Morgan Stanley

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A Guide to QSBS: How Qualified Small Business Stock Can Create Tax Savings

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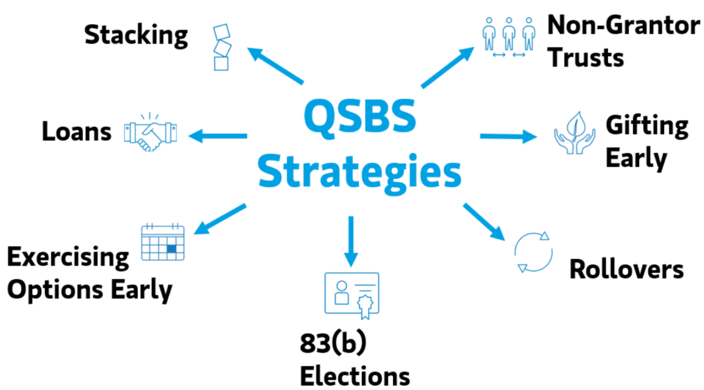
Adding to its complexity, tax planning is riddled with endless acronyms. Nonetheless, we believe that founders, executives and employees of startups will likely benefit from paying attention to one in particular: QSBS, which stands for qualified small business stock. Designed to encourage investment in small businesses, the QSBS exclusion is set forth in Section 1202 of the US Internal Revenue Code. This provision enables taxpayers selling their QSBS to avoid capital gains taxes up to the greater of $10 million or 10 times the adjusted basis of the stock, depending on the taxpayer's acquisition date with respect to the shares.

In this primer, we outline the planning necessary to allow QSBS investors to maximize their after-tax returns. We begin by reviewing QSBS basis and the required qualifications, considerations for QSBS "stacking" and other potentially tax-saving strategies. Please see Exhibit 1 for strategies to be discussed throughout this primer.

Exhibit 1: QSBS Strategies for Maximizing After-Tax Returns to Investors



Source: Morgan Stanley Wealth Management Global Investment Office

While the QSBS exclusion can deliver powerful tax savings, the eligibility criteria can be complex. For the IRS to consider a company a qualified small business, it must:

- Be registered as a US C-corporation;
- Have had gross assets of no more than $50 million at all times before and immediately after the investor's acquisition of their shares; and
- Have at least 80% of its assets used in the active conduct of a qualified business.

Importantly, certain business types are not eligible for classification as qualified small businesses. Among others, these include businesses in financial services and service-related industries, as well as those in the fossil fuel and farming industries and in the hotel and other hospitality industries.

Moreover, the IRS requires the following criteria for QSBS shareholders:

- Shareholders must have acquired the shares at original issue—that is, not through purchase on a secondary market.
- Shares must be held for more than five years prior to sale.
- Shareholders must have not had more than 2% of shares repurchased by the issuing company two years prior to and two years after the issuance of the QSBS stock.
- If a shareholder transfers shares to a disqualifying entity, such as a grantor trust, the value of such shares is included in the shareholder's $10 million exclusion. Grantor trusts are considered disqualifying entities because QSBS is based on a per taxpayer basis, and a grantor trust is not a separate taxpayer.

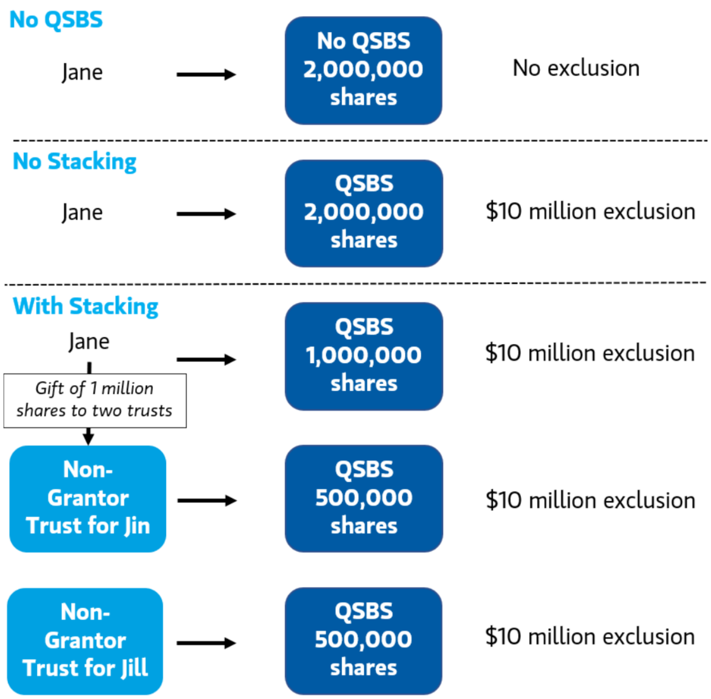
Options holders need to exercise their options and convert them into shares before securities become QSBS-eligible. For unvested options that permit early exercise, this scenario could occur due to an exercise shortly after the grant followed by an 83(b) election, because the shares need to be held for more than five years. Additionally, QSBS-eligible stock can come from company grants or individuals' purchases of founder shares.

