BALTIMORE
BUSINESS JOURNAL

HELP DESK

A closer look at a tax incentive for investing in small businesses

My favorite saying in life is "people do not know what they do not know." There is nowhere this rings truer than in the complex world of tax law.

Interpreting and implementing the internal revenue code involves understanding many regulations, court cases, proposed regulations and rulings. Once we cross that barrier, there are incredible tax savings opportunities to be found – in particular, the ability to sell C corporation stocks income tax-free.

Congress has provided many incentives to encourage people to invest in small businesses, and these have become substantially more generous in recent years. One frequently overlooked is the qualified small business stock (QSBS) election. It's a provision under Section 1202 of the internal revenue code, giving domestic corporations who meet specific criteria the ability to exclude up to 100% of the gain on the sale of qualified business stock.

The tax treatment for shareholders depends on when the stock was acquired and how long it was held. If the QSBS was acquired after September 27, 2010, 100% of the gain can be excluded. This percentage drops to 75% if acquired between February 12, 2009, and September 27, 2010, and to 50% if acquired between August 11, 1993, and February 17, 2009. In any case, the excludable gain is restricted to $10 million or 10 times the aggregate adjusted bases of the QSBS, whichever is greater.

Who qualifies for the exclusion?

To be classified as a qualified small business corporation, criteria include:

▶ The QSBS needs to be issued by a U.S. C corporation.

▶ The corporation cannot have more than $50 million in gross assets at the time it was issued.

▶ At least 80% of the corporation's assets must be used in operating an active trade or business.

▶ The corporation and shareholders consent to submit documentation regarding QSBS.

▶ The stock must be held for more than five years.

A qualified trade or business does not include:

▶ Banking, financing, investing, leasing or similar businesses

▶ Businesses providing services in the fields of law, health, accounting, architecture, engineering, performing arts, consulting, actuarial science, brokerage services, athletics, financial services or any business whose notoriety is based upon the reputation or skill of one or more employees

▶ Farming businesses

▶ Businesses involved in mining and other natural resource depletion

▶ Restaurants, hotels, motels and similar businesses

The 2017 Tax Cuts and Jobs Act (TCJA) reduced the corporate tax rate to 21%, dramatically enhancing the benefits of section 1202. There are many factors to be taken into consideration when choosing an entity, and deciding to operate as a C corporation for the potential benefits makes sense if:

▶ Holding the stock for a minimum of five years is realistic

▶ Future non-corporate investors can take advantage of Section 1202

▶ The anticipated appreciation of the corporate stocks value is enough to mitigate double taxation on the operating income

▶ Shareholders must be willing to keep some earnings in the corporation to lessen double taxation's effects

There are a plethora of tax and non-tax factors to take into consideration before deciding to operate as a C corporation. It's critical for business owners who choose this structure to work closely with their tax advisers. The guidance and proactive planning from an experienced consultant can help business owners maximize these potential benefits and keep more of their hard-earned money where it belongs – in their pocket.

Donald N. Hoffman, MS, CPA, is managing partner of The Hoffman Group LLC and president of The Prosperity Consulting Group LLC.