Advanced Planning Perspectives

Qualified Small Business Stock (QSBS)

Justin Makso and Kevin Chung, Financial Planners, First Republic Investment Management

Small businesses drive U.S. economic growth. Lawmakers are well aware of the significant contributions to economic and job growth made by small businesses. As a direct incentive for starting and investing in small businesses, Congress has provided varying levels of beneficial treatment in the tax code for Qualified Small Business Stock (QSBS) since 1993. However, recent tax law changes, including the reduction of the C Corporation income tax rate to a flat 21% (down from a top marginal rate of 35%) under the 2017 Tax Cuts and Jobs Act, have made C Corporation status and QSBS treatment more attractive than ever. As a result, entrepreneurs and investors should seriously consider the often-overlooked incentives for starting or investing in Qualified Small Businesses.

What is Qualified Small Business Stock (QSBS)?

Internal Revenue Code Section 1202 permits some or all of the gains on QSBS to be excluded from federal capital gains taxes when sold or exchanged by an individual or other non-corporate taxpayer, if certain conditions are met. In order to qualify for gain exclusion under Section 1202, QSBS must be held for at least five years. The stock may be acquired by the taxpayer in exchange for money or other property (not including stock), or as compensation for services provided to the corporation. To qualify as QSBS, the stock must be directly issued by the business. (In other words, it cannot be purchased on the secondary market.)

In order for a corporation to issue QSBS, the corporation must be a domestic C Corporation, the stock must have been issued after August 10, 1993, and the corporation's aggregate gross assets must not have exceeded $50 million both at any time before and immediately after the stock issuance. Aggregate gross assets are calculated as cash, plus the adjusted tax basis of property; liabilities are not considered in the calculation.

A corporation issuing QSBS must also satisfy the active business requirement that at least 80% (by value) of the corporation's assets (including intangible assets) must be used by the corporation in the active conduct of one or more qualified trades or businesses substantially all of the time (rather than simply as an investment company).

Most for-profit trades or businesses will qualify. However, certain trades and businesses are specifically not eligible for QSBS treatment:

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services (banking, insurance, financing, leasing, investing or similar business), brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.
- Any farming business.
- Any business involving the production or extraction of natural resources (including oil or gas).
- Any business of operating a hotel, motel, restaurant or similar business.

Basics of Qualified Small Business Stock (QSBS) taxation

Assuming that the above QSBS requirements are met, the maximum gain that is eligible for exclusion in a given tax year is the greater of $10 million (reduced by any eligible gain taken in previous years) or 10 times the taxpayer's adjusted basis in the stock sold during that tax year. The eligible gain limitations are applied on a per-taxpayer and per-issuer basis.

Example #1: If Jennifer sells all $30M of her QSBS with a total basis of $2M in a single tax year, then the amount eligible for gain exclusion would be $20M (the greater of $10M or $20M [10x $2M basis]).

The percentage of the eligible gain that is excluded from federal capital gains taxation could be 50%, 75% or 100%, depending upon the date that the QSBS was acquired. (The amount excluded is known as “Excluded Section 1202 Gain,” while the remaining eligible gain that is not excluded is called “Section 1202 Gain.”) A 50% gain exclusion is applicable for QSBS acquired between August 11, 1993, and February 17, 2009, while a 75% gain exclusion applies if acquired between February 18, 2009, and September 27, 2010. QSBS acquired on or after September 28, 2010, is entitled to a 100% exclusion. (The 2015 PATH Act permanently extended the 100% exclusion for QSBS acquired after December 31, 2014.)

Example #2: Let’s assume that Jennifer acquired the QSBS in January 2010, so she can exclude 75% of the eligible gain. As a result, 75% of the $20M eligible gain (or $15M) would be “Excluded Section 1202 Gain” while the remaining 25% (or $5M) would be “Section 1202 Gain.” In contrast, if Jennifer had acquired the stock in 2011, her QSBS would be subject to the 100% exclusion and all of the $20M eligible gain would be excluded from federal capital gains tax.

