

# In The Trenches\_ Conversation ...in Christmas and Brandon Bloom

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## SUMMARY KEYWORDS

QSBS program, qualified Small Business stock, Section 1202, Internal Revenue Code, C Corp tax rates, search fund, tax benefit, exit strategy, investment criteria, pass-through entities, dividend distributions, tax modeling, industry exemptions, rollover holders, legislative changes.

## SPEAKERS

Steve Divitkos, Kevin Christmas, Brandon Bloom

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**S** Steve Divitkos 00:01  
Kevin, Brandon, welcome to the show.

**K** Kevin Christmas 00:04  
Thanks, Steve. Appreciate you having us.

**B** Brandon Bloom 00:06  
Yeah, thank you.

**S** Steve Divitkos 00:08  
Okay, so we have never talked tax on this podcast, so let's see if we can get people interested in the topic at hand. We are talking about the QSBS program. So let's start at a very high level. What is this thing? And maybe talk to why should current and prospective searchers and CEOs care? Why should they bother listening to the next 45 minutes of this conversation?

**K****Kevin Christmas 00:35**

Yeah, I'm happy to jump in and start on this one. So what is it? Well, QSBS stands for qualified Small Business stock, which is a term defined in Section 1202 of the Internal Revenue Code, which is why you often hear this referred to as either QSBS or 1202. This was first enacted in 1993 but is only really seen an uptick, and sort of a level of popularity here, you know, in recent years, over the last five years or so. Likely, although there's a lot of other reasons probably that play a role in it, but, but due to the significant decrease in C Corp tax rates from 35% to 21% coming out of the Jobs Act. And so with all of that, why should anybody listen to a podcast about tax other than, you know, help falling asleep? This is in particular in the search fund world, a couple things. One is a construct that fits very well within the search fund world. We'll get into some of these details later, but given the general search fund approach, deal size, types of businesses typically acquired, and the sort of acquire, grow, sell strategy, it just fits nicely within all of the detailed requirements which we're going to get into later in the podcast. The big, sort of ringing endorsement, and the kind of high level thing that everybody gets excited about is the great tax benefit on exit for the investors and searchers and potentially rollover holders and other participants, which can be a significant boost to after tax returns. So generally speaking, assuming all of the requirements of QSBS treatment are satisfied owners of the stock, the qualified Small Business stock, can exclude gain on the sale of that stock up to the greater of ten million or 10 times their basis in that stock. So you can just, sort of on its face, there's a substantial benefit to both, both the investors participating in deal and the searcher. So I'll pause there. Brandon, feel free to chime in with any additional thoughts.

**B****Brandon Bloom 02:49**

No, those are the high points. I mean, I guess, what I'd add is people should care about it, because ultimately, this allows you to sell out of an investment tax free, and you don't pay any tax. Investors love that, right? And so they'd love to be able to sell out of investments at a 10x multiple and pay no tax on that investment. And so statute is very detailed. There's a lot of things that have to be done in order to qualify. You got to have the right business and a lot of other things lined up, but if you qualify, it's a significant tax benefit for your investors and the searchers.

**S****Steve Divitkos 03:28**

Okay, fantastic. So that is why we ought to pay attention to this. We're talking about 10 million or more of exit proceeds that can be received free of federal tax subject to various requirements. So let's dive in to some specifics, actually, before we do at the risk of changing courses already, can you guys just speak to like the basic idea behind the program? Like, what is the federal government or, I guess, what was the federal government looking to achieve or encourage when they first put this program into place?

**B****Brandon Bloom 04:00**

Yeah. So like Kevin said, the section 1202 first came into the code in 1993, and if you go back and you read the legislative history, you know, every time a new law is enacted, you all also have a lot of explanation coming out of either the Senate Finance Committee or the House of Representatives, and they explain why they're doing certain things. And so if you take a look at that for Section 1202, you you, you realize the basic idea was just to encourage investment in small businesses and encourage investors to take risks on startups and new ventures. You know, if you just read the committee report, it provides this big tax relief for investors who risk their funds and new businesses when those businesses might otherwise have a hard time securing equity financing. So really it was just meant to to grow business, to encourage new businesses and to encourage capital investment in those businesses.

