

## A Closer Look

# Qualified Small Business Stock: Planning Opportunities



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### In Brief

- **In an effort to stimulate small business growth, and U.S. economic growth generally, lawmakers have provided highly attractive tax incentives to investors in small businesses. In many cases, taxpayers are eligible for 100% gain exclusion on the sale of qualified small business (QSB) stock — potentially a zero-percent effective tax rate.**
- **For high-net-worth individuals, family offices, and venture capitalists, a closer look at QSB stock investment opportunities could make sense.**
- **If you're interested in QSB investing, given the complex qualification requirements for both companies and investors, you should consult with a tax professional about the most prudent course of action.**

It's no secret that small businesses drive U.S. economic growth. In fact, according to the U.S. Small Business Administration, small businesses have provided 55% of all jobs and 66% of all net new jobs since the 1970s, and they currently account for 54% of all U.S. sales. Moreover, in contrast to the broader corporate sector, the small business sector is expanding rapidly. The number of small businesses in the U.S. has increased by 49% since 1982, and since 1990, small businesses have added eight million new jobs while their larger counterparts have eliminated four million jobs.<sup>1</sup> Indeed, it's no exaggeration to say that supporting small businesses is essential for economic development. This fact has not been lost on lawmakers, who have in recent years provided significant tax incentives to entrepreneurs and investors who bear the risk of founding and investing in small businesses.

Most recently, in December of 2015, Congress passed — and the president signed into law — the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), which made permanent certain temporary provisions that provide beneficial treatment for qualified small business (QSB) stock. These provisions make taxpayers eligible for 100% gain exclusion on the sale of QSB stock and translate to a potential zero-percent effective tax rate. By way of comparison, the sale of long-term capital gain assets, such as regular non-QSB publicly traded stock, in 2016 would have resulted in an effective federal tax rate of 23.8%.

Given the potentially substantial impact of these provisions on after-tax investment returns, QSB stock investments could be worth a closer look for high-net-worth individuals, family offices, and venture capitalists.

### A Brief History of the QSB Provisions

Beginning in 1993, and for the better part of a decade, investing in (and selling) QSB stock provided some attractive tax advantages. Specifically, provisions in the Revenue Reconciliation Act of 1993 permitted a 50% QSB stock gain exclusion, although that excluded amount was subject to a 7% alternative minimum tax (AMT). The remaining gain — that is, the 50% that was not excluded — was then taxed at the QSB stock capital gains tax rate of 28%.

However, the QSB provisions lost momentum with passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003, which cut the regular long-term capital gains tax rate to 15%. Since the effective tax rates on the sale of QSB stock were now similar to those on long-term capital gains, the incentive for taxpayers to maintain eligibility under the QSB provision diminished.

<sup>1</sup> <https://www.sba.gov/managing-business/running-business/energy-efficiency/sustainable-business-practices/small-business-trends>

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That changed again a few years later, when difficult economic times prompted amendments to the QSB provisions to stimulate small business growth. First, the American Recovery and Reinvestment Act of 2009 bumped the QSB stock gain exclusion from 50% to 75%. And then the Small Business Jobs Act of 2010 pushed it to 100% and removed the 7% AMT. These provisions were then extended in subsequent years until they were finally made permanent with the “PATH Act” in 2015.

Exhibit 1 details the increasing gain exclusions over time. Exhibit 2 walks through a step-by-step example comparing the tax implications of the sale of publicly held stock (at current tax rates) and QSB stock in three different time periods.

### Exhibit 1: QSB Stock Gain Exclusion and Alternative Minimum Tax Rates Over Time

**Key Takeaway:** The tax advantages for QSB stock sales have gone from good to great in the past eight years.

Acquisition Period	QSB Stock Gain Exclusion	AMT Preference Item
Before February 18, 2009	50%	7%
February 18, 2009, through September 27, 2010	75%	7%
September 28, 2010, and thereafter	100%	0%

Source: Bessemer Trust

### Exhibit 2: Tax Comparison of QSB Stock and Regular Stock Sale<sup>1</sup>

**Key Takeaway:** The effective federal tax rate has remained unchanged for non-QSB stock while dropping all the way to zero for QSB stock.