Founders and executives should be mindful of certain company actions that can invalidate their company's recognition as a qualified small business:

- **Redeeming shares in size**. The issuer must not have carried out significant redemptions—covering 5% or more of the aggregate value of its outstanding shares—for at least two years before issuance.
- **Making illiquid investments**. Deploying corporate capital in noncash securities with lock-up periods of greater than 24 months.
- **Changing the business model**. Shifting activity into a nonqualifying business.
- **Exceeding asset thresholds**. Should the company grow to more than $50 million in outstanding shares, new shareholders cannot qualify for the QSBS exclusion. This scenario may occur after multiple funding rounds. Shares held prior to exceeding the $50 million threshold should remain QSBS-eligible.

QSBS shareholders may be able to boost tax savings by "stacking" the QSBS exclusion across multiple entities. Because the QSBS exclusion applies on a per-taxpayer basis, a QSBS shareholder can share the benefits of QSBS with other separate taxpayers, including non-grantor trusts with distinct beneficiaries (see Exhibits 2 and 3). Each taxpayer may qualify for an exclusion of up to $10 million, so that multiple exclusions may be claimed—a process known as stacking. The stacking strategy does not require an individual (or trust) who acquired the stock through gift or bequest to have personally satisfied the five-year holding period. In other words, the holding period's start date is tacked on to the original issue date. Stacking may be coordinated with other estate-planning strategies, such as gifting to non-grantor irrevocable trusts.

Exhibit 2: Potential QSBS Paths for Investors



Source: Morgan Stanley Wealth Management Global Investment Office

Exhibit 3: Leveraging QSBS and Stacking Strategies Can Help Investors Reduce Capital Gains Taxes

	No QSBS (million)	No Stacking (million)	With Stacking (million)
Quantity of Shares	2.0	2.0	2.0
Sale Proceeds	$50.0	$50.0	$50.0
Total Embedded Gain	$50.0	$50.0	$50.0
QSBS Exclusion	$0.0	$10.0	$30.0
Remaining Gain	$50.0	$40.0	$20.0
Potential Taxes Due	$11.9	$9.5	$4.8

Source: Morgan Stanley Wealth Management Global Investment Office

While stacking likely represents the most common QSBS strategy, shareholders may implement other strategies to attempt to limit taxable capital gains. They include:

- **Making an 83(b) election to expedite satisfaction of five-year holding requirement.** Individuals may use this selection on restricted stock awards (RSAs) and nonqualified stock options (NQSOs) with early-exercise provisions. For employees granted RSAs or NQSOs with early-exercise provisions, 83(b) may help facilitate QSBS eligibility because the holding period begins as of the 83(b) election date—rather than the vesting date—potentially satisfying the requisite holding period.
- **Exercising options early**. Exercising options starts the clock on the holding periods. Option holders must first verify the early-exercise provisions in their stock option agreement before pursuing this strategy.
- **Pursuing alternative liquidity strategies**. Given increasing demand for liquidity, shareholders may sell shares that could eventually be QSBS-eligible. We recommend that shareholders check eligibility well before selling and consider alternatives such as a loan or selling non-QSBS eligible equity, rather than selling QSBS-eligible shares before the five-year requirement is satisfied.
- **Leveraging careful estate-planning strategies**. Shareholders may consider funding trusts with QSBS early to minimize the use of lifetime gift-tax exemptions and compound estate-planning benefits. Gifting the shares prior to significant appreciation allows individuals to maximize their use of lifetime federal estate-tax exemptions.
- **Taking advantage of potential rollovers**. Serial entrepreneurs may roll over the capital gains from selling QSBS shares held for more than six months if the proper election is made. Under Section 1045, a taxpayer must purchase the new QSBS-eligible stock within 60 days of the prior sale. This strategy may be particularly useful when the original company is purchased or acquired prior to achieving the individual's five-year holding period; the shares in the new company retain their original acquisition date for purposes of QSBS eligibility. The taxpayer's basis of the shares in the new company is adjusted downward by the amount of gain deferred on reinvestment.
- **Confirming strategies with certified tax planners.** Shareholders can limit potential audit risk by confirming QSBS eligibility ahead of a sale with certified tax planners and obtaining a letter from their company's finance and legal teams certifying QSBS status.

Conclusion

To maximize potential tax savings, we encourage founders, private-company executives and other startup employees to learn about QSBS and QSBS strategies well in advance of a potential sale of shares. An optimal strategy will depend on a client's specific circumstances, needs and preferences. Please reach out to your Morgan Stanley Financial Advisor for assistance in sorting through these critical details.

Disclosure Section

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