



## Episode 126: QSBS, Tax Benefit Unlike Any Other, With Shahrooz Shahnava

### Episode Summary

One of the most misunderstood provisions in the entire tax code, the Qualified Small Business Stock (QSBS) has been around for more than 30 years. Yet it remained largely dormant — until now. The QSBS is “unlike anything in the code,” says [Shahrooz Shahnava](#), a tax partner at McGuireWoods.

In this conversation with colleague and host [Geoff Cockrell](#), Shahrooz reviews the history of this unique benefit and puts it into context for today’s M&A deal-makers. Tune in for his insights on the potential 100% exclusion of gain, the structural limits that bar some professions — including healthcare — from qualifying, and the One Big Beautiful Bill Act’s “generous” \$15 million per-shareholder, per-company cap.

### Transcript

Voice over (00:00):

This is The Corner Series, a McGuireWoods series exploring business and legal issues prevalent in today's private equity industry. Tune in with McGuireWoods partner, Geoff Cockrell, as he and specialists share real world insight to help enhance your knowledge.

Geoff Cockrell (00:20):

Thank you for joining another episode of The Corner Series. I'm your host, Geoff Cockrell. Here at the Corner Series, we try to bring together deal makers and thought leaders at the intersection of healthcare and private equity. Today, I'm joined by my good friend and partner, Shahrooz Shahnava. Shahrooz works in our tax department and he and I work on a bunch of transactions helping us navigate pretty complex tax issues. He's always a ton of fun to work with and we're going to be exploring an interesting topic that has gotten some increased focus in recent years. We're going to talk about the use of qualified small business stock in M&A context. Shahrooz, maybe give a little bit of your background and we can jump into a discussion.

Shahrooz Shahnavaz (01:00):

Hi, Geoff. Good to be here. Thanks for having me. I joined our firm less than a year ago and obviously started working with you right away and have enjoyed it early. Before that, I spent a lot of years at both accounting firms and law firms where I was an advisor to many private equity and corporate clients on the buy and sell side.

Geoff Cockrell (01:20):

So Shahrooz, talking about qualified small business stock, why has it become more talked about concept in recent times?

Shahrooz Shahnavaz (01:28):

That's a great question, Geoff. Qualified small business stock or QSBS is one of the most misunderstood code sections in the entire revenue code. It was dormant, as you alluded to for many years. It's actually been on the books for over 30 years, but was not used. And that's interesting and also makes this a little bit more challenging to work with now. And the reason why it wasn't used has to do with the history of it. And not to go too deep, but basically the benefit offered at the time was not significant enough for it to be relevant and I would use in our transactions. If you walked into a room of tax lawyers, forget corporate lawyers, tax lawyers in 2017 and asked 100 tax lawyers if they had worked with section 1202, which is the code section that provides a regime for QSBS, 95 would have said no.

(02:19):

And many of those wouldn't even know what the code section does. Things are a lot different now, as you know. That has to do with two things. One is the rates have changed. We used to have a much higher corporate rate, and so people are hesitant to form C corporations and use them to invest in and use them as their buyer entity and as their portfolio company. But the rates, as you know, went down from 35% in 2018 to 21%. And the other reason why it's now relevant is it used to have a much lesser benefit. And we'll go over that in a minute, but the benefit is now, believe it or not, 100% exclusion of your gain up to certain limitations that are very generous and keep getting more generous on a sale. So it's unlike anything in the code if you think about it.

Geoff Cockrell (03:07):

So the trade is if you can tolerate being a C corp and paying entity level tax, you avoid up to some limit paying any gain on the sale.

Shahrooz Shahnavaz (03:19):

That's absolutely correct. You make a great point. So that is the trade off. And that trade off became much more apparent, there's two landmarks, really. 2009, the great recession, the government puts in a phased approach. The benefit was capped at 50% before 2009. So for 17 years, this rule was

basically not used, which also explains why we have very little guidance on it. And we'll get to that a little bit later. '09, Treasury and IRS increase first temporarily. And then in '15, it becomes permanent, 100% exclusion. So until 2015, nobody really paid attention. Very rarely used, very little guidance. Then in 2018, as you know, the corporate rate goes down. So now you have a combination of a lower corporate rate and a 100% exclusion. And so if you can tolerate having a C corp for the duration of your investment, you will have 100% exclusion of your gain from taxable income, meaning you don't pay tax up to the capped amount.

Geoff Cockrell (04:18):

And what's the vicinity of the capped amount? I know it moves.