	Publicly Traded Non-QSB Stock Sale	QSBS Stock Sale		
	Held More than One Year	Acquired Before February 18, 2009	Acquired 2/18/2009 through 9/27/2010	Acquired 9/28/2010 and Thereafter
<b>QSB Stock Gain Exclusion %</b>	<b>N/A – Fully Taxable</b>	<b>50%</b>	<b>75%</b>	<b>100%</b>
<b>Alternative Minimum Tax %</b>	<b>N/A – 0%</b>	<b>7%</b>	<b>7%</b>	<b>N/A – 0%</b>
Total Sales Proceeds	\$11,000,000	\$11,000,000	\$11,000,000	\$11,000,000
Purchase Price	(\$1,000,000)	(\$1,000,000)	(\$1,000,000)	(\$1,000,000)
<b>Gain on Sale (a)</b>	<b>\$10,000,000</b>	<b>\$10,000,000</b>	<b>\$10,000,000</b>	<b>\$10,000,000</b>
Gain on Sale	\$10,000,000	\$10,000,000	\$10,000,000	\$10,000,000
QSB Stock Gain Exclusion %	x 0%	x 50%	x 75%	x 100%
<b>QSB Stock Gain Exclusion (b)</b>	<b>\$0</b>	<b>\$5,000,000</b>	<b>\$7,500,000</b>	<b>\$10,000,000</b>
<b>Remaining Taxable Gain (a) – (b)</b>	<b>\$10,000,000</b>	<b>\$5,000,000</b>	<b>\$2,500,000</b>	<b>\$0</b>
Remaining Taxable Gain	\$10,000,000	\$5,000,000	\$2,500,000	\$0
Regular Tax Rate on Sale of Capital-Gain Assets	x 23.8% <sup>2</sup>	x 31.8% <sup>3</sup>	x 31.8% <sup>3</sup>	x 31.8% <sup>3</sup>
<b>Regular Tax Liability (c)</b>	<b>\$2,380,000</b>	<b>\$1,590,000</b>	<b>\$795,000</b>	<b>\$0</b>
QSB Stock Gain Exclusion	\$0	\$5,000,000	\$7,500,000	\$10,000,000
AMT Preference Item %	x 0%	x 7%	x 7%	x 0%
AMT Preference Amount	\$0	\$350,000	\$525,000	\$0
Maximum AMT Tax Rate	x 28%	x 28%	x 28%	x 28%
<b>AMT Tax Liability (d)</b>	<b>\$0</b>	<b>\$98,000</b>	<b>\$147,000</b>	<b>\$0</b>
<b>Total Tax (c) + (d)</b>	<b>\$2,380,000</b>	<b>\$1,688,000</b>	<b>\$942,000</b>	<b>\$0</b>
<b>Effective Tax Rate</b>	<b>23.80%</b>	<b>16.88%</b>	<b>9.42%</b>	<b>0.00%</b>
<b>= Total Tax / Gain on Sale</b>				

<sup>1</sup> Example assumes investor will be subject to Alternative Minimum Tax and Net Investment Income Tax. Example excludes state income tax considerations and itemized deduction phase-out considerations.

<sup>2</sup> Comprised of the following: maximum long-term capital gains tax rate (20%) + NII tax rate (3.8%)

<sup>3</sup> Comprised of the following: QSB stock capital gain tax rate (28%) + NII tax rate (3.8%)

Source: Bessemer Trust

## How Do You Get the QSB Gain Exclusion?

Not all small businesses are “qualified” small businesses, and not all individuals and entities can take advantage of the QSB gain exclusion:

- **Issuers of QSB stock must be domestic C corporations; recipients of QSB stock cannot be C corporations themselves.** That said, not all C corporations can issue QSB stock. Domestic international sales corporation (DISCs), possessions corporations, regulated investment companies (RICs), real estate investment trust (REITs), and cooperatives all do not qualify.
- **You must hold QSB stock for more than five years.** In general, the holding period begins when you buy the QSB stock, but specialized rules apply. For instance, when QSB stock is converted into other stock of the same corporation, the newly acquired stock is also treated as QSB stock, and the prior stock-holding period is still used for purposes of the five-year requirement; the legal term for this is called “tacking.” A similar scenario arises when a taxpayer receives QSB stock as a gift or by inheritance. When this occurs, the holding period of the transferor still pertains (or “tacks”) for the recipient. (See Exhibit 3: How Does Holding-Period Tacking Work?)

- **You must acquire QSB stock as part of an original issuance,** either directly through the corporation or an underwriter, in exchange for money, property (other than stock), or as compensation for services provided to the corporation (other than as an underwriter).
- **The aggregate gross assets of the corporation must not have exceeded \$50 million at any time from August 10, 1993, until immediately after the issuance of your stock.** Generally, the term aggregate gross assets means the amount of cash plus the aggregate adjusted tax basis of property held by the corporation. (See Exhibit 4: Taking the Aggregate Gross Assets Test.)
- **A corporation must meet the active-business requirement during your holding period.** At least 80% of the corporation’s assets (including intangible assets) must be used by the corporation in the active conduct of a trade or business. Services in the fields of health, law, engineering, consulting, or financial services do not qualify, and the same is true for hotel, restaurant, oil, gas, banking, investment, farming, and certain other types of businesses. Research and start-up activities related to a future qualified trade or business generally may be treated as the active conduct of the qualified trade or business, regardless of whether these activities have generated any gross income.