**S****Steve Divitkos 05:00**

Okay, so the federal government has put into place an incentive by way of taxes to encourage investment in us small businesses. Makes sense to me. Now, for the purposes of brevity, we're not going to get into every single qualifying criteria, but I guess at a high level, let's talk about the most important criteria that folks should be aware of, vis a vis how one qualifies. So at a high level, how does a company or an investment qualify for qsbs treatment?

**K****Kevin Christmas 05:31**

Yeah, so the basic pillars of Section 1202 is that you have to have the right type of business, because there are certain types of businesses that don't qualify for this. And generally the definition is broad, right? It really means any business other than this specific list of businesses that don't qualify. And you find that a lot of the businesses that don't qualify are professional services type businesses and hospitality businesses, and investing in finance businesses and things like that. But outside of that world, there's a lot of businesses that qualify. So that would be pillar number one is that you have to have the type of business that qualifies. So think tech, software, manufacturing, anything that's kind of producing a good or a product, that's kind of what you're looking for. The next pillar is that the business has to be held in a C Corporation. Pass through businesses don't qualify for this benefit, and so you always have to make sure you're structuring the business in a way that's going to qualify. The other pillar is just it has to be a small business, which what 1202 means, that's a business that's worth less than \$50 million at the time you invest in it. So it has to be in the early stage, growth stage, those types of things. And then you have to structure the investment in a way so that the stock you hold in that business is qualified Small Business stock, and that means that you receive that stock in exchange for a capital investment or for your services that you're providing to that business as an employee. So you have to receive that stock in a way that qualifies, and then you have to hold that stock for longer than five years, and then when you sell it more than five years later, voila, you get to exit that investment tax free. So those are kind of the key pillars, right? It has to be structured in a way. It has to be a business that qualifies. It has to be the right valuation, and you have to hold it for a certain period of time.

**S****Steve Divitkos 07:40**

So we have to hold it for five years or more, which is typically the case within the search ecosystem. The company has to be less than \$50 million in enterprise value, which, again, is typically the case in the search ecosystem. You mentioned. It has to be structured as a C Corp, and that pass through entities don't count. So that's where I want to go next. Because, as you guys know, as experienced search fund lawyers, the vast majority of search funds, at least in the United States, are structured as LLCs, which is a pass through. So there might be folks listening to this who are saying, Oh, shucks, I'm structured as a pass through. Maybe I'm not eligible. So maybe if you could speak to that potential concern and also speak to this question of, does the company have to currently be structured as a C Corp, or can a quote, unquote new C Corp be created upon acquisition that will allow the searcher and her investors to benefit from this program?

**B****Brandon Bloom 08:33**

Yeah, it's a great question, and it's one that we get a lot in this space, because when you hear it sort of generally, it doesn't sound like it fits with the search fund structure, but the short answer is, is that it does so. So the way in which we structure these transactions is to address two things. One, the fact that most search funds are, Steve, as you pointed out, LLCs and the top go through which the investors invest in, is almost in all circumstances, going to be an LLC or perhaps a limited partnership, so that on its face doesn't sound like it works. The other thing that doesn't sound like it works is not all targets are C corps, oftentimes they're LLCs, S Corps, or other structures, so that on its face doesn't sound like it works. But the reality is that it does, because you structure this in a way. You have top Co LLC, which is your search fund that then forms a wholly owned C Corporation, which is the entity that issues the qualified Small Business stock. That entity is the buyer of either the assets or the equity of the of the target. So your investors invest the cash into the LLC. The LLC then acquires the qualified Small Business stock by funding the C Corp to pay the purchase price. The C Corp then takes that cash and buys the business. So it's the intervening hold co in that structure. And in almost all search fund structures that serves as the QSBS entity.

