Why Entrepreneurs Should Know About Qualified Small Business Stock

Key Takeaways:

- Investors in QSBS can potentially avoid paying capital gains tax on as much as $10 million in profits, if certain conditions are met.
- Some entrepreneurs use QSBS to attract both investors and high-quality talent for their companies.
- Some entrepreneurs invest in the QSBS of early-stage companies.

There's a type of stock that could potentially enable you to raise capital for your growing business, attract top employees and save millions of dollars in taxes down the road.

These shares are known as qualified small business stock (QSBS), and they've become a powerful financial tool for some entrepreneurs and investors in recent years. But they've also become part of the debate about whether the affluent get excessive tax breaks—and, as a result, some lawmakers would like to see changes to the QSBS rules.

As a business owner, specifically, you may find a lot to like about QSBS. With that in mind, here's a closer look at how QSBS works, ways to use it in your company and as an investor, and how it could potentially play a role in wealth planning strategies for your family.

A VERY LARGE TAX BREAK

The purpose of QSBS is to motivate early investment in promising small businesses that need capital to expand their operations. The incentive is, to put it mildly, eye catching: Early investors can avoid paying any capital gains tax on as much as *$10 million* in profits they generate from selling their shares, if certain conditions are met.

What's more, QSBS investors may have the ability to pass on that sizable tax break to

their heirs and other family members (more on that later).

These features can make QSBS of particular interest to entrepreneurs—especially those who are looking to raise money for their business, motivate and retain key talent that's vital to the company's success, invest in their peers' startups, and enjoy significant tax savings.

The details of the potential tax break vary depending on factors such as when the QSBS was acquired and how long it was held.

- **QSBS acquired after September 27, 2010:** If shares are held for more than five years, 100 percent of the gain is free from taxes—including income tax, alternative minimum tax and the 3.8 percent net investment income tax. (If it's held for more than one year but not more than five years, the gain is treated like any other capital gain taxed at up to 20 percent. If the stock is held for one year or less, the gain is short-term capital gain that is effectively taxed as ordinary income.)
- **QSBS acquired between February 18, 2009, and September 27, 2010:** If it's held for more than five years, 75 percent of the gain is excludable from gross income and not taxed. Also, 7 percent of the gain is subject to the alternative minimum tax.
- **QSBS acquired before February 18, 2009:** The exclusion of gain is limited to 50 percent, and 7 percent of the gain is subject to the alternative minimum tax.

In all cases, however, the amount of the gain that avoids taxation is $10 million or 10 times the original investment's adjusted cost basis (whichever of the two is greater).

Example: Say your income puts you in the highest tax bracket for capital gains tax (currently 20 percent). If necessary conditions are met and you sell your QSBS six years after you invested and realize a capital gain of $500,000, you'll pay $0 in federal tax—saving you at least $100,000.

USING QSBS STRATEGICALLY AS AN ENTREPRENEUR

Businesses that qualify to issue QSBS (see below) should consider using these shares strategically if doing so could help further their goals. Two ways some small businesses harness the power of QSBS are:

1. **To attract investors.** Companies starting up and those looking to expand may use QSBS (and its potential tax benefits) as a way to raise capital from investors.

2. **To attract, retain and motivate employees.** The shares can be one way to attract and retain talent without having to pay outsize cash salaries, and can also be a way to pay vendors and consultants for their services. This can be an especially good option if your company is looking to conserve cash to put toward fueling future growth. The potential to shield large sums of money from capital gains taxes someday can be a strong incentive to drive employees to grow the company. (Note that the stock may still be subject to other taxes such as income tax withholding, payroll taxes and others.)

DOES YOUR COMPANY QUALIFY?

There are many technicalities associated with QSBS, not surprisingly, and it's always best to consult with trusted experts on the topic.

For example, if your business wants to issue QSBS, it has to meet requirements including (but not limited to) the following:

- The company has to be a domestic C corporation when it issues the stock *and* when the taxpayer/shareholder sells it. That means S corporations and partner-

ships are not eligible. (A limited liability company can qualify if it elects to be treated as a corporation for tax purposes.)

- The company's gross assets at all times before and immediately after issuance of the relevant QSBS must be $50 million or less (including stock proceeds).
- The company must be engaged in a qualified trade or business during "substantially all" of the taxpayer's holding period in the stock, and use at least 80 percent of the value of its assets in the active conduct of a qualified trade or business. Companies that meet these criteria are typically found in sectors such as technology, retail, wholesale and manufacturing.
- Types of ineligible companies generally include—but aren't limited to—service-based industries such as health, law, engineering, architecture, accounting, financial services and consulting. Other ineligible companies include farming businesses and businesses operating a hotel, motel, restaurant or similar enterprise. Consult closely with a professional on this issue.

CAN YOU INVEST?

Any individual can potentially invest in QSBS and fund a small business. However, as an entrepreneur, you may have more opportunities (through your various networks and relationships) than many others to support early-stage companies—perhaps giving you a higher probability of generating significant tax-free profits over time.

However, to hold QSBS and get the tax benefits, you have to meet criteria including these:

- You must be an individual, trust, estate, partnership, S corporation, mutual fund or common trust fund.
- You must have acquired the stock from the company after August 10, 1993, from the company itself ("original issuance") in exchange for money, property (other than stock) or services. If you buy the shares from another shareholder on the secondary market, you won't be eligible for the tax break.
- You must hold the stock continuously for more than five years without engaging in certain transactions that hedge or minimize the risk of owning the stock. Stock acquired on exercise of an option will qualify, but the five-year period does not start until the option is exercised.

Assuming the issuer and shareholder requirements are met, you'll qualify for an exclusion from gain on the sale of the QSBS.

Important: You can still potentially benefit if you've held your shares for more than six months but you sell before the five-year minimum holding period. In that case, you can defer a capital gain by reinvesting the proceeds from the sale of the QSBS into *another* QSBS within 60 days.

A CONTROVERSIAL TOOL

In recent years, numerous once-small companies (often in the tech sector) have gone public and their shares have soared in value. This has put greater attention on the capital gains tax avoidance that can occur with QSBS. One report on QSBS in the *Columbia Law Review* noted that "the loss in federal tax revenue … is far greater than previously estimated, with the provision almost exclusively benefitting the wealthy."

Compounding the controversy is a strategy that involves investors in QSBS gifting some or all of the shares to relatives. Even though those recipients didn't invest their own money, they inherit the full tax break—meaning an additional $10 million or more in profits become tax-free. The reason: While

the tax break is denied to people who purchase shares from other investors, as noted above, it remains available to people (other than a spouse) who receive the shares *as gifts*. There are also no limits on the number of gifts that QSBS investors can make.

The upshot: Using this approach, the big tax breaks can essentially get stacked on top of each other—enabling families to potentially save tens of millions of dollars in taxes if the shares become extremely valuable down the road. The strategy, while legal, has been the focus of some lawmakers' efforts to rein in QSBS's tax benefits.

CONCLUSION

Clearly QSBS can present opportunities for some business owners. But it's an area where you need to tread carefully in order to meet the necessary requirements and stay on the right side of the rules—for your sake and the sake of any investors holding QSBS that your company issues. A qualified tax advisor and other experts can be important resources to consult if you decide that QSBS is something you want to explore.

Disclosure: Tax laws are subject to change, which may affect how any given strategy may perform. Always consult with a tax advisor.

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