Are You Eligible for Tax-Free Capital Gains? How Business Founders and Investors Can Exclude Up to 100% of Their Capital Gains from Federal Income Taxes under the Qualified Small Business Stock Exclusion

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Summary: The qualified small business stock exclusion allows qualified business founders and investors to exclude from federal income tax some or all of the capital gains they realize on qualifying stock sales. Eric Bardwell and Catherine DeBono Holmes of Jeffer Mangels Butler & Mitchell LLP show how to take advantage of the exclusion.

INSIGHT: Are You Eligible for Tax-Free Capital Gains?

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Tax code Section 1202 allows taxpayers to exclude up to 100% of the capital gains they realize on the sale of “qualified small business stock” (or “QSBS”) held for at least five years (Section 1202(a)). This provision of the tax code was added in 1993, but it originally allowed only 50% of eligible capital gains to be excluded. In 2009, the percentage of capital gains eligible for exclusion was increased to 75%, and in 2010, this percentage was increased to 100%, and the QSBS incentive was made permanent (Sections 1202(a)(3) and (4)). Many business owners and investors, as well as their tax advisors, are still not aware that they may be eligible for this benefit. In addition, existing small businesses and start-up founders may not be aware that the QSBS exclusion could enhance their ability to raise capital from investors seeking to boost their after-tax profits from investment in small and start-up businesses. This article explains the basic requirements to qualify for the exclusion and discusses tax planning opportunities to optimize the exemption.

What is QSBS?

QSBS is stock that meets the following requirements:

- issued by a U.S. “C corporation” any time after Aug. 9, 1993 (Section 1202(c)(1));
- issued by a corporation whose aggregate gross assets must not exceed $50 million at any time from Aug. 9, 1993, through the date of issuance of the QSBS (including immediately after issuance of the QSBS, but after that, the size of the corporation’s assets are not restricted—which means that the corporation could be much larger on the date the taxpayer sells the QSBS and it will still qualify for the exclusion) (Section 1202(d));
- issued by a corporation in which at least 80% of its assets are used in an “active business” for “substantially all” of the shareholder’s holding period of the QSBS (the following types of businesses are not eligible under Section 1202 of the Internal Revenue Code—service businesses such as health, law, engineering, architecture, accounting, consulting, athletics, financial services and brokerage services; banking, insurance, finance, leasing, real property rentals, and investing: farming; natural resources such as oil and gas; hotels and restaurants) Sections 1202(c)(2) and (e));
• held by the shareholder for more than five years (although as long as a shareholder holds the eligible stock for more than six months there is an option for a rollover (Section 1202(a)(1)); and
• acquired by the shareholder directly from the corporation (meaning it cannot be purchased from another shareholder) (Section 1202(c)(1)(B)), but –
  ▪ QSBS can be gifted during life or transferred at death by the original shareholder and still be eligible QSBS (in which case the date of acquisition by the donor/decedent is the acquisition date) (Section 1202(h));
  ▪ QSBS can be acquired by a partnership and distributed to its partners if they were partners on the date the partnership acquired the QSBS and they receive a pro rata share of the QSBS equal to the percentage of the partnership they owned when the QSBS was acquired (in which case date of acquisition by the partnership is the date of acquisition by the partners) (Section 1202(h));
  ▪ QSBS can also be held by a partnership or S corporation, and the partners or shareholders may exclude their share of any capital gain the partnership or S corporation recognizes on sale of the QSBS if the partners or shareholders held their interests on the date the QSBS was acquired by the partnership or S corporation (Section 1202(g)); and
  ▪ QSBS can also be acquired by exercise of an option, warrant, or conversion of a convertible note, in which case the exercise or conversion is treated as the acquisition date of the QSBS (Section 1202(f)).

What percentage of capital gains can be excluded from a sale of QSBS?

The date the QSBS was acquired by the shareholder determines the applicable exclusion percentage. The following are the applicable dates and percentages:

• After Aug. 9, 1993, and before Feb. 18, 2009 – 50% (Section 1202(a)(1))
• On or after Feb. 18, 2009, through Sept. 27, 2010 – 75% (Section 1202(a)(3))
• On or after Sept. 28, 2010 – 100% (Section 1202(a)(4))

Is there a dollar limit on the amount of capital gains that can be excluded from a sale of QSBS?

There are two limitations on the dollar amount of total capital gains that may be taken into consideration before determining the percentage of capital gains that may be excluded (which percentage is determined based on the date of issuance as described above). The greater of these two limitations apply (Section 1202(b)):

• $10 million, reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior tax years for sales of QSBS in the same corporation (the cumulative limitation); or
• 10 times the aggregate adjusted basis of QSBS that the taxpayer sold during the current tax year (the annual limitation) (which means that the total dollar amount of excluded capital gains could be higher than $10 million).