**S****Steve Divitkos 09:18**

Got it. So just because your search fund is structured as an LLC that does not preclude you necessarily from pursuing this treatment, and just because the target company may not be a C Corp, that also does not necessarily preclude you from pursuing this treatment. So I'd like to talk to you guys about the applicability of this program under two different investment theses. So in investment thesis A, the searcher is planning to return a material amount of capital back to her investors by way of regular dividends. In investment thesis B, the searcher, as is typically the case, is planning for this substantial majority of capital, capital to be returned to her investors at the end of the whole period, typically upon the sale of the company. So can you speak to each of those investment theses, again, A is dividend heavy. B is, you know, substantially all the money is coming back at exit. Can you talk about like the applicability or usefulness of the program under each scenario?

K

Kevin Christmas 11:03

Yeah, why don't I touch on this high level, and then Brandon can give some some of the additional details. But if you jump to the second one, so that that inherently sort of describes kind of the ideal fit for a QSBS transaction, there's no intention of making distributions. You're going to hold and reinvest profits and then have an and then have an exit. That is one in which, assuming all the other criteria are met, is a pretty easy analysis, assuming your investors are all on board with it, because you don't have to jump through any of these other sort of modeling exercises that will get into, or that Brandon can get into in more detail. The first, so the scenario where she's the the searcher is planning to return a material amount of capital back to the investors by dividends throughout the life cycle, before the exit. That would seem on its face as one that that is sort of just easy to say no to. But the practical reality is that it really comes down to a modeling exercise where you look at compare the anticipated distributions or dividends the corresponding tax rate. And then compare that to what would happen in a pass through structure, where the the income is being sort of allocated up on a pass through basis, and you're likely needing to make tax distributions to your investors. So the answer on the second one seems to be a pretty easy no brainer. The first one is a little more nuanced and is not a necessary No. So Brandon, I don't know if you want to chime in a little bit on sort of the kind of how we would think about that modeling exercise to do in Scenario one.

B

Brandon Bloom 12:34

Yeah, I mean, and I'd also just say that 1202 can be beneficial in either scenario. If you're going to be making regular dividend distributions when you're a C Corp, you are incurring a double layer of tax, right? Because the C Corp itself is going to pay tax on the operating income, and then when you dividend that money out to your investors or shareholders, they're going to incur a second level of tax on the dividends. And so that's the so called double tax of a C Corp. Now, even if you're doing that and you get to the end of the investment and you sell the C Corp as QSBS, you still get to exclude the capital gain from tax at that point. It's just that the dividend tax you've occurred incurred along the way is kind of a drag on your after tax return. The ideal situation, like Kevin says, is you really never take any dividend distributions from the company. You reinvest all of those operating profits back into the growth of the business, and then your only monetization event is really at exit when you sell the stock, and that's under 1202 that's tax free. And so you can see why 1202 can work in either scenario, but it's really most efficient when you don't take dividend distributions. And so you know the to kind of get into the details of the tax rates, right? If we were just a flow through business. And this is when searchers and investors are running these models, and they're trying to come up with, you know, how much is structuring this as QSBS really going to save me? The comparison, right is I'm going to project the next five to seven years, or however, long before exit in a flow through structure, versus in a C Corp structure. And what does that look like for the next five to seven years, and what does that look like on exit. And so in a C Corp world, you are showing a C Corp tax on the operating income of 21% at the federal level, plus any state taxes, and then another 20% on the after tax dollars, on any dividends, and then a tax free exit. When you do the math on that double level of tax, when you are distributing dividends, what you ultimately get to is a combined rate of 36.8% right, which is very close to the pass through tax rate of 37% right? When they lowered C Corp rates in 2017 they did it very intentionally, so that the double tax rate is very close to the pass through rate, but on exit is where it really starts to make a difference, right? The QSBS benefits going to mean you can sell the C Corp tax free, or as in a flow through business, you're going to recognize gain on the exit. So while the flow through structure provides you only one level of tax, and we say one level, even though any dividends are not being made, because that income flows through to the owners, and you're having to make tax distributions to those owners so that they can fund their tax obligations. So you view those tax distributions essentially as one level of tax that the business is incurring, and so but you still incur the tax on exit, and so that that modeling really helps you see what the benefit of the QSBS eligibility is. So all that to say, the modeling is very helpful in this case, and the assumptions that go into the model is very important. I guess the one thing I'd touch on too is the reason we see a spike in popularity in QSBS in the last few years that Kevin mentioned earlier, but when 1202 was first enacted, C Corp tax rates were 35% so when you committed to this structure, you were taking on more of a risk of that entity level tax, right? That C Corp was going to be paying tax at 35% plus state rates, and so it wasn't as beneficial, because you might get an exit that's tax free, but you're paying a lot of C Corp tax along the way. But since 2017 and since C Corp rates have come down to 21%, the 1202 benefit really has never been better than it is right now. And so you're seeing a lot more people think about this structure, because there's not as much cost to it as there used to be.

