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# Understanding the Qualified Small Business Stock Exclusion

## WHAT IS QUALIFIED SMALL BUSINESS STOCK?

In order to incentivize investment in American small businesses, the Revenue Reconciliation Act of 1993 established §1202 of the Tax Code, or what is more commonly referred to as the Qualified Small Business Stock ("QSBS") Exclusion. Initially a partial tax exclusion, it was further expanded by the Small Business Jobs Act of 2010, making it a significant benefit for business owners, their employees, startup investors, and those participating in private investments.

Understanding the benefits of QSBS, its eligibility, and the various considerations are critical in determining if you can qualify for substantial federal tax savings.

## TAX BENEFITS

A taxpayer may be eligible to exclude the gain from the sale of QSBS from capital gains tax treatment, up to the greater of $10 MM, or 10x the adjusted basis of the QSBS sold.

The percentage of the excludable gain will depend on when the QSBS was issued.

- QSBS acquired after September 27, 2010 will have 100% of the capital gains excluded, as well as full exclusions from the Alternative Minimum Tax and the Net Investment Income Tax.
- QSBS acquired between February 18, 2009 and September 27, 2010 will have 75% of the capital gains excluded, noting 7% of the excluded gain is subject to Alternative Minimum Tax treatment.
- QSBS acquired between August 11, 1993 and February 17, 2009 will have 50% of the capital gains excluded, noting 7% of the excluded gain is subject to Alternative Minimum Tax treatment.
- Stock issued before August 11, 1993 is not eligible for QSBS gain exclusion.

Not only is this a considerable tax benefit, but the limit is applied per taxpayer, opening the door for planning opportunities such as holding QSBS across various non-grantor trusts and eligible entities.

### Example

*In 2012, Sarah invested $2 MM in a startup company. The investment proved to be successful, and she decided to sell her shares for $18 MM in 2021. After consulting with her tax advisors and obtaining the necessary documentation, it was determined that her shares were eligible for the §1202 QSBS Exclusion. Given her $16 MM gain is under the $20 MM limit (i.e., 10x her $2 MM basis in the shares sold), Sarah will be able to exclude her entire gain from capital gains taxes. In the absence of this benefit, she would have been subject to approximately $3.8 MM of taxes (i.e., 20% Federal Capital Gains Tax, plus the 3.8% Net Investment Income Tax.*

Source: National Small Business Association, 2018 Report

## ELIGIBILITY

Determining eligibility for the QSBS Exclusion can be a complex process that includes thorough documentation and record-keeping, and as such we strongly advise discussing each situation with your Anchor Team and tax advisors.

The below includes a *non-comprehensive* list of eligibility requirements for corporations and shareholders.

### Corporate-Level Eligibility

- **Entity Size.** The entity must have had gross assets of $50 MM or less at all times before and immediately after the issuance of stock. Under this definition, gross assets typically include cash and the aggregate adjusted basis of other property held by the corporation. Companies often provide a 409A Valuation as supporting documentation.

- **Business Type.** Eligible entities cannot be involved in activities such as the following:

  - Any trade or business involving the performance of services in 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; or

  - Any business operating a hotel, motel, restaurant, or similar business.

    Eligible businesses are typically involved in technology, retail, manufacturing, or wholesale.

- **Entity Structure.** When forming a new business, new owners first must weigh the pros and cons of the various entity structures, such a C Corps, S Corps, LLCs, partnerships, and sole proprietorships. In recent years, LLCs have grown to become the most popular option due to its ease of formation and lower cost of administration. According to a recent study, 35% of new businesses established were LLCs, the highest chosen structure. With that said, currently only C Corps are eligible for the QSBS Exclusion. Of note, there is currently a bill in Congress which includes a provision to allow for S Corps to qualify as well.

- **Stock Requirement.** The QSBS Exclusion only applies to stocks. Options, warrants, and debt in an otherwise eligible entity would not qualify. Non-vested stocks will only qualify if the recipient makes a timely §83(b) election.

### Shareholder-Level Eligibility

- **Shareholder Type.** Eligible shareholders can include individuals, trusts, estates, partnerships, LLCs, and S Corps. This opens the door for planning opportunities as the exclusion limitation is applied per taxpayer. C Corps are not eligible to hold a QSBS.

- **Holding Period.** A QSBS stock must be held for at least 5 years in order to qualify for the exclusion. Generally, the holding period begins at the stock's issuance, but there are some transactions which can complicate the matter. For example, the holding period of stocks gifted, inherited, or distributed from a partnership will carryover to the new owner. Alternatively, recapitalizations and other corporate restructures may adversely affect the QSBS status. We strongly recommend consulting your Anchor Team and tax advisors to ensure the holding period is accurately determined.

  Notably, if the 5-year period is not satisfied and the shareholder sells the position, the proceeds of the otherwise eligible QSBS can be rolled over into another QSBS within 60 days, per §1045.

Source: National Small Business Association, 2018 Report

- **Original Issuance.** The eligible shareholder must have acquired the stock through the original issuance, as opposed to through the secondary market. Exceptions to this requirement include instances where the stock is gifted, inherited, or distributed from a partnership.

## STATE TAX CONSIDERATIONS

The QSBS Exclusion only applies to federal capital gains taxes. While most states conform to the US Tax Code on the matter, not all do.

Currently, Alabama, California, Mississippi, New Jersey, Pennsylvania, and Puerto Rico do not allow for the QSBS Exclusion at the state- or territory-level. Many other states partially conform with varying percentages and levels of the benefit.

Historically, Massachusetts residents were limited to a partial exclusion at the state-level, however as of 2022 the state began fully conforming to IRC §1202. Massachusetts residents are now able to exclude 100% of eligible QSBS gains at both the federal and state level.

## HOW ANCHOR CAN HELP

The Qualified Small Business Stock Exclusion may offer taxpayers a significant tax benefit. Determining eligibility, limitations, and obtaining the requisite supporting documentation can often be an intricate process. Contact your Private Client Advisor to review your individual situation further and design a strategic plan for you.

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Source: National Small Business Association, 2018 Report