The turbulent market's impact on qualified small business stock exclusions

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Key takeaways

- Changes in economic conditions have caused the rules regarding working capital and qualified small business stock (QSBS) exclusions to be reexamined, possibly impacting QSBS eligibility for growing companies.
- Founders and early employees with an understanding of the changing QSBS landscape will be better positioned to participate in the substantial tax benefits offered through QSBS.
- Revisiting your company's cash management and investment strategies with a team of professionals familiar with the nuances of QSBS exclusions can help protect your eligibility.

Why QSBS exclusions are being examined carefully

Rising interest rates and economic instability have sidelined many investors and reduced the flow of liquidity for growing companies. The current economic climate has forced many business founders to reexamine their existing capital and investment strategies. In this environment, requirements regarding qualified small business stock (QSBS) exclusions are also being scrutinized more closely.

Considering the current state of the economy, it's a good time for founders pursuing QSBS exclusions to be sure their companies' financial ducks are in a row. Because of their complexity and central role in corporate cash management policies, we will examine the guidelines surrounding working capital as it is defined within the confines of QSBS exclusions.

If you are a founder interested in taking advantage of the significant QSBS tax benefits, the cash management guidelines below can help you understand how working capital is defined and more effectively manage the eligibility requirements for QSBS treatment.

Properly defining working capital: A cornerstone of QSBS exclusions

To ascertain if a business qualifies for QSBS exclusions, founders should focus on determining whether a qualified trade or business is using its investments for future working capital needs **within a two-year period. This is critical as failure to meet working capital guidelines may cause shareholders to lose their QSBS exclusion benefits.**

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Businesses that meet the working capital safe harbor (and are able to issue QSBS) are entitled to:

- Hold assets or cash for its reasonably required working capital needs.
- Hold assets for investment, provided those assets are expected to be used to finance increases in the working capital needs of the company within the **subsequent two years.**

A critical factor here is your company's liquid position and the relation of that position to the company's current and anticipated needs. To determine liquidity, review your company's monthly bank statements and compare your average cash balances with average cash disbursements. This analysis will reveal liquidity which can then be compared with corresponding industry standards.

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Additional factors to consider when defining your business's working capital[1]

1. Bona fide expansion of the business.
2. Acquisition of another business enterprise through purchasing stock or assets.
3. Retirement of bona fide indebtedness created in connection with the business.
4. Investments and loans to suppliers or customers.
5. Redemption of stock held by minority stockholders.
6. A need to meet competition.
7. Reserves for business risks and contingencies such as self-insurance against casualties, potential liability from litigation and unsettled business conditions.
8. Need to finance employee pension or profit plans.
9. Possible loss of a principal customer.
10. Excess business holdings redemption needs of the business.
11. An actual or potential lawsuit.
12. Possible liability arising from contractual obligations.

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IRS guidance and rulings from the United States Tax Court regarding working capital make it clear that a company must document the intended use of its working capital. This may be achieved with contemporaneous board minutes explaining the rationale for company investments and future working capital requirements.

For example, if a startup can demonstrate that it has certain business expansion needs within the next two years, the IRS guidance and U.S. tax court rulings have shown that investments held to cover the expansion needs are viable uses of working capital.

Working capital vs. investments: QSBS guidelines

To qualify for QSBS benefits:

- 80% of company assets must be used in a qualified trade or business.
- No more than 10% of the value of the company can be held in stock or securities.
- No more than half of the value of the company can be working capital.
- **Please note:** Service businesses do not qualify for QSBS exclusions.

Understand QSBS requirements for your company

Although the qualification process is complex, the tax benefits of QSBS exclusions are substantial. To properly navigate the QSBS exclusion requirements for your organization, we recommend consulting with tax, accounting and legal professionals who are well versed in the nuances of cash management for qualified small businesses.

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To discuss your QSBS options, contact us today.

To learn how qualified small business stock requirements may impact your business and personal finances, contact your SVB Private advisor or visit svb.com/private-bank today.

Source: [1]IRS Non-Docketed Service Advice, 2001 IRS NSAR 0387

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