Founding and/or investing in startup businesses is known to be volatile given almost half of all businesses don't survive past five years[1]. This is one of many reasons the US tax code rewards business owners who succeed in creating jobs and adding economic value. The Qualified Small Business Stock (QSBS) gain exclusion is an example of one such tax provision that enables successful business owners to potentially save millions in taxes.

Background

Entrepreneurs and startup investors who own stock in companies meeting the criteria in Section 1202 of the Internal Revenue Code (IRC) have several avenues to maximize return on their investment through the QSBS gain exclusion. The percentage of gain eligible for exclusion is determined by the stock acquisition date. Regardless of the acquisition date, the maximum exclusion is limited to the greater of $10mm or 10 times the owner's basis.

Table I – Eligible QSBS Gain Exclusion by Acquisition Date

Acquisition Date	Gain Exclusion	Maximum Exclusion
After Sept. 28, 2010	100%	Greater of $10mm or 10x stock basis
Feb. 18, 2009 – Sept. 27, 2010	75%	
Aug. 11, 1993 – Feb. 17, 2009	50%	

Source: §1202(a)

For example, say a tech entrepreneur invests $500,000 dollars in their startup and issues qualifying stock in January 2011. In 2018, they sell the company for $11,000,000. There is a gain of $10,500,000, but the founder excludes $10mm via § 1202. In this case the exclusion saves the founder $2,380,000 in Federal capital gains taxes[2]. Had the founder invested $1.5mm and sold the company for $16mm the gain would be $14.5mm, but the founder excludes the entire gain using the 10x basis exclusion of $15mm.

Qualified Small Business (QSB) Criteria[3]

The QSBS exclusion is a valuable tax savings tool, but it is only available to specific types of businesses and owners who meet the §1202 criteria.

Entrepreneurs and startup investors should work with their business and personal accountants before making an investment to ensure the stock is QSBS eligible. In general, a company must be organized as a domestic C corporation in a qualifying field like manufacturing or technology, but not a service business such as financial services or law. In addition, the company's aggregate assets cannot exceed $50mm at any time before or immediately after stock issuance. Finally, 80% of the company's assets must always be used in the active conduct of their trade or business with no more than 10% of assets in real estate or stock of other companies.

While the company adheres to these standards, the owner of the stock must acquire the stock at original issue in exchange for money, property (not other stock), or as compensation for services performed and must hold the stock for more than five years.

QSBS Case Study

Consider an entrepreneur couple Jack and Jill who start a software company with $100k ($50k each). Three years later, the business is valued at $20mm and they accept an outside investment of $2mm from Frank Jackson in exchange for a 10% equity interest. Frank's investment catapults the company's growth and in year 5 they need another capital injection to continue scaling. Martha Brown invests $5mm in exchange for a 10% equity stake. Martha's shares are the last shares eligible for QSBS treatment as the company's gross assets soon exceed $50mm. Ten years later, the partners are ready to make their exit and accept an offer to sell the business for $160mm.

Table II – Results of Liquidity Event

Owner	Equity %	Equity Basis	Equity Value	Gain at Sale	Max Gain Exclusion	Reportable Gain	Tax Savings
Jack	40%	$50k	$64mm	$63.95mm	$10mm	$53.95mm	$2.38mm
Jill	40%	$50k	$64mm	$63.95mm	$10mm	$53.95mm	$2.38mm
Frank	10%	$2mm	$16mm	$14mm	$20mm	$0	$3.33mm
Martha	10%	$5mm	$16mm	$11mm	$50mm	$0	$2.62mm

Source: GenTrust Calculations

Jack & Jill's exclusion is capped at $10mm each since the $10mm far outweighs the 10x basis exclusion of $500k. However, Frank and Martha use the 10x basis exclusion since their initial investments were greater than $1mm. Absent any advanced planning, Jack, Jill, Frank, and Martha saved over $10mm in combined income taxes.

