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Qualified Small Business Stock Number Crunching

By Robert W. Wood • Wood & Porter • San Francisco

If you sell stock at a gain, you hope to pay tax at capital gains rather than ordinary income rates. As long as the stock wasn't tied to certain kinds of options, and as long as you've held the stock for more than a year, you should be happy. After all, the difference between a 15-percent rate and a 35-percent rate is monstrous.

But taxpayers are to be forgiven for not rushing to pay even a 15-percent tax when they don't have to. Even better, you might hope to qualify for a surprisingly little known (but quite generous) benefit to which company founders and certain others are entitled. The benefit is known generically as "Qualified Small Business Stock," or "QSBS" for short.

Although some of the rules are simple, the vast majority are not. It behooves every investor, lawyer and accountant to know the basics of this bonanza, particularly since so many taxpayers seem to be ignorant of the provision. Moreover, it turns out that for those taxpayers who do claim tax benefits under this provision, audit rates appear to be high. That means you need to know not only enough to claim the deduction or exclusion, but also enough to later defend it.

Internal Revenue Code Section ("Code Sec.") 1202 allows many taxpayers to exclude 50 percent of the gain on selling QSBS they held for more than five years. Three key issues are the holding period requirements, applicable tax rates, and the impact of the alternative minimum tax (AMT). Of course, before we get to those nuances, just what is QSBS?

QSBS Defined

To qualify as QSBS, the stock must be:

- issued by a C corporation with no more than $50 million of gross assets at the time of issuance;

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- of a corporation that uses at least 80 percent of the asset value in an active trade or business, other than in the fields of personal services, finance, farming, restaurants or hotels, *etc;*
- issued after August 10, 1993;
- held by a noncorporate taxpayer (meaning any taxpayer other than a corporation);
- acquired by the taxpayer on original issuance (although there are exceptions to this rule); and
- held for a more than six months (to be eligible for a tax-free rollover under Code Sec. 1045), and more than five years to qualify for a 50-percent gain exclusion.

It should be evident from this list that there are really two types of QSBS benefits, one involving an exclusion, and one just a rollover of the gain. The stock's holding period is the key. The rollover provision was first available for sales after August 5, 1997. Yet, since the corporation must have issued the stock after August 10, 1993, no one could qualify for the exclusion until August 12, 1998.

The exclusion has some wrinkles too. The 50-percent gain exclusion is generally limited to $5 million per taxpayer per issuer. Thus, a taxpayer who sells shares with a gain in excess of $10 million may be able to exclude 50 percent of the gain up to $5 million. If you are a company founder, or if you represent founders, this should get your attention.

The $50 million standard is unforgiving. In order for a corporation's stock to be QSBS, the following must apply:

- At all times after August 10, 1993, and before it issues the stock, the corporation must have aggregate gross assets (as defined below) that do not exceed $50 million.
- Immediately after it issues the stock, the corporation must have aggregate gross assets that do not exceed $50 million. For this purpose, amounts received in the stock issuance are taken into account.

A company may pass into and out of those standards, but it has consequences. If a corporation satisfies these gross asset tests on the date the stock was issued, but later exceeds the $50 million asset threshold, stock that otherwise constitutes QSBS does not lose that character solely because of that later event. On the other hand, if a corporation (or a predecessor corporation) exceeds the $50 million asset threshold, it can never again issue QSBS.

You don't have to be an individual to benefit from the QSBS rules. Nonrecognition of gain is possible through a partnership, S corporation, regulated investment company or common trust fund if the following apply:

- The entity held the qualifying stock for more than five years.
- A taxpayer sharing in the gain held the interest in the passthrough entity at the time the taxpayer acquired the qualifying stock, and at all times thereafter.

Four Holding Period Rules

When a noncorporate investor sells QSBS at a gain, the tax consequences depend on the taxpayer's holding period:

1. **Six months or less.** If the taxpayer has held the QSBS for six months or less, the gain is a short-term capital gain, taxed at individual

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rates. Obviously, this is not an attractive option, unless the gain can be offset with capital losses.

