

Tax Insights

From Grant Thornton's Washington National Tax Office

The 100% exclusion for gain on qualified small business (QSB) stock is now a permanent part of the Code and offers a substantial benefit for businesses considering organizing as a corporation or converting from a partnership to a corporation.

The 100% exclusion under Section 1202 was made permanent by the Protecting Americans from Tax Cuts (PACT) Act of 2015. It is available for QSB stock acquired after September 8, 2010. The provision builds on an earlier provision from the 2001 stimulus bill that had allowed a temporary 75% exclusion.

Before these provisions were enacted, QSB stock offered only a modest tax benefit. Taxpayers were allowed to exclude only 40% of the gain on QSB stock against a 20% rate. The resulting 10% tax on QSB stock gain was only one percentage point lower than the 15% rate generally allowed on long-term capital gain. The ability to fully exclude all gain on QSB stock offers a new tax opportunity that could change the analysis of how to organize a business.

Eligibility for exclusion

The requirements for qualifying for the gain exclusion at both the individual and business level may limit some of the potential benefits.

QSB stock must be original issue stock in a domestic corporation meeting active business requirements with aggregate assets not exceeding \$10 million (immediately after the issuance of the stock). An individual must hold onto the stock for five years to qualify for the exclusion, and the exclusion is limited to the greater of \$10 million or 10 times the adjusted basis.

To meet the qualified business requirements, the corporation must use 80% of its assets in the active conduct of one or more qualified trades or businesses. The statute specifically excludes the following from qualified trades or businesses:

- Services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial and brokerage services.

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