**S****Steve Divitkos 17:09**

I'd love to dig into the investors perspective, because in, you know, absent the QSBS program and structuring, in a quote, unquote typical scenario, the search fund is structured as an LLC, once they acquire a company, the company does not directly pay income tax at the corporate level. The investors pay taxes, and those taxes are funded through something called tax distribution. So I owe \$100 to the government. Here you go, investors, here's \$100 you'll pay the government on my behalf. That's kind of at 100,000 foot level. That's kind of how it works in a typical structure with qsbs treatment. I'd like to get into, like, the tactical, practical considerations for an investor. So do they still get K1s? Do they still pay taxes on behalf of their investee companies via tax distribution? So can you just talk about, like, the mechanics from an investor's perspective and any gotchas that they ought to be aware of in QSBS structures?

**B****Brandon Bloom 18:08**

Yeah, I'll jump in with a couple of thoughts there, and Kevin can chime in too with anything, yeah, but the the structure from the investors perspective, as far as what type of entity they're investing in, does not look that much different when you're doing a QSBS structure, because in most of these structures, we will still have an LLC at the top of the organizational chart, and that LLC will be taxed as a partnership. And so the investor is still putting money into an LLC taxed as a partnership. It's just that that money is then flowing down from that LLC into a C Corp, right? And so what that means up at the LLC level is that there really is no flow through income of that LLC, because all that LLC really does is own a C Corp. And because a C Corp pays C Corp level tax, there is no income that is flowing through to the investors. So while they might be getting K1s every year, they're those K1s are really just they just have zeros on them, right? Because there's no income to the LLC itself, and because the C Corp is paying all the tax down at the C Corp level, there's no need to make distributions up for taxes, because the K1s for the investors don't show any flow through income. It's what we call a dry partnership. So the LLC is a dry partnership in the sense that it has no flow through income. There's there's no complicated K1s, there's no allocations of income. There's no need to make tax distributions. From that perspective, it's a lot cleaner on the on the investors perspective, because they don't have to deal with paying paying taxes in different states, filing returns in all these different jurisdictions, and handling tax distributions. So the C Corp simplifies a lot of things, actually, in addition to the QSBS benefit.

**S****Steve Divitkos 19:57**

So when I first learned about this program, my first response was effectively, like, this sounds too good to be true. Like, there's got to be a gotcha in there somewhere, right? So I'm listening to this. I'm hearing as an investor, certainly as a searcher, okay, I can protect ten million or more of exit proceeds from capital gains. And hey, by the way, it also appears to be administratively easier, given the dynamics that you just walked through Brandon. So if anyone listening to this is having the too good to be true, reaction, can you potentially, can you just speak to that at a general level? Are there any gotchas hidden in the fine print that we ought to be aware of as investors?

B

Brandon Bloom 20:35

Yeah, for sure. Kevin, you want to take that one.