2. **More than six months but not more than one year.** If the taxpayer has held the QSBS for more than six months but not more than a year, the gain is a short-term capital gain, taxed at individual rates. However, as an alternative to recognizing short-term gain, the investor may defer the gain by rolling over the investment into other QSBS under Code Sec. 1045 within 60 days of the sale. As with other nonrecognition sections, the seller recognizes gain to the extent he retains part of the sales proceeds ("boot"). The basis of the stock sold becomes the basis of the QSBS purchased, subject to adjustment (less boot and plus gain recognized). Plus, the taxpayer may tack the holding period of the old stock onto that of the new stock.
3. **More than one year, but not more than five years.** If the taxpayer has held the stock for more than one year, but not more than five years, any gain is taxed at the maximum rate of 15 percent (five percent if the investor is in the 10 percent or 15 percent bracket), unless it is offset by capital losses.
4. **More than five years.** If the taxpayer has held the stock for more than five years, the tax benefits of QSBS are paradoxically cut back. Under Code Sec. 1202, a taxpayer does not recognize regular old long-term capital gain. Instead, the taxpayer is permitted to exclude one-half of the gain recognized (reduced by any gain deferred through a rollover) under Code Sec. 1202. However, the alternative minimum tax (AMT) creeps into the mix, which may cause the taxpayer to pay nearly as much tax—despite this long holding period—as he would under the regular long term capital gain rate.

Effective Tax Rates

Although the QSBS rules are a good deal, and worth fretting over the details, tax rate issues can sometimes be confusing. Even before we get to AMT (more about that below), there's a tax rate foible one must recognize. The whopping 50-percent gain exclusion for QSBS was enacted in 1993, at a time when the capital gain rates for noncorporate taxpayers were still 28 percent. Many readers will recall that the capital gain rate was reduced to 20 percent in 1997, and then again to 15 percent in 2003. There is much talk today of increasing the capital gain rate, but it remains at 15 percent for at least the foreseeable future.

The bad news here is that the 50-percent gain exclusion provided by Code Sec. 1202 requires reference to the historical 28-percent capital gain rate. A 50-percent exclusion from those historic rates means that a taxpayer will generally pay 14 percent on his gains. For a current sale, paying a 15-percent capital gain tax on the entire gain versus paying 28 percent on 50 percent of the gain (for an effective rate of 14 percent) seems like a trivial difference. It certainly accounts for the relative lack of interest in QSBS stock rules today compared with the period prior to 1997, and even up through 2003.

AMT in the Mix

AMT seems omnipresent lately. And of course, it changes the landscape of the exclusion. The gain from the sale of QSBS can be divided into two parts, excludable gain and includible gain. Let's start with the gain included in income. That gain is taxed in the 28-percent tax bracket, together with net long-term gains from collectibles and long-term capital loss carryovers. That's rather straightforward.

The excludable gain involves AMT and is a bit more complicated. To illustrate, let's say Joe purchases QSBS in a qualified entity on January 1, 1995. He holds the stock continuously until he sells the stock on January 1, 2005. The gain on the sale of the stock is $1 million. Joe is eligible for a 50-percent exclusion, which is $500,000. If the AMT does not apply, then Joe is taxed on only $500,000 at 28 percent, and pays $140,000 in taxes. The effective tax rate is 14 percent.

However, if AMT applies, seven percent of the $500,000 exclusion is treated as a preference item. That means Joe can only exclude $465,000 (7% x $500,000) of gain, rather than $500,000. Joe must include $35,000 in his taxable income, in addition to the remaining $500,000. Joe's effective tax rate increases to 14.91 percent (paying tax of $149,100) if he is in the 26-percent AMT bracket, or 14.98 percent if he is in the 28-percent AMT bracket (paying tax of $149,800).

The AMT creates a disincentive to hold stock for five years, because Joe, from the example above, could hold the stock for merely one year and be taxed at the long term capital gain rate of 15 percent (or pay a tax of $150,000). The obvious question is whether it's worth it to hold on to stock for an extra four years, if the taxpayer saves merely $200 in taxes.

New Mindset

Due to the obvious benefit of having gain on stock taxed as long-term capital gain, taxpayers have long been accustomed to thinking of "more than one year" as the requisite holding period to obtain tax savings. The QSBS rules require a considerably longer view (five-plus years), or a considerably shorter view (six months and a day). Indeed, taxpayers who invest in QSBS should not be misled. If they merely intend to reinvest their proceeds from the sale of QSBS in *other* QSBS stock, the relevant holding period is more than six months.

