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Inside the Qualified Small Business Stock (QSBS) Exclusion

Designed to encourage investment in small businesses, the Qualified Small Business Stock (QSBS) exclusion provides owners of eligible companies with a tax exclusion for some—or all—of the gains realized on the sale of their stock. But eligibility rules are complex, so advance planning and tax advice are critical.

Becoming a stockholder in a start-up can deliver outsized growth opportunities. However, rapid share price increases could also trigger outsized tax liabilities. Internal Revenue Code Section 1202, also known as the Qualified Small Business Stock (QSBS) exclusion, provides a way to reduce those federal income tax liabilities by offering a partial or full exclusion on the gains realized from certain small business stock. In fact, in some cases, shareholders may be able to shield 100% of their capital gains from tax.

While this may sound too good to be true, the benefits are very real. However, eligibility for the QSBS exclusion is quite complex.

To understand the eligibility rules and delve into some strategies taxpayers can use to help maximize the exclusion, we spoke with Brian Gormley CFA, CFP® from The Bankhead Group at Morgan Stanley & Tommy McCollister, CPA, Senior Manager, Compensation & Benefits at Armanino LLP, one of the country's largest independent accounting and consulting firms. While the information shared here provides a general overview of the QSBS exclusion, it should not be treated as tax advice. To understand how the QSBS exclusion may apply to your personal situation, we encourage you to seek independent tax and legal advice.

Eligibility for the QSBS exclusion can be quite complex for both companies and shareholders alike. In order to help maximize QSBS outcomes, you may not want to wait for exit to start thinking about it. Instead, we recommend thoughtful planning well ahead of time and seeking out independent tax and legal advice to better understand how the QSBS exclusion might apply to your unique circumstances.

–Tommy McCollister, CPA, Senior Manager, Compensation and Benefits at Armanino

QSBS Eligibility Rules

To qualify for the QSBS exclusion, companies must meet specific eligibility requirements. For instance:

- The stock must have been issued by a US C-corporation after August 10, 1993 and the issuing company must have aggregate gross assets of $50 million or less immediately following issuance.
- At least 80% of the company's assets must have been actively used in trade or business—although certain businesses aren't eligible (such as many personal services businesses, many financial services businesses, most hospitality businesses, farms and others).
- The issuing company must not have had significant redemptions (defined as 5% or more aggregate value of outstanding shares) of its stock for at least two years before issuance.

Similarly, shareholders who are issued qualified small business stock must adhere to certain rules:

- They must acquire the stock in exchange for money, property (not stock) or services.
- They must hold the stock for at least five years before selling or exchanging it.
- They must not have more than a de minimis amount of stock repurchased by the issuing company two years prior to, or two years after, the issuance of the stock.

How Much of the Gain is Excluded?

The percentage of the gain excluded from tax on the sale or exchange of QSBS depends on when the shares were issued:

- Shares issued between August 10, 1993 and February 17, 2009 are eligible for a 50% gain exclusion, subject to a 7% alternative minimum tax (AMT) addback.
- Shares issued between February 18, 2009 and September 27, 2010 are eligible for a 75% gain exclusion, subject to a 7% AMT addback.
- Shares issued after September 28, 2010 are eligible for a 100% gain exclusion with no AMT addback.

In all cases, the federal capital gains exclusion is capped at the greater of $10 million or 10x the adjusted basis of the shares.

That said, the QSBS exclusion is not available in every state. For example, as of April 2023, it's disallowed in California, Mississippi, Alabama, Pennsylvania, New Jersey and Puerto Rico. And Hawaii and Massachusetts only offer partial exclusions.

Strategies to Boost the Exclusion's Benefits

While the basic QSBS exclusion may confer many benefits, there are several additional strategies shareholders can potentially use to boost those advantages:

Stacking

The QSBS exclusion applies on a per-taxpayer basis. Notably, taxpayers for QSBS purposes can be individuals (non-spouse), trusts (non-grantor) or estates. Thanks to this definition, individuals may be able to "stack" the QSBS exclusion by transferring shares to other "taxpayers"—potentially enabling each taxpayer to qualify for an exclusion of up to $10 million, thus opening up the possibility to protect capital gains in excess of $10 million.

