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NEWSLETTER

Getting the Tax on Qualified Small Business Stock Correct

With the reduction of the corporate income tax rate from 35 percent to 21 percent and the ability to exclude a significant amount of gain on the sale of Qualified Small Business Stock (“**QSBS**”), many startups choose to organize as C corporations. Many practitioners believe that gain recognized above the excludible amount is not eligible for regular long-term capital gains and is taxed at a 28 percent tax rate. This is simply not the case and this misinterpretation has cost founders and other investors significant amounts in additional tax. It is important that the tax advisor has a thorough understanding of the QSBS rules including the applicable tax rates for certain gain recognized on the sale of QSBS stock.

Noncorporate investors may exclude 100 percent of the gain on the disposition of QSBS if the stock is acquired after September 27, 2010, and held for more than five years. The percentage of gain exclusion is lower for QSBS stock acquired in prior periods. The amount of gain eligible for this exclusion is limited to the greater of $10 million or ten times the taxpayer’s basis in the stock (“**1202 Eligible Exclusion Amount**”). QSBS is stock of a C corporation that is acquired at its original issue, provided the corporation is a qualified small business and meets an active business requirement.

For QSBS stock acquired after February 17, 2009, and on or before September 27, 2010, the exclusion from gain is 75 percent, and for stock acquired after August 10, 1993, and on or before February 17, 2009, the exclusion from gain is 50 percent. Internal Revenue Code (“**IRC**”) §1202 gain (“**1202 Gain**”) is the gain which would be excluded from gross income under IRC §1202 but for the percentage limitation. This means that the 28 percent tax rate for gain recognition on QSBS stock is limited to the 1202 Gain and does not include any gain in excess of the 1202 Eligible Exclusion Amount.

website: www.klugcounsel.com
email: info@klugcounsel.com
phone number: +1 202-980-4788

For example, assume that QSBS stock was sold in 2008 with gain recognition of $10 million when the exclusion from gain was 50 percent of the 1202 Eligible Exclusion Amount. Under this example, 50 percent of the $10 million gain would be subject to tax at a rate of 28 percent, or tax of $1,400,000. If the gain were instead $12 million, the additional $2 million of gain would be taxed at the regular long-term capital gains tax rate.

For QSBS stock acquired after September 27, 2010, 100 percent of the Eligible Exclusion Amount is excluded from tax and therefore the 28 percent tax rate is not applicable. For example, assume QSBS stock was sold for $50 million. The first $10 million would be excluded from tax under IRC §1202 and the remainder $40 million of gain would be taxed at 23.8 percent (**long-term capital gains tax rate + net investment income tax**), or tax of $9,520,000. If however, as we have often seen incorrectly occur, the long-term capital gains are taxed at 28 percent instead of 20 percent, then the resulting tax would be $12,720,000. This erroneous computation of the tax would cost the taxpayer $3.2 million in federal income tax.

QSBS tax treatment is a tremendous benefit and opportunity for noncorporate founders and investors. It is important that this benefit is not eroded by misapplication of the tax rates. It is important that the advisor understand how the QSBS exclusion works, how the 28 percent tax rate is applicable, and how gains above the 1202 Eligible Exclusion Amount are taxed to get the best result for the taxpayer.

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website: www.klugcounsel.com
email: info@klugcounsel.com
phone number: +1 202-980-4788