Understanding qualified small business stock & the capital gains exemption

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Benjamin Franklin suggested that death and taxes were life's only certainties. But perhaps his advisors didn't know enough about the Qualified Small Business Stock (QSBS) exemption. So if you are facing a potential taxable event from shares you acquired in a private company, understanding the ins and outs of Section 1202 of the Internal Revenue Code (IRC) just might ease the pain of one of life's inevitabilities.

Section 1202 of the IRC is commonly referred to as the QSBS exemption. If you are a founder, angel investor, or an employee of a successful early stage company, you need to be aware of certain qualifications that could help you protect up to $10 million (or 10 times your cost basis, whichever is greater) from federal taxes.

The basic requirements

You must meet several key requirements to benefit from the QSBS exemption. Particularly, you must have held your stock in a qualified small business for at least five years. For purposes of this part of the tax code, a qualified small business is defined as:

- A domestic C Corporation
- An entity with cash and other assets totaling $50 million or less, on an adjusted basis
- Any business other than: (a) services firms such as health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial or brokerage services, (b) banking, insurance, financing, leasing, investing and similar businesses, (c) farming, (d) mining and other natural resource businesses, (e) operation of hotel, motel, restaurant or similar business.
- An entity that is actively running a business. In other words, at least 80% of the assets of the firm must be used to actively run the business, not for investment purposes.

The other key requirement is to understand when and how you acquired the stock. This exemption has been in place since 1993, but it has since undergone a few improvements. The table below lays out the actual savings based on the date you acquired shares:

Date Acquired	Exclusion %	Effective Regular Tax & Net Investment Income Tax Rate	Effective AMT & Net Investment Income Tax Rate
On or before Feb. 17, 2009	50%	15.90%	16.88%
Feb. 18, 2009 to Sept. 27, 2010	75%	7.90%	9.42%
Sept. 28, 2010 or later	100%	0%	0%

A real world example

Let's say Mr. Jones started ABC Company on January 15, 2009, using $10,000 in cash. In October of 2010, Ms. Doe, an early employee received 200,000 options exercisable at $0.05/share which she immediately exercised. In July of 2012 Mr. Lee made an investment of $500,000 when the value of the firm was $5,000,000.

In June of 2016, the company was acquired for $100 million (we will assume that Mr. Jones received $10,000,000, Ms. Doe received $2,500,000 and Mr. Lee received $15,000,000). Champagne all around. But bear in mind Mr. Jones' effective tax rate (assuming AMT) is 16.88% on his profits. Ms. Doe on the other hand, has an effective tax rate of 0% (federal) on her gains. Mr. Lee on the other hand has not met the 5-year holding rule; however, being an astute investor, he decides to take $10,000,000 and invest in another 3 other startups and writes them checks within 60 days of the payout. With the remaining $5,000,000 he pays long-term capital gains at 20% plus the NII tax of 3.8%. If and when the other investments pay him back, his principal in those transactions will have an effective tax rate of 0% and any gains may qualify for QSBS treatment.

You must ask yourself: How exactly does one qualify for this potentially powerful exemption? The first requirement is that you must have acquired the stock directly from the issuing company for either cash, services, or property (including IP). Thus if shares are acquired through a secondary transaction they would not qualify. It is important to note that the shareholder must also be a non-corporate taxpayer.

The finer points

Certain redemptions can potentially disqualify some purchases of stock from QSBS treatment. Specifically, redemptions in excess of 5% of the aggregate value of the corporation's outstanding stock within one year (either before or after) of the purchase of stock will disqualify it from QSBS treatment. Redemptions from a "related person" of the holder within two years (either before or after) will also disqualify stock from QSBS treatment. Generally, redemptions from departing employees do not disqualify purchases from QSBS treatment.

Section 1045 of the IRC is also critical to understand. This pertains to the ability to achieve QSBS treatment on shares that have not been held for a full five years. Under this rule, if you have owned stock that qualifies as QSBS for more than six months but less than five years at the time of liquidation, you may roll the stock over into another qualified small business to maintain its treatment and receive the preferential exemption after a total of five years have elapsed.

Some common questions

1. What happens when you own QSBS that is acquired for stock that is not QSBS? In this case, the stock retains its treatment, but the gain eligible to be exempted under Section 1202 is capped at the time of the exchange. All stock received via gift, death or distribution also retains its QSBS treatment and the holding period of the original owner is tacked on to the subsequent owner.

2. What if you are a founder whose company is currently an LLC? If the asset requirement can be met, you may consider converting from an LLC to a C Corp (but make sure you get expert tax advice to make this a qualified transaction). Your holding period then begins at the time your shares are acquired from the C Corp.

3. What if you are using a SAFE or Convertible Note instrument? Importantly, the holding period and asset requirement does not begin until conversion is completed. This could leave you susceptible to receiving stock that is not QSBS eligible.

Final thoughts

There are a few other considerations that you should keep in mind. If you are using stock to gift to a charitable organization or Donor Advised Fund, you should consider avoiding using stock that qualifies for QSBS (unless it is in excess of the $10 million cap). Rather, it's better to use other low-priced stock which would otherwise be heavily taxed to maximize your after-tax benefit. And if you are an employee of an early stage company, consider exercising while the company is still a qualified small business. Be aware, however, that exercising directly before raising capital may disqualify the stock from QSBS.

It is critical that founders, investors, and employees who wish to utilize QSBS engage the right professionals for advice. In addition, it's prudent for companies to document the QSBS status of their newly issued stock at each round of financing.

We will work with you to better understand these guidelines, and refer you to qualified CPAs to execute on key strategies we advise upon. Document your purchase so that you have the correct date at the time of liquidity; you want to make sure to know when your five-year holding period has been met. But, above all else, seek advice from our Private Bank and qualified third-party tax advisors before you make decisions. The QSBS exemption could potentially save you a significant tax bill that you, and Benjamin Franklin, might have thought was inevitable.

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