during the period when the above facts apply. In the first alternative, the assets that are not treated as active assets under the working capital exception ($10 of C's money market fund investments) fall within the 10% limitation permitted under the portfolio stock limitation. In the second alternative, the 10% portfolio stock limitation rule does not apply to C's remaining assets ($10 of C's cash), which are not treated as active assets under the working capital exception.

Notes

1. This guidance assumes that if portfolio stock and securities constitute working capital, the working capital exception exempts from the portfolio stock limitation only the portfolio stock and securities that satisfy the 50% working capital test. Under an alternative reading of the statute, all assets meeting the definition of working capital can be excluded from the 10% portfolio stock limitation, not merely those that are excludable after application of the 50% test. Nevertheless, given the lack of guidance on the interaction of these tests – and significant stakes for shareholders if QSBS status is lost – as a planning matter, it is prudent to apply the portfolio stock limitation taking into account the 50% limitation (if applicable).
2. As noted in footnote 1, it would be prudent to take the 50% restriction under the working capital exception into account when calculating a corporation's stock and securities investments that may be disregarded for purposes of the 10% portfolio stock limitation. It also would be prudent to first treat investment assets other than portfolio stock or securities as working capital before including money market funds and other portfolio stock or securities, given that there is no authority on how to coordinate the working capital exception with the portfolio stock limitation.

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