Morgan Stanley

PRIVATE WEALTH MANAGEMENT

FINANCIAL PLANNING

Qualified Small Business Stock

Wealth and Estate Planning Strategists
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Fifty, Seventy-Five and One Hundred Percent Gain Exclusion

In general, Internal Revenue Code Section ("IRC") 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 5 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.
- 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 up to 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 a 100% exclusion of the gain (subject to the discussed maximums). Thus, the lesser gain exclusions (50% and 75%) continue to apply to QSB stock acquired during certain time periods.
- A 28% (plus the 3.8% 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 regular capital gain rate.
- However, the Alternative Minimum Tax ("AMT") may apply. Section 1202 generally permits noncorporate taxpayers to potentially exclude up to 100 percent of the gain realized from the sale or exchange of QSBS held for more than five years (provided the stock acquisition date is September 28, 2010 or later). The exclusion is applicable for both regular and alternative minimum tax purposes. The gain eligible for exclusion is limited to the greater of $10 million or 10 times the taxpayer's cost basis in

the stock of the issuer sold or exchanged during the year.

- In general, to qualify as a "small business" under IRC 1202, the corporation must have have less than $50,000,000 of gross assets at all times, 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 corporate cannot issue QSBS, even if its aggregate gross assets fall below $50,000,000 in the future.

- Among the numerous requirements of IRC 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
  - A banking, insurance, finance, leasing, investing or similar business
  - Any farming business
  - Any business involving the production or extraction of depletable assets; or
  - Any business of operating a hotel, restaurant or similar business.

- IRC 1202 applies to stock issued after the enactment of the 1993 legislation (August 10, 1993). Taking into account the 5-year holding period requirement, the exclusion became available to taxpayers beginning August 12, 1998.
  - Therefore, beginning August 12, 1998, taxpayers can sell qualified small business stock and not pay income tax on some or all of the gain up to the greater of $10,000,000 or 10 times the aggregate adjusted basis.

- In effect, this means that taxpayers can sell their investments and have more of the proceeds available for reinvestment.
- Keep in mind, the current long term capital gains rate is 20%, plus the 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 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.

Rollover

- IRC 1202 does not deal with 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 one qualified small business to another without recognizing the gain.
  - The original stock must have been held for more than 6 months and the replacement stock must be acquired within 60 days from the sale date. Only gain over and above 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 1045 allows taxpayers to dispose of their IRC 1202 QSBS without waiting more than 5 years.

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