The benefits of qualified small business stock

Eligibility requirements of QSBS are stringent, but with proper planning, both when the stock is acquired and when it is sold, shareholders may be able to take advantage of favorable tax provisions.

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Tax laws related to Qualified Small Business Stock (QSBS) provide significant opportunity for the reduction and deferral of taxes generated by the sale of QSBS. Founders, early investors and employees of companies may be able to reduce their tax liability upon the sale of QSBS by investing in the next great startup. Moreover, shareholders may significantly reduce or eliminate tax on a portion of the proceeds when they ultimately dispose of the stock.

What is QSBS?[1]

QSBS is stock in a small, domestic C corporation which operates an active business. To qualify, the corporation must use at least 80 percent of its asset value in the active conduct of one or more qualified trades or businesses. Also, the gross assets of the corporation, as of the date the stock was originally issued, cannot exceed $50 million. A qualified trade or business is defined broadly to include any business other than the following:

– Service businesses, including health, law and financial services.
– Banking, insurance, leasing, real estate, investing or other similar businesses.
– Any farming, mineral extraction or hospitality business.
– Certain specific business structures, including REITs and mutual funds.

In general, a non-corporate shareholder must have acquired stock at its original issue, in exchange for money or property, or as compensation for services rendered. Stock received by gift or at death also generally qualifies for QSBS treatment if all other requirements are met. In addition, certain transfers of QSBS from a partnership to a partner can be made without jeopardizing QSBS status.

The law permits indirect ownership of QSBS by allowing owners of pass-through entities to take advantage of QSBS status when QSBS is sold at the entity level if the following two requirements are met:

– The pass-through held the stock for at least five years.
– The owner of the interest in the pass-through held his or her interest the entire time the QSBS stock was owned.

For purposes of these rules, a pass-through entity includes a partnership, S corporation, regulated investment company or common trust fund.

Rollover of gain

Upon sale of QSBS held for more than six months, the seller may elect to defer realized gain by reinvesting the sale proceeds into new QSBS within 60 days. The seller’s basis in the replacement stock is reduced by the amount of gain deferred. Only non-corporate taxpayers may take advantage of this rollover provision.[2]

Exclusion of gain

The seller of QSBS may also exclude between 50 percent and 100 percent of the gain up to a certain dollar amount on the sale of that stock held for more than five years. The QSBS exclusion is limited to the greater of $10 million of a in or ten times the taxpayer’s cost basis in the stock. Any excess gain is taxed under the normal rules and may be subject to the maximum rate on capital gains.[3]

[1] Internal Revenue Code Section 1045(b); Internal Revenue Code Section 1202(c).
[2] Internal Revenue Code Section 1045.
[3] Internal Revenue Code Section 1202.

The exclusion percentage is determined based on the acquisition date of the stock as follows:

Federal gain exclusion

Acquisition date	Percent exclusion
Before February 18, 2009	50%
February 18, 2009 – September 27, 2010	75%
After September 27, 2010	100%

Stock received in a tax-free acquisition gets special QSBS treatment as well, even if the stock in the acquiring company would not otherwise qualify as QSBS. The new stock will continue to qualify as QSBS up to the amount of gain at the time of the acquisition (see "Acquisition Example" below).

Effective tax rates on QSBS

The benefit of the exclusions outlined above must be evaluated in light of the applicable tax rate. The QSBS rules were enacted in 1993, when the maximum capital gain rate was 28 percent. The exclusion is applied to the capital gain rate from 1993, not today's rate of 20 percent. As such, stock subject to the 50 percent exclusion is effectively taxed at 14 percent. Because of this rule, the benefits of the QSBS provisions for stock subject to the 50 percent exclusion are limited—a 14 percent tax rate rather than the current 20 percent rate for long-term capital gain. Of course, for QSBS qualifying for higher percentage exclusions, the size of the exclusions likely more than outweighs the higher rates. And while the QSBS rate could change, the capital gains rate may continue to increase by the time newly issued QSBS is sold. It is of particular note that the amount of QSBS gain excluded from income also avoids the 3.8 percent Medicare surtax. The surtax is calculated on net investment income which only includes net gains includable in taxable income. Because gain on the sale of QSBS stock is excluded from taxable income, the Medicare surtax would not apply to the amounts excluded from computing taxable income.

Alternative minimum tax treatment

Some of the benefit of the QSBS exclusion is diminished by the rules related to the alternative minimum tax (AMT). A portion of excluded gain is a preference item for AMT purposes. This means that it is added back to taxable income for purposes of calculating the alternative minimum tax. (The purpose of AMT is to ensure that high income taxpayers pay income tax at a rate of at least 26 or 28 percent.) For sales that qualify for the 100 percent gain exclusion, the excluded gain is not a preference item for AMT purposes.