### Exhibit 3: How Does Holding-Period Tacking Work?

Tacking — the transfer of a previous stock owner’s already-accrued holding period to the new stock owner — can clearly work to the taxpayer’s advantage. Let’s take a look at tacking in action:

In our scenario, Mary purchases QSB stock on January 1, 2011, and dies on January 1, 2013. Her son, Tom, inherits the QSB stock from Mary and sells the QSB stock on January 2, 2016.

Although Tom has only held the QSB stock for three years, he has still satisfied the five-year holding period requirement for QSB stock because he was able to “tack” the holding period of Mary’s stock.

Source: Bessemer Trust

### Exhibit 4: Taking the Aggregate Gross Assets Test

- **Pass.** Sam contributes \$10 million in cash to an existing corporation that holds assets with an aggregate adjusted tax basis of \$40 million. Sam’s stock (issued by the corporation) qualifies as QSB stock since the aggregate gross assets of the corporation do not exceed \$50 million (\$10 million + \$40 million ≤ \$50 million).
- **Fail.** Susan contributes property with a fair market value of \$60 million to a newly formed corporation. Susan’s stock does not qualify as QSB stock since the aggregate gross assets of the corporation exceed \$50 million (\$60 million > \$50 million).

Source: Bessemer Trust

### Are There any Limitations on the Gains You Can Exclude?

While there are gain-exclusion limitations, they are quite generous. The eligible gain you can exclude in any given year is limited to the *greater* of \$10 million or 10 times your aggregate adjusted tax basis in the stock sold during the taxable year. The gain exclusion is applied on a per-taxpayer and per-issuer basis — so an exclusion will apply each time you invest in a separate qualified small business. (See Exhibit 5: Gain-Exclusion Limitations in Action.)

#### Exhibit 5: Gain-Exclusion Limitations in Action

Each year, you can exclude from capital gains taxes up to \$10 million or 10 times your aggregate adjusted tax basis in the stock you sold that year — *whichever is greater*. As you can see in the following scenarios, the amount of gain you can exclude can sometimes be well in excess of \$10 million:

**Scenario 1:** William purchases QSB stock on January 1, 2012, for \$500,000, and sells it on January 2, 2017, for \$10.5 million. The gain is \$10 million (\$10.5 million – \$500,000). The entire \$10 million gain is eligible for exclusion — the greater of \$10 million or \$5 million (10 times the \$500,000 tax basis).

**Scenario 2:** Ann purchases QSB stock on January 1, 2012, for \$50 million, and sells it on January 2, 2017, for \$550 million. The gain is \$500 million (\$550 million – \$50 million), and all of it is eligible for exclusion — the greater of \$10 million or \$500 million (10 times the \$50 million tax basis).

**Scenario 3:** Zack buys QSB stock on January 1, 2012, for \$50 million, and sells it on January 2, 2017, for \$600 million. The gain is \$550 million (\$600 million – \$50 million), and \$500 million is eligible for exclusion — the greater of \$10 million or \$500 million (10 times the \$50 million tax basis). The remaining gain of \$50 million is taxable.

Source: Bessemer Trust

### Before You Invest in QSB Stock: Planning Considerations

If you're considering a QSB stock investment, your first step should be to determine whether the business will qualify under the QSB provisions — preferably by consulting with a tax professional who understands these complex requirements.

You should also consider tax efficiency before making an investment. Since QSB stock can only be issued by C corporations, taxpayers will be subject to double taxation (C corporations, unlike certain other business entities — such as LLCs or S Corps — pay taxes on their earnings; if they pay those already-taxed earnings to shareholders in the form of dividends or other distributions, shareholders incur a tax liability as well). As a result, you should assess whether the anticipated growth of the company in addition to the QSB stock benefits upon exit are capable of producing a favorable after-tax yield.

Alternatively, a double tax may be mitigated by investing in qualified small businesses that do not have a need to extract after-tax cash flow during the start-up phase. This strategy may circumvent a second level of corporate tax on dividends during the QSB stock holding period. Examples of these investments are companies — often technology companies — that face large hurdles in raising capital to sustain operations until they have a viable product in the marketplace.