Section 83(b) Election

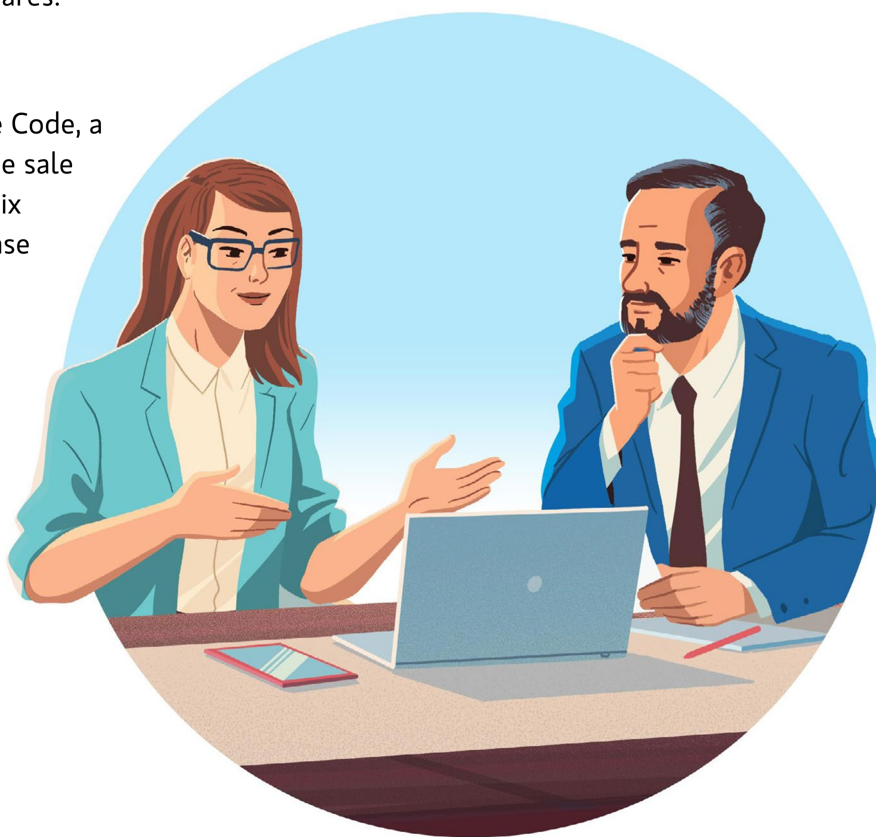
This election is commonly used for restricted stock awards (RSAs) and when exercising non-qualified stock options (NQSOs) that contain an early exercise feature. The election is also sometimes used with respect to incentive stock options (ISOs), though additional considerations apply. For taxpayers who hold RSAs or who early exercise NQSOs, Section 83(b) may provide for tax planning opportunities as the holding period for capital gain and QSBS purposes begins on the date of the election.

While the election must be made within 30 days of grant (for RSAs) or within 30 days of exercise (for NQSOs and ISOs), it generally doesn't start the capital gains and QSBS holding period for shares received upon the exercise of ISOs – which only begins when ISO shares are vested. This underscores the importance of working with a tax advisor to determine the mix of NQSOs and ISOs most likely to maximize the economic utility of the underlying option shares.

Rollovers

Under Section 1045 of the Internal Revenue Code, a taxpayer can roll over a capital gain from the sale of QSBS that has been held for more than six months. To do so, the taxpayer must purchase new QSBS-eligible stock within 60 days of the sale and make an election on their tax return.

This is particularly advantageous in cases where the issuing company is sold prior to the QSBS five-year holding period, as it may allow shareholders to defer taxes by rolling over their capital gains into a new QSBS-eligible company.



The QSBS Exclusion in Action

To understand how the QSBS exclusion may work in practice, consider the following example of a client of The Bankhead Group at Morgan Stanley. This client became the president of a new venture capital-funded start-up. When he was hired, he was granted an NQSO for 1.5 million option shares in the newly formed C corporation. Since the company had just been founded, his exercise (aka strike) price was only $0.10 per share.

His company allowed for the early exercise of stock options so, after consulting the company's general counsel and tax team, the client exercised the shares immediately after the grant and simultaneously filed an 83(b) election. At the time of exercise, the fair market value per share was equal to the exercise price, so there was no spread – and no income tax liability.

Since the exercise price was so low, he was able to exercise all 1.5 million shares for a total cost of $150,000. The early exercise triggered the one-year holding period for long-term capital gains and the five-year QSBS holding period. The company's aggregate gross assets were also below $50 million at that time, so the shares could potentially qualify for the QSBS exclusion if the company continued to meet the other Section 1202 requirements.

As the company was backed by several high-profile investors and the potential for growth was substantial, the client used his available federal gift tax exemption and transferred a portion of his shares into two non-grantor irrevocable trusts, one for each of his children as a beneficiary. The client, as grantor, created two non-grantor trusts for the benefit of different beneficiaries, which allowed for the creation of separate taxpayers under the tax code. Armanino also made sure to domicile the trusts in a state that allows for 100% QSBS exclusion up to the federal maximum.

From there, the client gifted 500,000 shares to each trust. Because the shares were still deemed to have been acquired by the client, they remained eligible for the QSBS exclusion. This gave the client and the trusts created by the client the access to a $30 million aggregate maximum exclusion ($10 million x 3 taxpayers).

Ultimately, the company garnered significant investor interest and its valuation skyrocketed. The client's 1.5 million shares granted at hire were now worth close to $50 million. After meeting the requisite five-year holding period, the shares will become qualified. If the total value of the shares do not decline below $30 million, all three taxpayers should be able to use their entire $10 million QSBS exclusion and should only need to pay federal income taxes on capital gains that exceed that amount. Additionally, since the shares in the trusts are no longer part of the client's estate, they should not be subject to federal estate taxes upon his passing.

It is important to consider the tax consequences of any gifting structure, and clients considering such structures should consult their tax advisor.

Making it Real

Given the potential tax advantages associated with the QSBS exclusion, both start-up companies and early-stage investors may benefit by working with an accounting firm to perform an eligibility analysis.

> The QSBS exclusion is an under-appreciated and under-utilized part of the tax code. The tax savings can be incredibly powerful if executed properly. Understanding the eligibility rules and applying the appropriate strategies is critical to maximizing the benefits of the exclusion.
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> *– John Bankhead from The Bankhead Group at Morgan Stanley*

The Bankhead Group is located in Boston, MA. They have been working with founders and executives at both private and public companies for over 30 years. Their experienced team understands the intricacies of equity compensation which allows them to help their clients manage concentrated positions in a tax-efficient and responsible manner.

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