Shahrooz Shahnavaz (04:21):

So interesting. Until last year, until the One Big Beautiful Bill, the cap was at 10 million per shareholder per company, meaning each QSBS per shareholder. So if you and I invested in a QSBS, each one of us would have gotten a \$10 million cap on our investment. Now that's a cumulative cap. But what most people also forget is if we don't sell it all at once, the second cap, which is based on your investment amount, meaning your basis, and used to be 10 times your basis. So if your basis was low, this was probably not a useful limitation because it's the greater of these two. But if your basis was high, if you invested a lot of cash, for example, or if you contributed property that had value and your basis was also high or the rules, the way they work in this code section would have increased your basis to be high, then this could very well come into play.

(05:13):

And they're not mutually exclusive, as I mentioned. So you could have, for example, if you sold blocks of shares, you could have maxed out your \$10 million cap and then also benefited from the annual limitation of 10 times your basis. Those were the rules up until last year, but One Big Beautiful Bill or OB3, as we call it in the tax community, changed all that. So now the cap is even more generous, 15 million per shareholder per company, and that in and of itself is a huge benefit and basis still 10 times, but because the asset value on the requirements is now capped at 75 million up from 50, this now increases to potentially a \$750 million benefit, and we can get into that a little bit later.

Geoff Cockrell (06:01):

So given the orders of magnitude of the benefit and the fact that being a C corp, even without this benefit is a much closer call, especially for a private equity backed company who's never distributing or usually not distributing money on a yearly basis out of the entity because they're using most of the excess cashflow to pay enterprise level debt. So you get the benefit of a 21% rate instead of a flow through much higher rate. Given the benefit, why is not every deal a, especially in the middle market, a QSBS deal, what are the limitations on when you have to enter this regime, whether it had to be there before, can you do it in the transaction, and what other limitations are there that might make it not a candidate in every sitting?

Shahrooz Shahnavaaz (06:57):

That's really the key. That's a million-dollar question. This is where the deals die. This is why not every deal that you and I do is a QSBS. Although, as you know, there's certainly increasing in number and relevance. But one of the reasons is, for example, it has to be a C corporation, as we mentioned, it has to be original issuance. So you can't buy shares from another shareholder. It has to be directly issued from the company. Now, it doesn't have to be a one-time only type of situation. It can be subsequent issuances, but they always have to be first issuance or original issuance by the company. That in and of itself is not obviously a deal breaker. But you combine that with a few other things, for example, the shares to benefit from Qualified Smart Business Stock or QSBS, you have to be a non-corporate holder. So you and me can hold it. A C corporation buyer cannot. A partnership or flow through can hold it, but it's tricky. You have to be very careful. You have to have the partnership acquire in first issuance the shares.

(07:58):

You and I cannot have shares, contribute them to a partnership, a JV that you and I form, and then say, "Okay, well, now this partnership, JV, holds QSBS stock." That's not how it works. Once you contribute QSBS in your hands to a partnership, it loses the status, but that doesn't work. That obviously complicates matters. So now you have to structure this from the beginning correctly. Another thing that limits the benefit of this is it was really intended, Geoff, when Congress promulgated the section, it was really intended for small business. That was not just a political fad or a selling point. And what they understood with small business in '93 to mean is a business that is really main street and not high level service provider or the classic professions, the historic professions.

(08:47):

So law firms, accounting firms, the practice of medicine, they're excluded by definition. So the code section actually says, "Those are out." So if you're looking at a target that's a financial services company or hospitality, even health, one topic that you and I care about a lot is somewhat broadly defined. But again, we're missing a lot of clarity here, but those are the professions that are excluded. Tech, biotech, manufacturing, those type of things, or mom and pops businesses on Maine Street, those qualify. And of course, a lot of our clients don't want to hold for a long period of time. Up until last year, the holding period was a five-year holding period. So that's another limitation that often applies and limits the benefit and usefulness of this code section. And finally, the limitation on the value of the business. In '93, they considered \$50 million maximum to be what a small business should be worth.

(09:42):

And so, the gross asset test, which is one of the biggest limitations here, is limited to 50 million up until last year. Meaning if you have a company and let's say you buy a Target and it's worth EV 60 million, it's probably going to be difficult to establish that its gross assets going forward are less than

50. Now, OB3 changed that limitation in a taxpayer-friendly way to 75 million, which clearly opens the door on deals that otherwise wouldn't have qualified, but still limits it to smaller or mid-sized deals, not necessarily the bigger deals that private equities does.

Geoff Cockrell (10:21):

A couple questions on the side from my encounters.

Shahrooz Shahnavaz (10:25):

Sure.

Geoff Cockrell (10:25):

The gross asset test plays out differently for different kinds of business. Some are asset-intensive, others are asset light, and it might be easier to navigate that for certain types of businesses, especially in the services arena. And then are you able to avail yourself of all of the mechanisms of small business status classification in the sense that if you look at SBIC lending and those sorts of investments, which I've encountered over the years, one of the ways that a business can be a small business is by headcount of employees, and that is often a pretty high level. For many industries, and it's by SIC code or NAICS codes, it might be pegged at a thousand employees, which you can get to be pretty big without having a thousand employees. Can you tap into the different mechanisms of designation of small business status?

