Permanent Exclusion of Gain on Sales of Qualified Small Business Stock

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Holders of certain qualified small business stock (QSBS) can permanently exclude 100% of up to $10 million[1] of gain realized on the sale of QSBS. The benefit, provided for under Section 1202 of the Internal Revenue Code, was recently made permanent as part of the Protecting Americans from Tax Hikes Act (PATH) in December 2015. Prior to PATH, the 100% exclusion had expired at the end of 2014.

Entrepreneurs and investors will, of course want to consider the QSBS benefit when structuring investments; but QSBS benefits are sure to be an important consideration for both buyers and sellers when evaluating the economics of an exit transaction.

Basic Requirements for the Taxpayer/Shareholder:

The taxpayer/shareholder may not be a corporation, but can hold the investment through an investment partnership under certain circumstances. For example, the taxpayer/shareholder must have held the interest in the partnership on the same date it acquired the QSBS and until the earlier of the sale or other disposition.

The taxpayer/shareholder must have received the QSBS as an “original issuance,” meaning when the company was formed, either directly, or through an underwriter, for money, property or for services provided for the issuing corporation; and must have held the QSBS for more than five years.

The 100% exclusion applies to QSBS acquired after September 27, 2010. QSBS’s acquired between August 10, 1993 and September 27, 2010 may qualify for a 50% or 75% exclusion, depending on the date of the acquisition of the QSBS.

Basic Requirements for the Issuing Corporation:

The tax benefit provided by Section 1202 applies only to equity investments in C-corporations conducting permitted active trades or businesses. Professional services, financial institutions, farming and most hospitality businesses do not qualify. The issuing corporation must use 80% of its assets in active conduct of one or more permitted active trades or businesses.

Prior to and subsequent to the taxpayer/shareholder’s investment, the issuing corporation’s gross assets must never have exceeded $50 million.

Exit Planning:

When an exit is contemplated prior to the required 5-year holding period, the shareholder/investor may want to structure the exit in a manner that could preserve the QSBS benefit for a later disposition of the equity consideration received.

If properly structured, QSBS of an issuing corporation can be exchanged for stock of another corporation; with the replacement stock received qualifying as QSBS. For example, if a corporation is acquired by another corporation in a reorganization that qualifies as a tax-deferred reorganization under IRC Section 368, the acquirer stock received by holders of QSBS of the issuing corporation can qualify as QSBS going forward. If the acquiring corporation qualifies as a qualified small business, then all of the stock received can be QSBS. If the acquirer is not a qualified small business, then the stock of the acquirer can be QSBS only to the extent of the gain that would have been recognized at the time of the Reorganization if the target's QSBS had been sold in a taxable transaction at that time.

For more information on this topic, please contact **Chip Wry**.

Footnote:

1. (or, if greater, 10 times the adjusted basis of the QSBS issued and disposed of that year)