Leveraging Multiple Exclusions

The QSBS exclusion is valuable as a standalone tax break, but foresight and planning by investors and their advisors can exponentially increase tax savings.

Not only is the exclusion applied on a per taxpayer basis, but recipients of gifted stock are treated as having acquired the

1 - US Bureau of Labor Statistics / 2 - 20% maximum capital gain rate + 3.8% Net Investment Income Tax / 3 - §1202(c-e) stock in the same manner as the transferor and will inherit the transferor's holding period[4]. Under these circumstances, QSBS owners can multiply the number of exclusions by gifting shares to individuals/entities like family members and/or irrevocable trusts to benefit future generations.

In the case study, Jack & Jill excluded $20mm of total gain from taxation but were still responsible for approx. $30.4mm in taxes on the remaining ~$128mm of gain.

Instead, assume Jack & Jill recognize their need for financial planning when the company is valued at $50mm. They engage a team of advisors and express their primary goal is transferring as much wealth as possible to their eight children and grandchildren. Their advisors recommend using their lifetime gift and estate tax exemptions to gift $3mm of company stock to irrevocable trusts for each child and grandchild.

Table III – Ownership after Gifting

Owner	% Equity	Equity Basis	Equity Value
Jack	16%	$20k	$8mm
Jill	16%	$20k	$8mm
Frank	10%	$2mm	$5mm
Martha	10%	$5mm	$5mm
Irrev. Trusts (8)	6% each (48% total)	$7.5k each	$3mm each ($24mm total)

Source: GenTrust Calculations

Gifting the stock to separate irrevocable trusts creates eight additional $10mm QSBS gain exclusions. When the business is sold for $160mm, each trust's $9.6mm stake is recognized tax-free.

Table IV – Results of Liquidity Event after Gifting Strategy

Owner	% Equity	Equity Basis	Equity Value	Gain at Sale	Max Gain Exclusion	Reportable Gain	Tax Savings
Jack	16%	$20k	$25.6mm	$25.6mm	$10mm	$15.6mm	$2.38mm
Jill	16%	$20k	$25.6mm	$25.6mm	$10mm	$15.6mm	$2.38mm
Frank	10%	$2mm	$16mm	$14mm	$20mm	$0	$3.33mm
Martha	10%	$5mm	$16mm	$11mm	$50mm	$0	$2.62mm
Irrev. Trusts	48%	$60k	$76.8mm	$76.7mm	$80mm	$0	$18.3mm

Source: GenTrust Calculations

Not only did the gifting strategy save over $18mm in income taxes, but the ~$53mm of appreciation captured in the irrevocable trusts will avoid the 40% estate tax, saving over $21mm in future estate taxes when both Jack and Jill pass.

IRC Section 1045 Deferral[5]

Even after excluding $100mm of capital gains, Jack & Jill still owe over $7mm in capital gain taxes. However, another QSBS strategy can be implemented to defer and spread the gain across multiple tax years.

Under §1045, if an eligible taxpayer has held QSBS for more than six months, sells the QSBS, then reinvests the proceeds into new QSBS within 60 days, the gain is not realized in that year.

In Jack & Jill's case, they could reinvest the taxable portion of the gain into a new QSBS eligible company formed by themselves or someone else, then hold the stock to defer gain recognition or sell shares over several tax years. In other instances, investors may want to sell their QSBS prior to the five-year holding period because they no longer believe in the company's mission and want to reallocate to a company aligned with their values without ceding their holding period and preferential tax treatment. In either case, a §1045 rollover may provide the solution.

There are many other §1045 strategies that require a thorough review of the investor's circumstances.

Conclusion

The strategies discussed represent a small subset of the tax benefits available to business founders and investors. These individuals should work with their tax, legal, business, and financial advisors to build a comprehensive plan and take advantage of the exclusive tax benefits extended to them as a reward for the economic value they create.

4 - §1202(h) / 5 - §1045