Shahrooz Shahnavaz (11:16):

Look, you can. It comes down to really, if you're contributing assets to a company or if you're buying assets, it's measured by the basis. But in order to avoid circumventing that rule, if the value, say it's low basis, high value business assets, the rule takes basis as meaning fair market value on contribution. So you can't circumvent the limitation by contributing high value, low basis, and say, "Okay, well, the basis was low, so it should be carryover basis, and so we avoid the issue."

Geoff Cockrell (11:49):

One question on that, is goodwill included in that? There's a lot of services businesses where they just don't have stuff, high basis, low basis regardless. The primary value of the business is its cashflow generation potentials, which gets measured if it's on the balance sheet at all, is measured as goodwill. How does that factor into some of those calculus?

Shahrooz Shahnavaz (12:11):

So we don't have clarity on the details of what the IRS would consider or treasury would consider to determine what really goes on, whether it's balance sheet, whether it's valuation or not. And that's one of the reasons why people have a lot of questions and are expecting the government at some point to comment on these things. But typically we would say, "Okay, well, if the enterprise value of a business is say 100 million, that includes because you and I are doing the deal and we're buying it

and that includes the goodwill or the intangibles." I think that you have a hard time then coming in and saying, "Well, but the assets are worth 30, so this should qualify as a QSBS because we have actual balance sheet assets that are worth 30 million and when we contribute it to the target or we buy the target, that should be the basis." I think there you would need a valuation actually done to show, okay, well, it's actually not worth more than 75 million if the deal were happening this year.

Geoff Cockrell (13:06):

Maybe taking a slight turn to some healthcare context that I've encountered for QSBS. You mentioned that certain types of businesses are just structurally excluded. Healthcare providers being one of them, and a lot of healthcare businesses are centered around healthcare providers. So there's many contexts where that might not be available, but some things that I've encountered in deals is businesses that might have mixed sorts of dynamics, where a portion of the business is of the type that you couldn't have QSBS, a portion of the business is. And in a recent deal, we restructured some of the components of the business to bifurcate those two pieces where one aspect of the business would qualify. It was a distinct part of the business, so it wasn't all smoke and mirrors, but we did some restructuring to enable a portion of the business to be qualified for treatment under this regime. How often do you see that thinking in the context of a live deal?

Shahrooz Shahnava (14:08):

I think we see quite a bit, and I think we'll see more and more of that. We'll see more and more attempts to say, "Look, this tranche of the business or this portion of the business, which is easily subdivided, is ineligible," but this part has really nothing to do other than tangential relationship with healthcare, for example, and this should qualify. And there are actually now rulings on that coming out. We don't have a lot, but the government seems to be more lenient. One taxpayer not too long ago asked about something similar and went to the government and said, "Look, this business is using healthcare in a very tangential context. The business provides machinery to doctors and healthcare providers and does have to work with them in order to fine tune the machinery and the equipment, but that's all it does. It doesn't really directly provide a healthcare service other than the machine being used for the doctor's office. Does that qualify?" And the government was supportive.

Geoff Cockrell (15:04):

Are there any other hooks that people should be mindful of, holding period or other dynamics that could impact the utility?

Shahrooz Shahnava (15:11):

Well, you have the holding period that has been become a little bit more lenient. You have a three-year holding period now after OB3, that's 50% haircut if you hold for three years at least, and then it goes to 75 if you hold four, and then back to 100% if you hold five years or more. I guess pitfalls are making sure the business is really eligible and having a law firm and an accounting firm particularly look into it and confirm that they think it's a good... We never know for sure. It's usually a little bit of a

guessing game, but there are obviously some businesses, say a plumbing business that is doing well and that's not necessarily related to the functions or the reputation of one person. That's one of the things that the service focuses on. They've lost that battle quite a few times in other areas and here a couple of times in 1202, but one of the limitations is that if it's a main street business, it has to be really servicing the community.

(16:10):

It can't be based on the superstar position of a local plumber or a electrician or whatnot. And so, that has been litigated and the IRS has lost in at least one case where the court agreed with the taxpayer that this particular business was not based on the reputation and the recognition level of one person, but rather by the 200 plus people that ran the business for that person. So that's one of the things that people really should pay attention to and maintenance. There are things that you can do inadvertently in the holding period that change the dynamics and then render this unavailable.

