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Q:

What should I know about “Qualified Small Business Stock”?

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COASTAL BRIDGE ADVISORS

The Qualified Small Business Stock (QSBS) exemption, outlined in Section 1202 of the Internal Revenue Code, provides one of the most beneficial capital gains tax benefits in federal income tax law. Yet, in our experience, too few take advantage of it.

That’s unfortunate, because the exemption gives entrepreneurs and investors a way to sell stock and avoid paying federal income tax on all or a portion of their gain, depending on the acquisition date.

We believe the reason many don’t avail themselves of QSBS is that they are simply unaware of or confused about its application. We think that should change.

Overview

The QSBS exemption was originally signed into law in 1993. Its intent was twofold: a) encourage increased investment in venture companies that traditionally had difficulty attracting risk capital; and b) create jobs in emerging industries.

Over the years, there have been numerous modifications to the exemption, but the objective of accelerating the pace of investment in high-growth industries and rewarding the founders and investors in qualifying businesses has remained intact.

How it works

The QSBS exemption eliminates federal income tax on the capital gain of the greater of $10 million or 10x invested capital, up to a maximum of $50 million in basis. It also eliminates the 3.8 percent Medicare surtax for the same amount. Assuming a basis of zero, an individual can save up to $2.38 million on a gain of $10 million (assuming a long-term capital gains tax rate of 20 percent plus the 3.8 percent surtax). In addition, some states follow the federal regulation, allowing taxpayers to eliminate state tax as well.

There are, however, specific guidelines one must meet in order to qualify for the exemption, as specified under the tax code. They include, but are not limited to, the following:

- The business was formed as a domestic C corporation at the time the shares were issued.
- Stock is acquired by the taxpayer directly from the company at original issuance for money, property (other than stock) or services. Secondary shares do not qualify.
- At least 80 percent of the corporation's assets must be used in the course of a qualifying trade or business. Service businesses, real estate, and farming do not qualify.
- The shares must have been issued when the aggregate value of the company was less than $50 million.
- Shares must be held for at least five years. If shares are from stock options, the acquisition date is the exercise date, not the date of the grant.
- If a taxpayer exchanges QSBS for stock of another corporation in a Code Section 368 reorganization or certain Code Section 351 transactions, the new stock generally will be treated as QSBS, and the holding period of the original QSBS given up will be tacked on to the holding period of the new stock received.
- Hedging transactions may disqualify the QSBS unless the taxpayer held the stock for five years prior to the transaction.

Planning considerations

- On new entities, consider forming as a C corp. For existing LLCs with a value below $50 million, consider converting to a C corp.
- Consideration could also be given to starting as an LLC and converting to a C corp prior to the company's fair market value (FMV) becoming $50 million. Since the shelter is $10 million or 10x FMV, if it were $40 million on the conversion/incorporation date, there would be the potential to shelter $400 million.
- As the exemption applies to individual taxpayers, consider having multiple family/entities, such as trusts with separate tax IDs, purchase or acquire stock from the issuer.
- After a six-month holding period, Section 1045 allows the possibility of rolling over the proceeds of QSBS stock into another qualifying company within a 60-day period. Gain on the existing sale is recognized only on the amount that exceeds the original investment.
- If the stock was purchased or acquired at different intervals, be mindful of time periods and cost basis, as these factors may dramatically affect the exemption.

Conclusion

The Qualified Small Business Stock exemption is a powerful planning tool that we think many entrepreneurs, investors and advisors often overlook. At Coastal Bridge Advisors, we seek to uncover these important planning opportunities for our clients. We believe our value add is not in our planning capabilities alone, but in the extensive network of leading tax and legal professionals we work with to help our clients navigate their financial futures. ●

ABOUT COASTAL BRIDGE ADVISORS

Coastal Bridge Advisors is an independent registered investment advisor offering a full range of wealth-management services. Often referred to as a "virtual family office," Coastal Bridge strives to bring clarity and control to the financial lives of its clientele by delivering customized personal and business solutions. From its offices in Westport, Conn., and Los Angeles, Coastal Bridge services high net worth individuals, families and foundations on both coasts and nationwide.

EXPERTISE

Financial Services Experience	Professional Services Provided	Assets Under Management
28 YEARS (Bill Loftus)	Financial planning, asset management, concentrated stock hedging, lending, cash management, alternative investments, due diligence and family office services	$2.5B (approximately, as of 12/31/2017)

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