Qualified small business stock exclusion

What is the qualified small business stock exclusion?

The qualified small business stock (QSBS) exclusion described in Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code") allows gains from the sale of qualified small business stock to be excluded from income, and thus not subject to full federal income tax. This provision can be very advantageous to individuals who own shares in start-ups or small businesses. Additionally, the exclusion applies for both regular income tax and the alternative minimum tax ("AMT"), though special rules apply with respect to the AMT.

How much is this worth to me?

The exclusion and preferential rates for QSBS are substantial, and will depend on when the stock was acquired. The Protecting Americans from Tax Hikes Act of 2015 ("PATH Act") has recently expanded the scope of the exclusion.

The exclusion rates are as follows:

- For stock acquired on or after September 27, 2010 there is a 100% exclusion
- For stock acquired between February 18, 2009 and September 27, 2010 there is a 75% exclusion
- For stock acquired before February 18, 2009 there is a 50% exclusion

The limit on the aggregate value of the exclusions is equal to the greater of:

- $10,000,000 less the aggregate amounts of any QSBS exclusions from prior years or
- 10 times the adjusted basis of the of the QSBS sold

The ceiling for the exclusion is very high, and most QSBS transactions will be fully excludable. For any stock not excluded the gain will be taxed at capital gains rates (20% for the top income bracket).

What qualifies as small business stock?

For stock to qualify as "small business stock," the following requirements must be met:

- The stock must have been held for at least 5 years
- The stock must have been originally issued to you, rather than bought from a secondary market
- The stock must be issued after August 10, 1993
- The stock must have been paid for with cash, other property, or services
- The stock must be issued by a "qualified small business"

So, what is a "qualified small business"? The following requirements must be met to be a qualified small business:

- It must be a C corporation
- The aggregate assets (cash plus adjusted basis of any property) of the company during any year since 1993 has not

exceeded $50,000,000
- During the stockholder's holding period of the stock, at least 80% (by value) of assets are used in the company's trade or business
- The business is a "qualified trade or business" within the meaning of 1202(e)(3) of the Code (*eg*, not a service industry such as health, law, engineering, accounting, banking/finance, mining, farming, restaurant, hotel, or similar business)

No "significant redemptions" by the company

Additionally, certain stock transactions can automatically *disqualify* stock as QSBS:

- If, in the 4-year period beginning on the date 2 years before the issuance of the stock, the corporation buys back stock from the taxpayer, and pays (i) more than $10,000 and (ii) the stock represents more than 2% of the taxpayer's (or taxpayer's relative) total shares, then the stock is disqualified
- If, in the 2-year period beginning on the date 1 year before the issuance of the stock, the corporation buys back (in one or more transactions) shares that (i) cost $10,000 or more and (ii) represent at least 2% of all shares purchased and (iii) in aggregate, represent more than 5% of all of the issuing corporation's stock based on the beginning of the 2-year period, then the stock is disqualified
- Note that stock purchased by the corporation from employees who are terminated, retired, or who passed away, are not considered "purchased" for these purposes of these exceptions

Though there are many requirements to qualify as QSBS, the potential savings are substantial and most startups generally qualify for the provision. It is worth noting that the provision specifically excludes investment companies and vehicles through the 80% asset-use requirement. Structuring your startup's capital to take advantage of this provision may be something to consider, especially given the savings potential.

Why it matters for startups

Many individuals with shares in start-ups will qualify for the QSBS exclusion, and given the PATH Act's expansion of the exclusion to 100% the tax savings for the shareholder can be immense. Newer businesses are more likely to take advantage of this provision in light of the 100% exclusion for companies created post-2009. Further, most stock sales from qualified small businesses qualify for the 50% exclusion at minimum, and the ceiling on the exclusion is high enough that nearly all gains from the sale can be excluded from income.
