PUBLICATIONS

A short summary of qualified small business stock tax benefits and requirements

QSBS Recap

Emerging Growth and Venture Capital Alert

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Many startups, investors, clients and friends have recently asked about the tax benefits associated with having stock qualify as qualified small business stock (QSBS). This is an important issue that investors, founders and employees receiving stock-based compensation should be aware of, particularly because if a stock is QSBS, the person who holds it may be eligible for 100 percent exclusion from federal tax on the first $10 million (or more) of the capital gain realized on its disposition.

The discussion below outlines the different requirements that must be satisfied for stock to be eligible for QSBS treatment. When forming or joining a startup company, founders, investors and employees often request a short opinion letter or a representation by the company that the company's stock to them should meet the corporate-level requirements for the stock to constitute QSBS. An opinion letter or a representation should be based on information provided through a questionnaire completed by the company.

BACKGROUND

Before 2010, the Internal Revenue Code (§1202) generally provided individual taxpayers with what was, in most cases, a very small tax rate reduction for gains recognized from sales of QSBS that was held for more than five years.

That all changed significantly following the 2008 financial crisis, when Congress passed the Creating Small Business Jobs Act of 2010 to encourage individual taxpayers to make additional equity investments in startup corporations during the remainder of calendar year 2010. The 2010 Jobs Act included an amendment to §1202 that for the first time provided for a complete US federal income tax exemption (with no application of the alternative minimum tax) for specific gains recognized by noncorporate investors on the sale of QSBS held for more than five years – but only if the stock was purchased at original issue in the limited window after September 27, 2010, and before January 1, 2011.

Although initially intended as a tax incentive for stock issued during a limited period, the 0 percent rate for gains on QSBS became so popular that Congress began expanding it. In fact, Congress repeatedly extended the applicable window for issuance of the 0 percent-eligible QSBS in successive one-to-two-year tranches. And recently, on December 15, 2015, President Barack Obama signed into law the Protecting Americans From Tax Hikes Act of 2015, making the 0 percent rate for specific gains from sales of QSBS a permanent tax benefit.

Thus, assuming all applicable requirements are met, the 0 percent federal income tax rate could now apply to gains from sales of QSBS acquired at any time after September 27, 2010.

However, several requirements must be satisfied before those benefits can be realized, and even if those requirements are met, there are important limitations on the amount of gain that can qualify for the 0 percent rate. These requirements and limitations are further discussed below.

GENERAL REQUIREMENTS

The general requirements for qualifying for the 0 percent federal tax rate on gains from the sale of QSBS include the following:

(i) ***Original issue***. The taxpayer recognizing the gain must not be a corporation and must have acquired the stock at original issue from a US domestic C corporation.

(ii) ***Five-year holding period***. The taxpayer must have held the stock for more than five years.

(iii) ***After September 27, 2010***. The taxpayer must have acquired the stock at original issue after September 27, 2010, in exchange for cash, property other than cash or stock, or services.

(iv) ***$50 million Gross Assets Test***. The aggregate gross assets of the corporation that issued the stock cannot have exceeded $50 million at any time before (and including the time immediately after) the issuance of the stock to the taxpayer. Importantly, the amount of a corporation's assets at any given time is generally measured by the corporation's adjusted tax basis in those assets, except when any property is "contributed" to the corporation. In that case, the property must be taken into account for this purpose based on its fair market value (FMV) at the time of the contribution.

(v) ***Active Business Test.*** During substantially all of the taxpayer's holding period of the stock, at least 80 percent of the issuing corporation's assets must be used by the corporation in the active conduct of one or more qualified trades or businesses. This includes assets used in furtherance of a prospective active business, *i.e.*, startup activities, research and experimentation, and in-house research. It also includes working capital, investments expected to finance research and experimentation or increased working capital within two years, and computer software rights that produce active business royalties. After the corporation has existed for two years, however, no more than half of its assets can be working capital or investments held for future research or working capital. Although many types of trade or business should qualify for this purpose, *the following are specifically excluded*: 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, and brokerage services. Also specifically excluded is any trade or business for which the principal asset is the reputation or skill of any of its employees.

(vi) ***No significant redemptions.*** The issuer of the stock must not have engaged in specific levels of buybacks (redemptions) of its own stock during specified periods before or after the date of issuance of the stock to the taxpayer.

LIMITATIONS

A noncorporate taxpayer who recognizes gain from the sale of stock meeting the above requirements can thus generally qualify for a 0 percent federal income tax rate. The amount of gain eligible for this 0 percent rate is subject to a cap, however. Section 1202(b)(1) states that the aggregate amount of gain for any taxpayer regarding an investment in any single issuer that may qualify for these benefits is generally limited to ***the greater of*** (a) $10 million, or (b) 10 times the taxpayer's adjusted tax basis in the stock. For a taxpayer who invests cash in the QSBS, basis would generally be equal to the cash purchase price. There is a special rule, however, for when a taxpayer instead purchases the QSBS for in-kind property (that is, other than cash). In those cases, the taxpayer's basis in the QSBS, solely for purposes of these §1202 rules, is deemed to be an amount not less than the FMV of the property transferred for that QSBS (often referred to as the basis-is-not-less-than-value rule).

The general purpose of the basis-is-not-less-than-value rule is to ensure that inherent built-in gain for any property contributed to a corporation in exchange for QSBS does not qualify for the §1202 benefits. Only the gains from the sale of QSBS that are attributable to appreciation in value of the QSBS occurring after the date of issuance are potentially eligible for the §1202 benefits.

ROLLOVER OF GAIN

A taxpayer other than a corporation (*i.e.*, individuals, partnerships, S corporations, estates and trusts) may elect to roll over capital gain from the sale of QSBS held for more than six months if QSBS is purchased by the taxpayer during the 60-day period beginning on the date of sale. Accordingly, gain is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement QSBS purchased during the 60-day period, as reduced by the portion of such cost, if any, previously taken into account. To the extent that capital gain is not recognized, that amount will be applied to reduce the basis of the replacement small business stock. The basis adjustment is applied to the replacement stock in the order the replacement stock is acquired.

TREATMENT FOR PASS-THROUGH ENTITIES

Gain on qualified stock held by a partnership, S corporation, RIC, or common trust fund is excludable if the entity held it for more than five years and if the partner, shareholder, or participant to whom the gain passes through held an interest in the entity when the entity acquired the stock and at all times thereafter. The partner, shareholder, or participant cannot exclude the gain to the extent that his or her share in the entity's gain is greater than what it was when the entity acquired the qualified stock, however.

Find out more about the tax benefits of QSBS by contacting the author.

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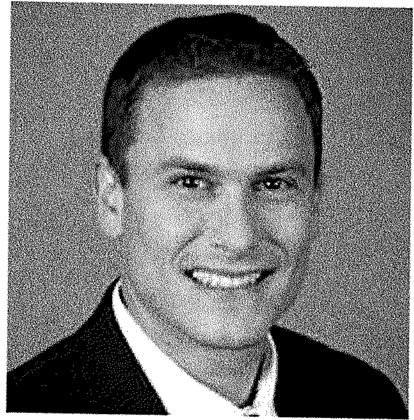
AUTHORS



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