

Qualified Small Business Stock: A Gem for Investors and a Marketing Tool for Entrepreneurs

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In this day and age, investors (Venture Capitalists, Private Equity, and Angel Investors) are concerned about maximizing their internal rate of return (IRR). Maximization of this important metric cannot be accomplished without minimizing the potential tax leakage of an investment. The reduction of the corporate tax rate to 21% in conjunction with the tax benefits provided by Internal Revenue Code (IRC)

§1202 can be used to achieve this goal.

IRC §1202 allows non-corporate taxpayers to exclude from income a certain percentage of gain derived from the sale or exchange of Qualified Small Business Stock (QSBS).

To qualify as QSBS, the entity:

- Must be a domestic C-corporation
- Gross assets must not exceed a value of \$50,000,000 at any time on and before the issuance of the stock
- Stock is required to be acquired at original issue and not from the secondary market
- Uses at least 80% of its assets in the active conduct of one or more qualified trade or businesses. Generally speaking, companies operating within the Consumer Product industry are considered to be a qualified trade or business.

The taxpayer is required to hold the QSBS for at least five years to receive preferential treatment. Furthermore, the amount of the gain excluded can be 100% of the gain for stock acquired since October 2010.

Redemptions - Be Aware:

Buried within the provisions of IRC 1202 are anti-abuse provisions to ensure taxpayers follow congressional intent of these provisions. Corporations engaging in redemptions may risk losing the tax benefits of gain exclusion under IRC 1202 for their investors.

Redemptions - a C-Corporation that redeems stock from an existing shareholder potentially can taint the qualified small business stock status of that existing shareholder.

Significant Redemptions (as defined in the IRC) - a C-corporation that enters into a significant redemption transaction risk losing the qualified small business status for all investors that stock was issued to.

With proper planning techniques your investors can ensure that their gain exclusion remains intact.

Other Considerations:

The information disclosed above provides a simple introduction to this specific planning tool. However, you should consider the following in your calculation of QSBS:

- An addback of a portion of the excluded gain for AMT purposes
- Gain exclusion is limited to the **greater of**: \$10 million or 10 times the taxpayer's adjusted basis
- IRC §1202 applies to both common and preferred stock
- IRC 1202 possesses a look-through rule, where the qualified business requirement will be satisfied through a subsidiary corporation that is at least 50% owned. (C-Corp blocker structures).
- Many states conform to the federal rules, however some do not.
- IRC §1045 which provides another planning opportunity (outside the scope of this alert) can be used along with IRC§1202 to defer the recognition of gain, a similar concept to like-kind

For more information on this planning tool and how it can be implemented in your business or particular investment, please contact your Anchin Relationship Partner or [James Ferrara](#), a Partner in Anchin's Consumer Products Industry Group, at 212.840.3456 or info@anchin.com.