Callan Capital

QUALIFIED SMALL BUSINESS STOCK EXEMPTION

What entrepreneurs need to know about the tax-savings opportunities on the sale of small-business stock.

+ QUALIFIED SMALL BUSINESS STOCK EXEMPTION

As an entrepreneur and business owner, you've put a lot of time as well as your heart and soul into building your company. You also likely have much of your net worth tied up in the business. In fact, for many business owners their equity in the business represents the bulk of their net worth.

This means that enhancing the after-tax value from the business should be a central part of your liquidity planning and wealth management strategy. We emphasize after-tax because together federal, state, and local income taxes can in some cases erode about half of the owner's proceeds.

There are many techniques that can be used to minimize the tax impact for business owners. One of the most powerful is the exemption for certain types of small business stock. In some cases, small business stock can be sold with little or no tax implications. Under Section 1202 of the tax code, qualified small business stock (QSBS) qualifies for significant tax breaks and can provide an excellent planning vehicle for the right business.

+ THE CURRENT RULES

The rules related to QSBS have evolved over time. The current rules have been in place since 2013, but keep in mind that Congress can—and has—changed the rules several times[1].

Here are some of the most important features of this potential tax break for business owners and shareholders:

- The excludable gain from gross income is the greater of $10 million or 10 times the adjusted basis the shareholder has in the investment.
- The stock must have been issued by a U.S-based C corp. Other types of entities, including S-corps and LLCs, aren't eligible. The stock must have been acquired via an original offering by the corporation, not as the result of a sale from a shareholder after this time.
- The corporation's assets must not have exceeded $50 million at any point during the company's existence or since August 9, 1993. This restriction applies to the period before and after the issuance of the company's stock[2].
- The corporation must have been an active, operating company at all times during its existence. Holding companies aren't eligible. The intent of the rules is to offer this tax break to companies engaged in a business, generally with assets and employees.
- Service businesses like a CPA firm, law firm or a financial advisor are excluded. Businesses engaging in farming, mining, hospitality, restaurants and similar industries are also excluded. This generally restricts the tax break to companies involved in manufacturing, distribution, retailing, technology and wholesaling.
- As part of the sale transaction, both the corporation and the selling shareholder will need to provide certain types of documentation for the transaction. This will include things like cost basis and other documentation to ensure the restrictions of Section 1202 have been met.
- The transaction must involve some sort of payment. This can be either cash or services provided in exchange for the stock. The exemption would not apply, for example, if the stock is gifted to another person.

1 U.S. Small Business Administration. https://www.sba.gov/blogs/qualified-small-business-stock-what-it-and-how-use-it
2 IRS Tax Code. https://www.law.cornell.edu/uscode/text/26/1202

- The acquisition date of the stock being sold matters.
  - For stock acquired after September 27, 2010, if it is held for at least five years the entire gain is excluded from the seller's gross income. There are no alternative minimum tax (AMT) implications either. If the stock is held for less than five years, the gain would be subject to capital gains taxes; if held for less than one year, the gain would be taxed as ordinary income.
  - For stock acquired between February 8, 2009, and September 27, 2010, if it is held for at least five years, 75 percent of the gain would be excluded from gross income. AMT would apply on 7 percent of the amount of the gain.
  - For stock acquired on or after August 11, 1993, but before February 8, 2009, if that is held for at least five years, 50 percent of the gain would be excluded from gross income. AMT would apply on 7 percent of the amount of the gain.
- Note: The above applies only to Federal taxes, some (but not all) states have related tax breaks for this type of transaction.

+ WHY AQUISITION DATE IS SO VITAL

To illustrate how a QSBS transaction might work—and why the timing of when the stock was acquired is so important—let's look at a hypothetical example. We'll assume that the stock is sold on March 1, 2018, for a gain of $5 million and that all of the other QSBS qualifications listed above are met.

The table below shows how the tax treatment would vary depending on when the stock was acquired.

DATE STOCK ACQUIRED	TAX TREATMENT
OCTOBER 1, 2017	NO EXEMPTION, GAIN IS TAXED AT ORDINARY INCOME
OCTOBER 1, 2014	NO EXEMTION, GAIN IS TAXED AT CAPITAL GAINS RATE
SEPTEMBER 28, 2010	GAIN IS FULLY EXEMPT FROM GROSS INCOME AND NO TAX IS DUE
FEBRUARY 9, 2009	75% OF GAIN EXEMPT FROM GROSS INCOME; 25% TAXED AT CAPITAL GAINS RATES; 7% WOULD BE SUBJECT TO AMT
JANUARY 1, 1995	50% OF GAIN EXEMPT FROM GROSS INCOME; 50% TAXED AT CAPITAL GAINS RATES; 7% WOULD BE SUBJECT TO AMT

+ HOW WE CAN HELP

If you're an owner or executive of a relatively small C corp., you should take the QSBS rules into account as you move forward in developing your wealth management strategy. While the QSBS exemption probably wouldn't affect your decision of whether to sell the stock, knowing about this exemption and whether you qualify can significantly influence what you could achieve with the after-tax proceeds from a liquidity event.

At Callan Capital, we have extensive experience guiding business owners through all aspects of their wealth management and liquidity planning. By taking the QSBS rules and other potential benefits of business ownership into account, we develop a customized plan for maximizing the after-tax proceeds generated by a liquidity event and turning that wealth into an enduring legacy for you and your family. Our team prides itself in coordinating the expertise of all of your advisors to ensure the best possible outcome.

If you have questions about how the QSBS exemption or other rules related to executive compensation could affect your wealth management strategy, please give us a call to discuss your situation.

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