When only a partial gain exclusion applies (i.e., QSBS acquired between August 11, 1993, and September 27, 2010, and subject to the 50% or 75% exclusion), the non-excluded percentage (“Section 1202 Gain”) will be subject to a special QSBS tax rate (same as ordinary income tax rates, but capped at 28%), plus an additional 3.8% Medicare surtax on net investment income. Note that the special “Section 1202 Gain” tax rates are higher than the preferential long-term capital gains rates.

Example #3: Since Jennifer excluded 75% of her $20M eligible gain, the remaining 25% (or $5M) of “Section 1202 Gain” would be subject to taxes of $1.59M (Calculation: $5M x 31.8% [28% special QSBS tax rate + 3.8% Medicare surtax]).

In addition, when a partial gain exclusion applies, 7% of the “Excluded Section 1202 Gain” is added back as a preference item when calculating the alternative minimum tax (AMT) and is subject to a maximum 28% federal tax rate. Note that the AMT inclusion does not apply to QSBS eligible for the 100% exclusion (i.e., QSBS acquired on or after September 28, 2010).

Example #4: Jennifer qualified for a partial gain exclusion, so 7% of her $15M of “Excluded Section 1202 Gain” would be included for AMT purposes. As a result, assuming she’s subject to AMT, the AMT inclusion would result in an additional $294,000 of alternative minimum taxes (Calculation: $15M x 7% AMT inclusion percentage x 28% maximum AMT rate).

Finally, any gain in excess of the eligible gain limitations is considered “Non-Section 1202 Gain” and is subject to normal capital gains tax rates (maximum 20%), plus the 3.8% Medicare surtax.

Example #5: Jennifer has realized gains of $28M (Calculation: $30M sale – $2M basis), of which only $20M is eligible for gain exclusion. The remaining $8M (Calculation: $28M realized gain – $20M eligible for gain exclusion) is “Non-Section 1202 Gain” and subject to a maximum 23.8% tax rate. As a result, Jennifer would owe approximately $1.904M in long term capital gains taxes (Calculation: $8M x 23.8% [20% long-term capital gains tax rate + 3.8% Medicare surtax]).

Illustration 1: Calculating QSBS gains

<table>
<tr><td rowspan="3">$30M
Total Sale</td><td>$8M
Non-Eligible
Gain</td><td colspan="2">Non-Section 1202 Gain</td></tr>
<tr><td>$20M
Eligible Gain
(Greater of
$10M or
10x Basis)</td><td>Excluded Section
1202 Gain
(50%/75%/100%
Exclusion Percentage)</td><td>Section
1202
Gain</td></tr>
<tr><td>$2M Basis</td><td colspan="2">Basis</td></tr>
</table>

Illustration 2: Exclusion/inclusion percentages

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QSBS Acquisition Date	QSBS Excluded Gain Percentage	AMT Inclusion Percentage
8/11/1993–2/17/2009	50%	7%
2/18/2009–9/27/2010	75%	7%
9/28/2010 or Later	100%	0%

The illustration below provides a detailed comparison of the federal tax liability for Jennifer's example under various scenarios (no gain exclusion versus the 50%, 75% and 100% gain exclusions).