(16:52):

For example, you have to use 80% of your assets in the active conduct of that eligible business, that qualified business. Let's say you have the rules met in year one, you get blessing from an accounting firm and your law firm, and then you don't monitor that. And year three, there's just too much cash on hand and not enough intangible value in the business to counter that percentage. And now, you've invalidated the position, the status, because your active business percentage is lower than 80%. So that's one thing that needs to be constantly monitored. Obviously, the best way to do that is to get a valuation, but you can't get a valuation every six months, but that's something that needs to be... I mean, you could, it's just prohibitive in terms of cost. It's something that needs to be constantly monitored for the duration of your holding period.

Geoff Cockrell (17:44):

Yeah. There's certainly foot faults to be mindful of in the deal that I did where we were segregating portion of the business into a QSBS structure, it interjected a number of other complications, meaning all of the interactions of the broader business with that component, you had to now be mindful of transfer pricing, rules, and treat that segment of your business with money moving between the broader business and that segment, you have to treat it at more of an arm's length basis. So there can be complications.

(18:17):

And one of the takeaways from having looked at this a few times is that yes, there are material benefits, but you have to be careful and probably need to not have that tail wag the dog. Meaning if you were in the zone of being comfortable being a C corp in general, and there's a lot of reasons why some folks are thinking more about that, regardless of QSBS status, you should probably start with that directional conclusion before structuring an entire business around this dynamic, which can be very valuable, but is fraught with a number of ways to mess it up.

Shahrooz Shahnava (18:58):

100%. And look, I think people are now starting to assume it's an automatic way of doing business. I think we see that more and more in the middle market, because it's become a tax hot button item, a six years' tax cuts. But you're right, I think you need to carefully think about, well, what kind of business am I in? I mean, we always think about that. It's like, look, if in five years you know that your buyers will demand that they buy assets. Do you really want to form a C corp and buy this business in C corp status when you know you're not going to have the full benefit of QSBS? And what I mean by that is when you exit, you have to sell the stock of this company. You can't say, "Okay, well, I had a QSBS for five years, I met all the rules, and now's the exit event. I'm just going to sell the assets of the corporation and then liquidate."

(19:50):

Well, you could, but you're not going to avoid the corporate level tax. When you sell the assets, as you correctly pointed out, that corporate entity will have a 21% federal rate and depending on the state, up to 10, 12% of state tax. Maybe less, maybe more depending on the state, and that is inevitable. So you have that cost. And then as of now, the rules might change. We don't know. We're desperately waiting for guidance and clarification on all these matters. And for a 30-year statute and provision, we have embarrassingly little guidance. And that's not the IRS's fault, the treasury's fault entirely, because people like you and me did not use this until say seven, eight years ago, nobody went to the service to ask for rulings. It didn't become a litigation item. You have a handful of cases, you have 20, 30, maybe rulings altogether.

(20:42):

But anyway, as I was saying, if you sell the corporate entity, as of now, you could pay the tax on the sale of the asset and then liquidate the corporate entity. And on the liquidation, you can likely take a position that's a 1202 transaction so you don't have a second tax that you normally would have when you liquidate a corporate entity as a non-corporate shareholder or shareholders. You can avoid that. So that gets you down to a one level of tax. It doesn't improve. It's probably still somewhat behind if you had just held the assets in flow through status either as an S corporation or as a LLC. So my point is, if you know you're not going to be able to sell a C corporation in your industry, you should really think hard about whether you want to form a C corporation and start holding the investment that way.

Geoff Cockrell (21:32):

Yeah. Adding up all the pieces, there's certainly some material benefits, but there's ways that, kind of events in the future could flow to undermine those either foot faults along the way or getting boxed into a corner of what the nature of a sale event has to look like. So it's a lot to think about. I think the learning, as I'm making my way through transactions, part of the learning is this is now for eligible businesses, this is a part of the calculus that people need to be having on every deal. And there'll be times when it is worthwhile, there'll be times when the juice is maybe not worth the squeeze, but it's

certainly a real thing now. Shahrooz, this has been a ton of fun and I'm sure we're going to see a lot more QSBS deals and questions along the way, but I really appreciate you joining this discussion. It's an important one.

Shahrooz Shahnavaz (22:25):  
Can't wait. Yeah, it's been fun.

Voice over (22:28):

Thank you for joining us on this installment of The Corner Series. To learn more about today's discussion, please email host Geoff Cockrell at [gcockrell@mcguirewoods.com](mailto:gcockrell@mcguirewoods.com). We look forward to hearing from you. This series was recorded and is being made available by McGuireWoods for informational purposes only. By accessing this series, you acknowledge that McGuireWoods makes no warranty, guarantee, or representation as to the accuracy or sufficiency of the information featured in this installment. The views, information, or opinions expressed are solely those of the individuals involved and do not necessarily reflect those of McGuireWoods. This series should not be used as a substitute for competent legal advice from a licensed professional attorney in your state and should not be construed as an offer to make or consider any investment or course of action.