CERITY PARTNERS®

TAX STRATEGIES

Qualified Small Business Stock

By: Michael Syer, CFP®

One of the most powerful, but often overlooked, tax planning opportunities.

Several years ago, the IRS enacted Section 1202 to encourage investments in small businesses and start-ups. This tax law allows taxpayers to exclude from gross income a percentage of the capital gain recognized on the sale of qualified small business stock ("QSBS") if it is held for more than five years. If qualified, investors can avoid tax on some or all the gain upon the sale of the stock. Depending on the date of acquisition, the current exclusion can be anywhere from 50% to 100% (if acquired after September 2010).

There is discussion in Washington about Congress potentially reducing the exclusion benefit to 50%. We are monitoring the potential tax law changes closely and believe tax planning using this powerful opportunity is now more important than ever. Regardless of any changes to the rules surrounding QSBS, this provision can provide some incredible opportunities for investors, employers, entrepreneurs and employees.

The Tax Benefit of QSBS

If qualified, the excludable gain from federal tax is the greater of $10M or 10x basis, providing significant tax savings. Many states conform to the federal law, but some states do not, so it is important to consult with your advisor to determine any state tax implications.

Example:

If you invested $1 million in a QSBS eligible company in 2014, you could sell that stock today for up to $11 million and pay zero federal income tax on that gain, providing tax savings in the millions at today's rates.

Other Benefits of QSBS

- With appropriate estate planning, the $10M exemption can be used multiple times ("stacking").
- Upon disposition of the QSBS, taxpayers can roll the gain into other QSBS eligible companies (Section 1045) affording investors the opportunity to defer realizing gains under section 1202 and transferring the holding period.
- QSBS is valuable for recruiting and retaining employees, especially executives.
- QSBS gives an edge to companies raising capital, as investors interested in small businesses may be attracted to the QSBS exemption.

QSBS Requirements

- Company must be a C corporation
- Stock must have been acquired via an original issuance from the company
- The company's tax basis must be in gross assets and must not exceed $50 million
- The company must allocate at least 80% of assets (by value) to an active (qualified) business
- The C corporation must conduct certain qualified active trades or businesses
- The stock must be held by the investor for more than five years

QSBS "Stacking" – Multiplying the Exclusion

Under current QSBS rules, the excludable gain from federal tax is the greater of $10 million or 10x basis. With early and effective planning, this exemption can potentially be used multiple times. This strategy is often referred to as "stacking and packing." Because the first $10M of gain can be free from federal tax (and in some cases state income tax), this can be a powerful tax savings tool for founders, entrepreneurs, and investors with gains of far more than $10 million. The strategy provides an opportunity to multiply the exclusion, increase tax savings, and create generational wealth for you and your family.

Here's how it works: A taxpayer can exclude the first $10 million of gain from federal taxes upon the sale of the shares, but gains above that will likely be subject to the highest capital gains tax. The QSBS exemption is per taxpayer, with each separate taxpayer eligible for their own $10 million exclusion.

Example:

Let's say a founder plans to sell his company and is holding QSBS shares that are valued at $50 million with no basis. While he can exclude his own $10 million gain, he would be subject to capital gains tax on the remaining $40 million gain. However, he is married with two young children. With the right planning, trusts could be set up and if qualified as separate taxpayers, each would get its own $10 million exclusion. Instead of paying capital gains tax on $40 million, the founder will only pay tax on the last $10 million, while also shifting generational wealth to his family.

It is never too early to start planning for the QSBS exclusion, particularly with a potential reduction or elimination of the QSBS exemption. In 2021, under the Build Back Better Act there was a provision to reduce the 100% exclusion rate to 50% for taxpayers with adjusted gross income of more than $400,000. Trusts and estates would also be ineligible for the 75% and 100% exclusion rates, regardless of income. Any of these changes would have a significant impact on the QSBS stacking strategy.

Pre-planning with QSBS eligible shares can not only have a tremendous impact on income taxes but also federal estate taxes. In 2022, each taxpayer has a federal estate exemption of around $12 million (inflated annually), which can be used throughout his or her lifetime. Gifting above these limits, aside from a spouse, can potentially generate estate and gift tax, which range from 18%–40%. Under current legislation, this lifetime exemption is scheduled to be reduced from roughly $12 to $6 million at the end of 2025, leaving a window of time to maximize wealth-transfer opportunities.

Stated simply, early planning and transferring QSBS shares out of an estate prior to appreciation in value will use less of this lifetime exemption and have a considerable estate tax impact too.

Conclusions and Next Steps

With the complexity and rules around QSBS, it is never too early to start planning with this valuable tax exemption. The earlier you start planning and exploring, the higher the potential tax savings.

At Cerity Partners, we tailor planning to the unique circumstances of our clients. We are specialists in ensuring that portfolios reflect our clients' values and visions while maximizing their tax savings through the optimization of planning opportunities such as QSBS.

Cerity Partners – Your Tax Planning Experts.

If you think that you may be holding QSBS stock, or just want to learn more, contact a Cerity Partners advisor today!

Contact Us