Qualified Small Business Stock: More Smoke than Fire

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Thirty years ago, Congress enacted Internal Revenue Code ("IRC") §1202, “Partial Exclusion for Gain from Qualified Small Business Stock” (“QSBS”), a special tax exemption for gains from the sale of Subchapter “C” corporation stock. Congress has tinkered with the exemption during that thirty years, but the lure of QSBS as a tax planning strategy for taxpayers starting a new business has remained intact. Essentially, §1202 promises the holder that a sale of qualifying "C" corporation stock will result in the holder paying a reduced or no tax when the stock is sold. The exemption of gain from the sale of QSBS started out in 1993 at 50% of the gain, was raised to 75%, and increased to 100% in the “Creating Small Business Jobs Act of 2010.”

The purpose of this article is *not* to describe the mechanics of the qualification of stock as QSBS. Rather, this article endeavors to answer the question: "Are the benefits of owning QSBS over-hyped?" In the author's experience, many QSBS shareholders are disappointed because the anticipated tax benefits could not be realized or are substantially diminished.

To benefit from the QSBS exemption, the corporation must be a “C” corporation, as distinguished from a “S” corporation. C corporation profits are taxed to the corporation at a current federal rate of 21%. In most cases, the operating income of a “C” corporation will also be taxed at state corporate rates. Distributions of profits are taxed again as dividends to the "C" corporation shareholders, leaving a combined effective federal and state tax higher than if the business was operated as a limited liability company or "S" corporation, where there is generally only 1 level of tax, at the member or shareholder level. If double tax is avoided by the "C" Corporation paying salaries instead of dividends, the effective tax rate will usually be the same or greater. Further, if excessive salaries are paid, the IRS may scrutinize whether the purported salary is really a disguised dividend. Also, stock of certain types of businesses cannot qualify as QSBS, such as professional businesses, hotels, and restaurants.

While the C corporation is engaged in business, operating losses, which usually occur in the early years of a business, do not pass through to the stockholders and therefore do not offset the income of the shareholders from other activities. The losses are locked inside the C corporation, can only be carried forward, and are limited to offsetting 80% of a succeeding year's income. For example, a CPA who has a lucrative accounting practice will not be able to use his share of the losses from a start-up "C" corporation that develops computer software for the engineering industry because the losses are not passed out to the CPA.

The real surprise occurs when a holder of QSBS attempts to sell his/her stock to a buyer. **Remember, the tax exemption for QSBS only arises if stock in a "C" corporation is sold**. **The sale of the "C" corporation assets will not qualify for the QSBS exemption.** This is problematic for the "C" corporation shareholder because most buyers want to purchase the assets of the "C" corporation, not the stock. The value of most successful businesses is in “self-generated intangibles,” notably goodwill and going concern value. “Goodwill” arises when customers return to a business because it has a good product. For example, goodwill arises when a business sells a good hamburger and customers return to buy more. “Going Concern Value” is the increase in value that occurs when assets are working together. For example, in a software development business, the computers and software developers are worth more collectively when working together. Every business begins with little or no goodwill or going concern value, but through operation, the business becomes valuable because of these self-generated assets. These assets have a zero-tax basis because they are self-generated. For example, a software development business may have assets outside of goodwill and going concern value of $100,000, but has a value of $1,000,000 because of goodwill and going concern value. If the software development business is operated through a "C" corporation, a purchaser of the "C" corporation stock cannot “write-up” the goodwill and going concern value and amortize the additional $900,000 (over 15 years). Further, a purchaser will not want to buy the stock, because of the potential for an unknown liability. In short, the buyer will pay a higher price for the assets than the stock, and the lower price that the seller of the "C" stock will receive may more than cancel the tax benefits from the sale of the QSBS. Also, "C" corporations do not qualify for the Qualified Business Income Deduction (§199A).

In short, before deciding to operate a business through a "C" corporation to obtain the benefits of the §1202 tax exemption, the benefits and burdens of "C" corporation status must be considered. Also, the taxpayer should sure that the stock will qualify as QSBS.