K

Kevin Christmas 20:38

Yeah, I'll chime in with some general thoughts, and then you come back over. But I mean, the gotchas inherent in this are making sure that you have good counsel and tax advisors to confirm that you meet the requirements and do it correctly, and therefore take a position on your final tax return upon exit that's correct and consistent with this. Because this isn't a, apply for QSBS and get an answer from the IRS type scenario you need to get, get have confidence and get comfort that that you're structuring this correctly. So the gotchas inherently lie in failing to do that. There are some other gotchas associated with it in, I don't we could get sort of a little too detailed to some degree, but, you know, with respect to whether you're doing redemptions of stock throughout the process, and those kind of things which can create ways in which you can sort of, you know, kind of destroy the benefits associated with it. But that largely doesn't happen in search fund structures, because if you ever redeem somebody, it would be up at the LLC level. But those are kind of the areas where you can, you know, foot fault or worse. The other kind of Gotcha, it's not really a gotcha, but it's something that investors will bring up from time to time, which is this sort of inherent thought that upon exit, you have to sell the C Corp and buyers are less inclined to buy C corps in particular, private equity buyers, because it's an inefficient structure, and, you know, they don't like to do it. While that is sort of a general statement, and it's generally true to some degree in our experience. You know, these buyers in particular, if it's a competitive sale process, will purchase C corps. They may discount the purchase price slightly as a result of the inefficient, inefficient tax structure and the, you know, lack of step up and basis and all that goes along with that. But typically that, you know, sort of that reduction in purchase price or offset, or however it's structured, is easily outweighed by the benefits associated with the BSQ structure. So again, a couple of sort of foot faults and gotchas, and then a couple of sort of responses that some investors may have relative to thinking about this in the future and sort of on exit.

**B****Brandon Bloom 22:53**

Yeah. I think I agree with all those. And I would say the overarching concern about C Corps is that it's an inflexible structure, if you ever try to get out of it, once you get into a C Corp structure, it's hard to get out of a C Corp structure without triggering some tax obligation. But dividend recaps are a good example of things that are just not as easy or not as efficient to do with a C Corp, because trying to do a dividend recap and distributing money out of the C Corp, you're going to trigger that dividend tax that no one likes to trigger. And the other thing that people think about is, you know, well, what if I get into this structure and I realize I want to sell before five years? And there's always options to consider at that point. But obviously, if you don't hold the stock for five years, you don't get the benefit on the exit. But there's other options to pursue at that point. There's a related code section to 1202, Section 1045, which allows you to sell BSQ before five years, and as long as you reinvest the proceeds into some other qualified small business, you can defer the gain on that sale. And so while you are kind of committing to the structure going into it without knowing how things are going to pan out, there are some options, and there's some ways to tackle the downsides that pop up.

**S****Steve Divitkos 24:19**

I'd love to talk about some exceptions, particularly from an industry perspective. And the reason why I asked this question is because I'm currently alongside one of the searchers that I'm supporting, looking at a healthcare services deal, and I came to learn that that industry is not subject to QSBS treatment. Said another way, it wouldn't qualify strictly by virtue of the industry in which it operates. So can you guys just talk to industry specific exemptions at a general level, and maybe also just speak to like why certain types of businesses or certain types of industries are exempt from this program?