How do you calculate the amount of capital gains that can be excluded from federal tax based on these rules?

Here are just a few simple examples:

• If a shareholder purchased QSBS after Sept. 28, 2010 (qualifying for the 100% exclusion) for $100,000 and sold it in 2019 for $20,000,000, the shareholder could exclude 100% of $10 million (the maximum dollar limit).
• If a shareholder purchased QSBS after Feb. 18, 2009, but before Sept. 27, 2010 (qualifying for the 75% exclusion) for
$100,000 and sold it in 2019 for $20 million the shareholder could exclude 75% of $10 million.
- If a shareholder purchased QSBS after Sept. 28, 2010, for $2 million and sold it in 2019 for $20 million, the shareholder could exclude 100% of $20 million (10 times the shareholder’s basis).

**What if QSBS is sold before the end of the required five year holding period?**

If QSBS is sold before it qualifies for the capital gains exclusion, a taxpayer (other than a corporation) can still retain the potential for the capital gains exclusion after five years under Section 1045 if the following conditions are met:

- the taxpayer has **held the QSBS for more than six months** before selling it; and
- the taxpayer rolls the capital gain from early sale of the original QSBS into **new QSBS within 60 days** of the sale, **in which case the taxpayer will recognize capital gains only to the extent that the amount realized on the sale of QSBS exceeds the cost of the replacement QSBS**.

**How can a founder or investor in QSBS optimize the capital gains exclusion?**

Through tax planning in advance of an acquisition or sale of QSBS, the capital gains exclusion can be multiplied, because the **maximum amount of the exclusion applies on a per shareholder basis**. In addition, taxpayers residing in high state income tax states have the opportunity to reduce their exposure to state income taxes using non-grantor trusts. This means that:

- a taxpayer can gift QSBS to one or more family members and each of the parties receiving a gift of QSBS would qualify for the capital gains exclusion up to the maximum amount allowed per taxpayer (**using the same five year holding period as the original owner of the QSBS**).
- a taxpayer can gift QSBS to one or more non-grantor irrevocable trusts, and each trust would qualify for the maximum amount of the capital gains exclusion (**using the same five year holding period as the grantor of the trusts**). These non-grantor trusts may be established in jurisdictions where additional state income tax benefits are available, offering taxpayers the ability to minimize both federal and state income taxes on a sale of QSBS.
- a taxpayer could also make “incomplete gifts” to one or more non-grantor irrevocable trusts, which might qualify for continued QSBS treatment of the transferred stock as well as benefit from the elimination or deferral of state income taxes.
- a non-grantor irrevocable trust could make a distribution of QSBS to one or more beneficiaries, each of which, along with the trust, would qualify for the capital gains exclusion up to the maximum amount allowed per taxpayer (**using the same five year holding period as the original owner of the QSBS**).
- an existing non-grantor irrevocable pot trust could split into separate trusts for each beneficiary, each of which, along with the original pot trust, would qualify for the capital gains exclusion up to the maximum amount allowed per taxpayer (**using the same five year holding period as the original owner of the QSBS**).
- a taxpayer can gift QSBS to one or more charitable remainder unitrusts, and each trust would qualify for the maximum amount of the capital gains exclusion (**using the same five year holding period as the grantor of the trusts**).

**How can the QSBS capital gains exclusion help founders of new businesses raise capital?**

The possibility of realizing **tax free capital gains** is intended to be a powerful incentive for investors to invest in small businesses. In fact, the QSBS capital gains exclusion offers more potential benefits to investors than investments in
qualified opportunity funds (QOFs) (a different tax incentive created under the Tax Cuts and Jobs Act of 2017 for investments in designated opportunity zones), because:

- anyone can invest in QSBS—but only investors with existing capital gains can invest in QOFs and receive the tax benefit under Section 1400Z-2; and
- the holding period for QSBS is only five years—versus a 10 year holding period for QOFs.

However, the types of businesses that qualify for QSBS are more limited than QOFs. Therefore, in order to determine which tax incentives will work for a new business, some early stage tax planning and structuring can optimize the use of either—or both—of these tax incentives for investors.

**Conclusion**—The QSBS capital gains exclusion is an often over-looked tax incentive that can result in substantial tax savings for all investors in qualified businesses. With proper front end planning, a shareholder may be able to exclude far more than $10 million from federal and state income taxes on the sale of a Qualified Small Business. We recommend that every business owner and investor consider these potential tax benefits when structuring and raising capital for their new business or planning for their exit strategy.

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