Illustration 3

		Publicly Traded Non-QSBS Sale	QSBS Sale		
		Long-Term Gain Stock	Acquired 8/11/1993–2/17/2009	Acquired 2/18/2009–9/27/2010	Acquired 9/28/2010 or Later
QSBS Gain Exclusion %					
Total Sale Proceeds		$ 30,000,000	$ 30,000,000	$ 30,000,000	$ 30,000,000
Adjusted Basis		(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)
Gain on Sale	(a)	**$ 28,000,000**	**$ 28,000,000**	**$ 28,000,000**	**$ 28,000,000**
Eligible Gain: Greater of $10M or 10x Basis[1]	(b)	$ -	$ 20,000,000	$ 20,000,000	$ 20,000,000
QSBS Gain Exclusion %		x 0%	x 50%	x 75%	x 100%
Excluded Section 1202 Gain	(c)	**$ -**	**$ 10,000,000**	**$ 15,000,000**	**$ 20,000,000**
Section 1202 Gain (b – c)	(d)	**$ -**	**$ 10,000,000**	**$ 5,000,000**	**$ -**
Tax Rate on Section 1202 Gain[2]		x 31.8%	x 31.8%	x 31.8%	x 31.8%
Tax Liability on Section 1202 Gain	(e)	**$ -**	**$ 3,180,000**	**$ 1,590,000**	**$ -**
Excluded Section 1202 Gain Subject to AMT Inclusion[3]		N/A	$ 10,000,000	$ 15,000,000	N/A
AMT Inclusion %		N/A	x 7%	x 7%	N/A
AMT Preference Item Amount		N/A	$ 700,000	$ 1,050,000	N/A
Maximum AMT Tax Rate		x 28%	x 28%	x 28%	x 28%
AMT Tax Liability	(f)	**$ -**	**$ 196,000**	**$ 294,000**	**$ -**
Non-Section 1202 Gain (a – b)	(g)	$ 28,000,000	$ 8,000,000	$ 8,000,000	$ 8,000,000
Tax Rate on Non-Section 1202 Gain[4]		x 23.8%	x 23.8%	x 23.8%	x 23.8%
Tax Liability on Non-Section 1202 Gain	(h)	**$ 6,664,000**	**$ 1,904,000**	**$ 1,904,000**	**$ 1,904,000**
Total Tax (e + f + h)		**$ 6,664,000**	**$ 5,280,000**	**$ 3,788,000**	**$ 1,904,000**
Effective Tax Rate (Total Tax / Gain on Sale)		**23.80%**	**18.86%**	**13.53%**	**6.80%**
Total Tax on QSBS Eligible Gain Only (e+f)	(i)	**N/A**	**$ 3,376,000**	**$ 1,884,000**	**$ -**
Effective Tax Rate on QSBS Eligible Gain Only (i/b)		**N/A**	**16.88%**	**9.42%**	**0.00%**

Assumes the investor is subject to AMT and the Net Investment Income (NII) tax of 3.8%. State income tax and other itemized deduction phase-outs are not considered.

(1) The $10M Limitation is reduced by any eligible gain taken in previous years. Assumes no eligible gain taken in previous years.

(2) Tax Rate on Section 1202 Gain represents maximum Section 1202 tax rate of 28% plus NII rate of 3.8%.

(3) Only applies to 50% and 75% gain exclusion.

(4) Tax Rate on Non-Section 1202 Gain represents maximum long-term capital gains tax rate of 20% plus NII rate of 3.8%.

State tax implications

While Section 1202 provides exclusion from federal taxation, the state and local tax treatment of QSBS gains may not follow the federal treatment and should be considered when planning for QSBS. Five states (California, Alabama, Mississippi, Pennsylvania and Wisconsin) do not recognize QSBS treatment so regular state capital gains tax rules apply in those states. (California eliminated its QSBS gain

exclusion for stock sold on or after January 1, 2013.) Certain states, including Massachusetts and New Jersey, provide a modified QSBS gain exclusion. Most other states either follow the federal QSBS treatment (e.g. New York, Connecticut and Oregon) or do not tax capital gains in general (e.g., Florida, New Hampshire and Wyoming).

The timing and order of QSBS sales matters

Keep in mind that the maximum gain that may be excluded in a given year is the greater of $10 million (reduced by eligible gain taken in previous years) or 10 times the basis of shares sold that year. Notice that only the $10M Limitation is reduced by previously taken eligible gains while the 10x Basis Limitation is not reduced. In other words, even if you use up the $10M Limitation, you may still be eligible for additional gain exclusion if you retain QSBS with basis. As a result, the timing and order in which you sell QSBS can affect how much gain you can exclude, especially when you have multiple lots with different cost bases.

