Morgan Stanley

Qualified Small Business Stock

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In general, Internal Revenue Code ("IRC") Section 1202 allows taxpayers (other than corporations) to exclude from gross income a portion of the gain from the sale or exchange of "qualified small business stock" ("QSBS") acquired at original issue and held for more than five years. The amount of gain from the sale of QSBS eligible for the exclusion is limited to the greater of $10,000,000 or 10 times the aggregate adjusted basis in the stock sold or exchanged during the year but may be further limited depending on the date the QSBS was acquired.

Date of Acquisition Limits

As a result of a series of legislation, differing rules apply to QSBS acquired during different periods. QSBS acquired prior to February 18, 2009, qualifies for an exclusion from tax of 50% of the gain (subject to the discussed maximums). QSBS acquired between February 18, 2009, and September 27, 2010, qualifies for an exclusion from tax of 75% of the gain (subject to the discussed maximums). QSBS acquired on or after September 28, 2010, qualifies for an exclusion from tax of 100% of the gain (subject to the discussed maximums). Thus, the date the taxpayer acquired the QSBS is an important factor when determining the applicable maximum gain exclusion.

A 28% (plus 3.8% Net Investment Income Tax (“NIIT”), if applicable) tax rate applies to the portion of the gain that is not excluded (i.e., the 50% or 25% included in the taxpayer’s gross income, based on acquisition date). To the extent the taxpayer's gain exceeds the limitation ($10,000,000 or 10x basis), the excess gain will be taxed at regular capital gains rates.

- For example, where the 50% exclusion applies, assuming that a taxpayer has a zero-cost basis in QSBS sold for $10,000,000, $5,000,000 could be excluded from income and $5,000,000 would be taxed at a rate of 28% (31.8%, if applicable).
- If the same QSBS were sold for $30,000,000, $5,000,000 could be excluded from income, $5,000,000 would be taxed at 28% (31.8%, if applicable) and the balance of $20,000,000 would be taxed at the federal long-term capital gain rate.

Alternative Minimum Tax

Taxpayers will also need to determine whether the Alternative Minimum Tax (“AMT”) may apply. For stock that was acquired on or after September 28, 2010, the exclusion is applicable for both regular and AMT purposes. However, for stock acquired before September 28, 2010, there may be an AMT addback applied to the excluded gain. In addition, to the extent the taxpayer's gain exceeds the limitation ($10,000,000 or 10x basis), the excess gain may be subject to AMT.

Small Business Qualifications

In general, to qualify as a “small business” under IRC Section 1202, the corporation must have $50,000,000 or less of aggregate gross assets at the time it issues QSB eligible stock, be a taxable domestic C-corporation, and be in the active conduct of a qualified business. Once a corporation’s aggregate gross assets exceed $50,000,000, the corporation cannot issue QSBS, even if its aggregate gross assets fall below $50,000,000 in the future.

Among the numerous requirements of IRC Section 1202 (not all of which are discussed here), one to pay particular attention to is the active business requirement. At least 80% of the assets of the corporation must be used in the active conduct of a “qualified” trade or business. In general, a qualified trade or business is any trade or business other than:

- A service industry where the principal asset of such trade or business is the reputation or skill of its employees (such as professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, consulting, or performing arts).
- A banking, insurance, finance, leasing, investing or similar business.
- Any farming business.
- Any business involving the production or extraction of depletable assets.
- Any business operating a hotel, restaurant, or similar business.

An entity’s activity will not be characterized as a “qualified” trade or business if more than 10% of the entity’s value is invested in other corporations or real estate. Additionally, not more than 50% of the entity’s value may be held for working capital needs or investment.

Effective Date & Federal Income Tax Rates

IRC Section 1202 applies to stock issued after the enactment of the 1993 legislation (August 10, 1993). Considering the 5-year holding period requirement, the exclusion became available to taxpayers beginning August 12, 1998, allowing taxpayers to sell QSBS after that date and not pay federal income tax on some or all of the gain up to the above discussed maximums, thereby retaining more of the proceeds for reinvestment.

The current federal long term capital gains rate is 20%, plus there is an additional NIIT rate of 3.8% for taxpayers with Modified Adjusted Gross Income (MAGI) over $200,000 for single filers and $250,000 for married joint filers. Thus, the maximum total federal long term capital gains rate is 23.8%. The excluded gain will not be subject to the 3.8% NIIT on capital gains applicable to high-income taxpayers.

However, it's important to note that not all states follow federal treatment of QSBS. California, for example, does not recognize the QSBS exclusion, so though a taxpayer may avoid federal income tax on the sale of QSBS, a California resident taxpayer would not avoid state income tax on the sale.

Reinvestment

IRC Section 1202 does not address rollovers of gain from one qualified small business to another. IRC Section 1045, enacted in 1997, allows a non-corporate taxpayer to rollover gain from QSBS in one qualified small business to another without recognizing the gain.

The original QSBS must have been held for at least six months and the replacement stock must be acquired within 60 days from the sale date. Only gain exceeding the cost of the replacement property is recognized. Gain that is not recognized is, in effect, rolled over into the replacement property (by reducing its basis).

In effect, IRC Section 1045 allows taxpayers to dispose of their IRC Section 1202 QSBS during the five-year holding period without recognizing gain up to the cost of the replacement property, as long as the sale proceeds are timely used to purchase replacement QSBS.

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