Qualified Small Business Stock (QSBS)

Raymond James Global Wealth Solutions

QSBS BACKGROUND AND BASICS

The purpose of the Qualified Small Business (QSB) Stock provisions under current federal income tax law is to promote direct investment in certain start-up small businesses and to reward successful risk taking. This is achieved through two special statutory provisions under the Internal Revenue Code (IRC) which allow a *non-corporate* taxpayer who sells QSB stock (or QSBS) for a gain to:

- Exclude from taxable income a specified percentage of gain (IRC §1202), and/or
- Defer (or rollover) gain from the sale (IRC §1045).

What is QSB stock? Generally, QSB stock must:

- Be issued by a domestic C corporation with assets not exceeding $50 million before and immediately after issuance of QSB stock (although the assets may later exceed $50 million without tainting QSB status);
- Be an "active" "qualified trade or business" (see below); and
- Satisfy several additional requirements.

A "qualified trade or business" means any trade or business other than:

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
- Any banking, insurance, financing, leasing investing or similar business;
- Any farming business (including the business of raising or harvesting trees); and
- Any business involving the production or extraction of natural resources for which a percentage depletion deduction is allowed.

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EXCLUSION OF GAIN FROM THE SALE OF QSB STOCK

IRC §1202 excludes a percentage of gain (50%, 75% or 100%) on the sale or exchange of QSBS held for more than five years, and the percentage of exclusion (the "exclusion percentage") depends on the date on which the QSBS was acquired. More specifically, a non-corporate taxpayer may exclude from taxable income a specified portion of capital gain from sale if original issuance QSBS is held more than 5 years and acquired as follows:

- 50% exclusion for QSBS acquired from Aug. 11, 1993 - Feb. 17, 2009.
- 75% exclusion for QSBS acquired from Feb. 18, 2009 - Sep. 27, 2010.
- 100% exclusion for QSBS acquired after Sep. 28, 2010.

Including the 3.8% tax on net investment income (Medicare surtax), the following chart states the maximum effective tax rates and exclusions, depending on whether the taxpayer is in AMT or not:

Acquisition Date	Exclusion %	Max QSBS Tax Rate	Max QSBS AMT Rate	Max Rate (No QSBS)
8/11/1993-2/17/2009	50%	15.90%	16.88%	23.80%
2/18/2009-9/27/2010	75%	7.95%	17.37%	23.80%
After 9/27/2010	100%	0.00%	0.00%	23.80%

Source of chart: "Qualified Small Business Stock (The Next Big Bang) - The Quest for Quantum Exclusions (Queries, Qualms, and Qualifications)," by Paul S. Lee, L. Joseph Comeau, Julie M. Kwon, and Syida C. Long, Heckerling Institute on Estate Planning, January 2019.

Other requirements for and comments about gain exclusion:

- Although a certain percentage of gain is excluded (depending on the applicable "exclusion percentage") (aka the "excluded" or "§1202 gain"), the "non-excluded gain" is taxed at 28%, not the 20% preferential long term capital gain rate. And any gain in excess of the exclusion ("non-§1202 gain") is taxed at a maximum rate of 23.80%.
- §1202 is not elective. In other words, exclusion is mandatory if the gain qualifies.
- Since 2003, 7% of the excluded gain has been a tax preference item for alternative minimum tax (AMT) purposes, but only for the 50% and 75% exclusion percentages.
- Generally, there is no significant benefit with the 50% and 75% exclusion percentages because the non- excluded gain is taxed at a 28% tax rate and due to the AMT preference.
- However, a substantial benefit is available with the 100% exclusion because the AMT preference only applies to the 50% and 75% exclusion percentages.
- In some situations, the sale of QSBS may be subject to a higher rate than if §1202 didn't apply, e.g., stock entitled to a 50% exclusion sold when the taxpayer's highest tax bracket is 15%.
- Certain other miscellaneous requirements under §1202.

