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Sweetening VC Secondaries With QSBS

CapGains HansonBridgett

In December 2023, the Venture Capital Journal examined whether 2024 would be the year of VC secondaries.[1] A confluence of factors makes the timing ripe for such deals, and the expected deal activity is already panning out.

Secondary transactions are typically transacted at discounts to the fair market value. The up to 100% capital gains tax exclusion offered by Qualified Small Business Stock (QSBS) can help compensate for a good amount of the lost gains, and with prior planning and the right help, the challenges associated with claiming QSBS can be overcome. Given the competition for secondaries, factoring in QSBS can prove to be a difference maker for both the seller and the buyer.

Beyond Liquidity: Aligning Interests and Amplifying Returns with QSBS

As reported in the VC Journal,[2] one recent secondary involved Primary Venture Partners selling a portion of one of its funds to StepStone Group. This transaction unlocked significant liquidity for Primary's limited partners (LPs), fulfilling the fund's promise to deliver.

"Our job is to send money back to the pensioners, endowments and foundations we manage money for," said Brad Svrluga, co-founder and general partner at Primary was quoted in the VC Journal.[2] "This transaction delivers on that promise, providing our LPs with the opportunity to realize a portion of their investment while allowing us to redeploy capital towards new opportunities."[2]

Both Primary and StepStone remain confident in the fund's long-term potential. The deal helped convert some of the fund's TVPI (Total Value to Paid-In Capital) into DPI (Distribution to Paid-In Capital). Svrluga expressed optimism for the portfolio's future, telling the VC Journal,[2] "If it never delivers another dime, it will be a good fund. We think it's going to deliver three to five times more than it has already delivered."

StepStone's participation in the transaction reflects its confidence in the underlying portfolio and aligns with a growing trend in venture capital (VC), where LPs seek liquidity and GPs explore alternative portfolio management strategies.

> "More GPs are considering whether there are solutions like this [secondary transaction] that translate a high TVPI to a higher level of DPI."
>
> Hunter Somerville, StepStone Group
> (as quoted in the VC Journal[2])

Combining liquidity with the power of up to 100% capital gains tax savings on Qualified Small Business Stock (QSBS) unlocks additional value for investors. This program has played a crucial role in amplifying returns for the fund's partners by allowing them to exclude federal capital gains taxes on qualified investments held for at least five years or rollover those held less than 5-years, and the benefits may even extend beyond federal taxes. Partners residing in states that conform to QSBS regulations can enjoy additional savings on state capital gains taxes.

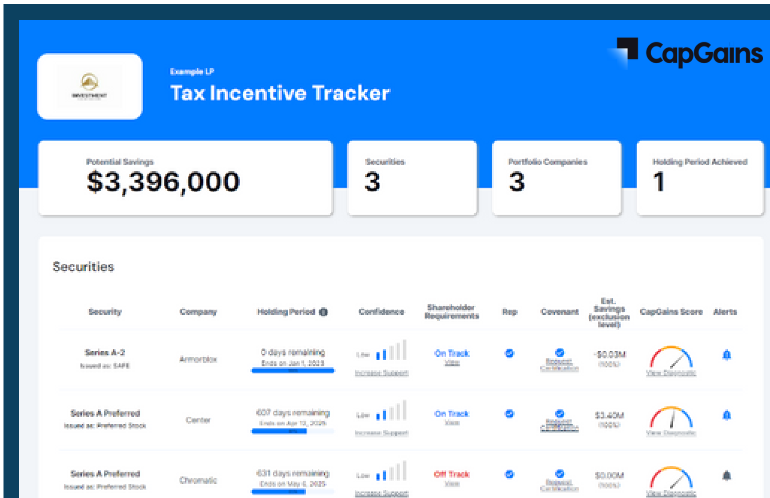
Primary's dedication to securing QSBS benefits for their partners adds icing on the cake of the fund's value proposition. For discerning investors seeking maximized returns, strategic value, and the opportunity to contribute to the growth of innovative businesses, the QSBS advantages present a compelling avenue.

Generating QSBS Eligible Gains

Evaluating whether a security is eligible QSBS is a challenging task that requires a careful analysis of multiple criteria, both regarding the portfolio company itself and the particular securities held. Primary's advanced planning enabled it to ensure that portfolio companies met the requirements for QSBS eligibility and that such benefits would be maximized for their partners.

They utilize CapGains' platform for managing QSBS and analyzing each security for potential eligibility.

