



SELLING YOUR BUSINESS? HOW TO GET THE FIRST \$10 MILLION TAX-FREE!

By Pat Hammond, The Business Guild

QSBS - A little known tax break for small business owners selling a business...

Have you ever had to pay capital gains tax after selling property or cashing out an investment?

It's disappointing, right?

No matter how much money you make in the deal, you know the government is going to be first in line for their share.

According to the IRS, most people are subject to a 15% capital gain tax, but depending on your taxable income and the particular item you sold, you might owe 25% or more on those gains. ^[1]

It's one thing to talk about houses, or stock, or rare coins, but think about what happens when you sell your business.

Whether it was a lifetime commitment, or a company you built hard and fast, ***your business is the direct result of your efforts and you want to maximize the reward for all that hard work, not give it to the government.***

What if I told you there is a little known law designed for small businesses that provides an exemption up to "a maximum of \$10 million or 10 times the adjusted basis of the stock?" ^[2]

Buried deep in IRS Tax Code, you can find Section 1202 - Partial Exclusion for Gain From Certain Small Business Stock.

Enacted in 1993, this law, commonly referred to as the Qualified Small Business Stock (QSBS) Exclusion, was designed to

encourage small business investment.

The benefits of this law have evolved over the last twenty-seven years with two significant changes in 2009 and 2015.

There were no changes to stock purchased prior to the act, but the American Recovery and Investment Act of 2009 raised the exemption rate from 50% to 75% on stocks purchased between February 18, 2009 and September 27, 2010. Five years later, the exemption rate was further increased by the Protecting Americans from Tax Hikes (PATH) Act of 2015.

The PATH amendment to Section 1202 raised the exclusion to 100% on stocks purchased after September 27, 2010.

Keep in mind this tax exclusion has several qualifications and only applies to the first \$10 million, but a 100% capital gain exclusion of \$10 million is still a significant benefit for any qualified business.

Who is this exemption for?

This is where the gotcha comes in. Congress developed QSBS to encourage small business investment and job growth at a time when there was a lot of excitement about new technologies. While it wasn't specifically written with tech companies in mind, technology



Skip the overwhelm, I can help you make sense of your taxes.

- Small Business Taxes
- IRS Audits & Demand Letters
- Estates & Trusts

If you have received an IRS demand letter or are being audited, I can help.

Ed Carter, CPA

781-799-1188

Call Today!

taxhelp@edcartercpa.com

edcartercpa.com

corporations are the type of organizations most likely to qualify.

Corporate attorney Robert Baker, partner at Peak Corporate Counsel in Manchester, NH says, *“What they want are scalable businesses that have the opportunity to hire folks and become the backbone of the American economy.”*

With that in mind, the IRS has five qualifying requirements before you can claim the QSBS exemption.

1. The business must be a C-Corporation
2. The business must meet the trade test
3. It must meet the 80/20 rule with at least 80% of the company's assets used in *active conduct* of a qualified trade
4. You must hold the stock for at least 5 years
5. The business value must be \$50 million or less

The C-Corp requirement may seem to fly in the face of how many perceive the typical American small business, but when you look at the trade test, the businesses that qualify for this exemption are the type of businesses that plan to seek investors and have a clear exit plan.

Remember, we're talking about an exemption for *qualified small business stocks* and limited liability companies (LLC) and sole proprietors can't issue stock.

What is a Qualified Trade?

In typical IRS fashion, the guideline for what types of trades qualify for the QSBS exemption is vague to the point of ambiguity.

They offer a general overview that says qualified trade ^[3.1] means any trade or 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 1 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.

As with most parts of IRS Code, once you start digging there are a lot of cross-references to other sections of IRS Code and IRS Court decisions that may clarify or contradict the part you're reading.

The short version is most organizations that provide a service are excluded, but don't make assumptions until you speak with your attorney.