For example, a taxpayer has a tax basis in QSBS of $5 million worth $100 million. Assuming the 50% limitation applies, the QSBS otherwise qualifies under §1202 and AMT does not apply, if a taxpayer sells the stock for $100 million, the resulting tax liability is determined, as follows:

Category Of Gain	Amount of Gain	Max Tax Rate	Federal Income Tax Liability
Excluded §1202 Gain	$25,000,000	0.00%	$0
§1202 Gain	$25,000,000	31.80%	$7,950,000
Non-§1202 Gain	$25,000,000	23.80%	$10,710,000
Totals	$95,000,000		$18,660,000

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ADVANTAGES OF GAIN DEFERRAL UNDER §1202:

- Permanently avoids taxation of a specified portion of capital gain.
- Avoid the 3.8% tax on net investment income (Medicare surtax) on excluded gain.
- Although there could be minimal federal income tax benefit for the 50% and 75% exclusions (due to the AMT preference), there may be a potential state income tax benefit.
- The 100% exclusion percentage with no AMT preference was permanently extended in 2015.
- QSBS basis steps-up to FMV at death and QSBS status and holding period carryover to heirs.
- Although there is no basis step-up for gifted QSBS, the holding period does carryover.
- A charitable gift of QSBS does avoid recognition of gain.
- A charitable remainder trust (CRT) may be an ideal strategy for a charitable gift.
- A taxpayer can multiply the Per-Issuer limitation (described below) with careful planning.

DISADVANTAGES OF GAIN EXCLUSION UNDER §1202:

- §1202 is only available for the non-corporate shareholders of a C Corporation.
- There are strict IRS requirements.
- Complexity and compliance costs.
- Exclusion is mandatory if gain qualifies.
- Excluded gain is limited to the greater of $10 million* or 10 times basis of QSBS sold in the year (the Per-Issuer limitation) and the $10 million exclusion limit is cumulative. * Note the $10 million lifetime cap is reduced by aggregate eligible gain for the taxpayer in prior years.
- Any portion of gain treated as ordinary income is taxed currently and not excluded.
- Minimal benefit is likely for the 50% and 75% exclusions due to capital gain rate structure (28% rate for non-excluded gain is locked-in based on the rate in effect in 1993 when §1202 was enacted) and AMT preference for 7% of excluded gain
- QSBS gain exclusion benefits are not available in or modified by some states.

DEFERRAL OF GAIN FROM THE SALE OF QSB STOCK

IRC §1045 allows a non-corporate taxpayer to defer capital gain (and the resulting taxation) from the sale of QSB stock by rolling over gain into another QSB investment if the shareholder:

- Has held original QSB stock for more than 6 months;
- Reinvests proceeds in another QSB within 60 days of sale; and
- Makes a special election on its tax return for the year of sale.

- Other rules/requirements for gain deferral:
    - Deferral/rollover under §1045 is elective if gain qualifies.
    - Deferral available only to extent the amount realized does not exceed the cost of the new QSBS purchased within the 60 day period after the sale less the portion of such cost already used to shelter gain under §1045 with other investments.
    - Certain other miscellaneous requirements under §1045.

ADVANTAGES OF GAIN DEFERRAL UNDER §1045:

- Can defer all or part of capital gain.
- The 3.8% Medicare surtax is also deferred.
- Tax rates could be lower in the year the deferred gain is subsequently recognized.
- QSBS basis step-up at death and status and carryover holding period for QSBS passing to heirs.
- No step-up for QSBS received as a gift but holding period does carryover.
- Charitable gift of QSBS doesn't trigger gain recognition (e.g., gain is permanently avoided).
- A charitable remainder trust (CRT) may be ideal for a charitable gift.
- Rollover provision is elective by the taxpayer if the gain qualifies.

DISADVANTAGES OF GAIN EXCLUSION UNDER §1045:

- IRC §1045 is only available for non-corporate shareholders of a C Corporation.
- Strict IRS requirements.
- Complexity and compliance costs.
- Any portion of gain treated as ordinary income is taxed currently and not deferred.
- Tax rates could be higher in year recognized (e.g., "tax rate" risk).

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