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Craig Smalley • Aug. 30, 2017

On December 18, 2015, embedded in the Protecting Americans From Tax Hikes (PATH) Act, was a tax break known as qualified small business stock (QSBS). QSBS isn't really something new, it just depends on the part of the Tax Code that you are talking about. For the purposes of this article, we are going to focus on IRC §1202 Stock.

First of all, to qualify as IRC §1202 Stock, the stock must be in a domestic C-Corporation. The stock cannot be held by an S-Corporation or a limited liability company (LLC). Another caveat is that the corporation may not have more than $50 million in assets as of the date of issuance of the stock or immediately thereafter. Further, the commencement period for holding the stock must begin with the original shareholder.

A person that acquires the stock on a secondary market is not eligible for the

- A service business in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services
- A banking, insurance, financing, leasing, investing, or similar business
- A farming business
- A business involving the production of products for which percentage depletion can be claimed
- A business of operating a hotel, motel, restaurant, or similar business

The tax benefits of IRC §1202 stock come to light as you hold the stock for a period of five years and then sell the stock – the first $10 million is tax-free. The remaining capital gain, if any, is taxed at 28%, presuming that you are in the 15% to 20% bracket for regular capital gains.

IRC §1202 capital gains tax avoidance depends on when you received your stock. If you received your stock before February 18, 2009, there is a 50% exclusion. If received between February 19, 2009 and September 27, 2010, there is a 75% exclusion, and finally for September 28, 2010 or later, the 100% exclusion kicks in.

Let's look at an example of how this would work. Say that you start a technology business in October of 2010. The business does well and an investor offers to buy you out. He offers you $9.5 million for your stock. The transaction would be tax-free. In another example using the same time frame only the offer was $11 million, you would pay 31.8% tax on $1 million. That would be calculated as 28% capital gains tax and 3.8% in Net Investment Income Tax (NIIT).

However, there is an issue on any stock that is bought before September 28, 2010. Not only is there a partial reduction in the amount of tax you pay, there is also that dreaded Alternative Minimum Tax (AMT) of 7%.

Remember how when we started off as tax professionals, we had it beat into our

company is a domestic C-Corporation if it has $50 million or less in assets immediately after your purchase, and that at least 80% of the company assets are used in the active conduct of a qualifying business.

One more thing to think about. Let's say that you have QSBS that you have held for less than five years and your shares are acquired by a larger company (Not a QSBS), and you receive stock in the acquirer instead of cash. Just because you disposed of the stock before the five-year term doesn't necessarily mean that the stock that you acquired doesn't become QSBS in your hands. This can happen if the QSBS in your hands is to the extent of the gain at the time of the transaction.

For example, let's say that you own 500,000 shares of XYZ Corp and that represents all of shares of stock in the corporation. Your basis in the stock is $1,000 and you acquired the stock February 15, 2010. On June 19, 2013, ABC Corp acquires 100% of your shares for stock with a basis of $6 million. You would have an unrealized gain of $5,999,000. Let's say in July of 2016, your ABC shares are now worth $8 million and you sell. You would have to pay tax on $2,001,000 because the first $5,999,000 would be tax free.

This is where we as professionals earn our money. Learn these rules and learn them well. You never know when you might use them.

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