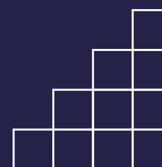
MICROACQUIRE

How to Minimize (Or Eliminate) Your Tax Liability When Your Startup Is Acquired

Introduction

Few could blame you for wanting to pay as little tax as possible on your acquisition. After all, you've invested years into building your startup to the point of exit. Think of all the late nights and difficult phone calls. The sweat, nerves, and exhilaration as you leaped from one success milestone to another. Now it's time to cash that check on your investment.

To minimize your tax liability on that check, consider pushing for a stock sale over an asset purchase. From a tax perspective, it's the simplest transaction as you pay just one tax at one level of tax: capital gains on the value of your shares (long or short, depending on the length of time you've held the shares) at the stockholder level. But more importantly, a stock sale could qualify you for a tax exemption if you hold Qualified Small Business Stock (QSBS).



Wait, what? Pay no tax?

That's right, if your startup is a "qualified trade or business" under Section 1202 of the Internal Revenue Code (IRC), your shares could be classified as QSBS. You could then exclude capital gains tax of up to $10 million or 10 times the adjusted tax basis of your QSBS, whichever is the greater. While this applies to all federal taxes, you might still be liable for state taxes in some states.

Now, before you start jumping with excitement, there are a few caveats. First, you need to qualify as a small business under the IRC. Your business must also fall under an acceptable industry (QSBS tax exemptions don't apply to hotels, for example). Finally, the exemption rules have improved over time, so how much you can exempt depends on when you got the shares.

Do You Qualify?

I'm not a tax attorney or CPA so please take what follows as guidance pending a full review with your legal and tax advisor. If you don't have a tax attorney for your acquisition, consider hiring from one of 50+ approved advisors in our M&A Advisor Directory. Whomever you choose to work with, they'll advise whether your stock qualifies as QSBS and how much tax you can save (if any).

Right, with that disclaimer out of the way, let's give you an idea of where you stand. First, to qualify for any capital gains exemption, your startup must have certain characteristics of what the IRS considers a small business. That is, your startup must be organized as a C-corporation with gross assets of less than $50 million, and at least 80 percent of those assets must be used in actively operating your startup.

Your startup must also fall under an acceptable industry, qualifying as a "qualified trade or business" under the IRC. To give you an example, technology, retail, and manufacturing qualify, but hospitality and financial services don't. The IRC designed the scheme to boost economic activity across target sectors so not all qualify. By now, you should know whether your startup qualifies. But what about your stock?

QSBS was introduced under the enactment of Section 1202: Small Business Stock Capital Gains Exclusion under the Internal Revenue Code in 1993. Initially, the exemption was for only a 50% exclusion of capital gains. For stock issued between Feb 18, 2009 and Sep 27, 2010, the gains exclusion increased to 75 percent, and for stock issued after Sep 27, 2010, the gains exclusion increased again to 100 percent.

How much capital gains exclusion you're due then depends on when the stock was issued. If you hope to write off as much as 100 percent of that due on your acquisition, your stock must all have been issued after Sep 27, 2010. You must also have held it for at least five years, or less if you invest it into another qualified small business in a 1045 rollover (the mechanics of which are outside of the scope of this blog, unfortunately!).

But even if you qualify for a 100 percent exemption at a federal level, you might still have to pay tax at the state level. Many jurisdictions follow the federal QSBS rules, but not all of them – most notably, California, where many of the world's most ambitious startups reside. There, you'll pay full capital gains tax (the saving grace is under QSBS you'll avoid federal taxation too!).

How to Claim Exemption Under QSBS

You will need a tax attorney or accountant to determine whether you're exempt from capital gains under QSBS. The earlier you hire one, the better your chances of minimizing your tax liability. Your advisor will help you prepare the required evidence of your exemption and file the correct paperwork. Structures like a 1045 rollover also need careful forethought.

Acquisition planning should ideally start when you first launch your business. If you know where you'll be three to five years down the line, you're more likely to realize your goals and stay focused. For example, qualifying for a QSBS exemption might influence when you choose to exit or even the type of business you build.

If you're curious about the tax implications of an acquisition, want to minimize your liability, or just want additional help with tax, consider hiring an approved tax advisor from our M&A Advisor Directory. Combining decades of experience, our advisors could help you plot a course for exit that results in you keeping most if not all of your proceeds from the sale.

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