### After You Make the Investment: Ensure QSB Requirements Continue to Be Met

After you make your QSB investment, you should closely monitor the QSB stock requirements. The two main pitfalls that can lead to disqualification under the QSB provisions are 1) receiving certain stock redemptions during the holding period, and 2) failing the active business requirement. Communicating with company management during your holding period to ensure the requirements are being met is advisable.

Many start-up companies have limited cash during the operational phase and issue equity or debt compensation for services rendered. Upon conversion of non-cash

compensation in a qualified small business, the stock issued will result in qualified small business stock. Upon receipt, the five-year holding period to obtain eligibility for gain exclusion begins. If you have been issued stock options, warrants, convertible debt, or restricted stock in a qualified small business, you should compare the traditional tax implications of converting to stock with the QSB benefit.

## When it's Time to Sell: Liquidity-Event Planning

Liquidity-event planning for QSB stock is essential to preserving gain exclusion. The main consideration before selling or otherwise disposing of QSB stock is whether you have fulfilled the five-year holding-period requirement. The easiest way to calculate the holding period is by comparing documentation from the acquisition and sale dates. A copy of the stock certificate is an ideal source to confirm the stock acquisition date, and tax records or bank statements can confirm the stock sale date.

Once you've determined that you've fulfilled the holding-period requirement, your focus should shift to maximizing potential gain exclusion with respect to the gain-exclusion limitations (the greater of \$10 million or 10 times the tax basis). Application of the rules can be less complex when you intend to sell one issuance of QSB stock with a single cost basis. However, planning for the sale of multiple issuances of QSB stock in the same company with separate cost bases is often misunderstood. The most prudent course would be to consult with a tax professional to ensure that potential gain exclusion has been fully utilized and substantial tax savings are not overlooked.

## Selling Before You Meet the Five-Year Holding Period Requirement: The Rollover

What happens if you are compelled to sell your QSB stock before you have met the five-year holding-period requirement? In these cases, a rollover can be an effective planning tool; that is, it is possible to defer the gain on the sale of your QSB stock if you fulfill several requirements:

- You must hold your initial investment in QSB stock for more than six months.
- You must sell the stock.
- You must purchase replacement QSB stock within 60 days of the sale of the initial QSB stock.
- You must make an election on or before the due date (including extensions) for filing your income tax return for the taxable year in which the QSB stock is sold.

Once you satisfy these conditions, you will recognize gains only to the extent that the proceeds you received from the sale of QSB stock exceed the cost of the replacement QSB stock. Moreover, the replacement QSB stock will now be subject to a new gain-exclusion limitation. If this technique is properly executed, it may result in the exclusion of more gain than was permitted on the sale of the initial QSB stock. (See Exhibit 6: Rollover of Gains.)

### Exhibit 6: Rollover of Gains

If you decide to sell your QSB stock before you've met the holding-period requirement, you're not necessarily out of luck when it comes to getting the QSB gain exclusion — if you purchase replacement QSB stock and meet several other requirements. Two examples:

**Scenario 1:** Jane purchases QSB stock for \$10 million and sells it seven months later — but before the five-year holding requirement has been met — for \$15 million. The gain is \$5 million (\$15 million – \$10 million). She then purchases replacement QSB stock, within 60 days, for \$15 million. She is eligible to defer the entire \$5 million gain since the purchase price of the replacement QSB stock equals the sale proceeds.

**Scenario 2:** This is similar to Scenario 1, except that Jane purchases replacement QSB stock for \$14 million. In this case, she can defer \$4 million of gain. The sale proceeds exceeded the purchase price of the replacement QSB stock by \$1 million (\$15 million – \$14 million). The remaining gain of \$1 million (\$5 million – \$4 million) will be taxable.

Source: Bessemer Trust

### QSB Provisions: A Win-Win All Around

QSB stock provisions appear to work as lawmakers intended — they can assist in stimulating small business growth by promoting a mutually beneficial relationship between founders and investors. Companies that require sufficient capital to bring a product to market and rapidly scale the business may now be better able to attract investors. Likewise, investors — particularly high-net-worth individuals, family offices, and venture

capitalists — may now be actively seeking entrepreneurial investment opportunities in these potentially high-growth companies.

When applicable, this QSB stock tax incentive should not be overlooked. If you're contemplating — or have already made — an investment that you suspect may fit the QSB requirements, you should probably consult with a tax professional sooner rather than later to ensure you take advantage of all the tax benefits available to you.

*Bessemer's tax consultants are available to discuss any questions you may have regarding QSB stock.*

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