

Tax Considerations for Mergers and Acquisitions: Qualified Small Business Stock and its Tax Benefits



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July 29, 2024 | **CORPORATE**

For an active business in the post-Tax Cuts and Jobs Act (TCJA) world of lower corporate tax rates, buyers and shareholders considering a future exit should always consider C corporations and the availability of potential “qualified small business stock” tax savings under Section 1202.

Qualified Small Business Stock (QSBS) Benefit

If a shareholder of a C corporation holds stock that properly qualifies as QSBS, such shareholder is eligible for significant capital gain exclusions with respect to the sale or disposition of such QSBS.

The capital gain exclusion in any tax year is equal to an amount of capital gain recognized in a sale of QSBS. This gain exclusion is limited but still potentially significant. The capital gain exclusion is limited to the greater of:

- \$10 million (reduced by any amount excluded in prior years from sales of the same QSBS); and

- 10 times the shareholder's adjusted tax basis in the QSBS stock.

C Corporation Considerations

As a potential buyer (or shareholder potentially contemplating an exit) of an active business, under current law, the 21% corporate-level tax rate warrants serious consideration of using a C corporation and availing oneself of the tax benefits of QSBS. The lower tax rate on corporate income combined with the ability to reinvest corporate earnings to grow or expand the business with only a single-layer of 21% tax on corporate income makes operating an active business through a C corporation much more tax-efficient than has historically been the case.

Alternatively, in order to receive the capital gain exclusions described above, a selling shareholder will need to find a buyer willing to purchase QSBS and forego the potentially significant tax benefits of an asset-level tax basis step-up obtained through an asset (or deemed asset) purchase. This transaction consideration could potentially cause a seller to take a lower sales price to compensate a buyer for the loss of the tax basis step-up. That said, the capital gain exclusion tax savings could still generate a “win-win” for the selling shareholders and buyer.

While the 21% corporate tax rate is not set to expire, many of the TCJA tax provisions are set to expire at the end of 2025 and it is possible there could be changes to the corporate tax rate or other corporate tax provisions. In addition, the repeal of the QSBS benefit has been discussed in proposed legislation and so there is no certainty that the program will exist for the duration of the required five-year holding period (discussed below).

High-Level QSBS Requirements

- Stock of C corporation must have been acquired by an individual, trust, or estate subsequent to 1993 in exchange for money, other property, or compensation for services.
- QSBS benefits *may* be available if the QSBS is held by a partnership or “S” corporation. Most notably the indirect owner of the QSBS must have held such QSBS via such partnership or S corporation at the time such pass-thru entity acquired such stock, and at all times thereafter before the disposition of such stock.
- During **substantially all** of the period since the issuance of stock, at least 80% (by value) of the assets of the corporation issuing the QSBS were used in an **active conduct** of a “**qualified trade or business**” (the 80 Percent Test).
- A “qualified trade or business” means a business other than:
 - 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,
 - any banking, insurance, financing, leasing, investing, or similar business,
 - any farming business (including the business of raising or harvesting trees),
 - 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 (e.g., oil and gas), and
 - any business of operating a hotel, motel, restaurant, or similar business.
- Notwithstanding the exclusion of some companies performing “services” in specified fields like health, the IRS has ruled that companies that deploy technology, manufacturing assets, or other intellectual property to provide services exclusively to clients in the healthcare industry would nonetheless qualify for QSBS status. The qualification for QSBS benefits of a service business may be a difficult question to answer as the guidance is

limited.

- The corporation issuing the QSBS must have an adjusted (tax) basis of its gross assets no greater than \$50 million immediately after the share issuance, which includes the issuance (and thus counts any money or property contributed as part of the issuance) in calculating the limitation. The full details of how this \$50 million is calculated are beyond the scope of this article.

QSBS Holding Period

QSBS must be held for more than five years to claim exclusion. The holding period begins at the time of the original issuance and therefore commences on the date an existing business converts from LLC to a corporation.

Additionally, the amount of potential exclusion is based on appreciation after conversion. For example, if the fair market value of property deemed to be contributed because of the check-the-box election equals \$25 million (with carry over adjusted tax basis of \$5 million), the first \$20 million of gain is not eligible for section 1202 exclusion. Any gain in excess of the built-in-gain at the time of conversion will potentially be eligible for exclusion.

Our Tax team, alongside our M&A / Private Equity Team, works with clients on tax considerations with respect to M&A transactions, including all aspects of potential QSBS structuring. To further discuss, please feel free to contact Devon McDonald (Director of Tax, CPA), Tom Mitchell (Counsel – Tax), or John Koeppel (Partner and Private Equity Leader).

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