In particular, if you hold only 100% exclusion QSBS, then you can maximize your overall eligible gain exclusion by selling the lowest basis lots first until you exhaust the $10M Limitation. Then, in subsequent years when only the 10x Basis Limitation remains, you could sell the higher basis lots to increase the amount of eligible gain exclusion. (Note: More complicated calculations are required to determine the optimal strategy when you hold QSBS with various gain exclusion percentages.)

Example #6: Jennifer has two lots of QSBS that each qualify for 100% gain exclusion and are worth $15M each for a combined $30M. She was the founder of the company, so her basis in the first lot (acquired in January 2013) is $0. Her second lot was acquired in January 2014 for $2M.

If Jennifer sells all $30M of her QSBS in a single tax year, then she would have a total gain of $28M ($30M FMV – $2M basis), of which $20M (greater of $10M or 10 times her $2M basis) would be "Excluded Section 1202 Gain" (no federal taxes) and the remaining $8M would be "Non-Section 1202 Gain" (subject to capital gains taxes).

Scenario	Year Sold	Basis	Sale Price	Gain	Remaining $10M Limitation	10x Basis Limitation	Excluded Section 1202 Gain (100%)	Non-Section 1202 Gain
Sell All in Same Year	2018	$2M	$30M	$28M	$10M	$20M (10x $2M Basis)	$20M	$8M
Total		**$2M**	**$30M**	**$28M**			**$20M**	**$8M**

However, if Jennifer sells the lower basis lot first in February 2018 and the higher basis lot in February 2019, she could increase her overall excluded gain. When the first lot is sold in 2018, she could exclude $10M (greater of $10M or 10 times $0M basis) of the $15M gain. When the second lot is sold in 2019, she would have already used up her $10M Limitation in the previous year, but would still have her 10x Basis Limitation available. Thus, she could exclude up to $20M (greater of remaining $0M or 10 times her $2M basis), enough to shelter all of her $13M gain on the second lot. As a result, Jennifer is able to exclude a combined total of $23M (versus $20M if she sold all of her QSBS in a single tax year.)

Scenario	Year Sold	Basis	Sale Price	Gain	Remaining $10M Limitation	10x Basis Limitation	Excluded Section 1202 Gain (100%)	Non-Section 1202 Gain
Sell Lot #1 in Year 1	2018	$0M	$15M	$15M	$10M	$0M (10x $0M Basis)	$10M	$5M
Sell Lot #2 in Year 2	2019	$2M	$15M	$13M	$0M ($10M-$10M)	$20M (10x $2M Basis)	$13M (up to $20M)	$0M
Total		**$2M**	**$30M**	**$28M**			**$23M**	**$5M**

Note: Jennifer could have fully optimized the gain exclusion by limiting the amount sold in the first year to the $10M Limitation and limiting the amount sold in each subsequent year to the 10x Basis Limitation. If Jennifer sells only $10M of Lot #1 in 2018, she could exclude all $10M ($10M FMV - $0 basis) of gain. When the remaining shares are sold in the following year, Jennifer could exclude up to $20M (greater of remaining $0M or 10 times her $2M basis), enough to shelter all of the $18M gain on her remaining $20M of shares. As a result, Jennifer could exclude the entire $28M gain if she is able to control the timing and amount of shares sold in such manner.