K

Kevin Christmas 24:57

Yeah, I'll hit sort of the ones that are exempted. And then Brandon can chime in with some of the why's but, but the So, the general rule is that under 1202, sort of any trade or business other than and then there's a litany of of businesses that that don't apply. And I'll get into those. And it's typically focused around, you know, professional services type businesses that it does not apply to, you know, as Brandon alluded to earlier, the idea behind all this was invest in small businesses that are producing something outside of just a professional service. And so the list includes, you know, businesses involving performances of services in health, law, engineering, architecture, accounting, consulting, athletics, financial services, brokerage, banking, insurance, farming, investing, and then sort of hospitality, hotels and restaurant operations. I think the important thing to note is that those are obviously illustrative and give good guidance as to what you can do, but it's a facts and circumstance test. So again, you're not submitting an application and getting an approval unless you were to submit a letter to the IRS asking for a letter ruling. Which I'll get into in a minute, but you need to, so it's important to work with your advisors to figure it out and to make sure that you know that you do qualify, or if you think you don't, make sure that that that's correct. You know, as I said, there's not necessarily a bright line test outside of those, the list of kind of exempted items. And so you often have to look to what are called IRS letter rulings, which is when somebody has submitted a notice to the IRS that said, I'm looking at acquiring this business or starting this business. It's in this industry, and it does X, Y and Z, would this qualify? And so those are are published and available, sort of just like you would look at case law. If you were doing a sort of, you're involved in litigation, you kind of look at those for guidance. So that's, that's kind of a very high level overview. Brandon, you want to chime in with anything you have to add there?

**B****Brandon Bloom 27:14**

Yeah, I'd say when you start getting into the details of Section 1202, you realize there's a lot of gray area on some of these things, and this particular issue about whether or not the business qualifies, it can get difficult to say with certainty. Because some of these categories of businesses are not well defined. And so, you know, we may have a business that we're looking at that they would say, Look, we sell software as a service. We're a SaaS business, but we also do some consulting. We also, you know, charge our customers a fee for consulting. And then the question is, okay, well, that does that make you a consulting business for 1202, because that means you're out. And so we have to kind of look at the business and say, Okay, well, how much of your business is consulting? Is there any way to characterize that revenue differently so that there's not so much risk around this issue? And so there's a lot of gray areas where things aren't well defined. And that's where, you know, you start to look at, how do I get more certainty on this? Do I need to go to the IRS and ask them to bless my structure before I go into it and things like that? So there can be some tough calls sometimes with 1202 when the business is kind of on the edge of whether or not you qualify. You know the reasons Steve, you asked, you know why are some of these businesses excluded? And there's not a lot of legislative history on this particular point. But you know, I think what you can glean from the rules and where this kind of distinction is drawn in other parts of the tax code is that what they're really trying to encourage is capital investment into businesses that provide some type of product or good. Or even a service that is more like a product or good and not so much of a professional service or an advisory service. And in other parts of the code where this distinction is drawn, what they're really what from a policy perspective when they're writing these laws, what they're really trying to do is encourage capital investment in businesses that grow by scale or generate goodwill. But businesses that are really more in the nature of someone's unique abilities or skills, like a doctor or a lawyer or an accountant or an engineer, those are not necessarily the businesses that they're looking to subsidize here. And so a lot of tax policy is that that type of income earned by those types of services really is just compensation income. It shouldn't be taxed any differently than someone's salary, but if it's a business. Manufacturing a good or producing a product that's more of a capital intensive business, so let's encourage the capital investment in those businesses. So unfortunately, Kevin and I, as lawyers, we don't get these types of benefits. We just charge by the hour. But it's really a tax policy that kind of permeates throughout a lot of areas of the tax code, which is why, if some businesses qualify for these types of things and some businesses don't.

**S****Steve Divitkos 30:27**

Okay, so ultimately, whether or not you are providing a good or service sounds like it's very nuanced, as is the case with most things taxed. So just because you think you are providing a service, that does not necessarily preclude you from going down the qsps path. And actually, the example that you mentioned is particularly top of mind, software as a service. Right? In some ways, the word service is quite literally in the name of the industry, but in other ways, you know more matter of factly, you are very much selling a product. I mean, you're selling access to a code base. And so whether or not a software company, for example, is providing a product or a service, certainly sounds like something that requires more nuanced analysis.

**B****Brandon Bloom 31:13**

Yeah, I agree. I mean, we look, we see a lot of SaaS businesses and and I don't think we have any question that most of these businesses qualify. It's when the business really is kind of doing some, you know, providing software as a service, but also doing a lot of consulting and advisory work in connection with their business, and where we have to take a closer look. But I think providing software as a service is very akin to making a product, right? That's how people think about those businesses. And so yes, that's the right way to think about it.