Continuing to hold the stock and passing the one-year mark may not offer an additional tax benefit. On the other hand, five years is a long time. For those taxpayers who may have been encouraged to purchase QSBS because of the potential for a 50-percent exclusion of gain if they hold the stock for more than five years, that five years and a day may seem a long time coming.

Moreover, taxpayers who are subject to AMT may find the benefit of reaching this more than five year holding period (rather than the shorter one for long-term capital gain) to be minimal.

If You Have Losses on QSBS

Although the tax bonanza of the QSBS rules are plainly geared toward gains, losers are not entirely left out. In fact, there is limited ordinary loss treatment. Under Code Sec. 1244, an individual may deduct (as ordinary losses) up to $50,000 per year ($100,000 on a joint return) of losses on "small business stock," even if the stock is *also* QSBS. This is a broader class of stock than QSBS. Yet, only the first $1 million of stock qualifies for this ordinary loss treatment.

Note that this rule applies only to individual taxpayers, which is a much more restrictive classification than the noncorporate taxpayer eligibility rule in Code Sec. 1202. Furthermore, only the original shareholders are eligible, and an active trade or business must generate more than half the gross receipts. The loss may be a result of a sale, worthlessness or a liquidation.

To Pay or Not to Pay?

One hallmark of any tax rollover is that you are delaying the incidence of taxation. Tax deferral is traditionally the province of tax planners. Axiomatically, a tax paid later is always better than one paid today.

Yet, with federal capital gains rates at a historic low, and with nearly every projection contemplating an eventual increase in capital gains rates, paying tax now can make sense. Our primordial urge to defer gain should be tempered with the knowledge that every rule should occasionally be broken. Even axioms can have exceptions.

The benefit of holding QSBS has arguably declined with falling capital gain rates. The complexity of the federal statute, together with state QSBS rules that can be dizzying, may offset some of the anticipated tax benefits. In some cases, it may pay intentionally to fail the QSBS tests. One variable in this analysis should be whether the taxpayer is paying AMT.

Of course, for many of us, a rollover opportunity is still significant. If a taxpayer plans to reinvest any proceeds from the sale in any event, or if a taxpayer is making another investment that might meet the timing of Code Sec. 1045 discussed above, the rollover should be considered. Just as with Code Sec. 1031 like-kind exchange analysis for real estate investments, consider the benefits and burdens of each approach.

The federal rollover provision, Code Sec. 1045, provides for the deferral of gain from the sale of QSBS where replacement QSBS is acquired. A taxpayer may elect to defer the gain on acquiring QSBS within 60 days from the sale. The IRS has been liberal in its allowance of elections. In fact, Rev. Proc. 98-48 allows the taxpayer to make this rollover election either on an original return or an amended return.

In California, the FTB has adopted the IRS rules and procedures relating to QSBS and qualified rollovers. Yet, if replacement stock is purchased within 60 days of the sale of the QSBS, but the taxpayer fails to label the replacement stock on the taxpayer's income tax return, California auditors will generally disallow rollover treatment and refuse to permit the taxpayer to file an amended return correcting the election. However, where the taxpayer reinvests and elects, and the only issue is whether the election does not reference the correct date of sale, an amended return is allowed under IRS procedures (adopted by the FTB) to remedy this situation.

Conclusion

No one will accuse the QSBS rules of being particularly user-friendly or capable of quick summary. Still, there are tax benefits here that more people probably need to know about than currently do. This is the case notwithstanding the currently modest tax rates, that to some observers might suggest that taxpayers should simply pay a 15-percent capital gain tax on their gains and not worry about sophisticated tax planning.

After all, while the need for tax-free rollover provisions may be particularly poignant during times of high tax rates, there has been no suggestion from other sectors of the economy (for example, tax-free real estate exchanges under Code Sec. 1031) that taxpayers are happy to pay their tax in times of low rates. That leads me to think that the QSBS rules should be examined more closely by more taxpayers.

From a practitioner's point of view, one might well regard the QSBS rules as a malpractice suit waiting to happen. Rather than proving to be a reason practitioners should steer clear of any knowledge of the QSBS rules, perhaps that should serve as a wake-up call that at least its rudiments should be mastered.