Scenario	Year Sold	Basis	Sale Price	Gain	Remaining $10M Limitation	10x Basis Limitation	Excluded Section 1202 Gain (100%)	Non-Section 1202 Gain
Sell $10M from Lot #1 in Year 1	2018	$0M	$10M	$10M	$10M	$0M ($10x $0M Basis)	$10M	$0M
Sell Remainder of Lot #1 in Year 2	2019	$0M	$5M	$5M	$0M ($10M - $10M)	$20M (10x $2M Basis)	$18M (up to $20M)	$0M
Sell Lot #2 in Year 2	2019	$2M	$15M	$13M				
Total		**$2M**	**$30M**	**$28M**			**$28M**	**$0M**

IRC Section 1045

If the stockholder sells QSBS, but has not yet held it for the minimum five-year holding period to qualify for gain exclusion, Section 1045 allows the stockholder to continue gain deferral by reinvesting the proceeds from the sale of the QSBS into another QSBS within 60 days. In order to qualify for the Section 1045 deferral, the taxpayer must have held the original QSBS for at least six months and the replacement QSBS must be purchased within 60 days after the sale of the original QSBS. In addition, the taxpayer must make an affirmative election to defer recognition of gain under Section 1045. The unrecognized gain is rolled over into the taxpayer's new QSBS and the taxpayer's basis in the new QSBS must be reduced by the amount of unrecognized gain.

> **Example #7:** Steven purchases QSBS for $2M and sells it one year later for $5M at a $3M gain. Steven has not yet met the five-year holding period requirement for QSBS gain exclusion. To continue deferring the gain, Steven immediately purchases replacement QSBS for $5M. Steven is eligible to defer the entire $3M gain since the purchase price of the replacement QSBS equals or exceeds the sale proceeds. His basis in the replacement QSBS is $2M ($5M purchase price – $3M deferred gain). If he holds the replacement QSBS for at least another four years, so that his combined holding period is at least five years, then he will be eligible for the QSBS gain exclusion when he sells the replacement QSBS.

Converting or exchanging stock

QSBS that is acquired through a *conversion* from other QSBS may continue to be treated as QSBS. The acquired QSBS is treated as having been held during the period which the original QSBS was held. The holding period of the converted stock is "tacked onto" the newly acquired stock. For example, if QSBS is acquired on January 1, 2017, and then converted to new QSBS on July 1, 2017, the new QSBS would have a holding period that started on January 1, 2017.

If QSBS is *exchanged* for an acquiring company's stock before the five-year holding period requirement has been met, the resulting shares in the acquiring company may be treated as QSBS, even if the acquiring company's stock would not otherwise qualify as QSBS. In such cases, if the shareholder later sold the acquiring company's stock after meeting the five-year holding period, the embedded *pre-exchange* gain would be eligible for QSBS gain exclusion while the *post-exchange* gains would be taxed under the normal rules.

Planning ahead for the benefits of QSBS

When you acquire QSBS, there are several important steps you should take right away to ensure that you can benefit from Section 1202 gain exclusion when you ultimately sell, convert or exchange your stock:

I. Document your purchase.
   a. Keep good records for each stock purchase in your portfolio, including the date the stock was purchased and the amount paid.

b. Retain a copy of the canceled check or wire confirmation, along with an account statement showing the funds leaving your account.
c. Save a copy of the share certificate.

II. Have your stock certified. If you think you are making an investment that may qualify for QSBS treatment, ask the company to certify that the following requirements are met:
a. The company is a domestic C Corporation.
b. The stock was issued after August 10, 1993.
c. The corporation's aggregate gross assets never exceeded $50 million at any time from August 10, 1993, until immediately after the issuance of your stock.
d. At least 80% of the company assets are being used in the active conduct of a qualifying trade or business.

Also, before selling the stock, be sure to verify that you have met the five-year holding period requirement by reviewing the documentation obtained upon purchase.

Strategies to multiply the gain exclusion

Multiplying QSBS gain exclusions through gifting. A donor may be able to multiply the number of available gain exclusions by gifting shares of QSBS to other family members or transferring QSBS to certain types of irrevocable trusts. The $10M or 10x Basis Limitations are applied on a per-taxpayer basis, so gifts of QSBS to another taxpayer can generate multiple new QSBS exclusions across family members. Individuals and non-grantor trusts that receive gifts of QSBS are treated as new taxpayers while the transferred shares receive a carryover holding period and basis for QSBS eligibility purposes in the hands of the recipients. Keep in mind that, although the transfers could help lower income taxes, the transfers may be subject to gift taxes.

