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Identifying Qualified Small Business Stock can help you realize significant tax savings

A U.S. capital gains tax exclusion applicable to the sale of Qualified Small Business Stock (QSBS) is of significant value to entrepreneurs and others who invest in many early-stage private companies. Below are answers to some of the frequently asked questions we're hearing, and that can be a helpful first step to determine if you meet the special requirements for tax savings.

Q: WHAT IS THE QSBS EXCLUSION?

A: In 1993, Congress created a tax incentive to encourage investment in certain small businesses. If you and your stock meet certain criteria, you may be able to reduce or eliminate capital gains tax on its sale.

Q: HOW MUCH CAPITAL GAINS CAN I EXCLUDE?

A: Gain on QSBS up to the greater of (a) $10 million or (b) 10 times your cost basis could receive preferential tax treatment. Depending on when the stock was acquired, you may be able to exclude from 50% to 100% of the gain from capital gains tax.

Acquisition Date	Gain Exclusion	Effective Rate	Effective AMT* Rate
08/11/93-02/17/09	50%	15.90%	16.88%
02/18/09-09/27/10	75%	7.95%	9.42%
09/28/10 or later	100%	0%	0%

* Alternative Minimum Tax.

Q: WHAT TAX RATE APPLIES TO THE QSBS GAIN ABOVE THE EXCLUDABLE AMOUNT?

A: For QSBS acquired from August 10, 1993 to September 27, 2010, the non-excludable gain within the per-issuer limit (typically $10 million) is taxed at a flat rate of 28%, plus the 3.8% surtax on unearned income. For instance, if you realize gains of $10 million on zero-basis QSBS acquired in August 2010 (when the exclusion was 75%), you would pay no tax on $7.5 million of gain, but at a flat 31.8% (28% + 3.8%) rate on the non-excludable $2.5 million.

Q: WHAT ARE THE QSBS REQUIREMENTS FOR MY BUSINESS?

A: For your stock to be considered QSBS, the business must:

1. Be a domestic C Corporation throughout your holding period (company cannot be a pass-through entity, such as a partnership or S Corporation)
2. Have had gross assets of $50 million or less when you received shares and at all times prior
3. Not be in an excluded industry (see below)

Q: WHAT INDUSTRIES ARE EXCLUDED?

A: The stock of businesses in certain industries will not be QSBS eligible. Those industries include (but are not limited to) financial services, farming, accounting, consulting, healthcare, law and hospitality.

Q: WHAT ARE THE QSBS REQUIREMENTS FOR ME AS AN OWNER?

A: For your stock to be considered QSBS, you must:

1. Be a non-corporate taxpayer
2. Have received the stock at "original issuance"
3. Have held shares for five years or longer
4. Not have an offsetting position with regard to the stock

Q: HOW IS THE GROSS ASSET VALUE CALCULATED?

A: The gross asset test is generally based on the corporation's adjusted cost basis, not its fair market value at the relevant time.

Q: WHAT DOES "ORIGINAL ISSUANCE" MEAN?

A: It means that the taxpayer must either have purchased or received the shares directly from the corporation. This includes receipt of shares as compensation—for instance, someone who received "founder's shares" or received stock as compensation, or acquired the stock by exercising options. Stock acquired from another investor is not QSBS.

Q: IF I INHERIT SHARES OR RECEIVE THEM AS A GIFT, DOES THE FIVE-YEAR HOLDING PERIOD RESTART?

A: No, you would tack onto the original owner's holding period.

Q: IF I OBTAIN QSBS FROM EXERCISING OPTIONS, WHEN DOES THE HOLDING PERIOD BEGIN?

A: The holding period would begin on the date of exercise, not the grant date.

Q: CAN I "STACK" ADDITIONAL QSBS EXCLUSIONS BY GIFTING TO A TRUST?

A: Some owners of QSBS seek to maximize the $10 million exclusion amount by gifting to separate non-grantor irrevocable trusts for the benefit of children or other family members. The theory is that each trust then has its own $10 million gain exclusion. However, this interpretation is not certain under controlling law. We recommend consulting with outside tax advisors to independently determine the technical merits of this position.

Q: IF I SELL QSBS-ELIGIBLE SHARES AND THEN INVEST IN ANOTHER QUALIFIED SMALL BUSINESS, CAN I MAINTAIN MY INITIAL HOLDING PERIOD?

A: Yes. Doing so would also allow you to defer gains recognition. However, you must have held the initial QSBS for more than six months and must roll the proceeds into the new company within 60 days of the sale.

Q: DOES THE QSBS EXCLUSION APPLY TO STATE-LEVEL TAXES?

A: Not necessarily. Some states allow an exclusion from state-level taxation; others do not. In New York, for example, the exclusion on a state level mirrors that of the U.S. government. However, California does not recognize QSBS for state purposes.

Q: IS QSBS GAIN SUBJECT TO THE ALTERNATIVE MINIMUM TAX (AMT)?

A: For shares acquired prior to September 28, 2010, 7% of the excluded portion of the gain is a preference item for AMT purposes.

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