**S****Steve Divitkos 31:48**

So as you guys know, the substantial majority of search fund transactions include one of or two of, or sometimes all of, a seller note, an earn out or an equity role. Can you guys just speak to these very common deal structuring mechanisms and talk to whether or not they complicate or preclude QSBS treatment?

**K****Kevin Christmas 32:12**

Yeah. I mean, just from a very high level. I mean they they do not preclude it, and they can be structured in ways in which, in which they do not preclude it. The area that gets a little bit interesting and a little bit technical is the rollover structure, and whether or not the rollover seller can get the benefit of 1202 on a on a subsequent exit. And that's the piece of the puzzle that likely requires the most sort of thought and input. With anything the seller note or the earn out, there are structuring considerations as to kind of like where things sit and how the money flows and that sort of thing. But those are things that are pretty easily worked out and not really something to at least from my perspective, Brandon can chime in things differently to really sweat about. It's the earn out that can be a little bit tricky, and not in a way that it's like the earn out, if it's structured correctly, would sort of ruin the sort of 1202 treatment, but at least, sort of the more relevant piece of it is whether the the rollover holder can get the treatment. There are certainly ways in which you could impact the use of 1202 with a rollover. But I don't see that as common. And it's pretty easy as long as you have an advisor that kind of knows what they're doing with these structures, it shouldn't be an issue. But Brandon let me know if you have different thoughts.

B

Brandon Bloom 33:38

Yeah, that's right. I mean, I'd say, usually, we can structure just about any acquisition, regardless of what the target is currently structured as, we can structure the acquisition in a way that's going to allow the new investors to get QSBS treatment, assuming the business qualifies, and all those other things. There's there's usually not a whole lot about the acquisition itself, that's going to preclude 1202 unless it's kind of unique in the sense that maybe you're not acquiring a controlling position, which is not the case with search funds, but it can come up in other deals where maybe you're more of a minority investor, or growth investor, or something like that. There can be some structural considerations that make it more difficult to qualify for 12 or two in those cases, those cases. But usually there's not a lot about the acquisition itself that's going to be a big obstacle. Other than, like Kevin said, we do have to give a fair amount of thought around rollover and how we structure that so that those rollover holders might get the same benefit as the new investors. I guess, the other thing you have to think about is, when you go to acquire the next company an add on acquisition, or you're putting more growth capital into the company, anytime you're putting more capital into the company, you want to structure that in a way that's going to qualify for QSBS, and there's always considerations there too. Because simply just putting the money into the company and using it to go buy another company doesn't always work. You need to actually issue new shares so that you can identify those shares as QSPS, and just kind of jump through the hoops each time you're making a new capital investment. So in my attempt to kind of tie a bow around this conversation. Let's say I can acquire a C Corp or absent that I can form a C Corp that itself can acquire the company in question. It's less than \$50 million in enterprise value. My plan is to hold it for five years or more. I suspect that most of the capital will be returned to my investors via exit proceeds. I'm in an industry that qualifies. This is probably a silly question, but is there a reason I wouldn't pursue this? And why do you think more folks are not pursuing this? Is it as simple as, like, a lack of awareness around the program?

