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## Quick Guide to Qualified Small Business Stock

Section 1202 of the Internal Revenue Code allows non-corporate taxpayers to exclude from gross income all or a portion of gain realized from the sale or exchange of “qualified small business stock” (QSBS) held for more than five years. For QSBS acquired after Sept. 27, 2010, 100% of the taxpayer’s gain may be excluded, subject to a cap, which is the greater of (i) \$10 million reduced by the aggregate amount of gain previously excluded under Section 1202 by the taxpayer with respect to the same qualified small business or (ii) 10 times the taxpayer’s adjusted basis in the stock sold during the taxable year.

There are several requirements for stock to qualify as QSBS that may pose challenges for taxpayers planning to qualify for the potential tax benefit. GT’s Quick Guide to Qualified Small Business Stock summarizes the key requirements for stock to qualify as QSBS.

**KEY REQUIREMENTS FOR QUALIFIED SMALL BUSINESS STOCK**

Original Issuance by C Corporation	Active Business Requirement	Five-Year Holding Period	\$50 Million Gross Assets Test
<p><u>C Corporation</u>: The company must be a domestic C corporation.</p>	<p>The company must satisfy an active business requirement during substantially all of the taxpayer's holding period.</p>	<p>The taxpayer must hold the QSBS for more than five years.</p>	<p>The corporation's gross assets must not exceed \$50 million at any time since Aug. 10, 1993, and through immediately after the stock issuance (determined by taking into account amounts received in the issuance).</p>
<p><u>Original Issuance</u>: Stock must have been originally issued by the C corporation in exchange for money, property (not including stock), or services.</p>	<p>At least 80% of the company's assets must be used in the active conduct of one or more qualified trades or businesses.</p> <p>Certain types of businesses do not qualify.</p>	<p>For stock obtained through convertible securities (e.g., convertible notes, options, or warrants), the five-year holding period begins after the stock conversion.</p>	<p>Aggregate gross assets are measured by the amount of cash and aggregate adjusted bases of other property the company holds (but contributed assets are measured by their fair market value at the time of contribution).</p>
<p><u>Pass-Through Entities</u>: An investor in a pass-through entity (e.g., a partnership or S corporation) that holds QSBS with Section 1202 gain may be eligible for the benefit of Section 1202 with respect to its proportionate share of the gain if the investor held its interest in the pass-through entity on the date the pass-through entity acquired the stock through the date of sale.</p>	<p>If a company owns more than 50% (by vote or value) of another corporation, it is deemed to conduct its ratable share of such other corporation's activities for purposes of the active business requirement.</p>	<p>Certain transferees (e.g., recipients of a gift or a distribution from a partnership) may include the transferor's holding period for purposes of the five-year holding period requirement.</p>	<p>If an issuing corporation owns more than 50% (by vote or value) of another corporation, it is deemed to own its ratable share of such other corporation's assets for purposes of the gross assets test.</p>

**Additional Issues and Considerations**

<p><u>Contributions to Partnerships or S Corporations</u>: QSBS status is lost if the taxpayer contributes the QSBS to a partnership or S corporation.</p>	<p><u>Stock Redemptions</u>: Certain redemptions by the company could disqualify what would otherwise be QSBS.</p>	<p><u>Tax-Free Reorganizations</u>: If QSBS is exchanged for another corporation's stock in a Section 351 transaction or tax-free reorganization, the other stock may qualify for the QSBS exclusion if certain conditions are satisfied, and subject to certain limitations.</p>	<p><u>Profits Interests/Carried Interest</u>: Holders of partnership profits interests (including GPs of investment funds in respect of carried interest) should consider applying QSBS rules to gain on the sale of QSBS allocable to them in respect of their profits interests.</p>
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