

Answering Your Top 10 QSBS Questions

Many founders are familiar with [the qualifications](#) for Internal Revenue Code (IRC) Section 1202, otherwise known as the Qualified Small Business Stock (“QSBS”) exclusion, and how they can [multiply the exclusion](#) by stacking their gifts. But some founders and early employees may not be as conversant, opening themselves up to common misconceptions. Below we outline a few of the most frequent questions we hear when planning around IRC Section 1202:

5-Year Hold

1. I just received a bid to sell my company, but I've only held my stock for 4 1/2 years. Can I still qualify for 1202?

To qualify for IRC Section 1202, you must have held the eligible stock for five years. Failure to meet the five-year hold may disqualify you from the exclusion. The clock for the five-year hold begins when you acquire the stock. In other words, it's issued to you, you exercise an option, your shares vest, or you make an 83(b) election, to name a few.

If you have held the stock for only 4 ½ years, you could explore an IRC Section 1045 exchange where you roll the gain to another qualified small business stock within 60 days.¹ Alternatively, if your company goes through an Initial Public Offering (IPO) before the five-year mark, consider holding the shares for the time needed to meet the five-year requirement. Finally, if you receive stock in a new company as the result of a merger or reorganization, the new shares may continue being treated as QSB stock accruing towards the 5-year holding period.² However, the amount of gain that can be excluded in a subsequent sale is limited to the gain at the time of the merger.³

\$50 Million Threshold

2. My company is worth \$75 million. Am I disqualified from receiving QSBS eligible stock?

To qualify for 1202, the aggregate gross assets of the company—not its market valuation—must remain below \$50 million⁴ at all times before and immediately after the issuance of stock. The aggregate gross assets of the company are defined as “the amount of cash and the aggregate adjusted bases of other property held by the corporation”.⁵ Thus, the gross asset value of your company may meet this test, even though the value of the company's stock (or the actual value of its cash and assets) exceeds \$50 million.

When growing your business, be mindful of cash injections into the company during various funding rounds. Once the aggregate gross assets breach \$50 million, any stock issued after that point will no longer qualify for Section 1202. Companies that currently have less than \$50 million in gross assets should look back to ensure that the \$50 million threshold was not inadvertently breached at an earlier date.

Sale Structure

3. I received an offer to sell my company, but the buyer only wants to buy my company's assets. Does the sale have to be structured as a stock sale to qualify?

How a company's sale is structured is vital in determining whether the transaction will qualify for the exclusion. The 1202 exclusion is only available when eligible “stock” of the company is sold. If the deal is structured as an “asset” sale, then the gain may not be excluded under section 1202. In that case, the corporation will have to pay the tax at the corporate level and then any amount distributed to the shareholders may result in a second layer of taxation.⁶

Early Exercise

4. I only own options, but they don't vest for 3 years. How do I qualify for 1202?

If a company allows you to exercise Non-Qualified Stock Options (NQSOs) before they vest, you can make an 83(b) election within 30 days of receiving the stock. This would start the holding period from the date of exercise for eventually qualifying for the Section 1202 gain exclusion.

However, for Incentive Stock Options (ISOs), the IRS has informally stated that an 83(b) election is invalid for regular tax purposes and that the holding period begins when the options would have vested—not when they were exercised.⁷

Redemptions

5. The company just redeemed my shares. Is that an issue?

Certain redemptions of the stock by the corporation could disqualify QSBS for the shareholder in question, as well as all others.⁸ However, as long as the number of shares redeemed were *de minimis*, the redemption should not cause any issues. Notably, if more than a *de minimis* amount of stock is redeemed by the corporation, then all stock—not just the shares that were redeemed—could lose their QSBS status.

Original Issuance

6. My uncle offered to sell me his shares. Do I still qualify for 1202 if I hold them for 5 years?

Shares must be issued directly by the company and paid for using money, other property, or as compensation for services provided to such corporation.⁹ Shares can also be received by gift, death, or to a partner from a partnership.¹⁰ However, if shares of eligible QSBS are transferred into a limited partnership, the QSBS status is lost. To qualify for sale of QSBS stock received from a partnership, the partner must have been holding their partnership interest on the day the partnership acquired the stock and at all times thereafter.

Qualified Trade or Business

7. I own a company that provides “consulting” as part of my business. Do I qualify for 1202?

To qualify for 1202, the company must be a “qualified trade or business”.¹¹ Some businesses clearly qualify or do not qualify, while others may fall into gray areas. Consider the terms “services” and “consulting,” which are very broad and not typically considered a “qualified trade or business”.

In Private Letter Ruling (PLR) 202342014, the company in question offered data migration and management services to businesses. As part of its offering, it did not sell software or technical equipment. The PLR deemed that the company was 1202 eligible because “[it] does not separately bill for advice and counsel, but only for its final product of implementing data management solutions”. Since your company provides consulting services, it may cross into a gray area. It may be worth exploring further to determine if you qualify. Importantly, PLRs are specific responses to a given taxpayer’s situation and do not set any kind of tax precedent.

Loans

8. Can I take a loan from the company to acquire shares?

Loans made by a company to a founder or employee can help provide much-needed liquidity but pay special attention to non-recourse loans. According to Treasury Regulations Section 1.83-3(a)(6), when the transferee has no personal “risk of loss” (as a beneficial owner of the property would), no transfer is deemed to have been made. As a result, if a founder or employee takes a non-recourse loan from a company to acquire QSBS eligible stock, no transfer occurs until the loan has been substantially repaid. This impacts the starting point of the 5-year holding period for 1202 eligibility. If an owner seeks a loan to acquire stock or to exercise options, they should pursue one from an outside bank or lender.