K

Kevin Christmas 35:56

I'll start at the end. I mean, I think yes, to some degree, it's a lack of awareness thing, one sort of caveat I wanted to mention in the examples that you gave, that there really isn't a scenario where you could acquire a C Corp without the structuring that we talked about, setting up a new C Corp, and get 1202 because it has to be an original issuance of stock, meaning they can't be buying the stock from another person. So just a little technical point, but yeah, so why is this not used more often? People are concerned about the five year hold period and being boxed in. Sometimes there are international investors, or a sort of majority of international investors, and the thought is they don't get the benefit of 1202, so why go down this path? The interesting nuance there is that some international investors are the ones that are the most intrigued by this, largely because it puts a C Corp in the structure, which functions as a blocker. So I think the important sort of point there is for searchers to recognize, even if you have international investors and they don't get, you know, they're not US taxpayers or whatever it is, so they don't get the true benefit of this, don't stop there, pursue it and see if it works, because oftentimes there is a benefit associated with it in that construct. The other reason people don't do it is something that Brandon pointed out. If you know they're not, there's uncertainty around how you're going to get to a liquidity event. Is it going to be a dividend recap? Is there going to be some other structure that's not going to involve sort of a true exit in the context of a sale of the of the applicable C Corp, and then the last one is something that happened here recently, right? Is the uncertainty around legislative changes, the election, what happens to C Corp tax rates if there was a different administration, and all the things that go along with that. And so those things create some uncertainty. But I think the probably biggest driver is lack of familiarity with the program and what it means.

S

Steve Divitkos 38:07

On the five year hold period in particular, of course, it's very, very difficult to know at the outset of an investment what the whole period is going to be. We can have a general idea, but of course, we don't know. Let's say that three years into our investment thesis, despite our original plans, an offer comes across the table that knocks our socks off, and it would be imprudent not to take it what and we did three years prior pursue this QSBS treatment. What would actually happen if we sold within that five year window? Are we quote, unquote, penalized in some way, or do we simply just pay the tax rate that we would have otherwise paid in a more traditional structure? Can you just speak to that?

**B****Brandon Bloom 38:48**

Yeah. I mean, you're right. I mean, effectively, you would just be in the same boat you would be in if you never set it up to qualify for 1202 to begin with, and you would pay capital gain on the sale, assuming you've held it for at least one year. And so, from that perspective, you get three years into it, someone gives you an offer you can't refuse, you're no worse off. You're still just paying capital gains tax like you would had 1202, not existed. And that's why a lot of people get comfortable with the structure, because they know they're committing to it, but even if they sell before the five years, they're really no worse off assuming they've kind of gotten comfortable with their modeling and all those things. And, you know, there's also investor level decisions to be made there as well, because, like I said, there's a rollover provision that allows investors to take proceeds from the sale of QSBS that has not been held for five years and reinvested into a new qualified small business, and defer that game and kick that can down the road further. So even if you sell before five years, doesn't mean you have completely lost the benefit, necessarily, but you're no worse off.

**K****Kevin Christmas 40:05**

Yeah, and like I mentioned before, it's not like you're, I don't know. You're making an S election to be an S corp, or checking the box, or you're not making an election at the time you're doing this, you're looking, such that you would have to undo anything. I mean, you're making a decision to move forward in a structure that that could, if you go down the right path, have these benefits, but there's not some punitive measure associated with it, with an early exit outside of just paying the sort of tax like you normally would.

**S****Steve Divitkos 40:32**

Got it. So like we mentioned at the outset of the episode, the intent today was not to cover every single consideration that one ought to consider prior to pursuing this type of treatment, but instead, to give a high level overview of, let's call it the art of the possible, for those searchers and or investors who are interested in learning more, what's the best place and what's the best way to get in touch with both of you?

**K****Kevin Christmas 40:59**

Great question. Appreciate the softball. So the first is we have recently, actually, back in October, so not necessarily that recent, but we put out a white paper on, sort of effectively a look at 1202 in the search fund context. It's very detailed, covers more than what we talked about here, that is available on our search fund landing page at HKLaw.com and then both of our contact details are available there as well, and some additional resources for searchers, but the level of detail that folks will be looking for is set out in that white paper.

**S** Steve Divitkos 41:43

Fantastic. And for anyone who wants to read that white paper, I will link to it directly in the show notes, so feel free to just click on it. Kevin, Brandon, thank you so much for your time today. We really appreciate you joining us.

**K** Kevin Christmas 41:53

Appreciate you having us.