In addition to helping to ensure that the eligibility criteria (i.e. entity type, qualified trade, gross asset level, active business requirement, original issuance, holding period requirements, etc.) are met for each security the platform helps the fund avoid "tripwires" that could cause shares not to qualify over the course of the holding period.



Screenshot of CapGains' Platform demo

> "QSBS is an extremely technical area. We are thankful to be able to tap the expertise of CapGains' and Hanson Bridgett to deliver the highest after-tax returns possible."
>
> Mike Witkowski, CFO Primary Venture Partners

In preparation for the liquidity event, CapGains performed a more detailed analysis of each security and identified where additional data would be helpful. The fund then utilized the CapGains platform to request QSBS questionnaires from each relevant portfolio company.

The right to request such confirmations has become typical in Investors' Rights Agreements. However, merely having the right to request this data does not mean that it will be easy to collect or that it will be fully complete. The responsibility for completing these questionnaires typically falls to a company's CFO or General Counsel, but given the complexities of evaluating QSBS eligibility, companies tend to lack the technical knowledge and know-how to fully evaluate whether the criteria were met themselves.

Several such situations encountered included:

(1) Whether at least 80% of the company's assets were utilized in a Qualified Trade (Section 1202(e)(1)(A))

A careful legal analysis can help analyze a company's business activities against how the IRS has viewed similar companies in cases or Private Letter Rulings. QSBS focused attorney, Christopher Karachale of Hanson Bridgett compiled an interactive guide[3] helps to interpret such rulings.

Additionally, a portion of certain SaaS businesses may involve excluded fields such as leasing or banking, so it becomes important to quantify the portion of assets involved in these fields to evaluate if the 80% threshold had been met over "substantially all" of the shareholder's holding period.

(2) If stock repurchases are considered "significant redemptions" and thereby disqualified stock from being QSBS (Section 1202(c)(3)(B))

It is typical that in conjunction with a financing round, a company will repurchase stock from founders, early employees or shareholders. The QSBS regulations prescribe a method for testing whether the redemption rises to the level of being "significant" based on comparing the redemption to the total value of equity both at the time of the redemption and 1-year prior. Often, determining what value to use requires an evaluation of the facts and circumstances and varying rights / preferences of the share classes.

(3) If the Company's gross assets exceeded $50M at the time the securities were issued (Section 1202(d))

Often companies become too large to be considered to be a Qualified Small Business during financing rounds. It is therefore important to measure the tax basis of assets prior to the financing, to help evaluate whether or not the company may cross the $50M threshold and if steps could be taken to maintain the level below the threshold.

Given the complexities of QSBS and the downstream impacts to each individual partner in the fund claiming the exclusion individually, funds play a crucial role in gathering and providing the strongest possible support to their limited partners.

To tie up any potential legal loose ends, Christopher and his team at Hanson Bridgett leveraged both the CapGains' analyses and the QSBS questionnaires received from the portfolio companies to further evaluate the merits of QSBS treatment for the subject securities.

The combination of the QSBS analysis performed by CapGains, the checklists received from each company and the legal memo provided a very comprehensive review to support claiming QSBS, which also provided comfort to the fund's tax preparers when disclosing the QSBS aspects of the gains in the K-1s issued to each partner.

With its thorough and comprehensive approach to QSBS eligibility, partners within Primary can remain confident that the fund is prioritizing their best interests.

More to Come

Investment firms are always on the lookout for ways to increase returns for their stakeholders. The combination of achieving liquidity through secondary transactions and QSBS can unlock significant benefits for investors. We will see if 2024 does indeed become the year of VC secondaries, however, QSBS eligibility could be a critical factor on both sides of the transaction - seller and purchaser.

Navigating the intricacies of QSBS can be challenging. Knowing which securities are likely QSBS eligible can become crucial, and therefore it is important to gather the appropriate data and analyses in advance in order to be ready when liquidity opportunities arise.

The Primary case serves as a compelling example of the mutually beneficial outcomes achievable through strategic partnerships and advanced planning. By leveraging specialized expertise, Primary not only optimized returns for their stakeholders but also demonstrated how they are a leader in responsible and innovative portfolio management.

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Sources

(1) "Will 2024 be the year of VC secondaries?"; Venture Capital Journal - December 22, 2023; article link

(2) "Primary delivers nice payday to LPs via secondary sale to StepStone"; Venture Capital Journal - February 1, 2024; article link

(3) Hanson Bridgett's Interactive Guide to Qualified Trades or Businesses for QSBS Qualification - https://www.hansonbridgett.com/publication/interactive-guide-qualified-trades-or-businesses-qsbs-qualification