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Working with the Wealthy

Simplifying QSBS: Tax Benefits and Questions To Ask

By: Holly Swan | September 20, 2023

One of the best examples of Uncle Sam being a coach, rather than a referee, is the qualified small business stock (QSBS) exclusion. While you don't need to know the ins and outs of the Internal Revenue Code (IRC), understanding the benefits of QSBS from a tax perspective can help you ask questions to spot issues and opportunities that should be addressed by your clients' tax advisors.

Tax Benefits of QSBS

Uncle Sam wants to encourage investments in smaller businesses with the QSBS exclusion. Here's some history of this tax incentive:

- In 1993, IRC section 1202 was enacted as an incentive for taxpayers to start and/or invest in certain small businesses. At that time, qualifying shareholders could exclude the larger of 50% of the gain on the sale of qualifying stock up to $10M or 10x their basis in the stock.
- In 2009, the percentage of gain that could be excluded increased to 75%.
- In 2010, the percentage of gain that could be excluded increased to 100%.

It's important to note that a company must be considered an "active business" in a *qualified trade* for the required holding period in order to qualify for the QSBS exclusion. Personal services (e.g. legal, accounting, engineering, etc.), banking, finance, leasing, farming, hotels, restaurants and several other industries are excluded from qualifying.

Questions To Ask

Here are a few questions you can ask your clients to determine if they're potentially eligible for the QSBS gain exclusion:

- **"Is your company structured as a domestic C-corporation?"** In order to be eligible, the company must be one of the following: (i) domestic C-corporation, (ii) partnership or LLC taxed as a C-corporation, (iii) S-corporation that has converted to C-corp.
- **"Do you know what year the company was formed?"** Stock issued before 1993 is not eligible for the QSBS exclusion. Qualifying stock issued between August 11, 1993, and February 17, 2009, is eligible for a 50% exclusion. Qualifying stock issued between February 18, 2009, and September 27, 2010, is eligible for a 75% exclusion. Qualifying stock issued after September 29, 2010, is eligible for the full exclusion.
- **"How long have you held your stock?"** Stock from a qualified company must be directly issued by the company and must be held for a minimum of five years in order to qualify.
- **"Do you know what the company's value was prior to the issuance of your shares?"** The company must have had less than $50M in aggregate gross assets at the time the stock was issued.

If clients' answers to these questions lead you to believe they could be QSBS eligible, encourage them to involve their CPA and tax attorney.

Bottom line: Help clients understand the potential tax advantages of QSBS, especially clients who are contemplating liquidity events and need to know whether their stock is QSBS.

Source: Internal Revenue Code Section 1202.

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