Separately, Sarbanes-Oxley—the law passed in 2002 to improve auditing and public disclosures—forbids public company executives or board members from procuring a company loan.

Definition of Equity

9. I am considering investing through a Simple Agreement for Future Equity (SAFE). When does the 5-year holding period to qualify for the QSBS exclusion begin?

Be careful when considering a SAFE investment, which allows investors to convert the amount they invested into equity in a future funding round. Although the parties to the transaction may claim that the SAFE will be considered equity, the IRS may not agree. Instead, they may re-characterize the SAFE as a type of prepaid forward. If this occurs, the 5-year holding period would not start at the SAFE's acquisition date, but rather when the instrument converted to a fixed number of shares.

Basis Planning

10. I already used some of my \$10 million exclusion on previously sold QSB Stock but am planning to sell more shares. Can I still receive a tax benefit?

When calculating 1202 gain, the amount of eligible gain in a given taxable year that a taxpayer can consider is the greater of \$10 million, reduced by the aggregate amount of eligible gain accounted for by the taxpayer in prior years—or 10 times the aggregate adjusted bases of the stock sold in a given taxable year without regard to prior-year exclusions.¹² The limit per “taxable year” appears to allow taxpayers to use both the \$10 million aggregate gain plus the 10 times basis over multiple years.

Consider the following example:

I acquired 1,000 shares of eligible 1202 stock in 2014 when I contributed \$2.0 million to the company. I sold 30% of those shares in 2019 for \$8.0 million, which was tax free, and am now selling the remaining 70% for \$14 million. Do I owe tax on the \$14 million second sale?

When the initial 300 shares were sold for \$8.0 million, you were able to exclude the greater of \$10.0 million or \$6.0 million (10 times your adjusted basis of \$0.6 million for the shares sold). Thus, the initial \$7.4 million was excluded from gains as part of the cumulative limitation. When you later sell the remaining 700 shares for \$14 million, you are able to exclude the greater of \$2.6 million (\$10.0 million minus \$7.4 million of prior year gains) or \$14.0 million (10 times your adjusted basis of \$1.4 million of the shares sold). Therefore all \$14.0 million may be excluded from gains as you can consider the gains in the given year.

Avoid Potential Pitfalls

To qualify for Section 1202, there are many complexities and nuances that need to be considered, as demonstrated here. By enlisting the help of a professional to avoid these and other potential issues, founders, employees and investors can create a successful pathway to enjoy the benefits of the Section 1202 gain exclusion. Please contact your Bernstein advisor if you wish to explore this further.

- 1 To qualify for the deferral under Section 1045, the QSBS must have been held for more than six months at the time of sale, and a Section 1045 election must be made on or before the due date (including extensions) of the tax return for the year of sale. See § 1045(a).
- 2 IRC § 1202(h)(4)(A). In addition, the issuing corporation must hold at least 80% of the QSB corporation contributed at the end of the transaction to qualify for the tax-free treatment under Section 351. See IRC §§ 1202(h)(4)(D), and 368(c).
- 3 IRC § 1202(h)(4)(B)
- 4 IRC § 1202(d)(1)
- 5 IRC § 1202(d)(2)(A)
- 6 A shareholder may be able to claim QSBS in a corporate liquidation as Section 331 treats the amount shareholders receive as an exchange for stock. See Tony Nitti, Qualified Small Business Stock Gets More Attractive, The Tax Advisor (November 1, 2018), https://www.thetaxadviser.com/issues/2018/nov/qualified-small-business-stock-more-attractive.html#fn_61
- 7 T.D. 9144
- 8 QSBS status may be lost if the issuing corporation redeems or otherwise purchases its stock within a period surrounding the issuance of the stock.
 - i Redemptions from Taxpayer or Related Person. QSBS status may be lost if the issuing corporation at any time during the four years beginning two years before the issuance of the stock purchased (directly or indirectly) any of its stock from the taxpayer or a person related to the taxpayer. Related persons include brothers and sisters (whether by whole or half-blood), spouses, ancestors, and lineal descendants. The Treasury Regulations provide a *de minimis* exception under which the QSBS status is retained if the aggregate amount paid for the stock does not exceed \$10,000 and no more than two percent of the stock held by the taxpayer and related person is acquired. Further, the disqualification only applies to stock acquired by the taxpayer, not other stock held by other shareholders. See IRC § 1202(c)(3)(A), Treas. Reg. § 1.1202-2(a).
 - ii Significant Redemptions. In addition, all stock issued by a corporation will lose QSBS status if, during the two years beginning one year before the issuance of the stock, the issuing corporation purchased or redeemed an aggregate value exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the two years. The Treasury Regulations provide that QSBS status is retained if the purchase or redemption is limited to a *de minimis* amount in which the aggregate amount paid for the stock does not exceed \$10,000 and more than two percent of all the outstanding stock is purchased. For purposes of the two percent limit, "The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase". Finally, the *de minimis* calculation is determined at the time of the purchase, but the five percent limit described in the Code is determined at the beginning of the two years. The Code and Regulations provide several exceptions to the disqualifying redemptions and purchases rules. See IRC § 1202(c)(3)(B), Treas. Reg. § 1.1202-2(b).
- 9 IRC § 1202(c)(1)(B)
- 10 IRC § 1202(h)(2)
- 11 IRC § 1202(e)(3) a qualified trade or business is any business other than (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, 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, (B) any banking, insurance, financing, leasing, investing, or similar business, (C) any farming business (including the business of raising or harvesting trees), (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and (E) any business of operating a hotel, motel, restaurant, or similar business.
- 12 IRC § 1202(b)(1)

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