Taxpayer	Basis	Sale Price	Gain	Remaining $10M Limitation	10x Basis Limitation	Excluded Section 1202 Gain (100%)	Non-Section 1202 Gain
Joshua	$0	$40M	$40M	$10M	$0M (10x $0M Basis)	$10M	$30M

Example #8: Joshua owns $40M of QSBS with $0 basis that he acquired in 2013 (subject to the 100% gain exclusion). If he sells all of his QSBS in 2019, he will realize $30M of gain, of which only $10M would be eligible for exclusion.

However, if Joshua gifts $10M of QSBS to irrevocable non-grantor trusts for each of his three children, then each child (as the beneficiary of their respective non-grantor trust) could qualify as a separate taxpayer with their own separate $10M or 10x Basis Limitations. The shares transferred to each child's trust will have a carryover basis of $0 and will be treated as if the child acquired the shares in 2013. As a result, Joshua and the three children's trusts can each qualify for $10M of QSBS gain exclusion and the family can exclude all $40M of gain. (Note: Keep in mind that the transfers would still be subject to gift taxes.)

Taxpayer	Basis	Sale Price	Gain	Remaining $10M Limitation	10x Basis Limitation	Excluded Section 1202 Gain (100%)	Non-Section 1202 Gain
Joshua	$0M	$10M	$10M	$10M	$0M (10x $0M Basis)	$10M	$0M
Trust for Child #1	$0M	$10M	$10M	$10M	$0M (10x $0M Basis)	$10M	$0M
Trust for Child #2	$0M	$10M	$10M	$10M	$0M (10x $0M Basis)	$10M	$0M
Trust for Child #3	$0M	$10M	$10M	$10M	$0M (10x $0M Basis)	$10M	$0M
Total	**$0M**	**$40M**	**$40M**			**$40M**	**$0M**

Converting to a C Corp prior to a sale. An existing non-corporate entity (such as a sole proprietorship, partnership or LLC) that is anticipating a future sale can be converted to a C Corporation in order to qualify its shares for QSBS treatment, assuming all other QSBS requirements are met. Note that the required five-year holding period for QSBS gain exclusion would begin on the date of the conversion to C Corporation status. For purposes of the 10x Basis Limitation, the basis of the new C Corporation shares will generally be equal to the fair market value of the assets contributed in the conversion. As a result, a business owner could potentially maximize his available QSBS gain exclusion by carefully timing the conversion to occur when the Aggregate Gross Assets reach (but do not exceed) the $50 million limit. By delaying the start of C Corporation status until the business's assets approaches $50 million, a founder could exclude up to $500 million (10x $50M basis) of gain when he eventually sells his QSBS.

> **Example #9:** Michael is the sole owner of Start-Up Business, LLC, which he founded three years ago. He plans to sell the company in five years and would like to take advantage of the QSBS gain exclusion. Michael contributes assets worth $30M with a $10M basis to the new C Corporation in a tax-free conversion. For QSBS gain exclusion purposes, Michael now has a $30M basis in the QSBS, although he has $20M built-in (deferred) gain on the $30M assets contributed. When Michael sells his QSBS in five years, he will be able to exclude up to $300M gains (Calculation: 10x $30M basis). However, Michael will be subject to normal taxes on the $20M of built-in gain that was deferred.

Conclusion

The Qualified Small Business Stock (QSBS) benefits under Section 1202 and Section 1045 offer valuable opportunities to realize significant tax savings. However, the application of QSBS rules in any specific situation can be complex and requires careful planning and documentation. Taking time to plan ahead with experienced financial and tax advisors before starting or investing in a small business can help reduce tax costs and magnify tax savings when you ultimately sell your business or investment.

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