More often than not, companies whose

SCHEDULE D (Form 1040 or 1040-SR)		Capital Gains and Losses		OMB No. 1545-0046
Department of the Treasury Internal Revenue Service (IRS)		<p>▶ Attach to Form 1040, 1040-SR, or 1040-NR.</p> <p>▶ Go to www.irs.gov/scheduleD for instructions and the latest information.</p> <p>▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.</p>		<p>2019</p> <p>Attachment Sequence No. 19</p>
Name(s) shown on return		Your social security number		
<p>Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.</p>				
Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)				
See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.				
	(f) Proceeds (sales price)	(g) Cost (or other basis)	(h) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(i) Gain or (loss) Subtract column (g) from column (f) and combine the result with column (h)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b.				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain (or loss) from Forms 4684, 6781, and 8824				4
5 Net short-term gain (or loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions.				6
7 Net short-term capital gain (or loss). Combine lines 1a through 6 in column (i). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back.				7
Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)				
See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.				
	(f) Proceeds (sales price)	(g) Cost (or other basis)	(h) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(i) Gain or (loss) Subtract column (g) from column (f) and combine the result with column (h)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b.				
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked				
11 Gain from Form 4797, Part I, long-term gain from Forms 2439 and 6252; and long-term gain (or loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain (or loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions.				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions.				14
15 Net long-term capital gain (or loss). Combine lines 8a through 14 in column (i). Then go to Part III on the back.				15
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 1 13384 Schedule D (Form 1040 or 1040-SR) 2019				

IRS Schedule D - Capital Gains and Losses

value is derived from development of technology or intellectual property are going to pass this test.

For example, the rule specifically excludes “any banking, insurance, financing, leasing, investing, or similar business,” but I’ve seen an argument that suggests a company like Square, a business known for payment processing, could pass the QSBS trade test if their core assets are derived from the sale of their Square Reader and other payment processing products rather than the act of processing payments. [4.]

Except for the trade test, the other exemption qualifiers are fairly straightforward.

The requirement to own the stock for at

least five years to qualify for the exemption shouldn’t be an issue for the founders who are issued stock at inception, though it is possible an employee who takes company stock as an equity incentive could miss the cut-off if the business is sold before they reach that 5-year threshold.

To satisfy the 80% test, you simply need to prove that 80% of the company’s assets have been used for active conduct of qualified business activities.

With a few minor exceptions, that means the business had to use 80% of its assets as working capital for a product or service that meets the trade test. You can offer other non-qualified products and services as long as you can prove that 80% of your assets went into the ones that fell within the qualified trade guideline.

For the last requirement, all you need is a balance sheet to prove your company’s assets are \$50 million or less.

How to Get Started

The best way to get started is by talking with your attorney about choosing the right form of business when you start your company.

Having an open dialogue with a tax specialist or legal professional will help you dodge hurdles and find hidden gems and unexpected bonuses like the QSBS exclusion.

Attorney Andrew Grosvenor, with Merritt and Merritt in Manchester, NH says *“It’s good to know about QSBS if you’re in the*

tech sector as a C-Corp, but there isn't much you have to do that is deliberate other than setting up as a C-Corp."

He says he hasn't seen too many people take advantage of the exemption, though Baker says he's had in-depth conversations about QSBS with about half of his clients with 5 or 10-year exit plans.

And that may be the key to this. Nobody is going to start a business and build it around the hope that a law enacted in 1993 is going to be on the books by the time they're ready to sell their business, but it is nice to have this information when it's time to sell.

The upside of all this is once you jump through all those hoops making sure you qualify for your \$10 million tax

exemption, all you have to do to claim it is complete Schedule D - Capital Gains and Losses and attach it to your standard 1040 tax form.

If you want more information or need advice about whether your business qualifies, talk to your attorney or tax accountant. In my research, every attorney and tax specialist I spoke with was familiar with Section 1202, but none of the general accountants I interviewed had ever heard of it.

Where to find resources

**Attorney Robert Baker,
Peak Corporate Counsel**

**Attorney Andrew
Grosvenor, Merritt and
Merritt**

Ed Carter, CPA

REFERENCES

1. IRS Tax Topic: Capital Gain Tax Rate
2. Investopedia Section 1202, Will Kenton
3. Internal Revenue Code Section 1202, page 3
4. What is Qualified Small Business Stock (QSBS)?, Andersen Tax, LLC