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State income tax

Clients in states with a state level income tax will need to determine how their particular state treats the gain from the sale of QSBS. While the benefit of the 50 and 75 percent exclusions is lessened by the AMT at the federal level, the benefit of QSBS may be significant for clients in states that have adopted the QSBS rules for state income tax purposes. Of course, each state is different, and the rules must be examined closely to determine the benefit.

Some states have simply adopted the federal framework without change, while others have modified the federal rules significantly to limit or eliminate the QSBS exclusions. For example, California has adopted the federal law provisions with a number of significant modifications. California previously

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had legislation that generally complied with the federal rules on QSBS, allowing for QSBS rollovers and gain exclusions for California tax purposes. In reaction to a state Court of Appeals decision interpreting California's QSBS law, the California Franchise Tax Board (FTB) in late 2012 declared invalid and unenforceable the California QSBS rules. As a result, California taxpayers who had previously claimed QSBS rollovers or exclusions for state income tax purposes were forced to file amended state returns and pay back California tax. Going forward California taxpayers would not receive the benefits of QSBS treatment for state income tax purposes.

In early October 2013, legislation was passed to, in part, reverse the FTB's position. For sales that occurred between 2008 and 2012, California taxpayers may take advantage of QSBS rollover and the 50 percent gain exclusion for state income tax purposes. The legislation allows the exclusion for sales of QSBS where 80 percent of the payroll of the subject company was paid in the state of California when the stock was issued. Note this is more lenient than previous rules, which required that 80 percent of the business activity occurred in California during substantially all of the taxpayer's holding period.

As a result of all of these rules, any sale of QSBS after 2012 receives no special tax benefit under California law, and is an example of a state which has chosen to limit the applicability of QSBS. While these variations have occurred at the state level, the federal provisions for gain exclusion and deferral of QSBS remain unchanged, effective, and available for all eligible taxpayers.

General example

To illustrate the benefits of QSBS, assume that in January 2014, Joe Entrepreneur invests in Tech Inc., purchasing a 10 percent ownership interest in the company for $500,000. Tech Inc. is a startup technology company with roughly $5 million in assets, consisting primarily of intellectual property. The Tech Inc. stock that Joe purchased meets the requirements of QSBS. In July 2019, Tech Inc. is acquired in a cash deal for $200 million. Joe receives $20 million for his 10 percent interest in the company. Because he held the stock for more than five years, Joe is able to exclude 100 percent of the first $10 million of gain upon the sale for federal capital gains tax purposes, leaving him with $9.5 million of gain. In August 2019, Joe chooses to invest $5 million of the sale proceeds into a new company that meets the requirements for QSBS. By using a part of the sale proceeds to invest in a qualified small business, Joe is able to defer $5 million of gain. Joe's basis in his stock of the new company is zero as a result of the $5 million gain deferral. The remaining $4.5 million of gain from the sale of Tech Inc. is subject to federal capital gains tax and the Medicare surtax. After taking advantage of both the exclusion and rollover provisions of QSBS, of the $20 million sales proceeds, only $4.5 million is treated as long-term capital gain on which Joe must currently pay federal tax.[4]

Acquisition example

As noted above, stock in an acquiring company received in a tax-free exchange remains QSBS after the transaction up to the amount of gain at the time of the acquisition. Any growth after the transaction will not be eligible for QSBS treatment unless the stock in the acquiring company qualifies as QSBS on its own.[5] To illustrate, assume two years ago in 2017 Joe Employee purchased 1,000,000 shares of Morning, Inc. for $1 per share. The stock was QSBS in Joe's hands. In 2019, Morning, Inc. is acquired in a tax-free, stock for stock

[4] This example does not incorporate an AMT calculation, because QSBS gain that qualifies for the 100 percent exclusion is not a preference item for AMT purposes.
[5] Internal Revenue Code Section 1202(h).

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transaction by Afternoon, Inc., which is not a qualified small business at the time of the acquisition. Joe receives 1,000,000 shares of Afternoon, Inc. for all of his Morning, Inc. shares, with a current value of $10 per share. Joe's $1 per share cost basis in his Morning, Inc. shares carries over to his Afternoon, Inc. shares. Joe sells his Afternoon, Inc. stock in 2022 for $15 per share. Joe recovers his $1 per share cost basis, and for federal tax purposes, may only exclude the $9 per share of QSBS gain that existed at the time of the acquisition, paying tax on the remaining $5 per share.

Conclusion

In light of the 100 percent gain exclusion for QSBS acquired after September 27, 2010, new small business investments may be more attractive than previously imagined. Eligibility requirements of QSBS are stringent, but with proper planning both when the stock is acquired and when it is sold, shareholders may be able to take advantage of favorable tax provisions.

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